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Report No. P-6891-KG

REPORT AND RECOMMENDATION

OF THE

PRESIDENT OF THE

INTERNATIONAL DEVELOPMENT ASSOCIATION

TO THE

EXECUTIVE DIRECTORS

ON A

PROPOSED FINANCIAL SECTOR ADJUSTMENT CREDIT

IN AN AMOUNT EQUIVALENT TO SDR 31.2 MILLION

TO

THE KYRGYZ REPUBLIC

MAY 31, 1996

CURRENCY EQUIVALENTS

(as of March 31, 1996)

Currency Unit	=	Som
1 Som	=	US$ .093
US$1	=	10.8 Som

AVERAGE EXCHANGE RATES

Som per US$1

	1993	1994	1995	March 1996
Period Average	6.0	11.0	10.8	10.8
End of Period	8.3	10.6	11.2	10.8

WEIGHTS AND MEASURES

Metric System

KYRGYZ REPUBLIC - FISCAL YEAR

January 1 - December 31

ABBREVIATIONS AND ACRONYMS

ADB	-	Asian Development Bank
APEAC	-	Agricultural Privatization and Enterprise Adjustment Credit
BRU	-	Bank Restructuring Unit
BSD	-	Bank Supervision Department
CAS	-	Country Assistance Strategy
CTC	-	Coupon Trading Center
DEBRA	-	Debt Resolution Agency
DRU	-	Debt Recovery Unit
ERRA	-	Enterprise Reform and Resolution Agency
ESAF	-	Enhanced Structural Adjustment Facility
FINSAC	-	Financial Sector Adjustment Credit
FSU	-	Former Soviet Union
GDP	-	Gross Domestic Product
GNP	-	Gross National Product
IAS	-	International Accounting Standards
ICB	-	International Competitive Bidding
IDA	-	International Development Association
IFC	-	International Finance Corporation
IMF	-	International Monetary Fund
JSC	-	Joint Stock Company
KSC	-	Kyrgyz Stock Exchange
MIGA	-	Multilateral Investment Guarantee Agency
MOF	-	Ministry of Finance
MOJ	-	Ministry of Justice
NBFI	-	Non-Bank Financial Institution
NBK	-	National Bank of Kyrgyzstan
PESAC	-	Privatization and Enterprise Sector Adjustment Credit
PMU	-	Project Management Unit
PPF	-	Project Preparation Facility
SDR	-	Special Drawing Rights
SAS	-	State Agency for Securities
SPF	-	State Property Fund
TA	-	Technical Assistance
USAID	-	United States Agency for International Development
VAT	-	Value Added Tax

KYRGYZ REPUBLIC

FINANCIAL SECTOR ADJUSTMENT CREDIT (FINSAC)

PRESIDENT'S REPORT

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This report is based on the findings of Preappraisal and Appraisal Missions which visited Bishkek in December 1995 and April 1996, respectively. The missions were comprised of **Ms. F. Aynur Sumer**, Mission Leader and Task Manager (EC3AI), Ms. Ulgenerk (EMTPS), Mr. du Marais (LEGPS) and Messrs. Polizatto, Wills, Brown and Satterfield (Consultants). The Peer Reviewers were Mr. Gelb (WDR), Mr. Pohl (EMTPS), and Mr. Murgatroyd (FSD). Mr. Michael A. Gould and Mr. Yukon Huang are the managing Division Chief and Department Director, respectively.

ANNEXES

KYRGYZ REPUBLIC

FINANCIAL SECTOR ADJUSTMENT CREDIT (FINSAC)

CREDIT SUMMARY

Borrower:	The Kyrgyz Republic
Executing Agency:	The National Bank of the Kyrgyz Republic
Amount:	SDR 31.2 million (US$45 million equivalent)
Terms:	Standard IDA terms with a 35 years maturity
Credit Objectives:	The principal objectives of the Reform Program to be supported by the proposed Credit are: (i) the creation of a policy and regulatory environment conducive to the sound growth of a competitive and efficient banking system; (ii) the liquidation of the two dominant and insolvent state-owned banks, which through their practices stifle the growth of their young private competitors; (iii) the downsizing and financial restructuring through private re-capitalization of two others, survival of which has been possible only through preferential treatment and support of the Central Bank; (iv) the establishment of a temporary Debt Resolution Agency (DEBRA) to help collect or write off the old non-performing loans, and thus accelerate enterprise restructuring or liquidation in the process; and (v) the creation of a regulatory and supervisory framework for the development and growth of emerging non-bank financial institutions.
Credit Description:	The credit will be quick-disbursing and will provide balance of payments and budget support, linked to the conditionality specified for first and second tranche releases. The first tranche will become available upon credit effectiveness, expected in July/August 1996, and the second tranche upon a review, satisfactory to IDA, of successful implementation of the Reform Program as a whole and fulfillment of the specific tranche release conditions. The proceeds of the credit will be used for financing the foreign exchange costs of general imports, except for a small negative list of ineligible goods.
Benefits:	The proposed Credit would allow increased production and capacity utilization through the provision of foreign exchange resources to finance imports of inputs, raw materials, spare parts and services. The Reform Program to be supported by the proposed Credit would help create a

competitive, sound and efficient banking system. This, together with a sound policy and regulatory framework and appropriate prudential norms and regulations, would help to improve public confidence in financial institutions. Enforcement of financial discipline resulting from the reforms in the banking system would encourage a similar discipline within the enterprise sector, fostering a healthy adjustment and renewed growth in this sector, which in turn would contribute to the stabilization objective. In addition, the development and enforcement of a regulatory and supervisory framework along with a supporting policy environment would encourage the development of sound contractual savings organizations which would be instrumental in mobilizing additional savings. Technical assistance to be provided in parallel to the Credit would contribute to the development of technical capacity in banking and financial management and would reinforce the implementation of the Reform Program as a whole.

Risks: The Credit faces four major risks. (i) The Government may not be able to achieve one of its critical macroeconomic objectives, namely to sustain macroeconomic stability. High and sustained budget deficits may continue to threaten macro/financial stability and drive up interest rates further. (ii) The second risk relates to the complexity of undertaking a massive restructuring of the banking system which requires not only the strong commitment of the Government but also the full cooperation of the banks' managements. (iii) The liquidation and downsizing of banks may proceed more slowly than anticipated, if the bank restructuring component encounters political resistance. (iv) A slowdown or reversal in enterprise reform would have adverse effects on the loan quality of the banking system, and so would delays in the establishment of a framework for secured lending.

The first, third and fourth risks would be mitigated largely by the Government's strong commitment to the IMF/IDA supported stabilization and structural adjustment programs. Technical assistance to be provided along with the Credit would help to reduce the second risk, although it would not fully mitigate it. Finally, proposed improvement of the regulatory framework and strengthening of supervisory functions for banks and non-bank financial institutions are expected to ensure the competitiveness, efficiency, and soundness of the financial system in the future.

Disbursement: The proceeds of the Credit would be disbursed in two equal tranches: SDR 15.6 million (US$22.5 million) equivalent soon after credit effectiveness and SDR 15.6 million (US$22.5 million) equivalent after a performance review expected to be carried out by IDA about seven months after Credit effectiveness.

Poverty Category: Not applicable

Rate of Return: Not applicable

Credit ID: KG-PA-34095

REPORT AND RECOMMENDATION
OF THE PRESIDENT OF THE
INTERNATIONAL DEVELOPMENT ASSOCIATION
TO THE EXECUTIVE DIRECTORS
ON A PROPOSED FINANCIAL SECTOR ADJUSTMENT CREDIT
TO THE KYRGYZ REPUBLIC

1. I submit for your approval the following report and recommendation on a proposed Financial Sector Adjustment Credit (FINSAC) to the Kyrgyz Republic for the equivalent of SDR 31.2 million (US$45 million) to provide financial support for the Government's Financial Sector Adjustment Program (FSAP) during 1996-97.

2. The Kyrgyz Republic has been one of the most rapidly reforming countries in the former Soviet Union (FSU). Since 1992, the Government has made significant progress in achieving macroeconomic stability and eliminating market imperfections inherited from the previous command economy. These reforms have been supported by a Rehabilitation Credit (FY93) and two adjustment operations, the Privatization and Enterprise Sector Adjustment Credit (PESAC), and Agricultural Privatization and Enterprise Adjustment Credit (APEAC) from IDA, and successive IMF arrangements in the upper credit tranches. The proposed FINSAC is consistent with the high-case scenario of the Country Assistance Strategy (CAS) as discussed by the Board of Directors on June 28, 1995.

3. The proposed FINSAC follows the successful privatization of most Kyrgyz productive assets, and key reforms in leading real sectors. At this stage of the transformation process, a more stable and efficient financial sector, with an effective banking system at its core, will be essential to help sustain macroeconomic stability, stimulate savings mobilization, support enterprise recovery and expansion, and enhance the development of the private sector. The principal objectives of the Reform Program to be supported by the proposed FINSAC are: (i) to improve the enabling policy and regulatory environment for the development of a sound, competitive and market-oriented banking system, by eliminating policy-induced barriers to competition, efficiency and profitability and by strengthening prudential laws and regulations, accounting and auditing, and payments and settlements systems; (ii) to liquidate or restructure the four dominant insolvent specialized banks, and assist with the establishment of a competitive and efficient private banking system which is sound and capable of providing a broader range of financial services to both borrowers and savers; (iii) to help collect part of the non-performing loans extended by these banks, and thus accelerate enterprise restructuring or liquidation in the process; and (iv) to promote the development and growth of emerging non-bank financial institutions. The proposed Credit will be quick-disbursing and will provide balance of payments and budget support, linked to the conditionality specified for first and second tranche releases.

PART I. MACROECONOMIC PERFORMANCE AND FINANCING REQUIREMENTS

A. Macroeconomic Stabilization and Performance

4. **Introduction.** The Kyrgyz Republic continues to cope with severe economic dislocations caused by the breakdown in FSU trade and budget support arrangements. Trade and production are about one-half their previous levels, while the price of imported energy has increased substantially since 1991.

Budget support from the former Soviet Union, previously equal to about 10% of GDP, has been only partially replaced by external borrowing and grants. Yet the Government has made significant progress in stabilizing the economy and has remained essentially in compliance with the IMF programs approved to date — an initial Stand-by arrangement in 1993 and a three-year ESAF program in 1994, of which the second year program was approved in December 1995. The Government is also engaged in a far-reaching program of structural reforms aimed at creating a market economy and transferring almost all productive assets into private hands.

5. **Political.** President Akaev has been a strong proponent of economic reforms in the past and is committed to continuing the process of transforming the economy. His political position was recently strengthened when he won re-election to a second five-year term, with a 75% majority, in December 1995. He is likely to become even more central to policy direction in the future, in view of overwhelming support in the February 1996 referendum for changes to the constitution. As a result of the referendum, the President now enjoys broadened powers to issue decrees and increased authority over the Prime Minister, who must now report directly to the President. These enhanced powers are expected to speed up the adoption of economic reforms. They may, however, also diminish the checks and balances within the Government, as well as between the Government and the Parliament.

6. **Production and Employment.** Production is currently 45% below its level in 1991. GNP per capita has fallen commensurately and was estimated at US$610 in 1994. Output began to recover in 1995, however, led by modest growth in crop production and by the establishment of a growing private service sector. Also, the decline in industrial production is believed to have bottomed out, as companies that survived the effects of lost markets and tight credit during the previous year began to stabilize production. Preliminary data suggest that overall GDP grew by 1.2% in 1995, and indications are good for growth of 2-3% in 1996. Employment data are highly uncertain, due to the growth of unrecorded activity and net emigration. Officially, only about 75,000 people are registered to receive unemployment benefits, representing about 3% of the work force. However, four to five times this number are believed to have been laid off as a result of industrial restructuring during the past two years. The average real wage has remained stagnant during the past two years at about 50% below its 1992 level.

7. **Money, Credit and Prices**. The Kyrgyz authorities assumed full control over macroeconomic policies with the introduction of the national currency, the Som, in May 1993. During 1994, deposit and credit interest rates were liberalized, directed credits were discontinued, refinance credit auctions were temporarily suspended, and domestic bank financing of the budget deficit was sharply curtailed. All prices, including bread, have been liberalized, except utility tariffs which remain highly subsidized. The tight monetary stance in 1994 succeeded in bringing inflation down to around 3% per month in the second half of 1994, and to about 87% annually by year-end. Inflation remained in the 1-2% per month range during 1995, with the annual rate of inflation down to 30% by year-end. Interest rates have followed a similar path, with real interest rates declining from over 200% in August 1994 to around 30% in December 1995. The monetary stance eased somewhat during 1995, permitting a modest increase in the amount of money in circulation and providing some relief to a cash-strapped economy.

8. **Public Finances.** Government expenditure has undergone severe compression during the past three years, with total expenditure declining from 37% of GDP in 1993 to 27% in 1995. This was accomplished through the elimination of consumer subsidies, a reduction in transfers and the phase-out of direct lending to state enterprises. At the same time, however, the receipt of budgetary support grants — previously provided from the Soviet Union — fell by 8% of GDP. As a result, the budget deficit has

remained high throughout the period, declining only from 13% of GDP in 1993 to 11% in 1995. The bulk of the deficit continues to be financed through foreign borrowings and the balance through central bank credit, which remains a source of concern both for sustaining the stabilization program and for improving conditions in the financial markets.

9. **External Transactions.** As part of its stabilization program, the Government established a foreign exchange auction market, a floating exchange rate, and a fully liberalized exchange regime with no restrictions on current or capital account transactions. A major liberalization of the trade regime also occurred. Non-tariff barriers were removed, and export taxes have been eliminated on all goods. A uniform 10% duty on non-FSU imports replaced the former Soviet tariff, and free trade agreements exist with the Kyrgyz Republic's main FSU trading partners. Both imports and exports began to recover in 1995, while the current account deficit, including official transfers, declined from 11% of GDP to 7% last year. Gross reserves currently stand at about 2 months of imports.

B. Structural Reforms

10. Since 1992, the Government has been implementing a comprehensive reform program aimed at creating a market economy. In addition to the above-mentioned reforms in the areas of price liberalization, trade and exchange regimes, the Government has focused on implementing a comprehensive privatization and enterprise restructuring adjustment program, including land and state farms.

11. **Privatization.** The privatization program began with the transfer of the housing stock to the occupants in 1991-93 and the cash sale of small businesses. In December 1993, a Privatization Law was adopted that aims at divesting all productive and social assets. Initially, the majority of shares in some enterprises were transferred free of charge to the workers' collectives. Since May 1994, however, the Government has implemented a new "mass privatization" scheme which aims to ensure a wider distribution of ownership in medium and large scale enterprises, those with over 100 employees, through the use of coupon and cash auctions. The new procedures have significantly improved the transparency and equity of the privatization process. As of March 1996, the mass privatization program had put over 900 medium and large scale enterprises through the coupon stage of the program. Of these 900 enterprises, state shares in about 450 enterprises have been completely sold. With the aim of speeding up full divestiture in the other 450 enterprises, the Government recently reaffirmed its policy of selling shares in the second round of cash auctions without reference to a minimum floor price. It has also approved the 1996-97 privatization program which will cover the remaining medium and large scale enterprises in the commercial and productive sectors (about 320). As part of the program, it will also offer up to 10 percent of shares in the major utilities through coupon auctions.

12. The issue of private ownership of land is still under debate in the Kyrgyz Republic. There is consensus, however, that the right to use land should be legally safeguarded and transformed into a property right that can be freely transferred, inherited and used as collateral. The right to use land for 99 years has been established by Presidential decree, and a new Land Code is under preparation that will confirm these rights. Land use shares in agricultural land are being issued throughout the Republic and have led to the breakup of most state farms and collectives. A new land registration law that covers the registration of all land, rural and urban, will soon be submitted to Parliament. Once approved, the legal conditions will exist for the emergence of a market in land use rights.

13. **Enterprise Restructuring**. The Government has also created a special program to isolate 29 of the most seriously indebted enterprises. These enterprises were cut off from access to bank credit and put under the control of an Enterprise Reform and Resolution Agency (ERRA). Following diagnostic assessment of their economic prospects, five of the enterprises without current or potential economic viability are being fully liquidated, while others have undergone massive downsizing and financial restructuring. The restructured enterprises have been given working capital and a period of six-to-nine months to demonstrate their financial viability, after which they are to be privatized, with the proceeds used for paying off the creditors of the former enterprises. The success of this program has been widely recognized in the Kyrgyz Republic as a demonstration of how the bankruptcy and liquidation process is supposed to work in a market economy.

14. **Social Protection**. Regarding the system of social protection, in January 1995 the Government introduced a common monthly subsidy scheme to replace the previous social assistance benefits of various kinds. It is based on the principles of income testing and self-selection and is aimed to raise the per capita income of the non-working poor to the minimum wage level. The Government also rationalized and simplified unemployment benefits and allocated adequate budget funds to provide social protection for the unemployed.

C. External Financing Requirements

15. Over the medium term, the Republic's primary objective is to reverse the sharp decline in output, improve the country's export capacity and reduce its dependence on imported energy, so as to move toward a sustainable balance of payments position. The aim for 1996-98 is to achieve real GDP growth of at least 4% per year, and to reduce annual inflation to single digit levels.

16. **Fiscal Outlook**. The Government's medium-term program is underpinned by a rapid fiscal adjustment in 1996 with the aim of reducing the fiscal deficit to 6% of GDP, mainly through reductions in expenditures. A major tax reform is being developed, with the assistance of the IMF, that aims at the development of a simple and transparent tax system consisting of a relatively small number of important taxes with a relatively broad base, including a uniform 20% VAT. The medium-term revenue outlook is clouded, however, by the announcement that the Kyrgyz Republic intends to join the Russia-Belarus-Kazakstan customs union, which would result in the adoption of a common external tariff based on the Russian tariff. Care will be needed to ensure that revenue is not lost in the transition from the old to the new tax structure and that participation in the customs union is not detrimental to Kyrgyz production and growth. Expenditure rationalization will also begin, but while there is scope for significant savings over the medium term, savings in the short term will be difficult to achieve, as expenditures have already been severely compressed in real terms. The total amount of external financing available for the budget has been falling rapidly due to the scaling back of the initial burst of support received at the outset of the transition period. It has declined from 14% of GDP in 1993 to 7% in 1994 and 1995. For 1996, gross external financing (including grants) is estimated at only 4.7% of GDP. Net of amortization, external financing is estimated at only 2.5% of GDP in 1996. The above fiscal program excludes the cost of the bank restructuring program that would be supported under FINSAC. The proposed FINSAC would cover these costs, and provide (at least) an additional US$13 million of budget support during its implementation, to help meet the financing gap (Chapter IV).

17. **Balance of Payments Outlook**. The Kyrgyz economy will continue to face structural balance of payments deficits for many years to come. The balance of payments projections for 1996-98 assume export growth of around 7-8% per year in real terms, following 15% growth in 1995.

Considerable export growth can be expected following the liberalization of agricultural prices, the removal of export taxes and the stabilization of demand in regional markets. In addition, the investment projects with a high import content at present would enter into production stage leading to significantly higher exports (in particular, gold) in the following years. The volume of imports is projected to grow by 16% in 1996, reflecting a recovery from the substantial decline in 1994 and the import content of large investment projects. More moderate import growth of 3-4% per annum is expected thereafter, reflecting the rationalization of domestic energy use and increased domestic production of wheat. Under the above scenario, the current account deficit, excluding official transfers, is expected to decline from 14% of GDP in 1996 to 10% in 1998. Including official transfers, the current account deficit would fall from 9% of GDP to 7% over the same period. External debt service is expected to average 18% of exports during the next three years, but would decline to under 15% by the end of the century as the debt to FSU countries is paid off and the remaining debt stock becomes increasingly concessional.

18. Under the above scenario, the current account deficit, excluding official transfers, is expected to average US$260 million per year during 1996-98. Taking into account amortization payments of about US$50 million per annum, and increased international reserves, rising to three months of imports, gross financing requirements would average US$360 million per year during this period. Of this amount, foreign direct investment is expected to cover about US$40 million a year. Given the absence of non-concessional borrowing to date, the balance of the Kyrgyz Republic's external capital requirements would need to be met from official sources. Existing commitments are estimated to provide about US$210 million per year in disbursements. Three-quarters of this amount would come from multilateral creditors, including about US$50 million per year from IDA. New commitments would need to provide the remaining US$110 million per year, on average, to close the financing gap. Future IDA commitments, including the proposed FINSAC, could provide about one-third of this amount. The remaining gap would have to be closed primarily by bilateral donors. This appears feasible in view of recent levels of bilateral grant assistance, which is typically committed on an annual basis.

PART II. THE FINANCIAL SECTOR: KEY ISSUES AND PERFORMANCE

A. Sector Structure

19. Before 1991, the Kyrgyz financial system was a regional component of the Soviet financial system which mobilized and allocated resources according to the decisions of the Union government in Moscow. In June 1991, the first set of financial sector reforms were introduced with the establishment of a two-tier banking system, with the National Bank of Kyrgyzstan (NBK), the central bank, created under the supervision of Parliament. In December 1992, a comprehensive Central Bank Law and a Commercial Banking Law were enacted giving independence to NBK. In 1993, the NBK assumed an even more important role for the conduct of monetary policy with the introduction of the national currency. At the same time, a fully liberal currency law was enacted, and a full range of indirect monetary policy instruments was introduced. In addition, weekly foreign exchange sales by the NBK to the interbank market, regular treasury bill auctions, and credit auctions were launched. Reserve requirements were unified in July 1993, and a Lombard facility was introduced in August 1993.

20. At present, the Kyrgyz financial system consists of NBK, 17 commercial banks and a savings bank. The "Big Four" specialized banks (Agroprombank, AKB Kyrgyzstan, Promstroi and Elbank) dominate the financial system, accounting for over 80% of the banking system's assets. With the closure of five small banks during 1994-95 (Urmat, Djyrgal, Saturn, Adil, and Dyikan), the number

of operating banks was reduced to 18, including the savings bank. In 1995, the 18 banks combined operated 170 branches and had assets totalling 2,650 million Soms, equivalent to about 16.5% of GDP. Though money and capital markets are underdeveloped, there are also a number of non-bank financial institutions. These include 17 investment funds, 30 insurance companies, a stock exchange (KSE), a Coupon (privatization) Trading Center (CTC), and one significant state-owned and two smaller private pension funds. In 1993, as a part of its liberalization program, the NBK began to license foreign exchange bureaus to buy and sell foreign currencies for a range of current account transactions. There are currently about 600 licensed exchange counters operating in the Kyrgyz Republic.

B. Financial Market Developments And Key Issues

21. After the breakup of the Soviet Union, inflation in the Kyrgyz Republic accelerated rapidly and, over a relatively short period, the real value of bank deposits was massively eroded by negative real interest rates. Following the introduction of the Som in May 1993, considerable success has been achieved in macro-financial stability, with inflation falling to an annual rate of 30% by 1995. The introduction of credit auctions as the main determinant of interest rates, and subsequent adherence to a tight credit policy, has resulted in interest rates turning substantially positive since end-1993.

22. Deposit growth, however, has lagged behind the growth of money supply. Deposits fell from 43% of broad money at the end of 1993 to an estimated 33% at the end of 1994. NBK's attempts to increase liquidity in the economy and injection of cash into the system in the second half of 1994 were hampered as most of this remained outside the banking system. The most buoyant subsector has been the household deposits, which have grown from 42 million Soms in mid-1993 to 202 million Soms in 1995. Much of the nominal growth in deposits has been due to crediting of accrued interest. There has been practically no injection of new funds to the banking system.

23. **Lack of Confidence in the Financial System.** The failure of deposits to grow in the face of high positive real interest rates reflects a widespread lack of confidence in the banking system. Past experience has been dominated by the massive loss in the real value of deposits discussed above, and by periodic instances of difficulties in withdrawing deposits. This lack of confidence is also reflected in the very high level of interest rates being offered on foreign currency deposits. Rates of interest above 20% on foreign currency deposits reflect a high perceived risk of default. The failure of Kyrgyz banks to mobilize deposits is clearly linked to the sector's insolvency problems. A further factor inhibiting deposit mobilization is the practice of seizing the deposits of those believed to be in arrears on tax payments. The unusually strong powers granted to the Tax Inspectorate in February 1994 in respect of deposit seizures are a strong deterrent to depositors. Very high bank commissions and charges are also a reason for enterprises avoiding the local banks.

24. The most important macroeconomic consequence of the low domestic savings and low monetary assets ratio is that it severely complicates the task of financing Government deficits. In the absence of bill, bond and other securities markets, the Kyrgyz Government has financed almost all of its budget deficits in recent years through borrowing from the domestic banking system, primarily NBK, and from external sources. Deficit financing through central bank credit proved to be highly inflationary, as witnessed in 1993, which in turn has eroded the deposit base of the banking system, reducing the basis for extending credit to viable, creditworthy private customers. Rebuilding confidence in the financial system will require a major restructuring of the banking system and the continued strengthening of the regulation and supervision capabilities of NBK.

25. **Money and Interest Rate Policies.** In contrast to the developed financial markets, the financial markets in the Kyrgyz Republic are extremely imperfect. There is considerable uncertainty about the future path of inflation, and due to the technical insolvency of a major proportion of the banking system, there is only a weak linkage between loan and deposit developments and the demand for bank reserves. Market imperfections have produced a situation where the demand for NBK credit may not reflect system-wide demand for bank reserves. The absence of an effective interbank market results in the failure to pool liquidity among banks. The dominance of non-performing loans results in many banks bidding for NBK credits to support distressed borrowings. It is common in financial markets for distressed borrowers to bid for funds in a manner that exceeds the likely return on capital. The absence of a consistent system-wide demand for liquidity and the importance of distressed borrowings is reflected in the size of spread evident in the credit auctions. Over 1995, the average spread in the annual interest rates between the lowest and highest bids in the credit auctions was 47%. A further consequence of these market imperfections is the exceptionally large variation in interest rates offered by different commercial banks. In early 1995, commercial banks were offering annual interest rates of between 35% and 100% for 3 to 6 month deposits. Annual interest rates on three month loans varied from 60% to 125%. As the banks do not quote effective rates of interest, the scope for variation was even greater, depending on the compounding practices of individual banks.

26. The dominance of distressed borrowers and the segmentation of the financial market undermine the role of interest rates as means of pricing deposits, and pricing and allocating credit. Where the financial markets are highly imperfect, with widespread insolvency among financial institutions, the insolvent institutions can produce unsustainably high real interest rates, jeopardizing effective financial intermediation by sound financial institutions. The adverse effects of distressed borrowers on interest rates will need to be dealt with through a carefully designed bank restructuring program.

27. **Oligopolistic Nature and Insolvency of Commercial Banks.** The commercial banking system is dominated by the Big Four commercial banks which are insolvent. Other weaknesses in the banking system include a low level of capitalization, an inadequate accounting system, deficient communication and payment systems, a lack of adequate banking skills at all operational levels, and the ill effects of the directed credit policy followed in the past as reflected by the poor quality of the banks' loan portfolios. The adverse economic conditions of the past few years have led to further deterioration in banks' portfolios and accentuated the problems faced by the banks.

28. At least nine of the eighteen banks making up the banking system, including the Big Four, are currently insolvent. The combined non-performing loans of the Big Four were estimated at 1,386 million Soms in March 1995. This represents 92% of their gross loans and 10% of GDP. Their negative net worth was estimated as 1,215 million Soms, or about 9% of GDP. The ratio of non-performing to gross loans was 98% both at Agroprombank and at Elbank; 85% at AKB Kyrgyzstan Bank; and 60% at Promstroi Bank. Agroprombank's negative capital was as much as 953 million Soms, or 7% of GDP. The survival of the Big Four banks has been possible only because of specially negotiated terms for the NBK debt and because of exemption from prudential regulations. Five of the 14 private banks, which are currently being administered by the NBK, also have little prospect of survival.

29. Several of the remaining banks are profitable, however, and new capital has been invested recently in Maksat, Kurulush, Akniyet and Kyrgyz-Jer, while the capital of Orient and Kramd Banks has grown from profitable operations. Since 1995, three new banks have been licensed and have commenced operations. Several of the banks are using their powers as universal banks to enter non-

banking fields. Orient, in particular, owns an insurance company, has interest in an investment fund and is a founding member of the stock exchange.

30. **The Bad Debt Problem.** The poor quality of the banks' loan portfolios is largely a legacy of the past, directed lending as well as poor lending policies and practices of the newly established banks. Directed credits to enterprises and agriculture continued until early 1994. Most of this lending covered losses or was to maintain employment, and was not undertaken on the basis of objective criteria. The decisive tightening of monetary policy by NBK in 1994 not only cut the commercial banks' access to NBK resources but also uncovered the extent of bad loans in the sector. By the end of 1994, as a consequence, large banks had a very large portion of their loans in the non-performing category. It was estimated that in early 1995, only 8% of the system's gross loan portfolio was performing, with about 13% considered as substandard, a further 15% is classified as doubtful, and the remaining 64% considered as irrecoverable or total loss. In the case of the Big Four banks, the ratios--as of April 1996--were even more alarming: only 5% of their combined portfolios was classified as performing, with 8% considered as substandard, 7% as doubtful, and 80% as total loss. This is, to a large extent, explained by the fact that a sizeable proportion of the combined outstanding loan portfolios of the Big Four were extended to the state sector, as compared to 9% for the remaining newly established banks.

31. Of Agroprombank's total loan portfolio, almost one-half is to the agro-processing enterprises and distribution complexes, of which Dan-Azyk alone accounts for 25% of the portfolio. A further 30% is to the former collective and state-owned farms. Similarly, over 40% of Promstroi's loans are to Kyrgyz Gas, and a further 25% to five other large state-owned enterprises. With low public confidence in the system, and NBK providing fewer funds as part of its monetary policy, the new lending by the banking system is increasingly dependent upon the recovery of their non-performing loans. By linking the banks' future lending to past lending, the bad debt stock problem has become a serious constraining factor for the entire banking system.

C. Sector Performance

32. Because of the systemic deficiencies in the financial system, discussed above, the formal financial sector in the Kyrgyz Republic has not been an effective vehicle for mobilizing financial resources and allocating these to their most efficient uses. The M2/GDP ratio at 12% is among the lowest in the world, and indicates the low level of savings and financial intermediation. Incentives for financial savings by the private sector have been undermined by lack of confidence in the financial system and, until recently, by substantially negative real interest rates. Despite these disincentives however, the private sector has been generating (small) positive savings while the Government at large, including state-owned enterprises, has been the biggest dissaver (i.e., overall net borrower).

33. For the majority of the banking system, NBK credit has formed the dominant source of new resources, although the amount of credit auctioned declined sharply over the second half of 1994. With an extremely low deposit and resource base, the level of credit relative to output has been low or nonexistent in all sectors with the exception of trade and commerce. It is estimated that total incremental lending by the banking system amounted only to 350 million Soms (3% of GDP) during 1994. This largely reflects the curtailment of the refinancing by NBK over this period, a freeze on new lending to enterprises in arrears, the lack of new deposit mobilization and the extent of non-performing loan portfolios of the commercial banks. The banks that have access to Government securities have also stopped voluntary new lending to enterprises. The purchase of NBK credit and the purchase of Treasury Bills have formed a significant proportion of commercial bank business during most of 1994. The

commercial banks took advantage of the segmentation in the market and secured NBK credit at lower interest rates than that paid by the NBK on Treasury Bills. This substantially reduced the NBK's profits and improved the position of some commercial banks. At present, the majority of banks in the commercial banking system remain technically insolvent, and the existing financial system is incapable of performing the fundamental role of mobilizing deposits and transforming these into loans.

PART III. PROPOSED FINANCIAL SECTOR ADJUSTMENT PROGRAM

A. Objectives And Strategy

34. An efficient financial sector, with an effective banking system at its core, is essential to support and foster the Kyrgyz Republic's stabilization and structural adjustment efforts. The Government's objective is to develop and deepen the financial system, restore public confidence, and to establish, over the medium term, an efficient system of resource mobilization and allocation which would become increasingly liberal and market-oriented and offer a greater variety of instruments to both borrowers and savers. "Efficiency" requires sound financial institutions operating in a competitive market structure and in a policy environment that enables proper assessment of risks against returns. An "effective" financial system fosters longer-term growth and development and requires that savers and borrowers are adequately served throughout the country. The reforms required to achieve these longer-term goals will need to be phased over a number of years, given the emerging nature of key financial institutions in the Kyrgyz Republic and the limited implementation capacity of the country. Furthermore, some of these reforms are prerequisites for the others: Financial sector deepening and diversification can take place cohesively and with success only if an enabling policy and regulatory environment is in place and key financial institutions are sound and functioning. The growth and viability of the financial system also depends heavily on the growth and viability of the real sectors. The types of financial services and products needed by the real sectors, and the availability of bankable opportunities in the economy as a whole, will largely determine the growth of financial services in the future.

35. The proposed strategy for financial sector reform in the Kyrgyz Republic contains the following key elements: (i) creation of a policy and regulatory environment conducive to the sound growth of a competitive and efficient private banking system; (ii) liquidation of the two dominant and insolvent state-owned banks: Agroprombank and Elbank (the Savings Bank), which, through their practices, stifle the growth of their young private competitors; (iii) downsizing and financial restructuring through private re-capitalization of two large and insolvent former state banks: Promstroi and AKB Kyrgyzstan Banks, survival of which has been possible only through preferential treatment and support of the Central Bank; (iv) creation of a temporary Debt Resolution Agency (DEBRA) to help collect, restructure, sell or write off the old non-performing loans, and thus accelerate enterprise restructuring or liquidation in the process; and (v) creation of a regulatory and supervisory framework, and supporting policies and infrastructure, for the development and growth of emerging non-bank financial institutions (NBFIs).

36. The successful implementation of the Reform Program to be supported by the proposed FINSAC would lead to the creation of an initially smaller but more solvent and efficient banking system, owned and managed by the private sector. In rural areas, Agroprombank and the existing system of poorly directed Government-financed credit programs would initially be superseded by a better managed interim rural credit system, and over the longer term by a self-sustaining, commercially viable system of rural banking and cooperatives. In the enterprise sector, private enterprises would be served by

smaller, private sector banks better regulated by sound prudential measures and equipped with sound credit policies and trained staff. The temporary Debt Resolution Agency (DEBRA) would help collect some part of the debts carved out of banks, with the main objective of encouraging discipline in the enterprise sector and forcing the least viable firms out of the market. This agency would be closed down within three years. The establishment of equity markets is already underway, and would over time lead to more active trading of the shares of private enterprises, thus also contributing to better governance. The creation of a more sound legal and regulatory framework would also enhance the efficiency and security of financial institutions; help restore public confidence in the financial system; and encourage the emergence and expansion of NBFIs, including sound contractual savers such as insurance companies and pension funds.

B. The Enabling Policy Environment

Sustaining Macroeconomic Stability

37. Sound macroeconomic policies are essential if financial sector policies are to be effective. The ability of financial markets and institutions to mobilize and allocate resources efficiently will depend heavily on the existence of a stable macroeconomic environment. Despite considerable success achieved in reducing inflation, there remains uncertainty over future inflation expectations and movements. The maintenance of price stability, which is an essential prerequisite for savings mobilization as well as for the development of the financial system, will remain a key priority. Fiscal policy has been the source of much instability in the Kyrgyz economy over the past few years. Restructuring/liquidation of insolvent banks will temporarily increase the need for public funding, thus adding to the already severe fiscal problem. The success of the reforms in the financial sector will continue to be dependent on a responsible fiscal policy, one that minimizes the need to monetize the Government deficit and that prevents the build-up of domestic arrears.

38. The Government has re-affirmed its intention to continue to reduce both the size of the fiscal deficit as well as its financing through the domestic banking system. *Because of the importance of macroeconomic stability to the success of financial sector reforms, the proposed FINSAC explicitly links the first and second tranche release to satisfactory macroeconomic and fiscal performance, in FY96 and FY97.*

Removing Policy-Induced Barriers to Bank Profitability and Security

39. At present, the banks are adversely affected by the fiscal policy. Current tax legislation recognizes only loan-loss provisions against net income after tax. Thus, pre-tax profit is artificially inflated and taxed away. This unduly drains the capital base of the banks and discourages bank management from fully accounting for likely loan losses and thus fairly presenting the banks' condition. In addition, there is a heavy tax burden on the banking system. Levies currently include a 45% corporate tax (as compared to 30% for non-financial enterprises), and a transaction tax on gross income.

40. There is also a lack of clarity about the application of VAT, and about the tax regime in general. At present, banking services are mostly exempt from VAT. This is true in the current system and in that proposed for introduction in 1996. However, many banks are applying VAT to certain money transactions because they believe these services to be subject to VAT. Similarly, the application of the corporation tax exemption for the first years of joint venture companies needs to be applied uniformly

and without vexatious disputes. Given the potential size of transactions in banking, such a lack of clarity is a major obstacle.

41. *Under the Reform Program, the Government has submitted to Parliament a Tax Reform Bill. Before the release of Second Tranche, the Borrower will enact this Reform Bill through which: (i) the banks will be allowed to take loan-loss provisions against gross income, before tax; (ii) the profit tax rate on financial institutions (45%) will be harmonized with the productive sectors (30%) in order to allow the banks to build up their capital, and to lower substantially the costs of financial intermediation; and (iii) the existing tax regime will be clarified to avoid confusion about tax exemptions, and whether and which financial transactions are subject to VAT.*

42. To build depositor confidence in the financial system, ***all*** state organs will need to desist from practices that are not appropriate in an economy striving towards secure private contracts and those which discourage the public from using banks for deposits and transactions. This applies in particular to tax collection throughout the year at the source, and seizure of bank deposits of those believed to be in arrears on tax or loan payments, by the Tax Inspectorate. Current legislation does not provide adequate safeguards against potential abuse of access to restricted financial information. A sharper legal definition of the scope, reasons for, and nature of information disclosure on clients' accounts and transactions to various investigative organs will help in bringing savings and transfers into the formal banking sector.

43. *Under the Reform Program, the Government has submitted to Parliament a Tax Reform Bill which: (i) cancels the extraordinary powers given to the Tax Inspectorate in February 1994, including in particular the seizure of deposits; (ii) cancels such powers given to other State organs; and (iii) limits the Tax Inspectorate's and other State organs' rights (except those of NBK) to obtain information from banks to instances in which due cause justifies an investigation, thereby barring the current practice of obtaining information from banks on a mass scale without specific justification.*

Building a Competitive Market Structure

44. At present, there is a high degree of market concentration in the banking system. The "Big Four" dominate the financial sector. These banks are able to outbid, at a loss, their more efficient young competitors in the competition for resources and business, and to continue operating, also at a loss, their large branch networks that dominate almost every area outside Bishkek. Several factors account for that behavior. First, Agroprombank and Elbank are under pressure by authorities to keep providing certain services. Second, the Big Four still enjoy some implicit subsidies, including the free lease of many local premises and the rescheduling of some NBK refinancing on soft terms. Third, and most importantly, their shareholders and managers show little concern about further losses, since these banks are already insolvent and are waiting for some form of a bail-out from the Government. The behavior of the Big Four banks affects the much sounder, profit-oriented newcomers in the banking sector in several ways: It hinders the small competitors' growth; absorbs the scarce resources and attention of the Government and NBK; and undermines public confidence in the banking sector.

45. To raise efficiency among banks, as reflected in performance indicators such as improved productivity, reduced intermediation costs and increased profitability, the Government will take actions to encourage competition among banks and to reduce its own participation in the financial system. The liquidation/restructuring and privatization of state-owned banks will receive top priority in the proposed financial sector Reform Program. The Government will also simplify licensing procedures and promote

the entry of foreign banks. To avoid an excessive proliferation of small banks, the Government will increase the minimum and ongoing capital adequacy requirements for new and existing banks.

C. Legal And Regulatory Environment

46. A sound legal and regulatory framework is essential to improve financial sector efficiency and prudence. Considerable progress has been achieved in this area. However, significant work remains. In August 1995, the President issued two decrees which set forth the agenda to amend existing or adopt new financial legislation. This agenda properly prioritizes the promulgation of necessary laws and regulations for the further development of the financial sector. If progress on legal reforms proceeds as detailed in the Presidential Agenda, with the addition of legal reforms proposed under FINSAC, the Kyrgyz Republic will continue to be one of the most progressive FSU countries in the area of legal reform.

Ensuring Prudent Banking

47. Since 1992, significant progress has been achieved in stipulating prudential norms and phasing in their implementation, giving NBK enforcement powers, and developing NBK's supervision capabilities. Nonetheless, further progress is warranted and requires appropriate disposition, especially in the upcoming new Banking Law and further NBK prudential regulations.

48. **The New Banking Law**: The first Banking Law was adopted in 1991 and amended in 1994. The new Banking Law, prepared as part of the FINSAC reform agenda, will contribute significantly to ensuring bank prudence. The new Banking Law will be further strengthen NBK's powers to set up limitations on banks' single currency holdings, real estate holdings, dealings in precious metals or jewelry other than bullion or coins of a minimum purity, and transactions with affiliates and other connected parties. To prevent the sudden withdrawal of capital by bank owners, the new Law will require banks to be exclusively joint stock companies.

49. The new Banking Law will also authorize a broad range of enforcement powers and sufficiently high ceilings for sanctions; both are inadequate at present. In revising these provisions, care will be taken not to grant excessive powers, and to be broadly in line with international standards. Under the new Law's provisions, NBK will be able to exact penalties from banks that report inaccurate information. Careful consideration will also be given to granting bank supervisors the power to mandate provisions and to include the affiliates of banks in their examination. To further enhance the effectiveness of bank supervision, NBK will no longer be required to share its annual examination plans with the banks (which currently provides them with advance warning). *Before the release of Second Tranche, the Borrower will enact the new Banking Law, satisfactory to IDA.*

50. **Prudential Regulations**: A number of new prudential regulations for banks have recently been adopted by NBK. These include minimum and ongoing capital adequacy requirements; liquidity ratios and reserve requirements; loan classification and provisioning guidelines; foreign exchange exposure limits; and lending limits including lending to shareholders and to a single borrower. Guidelines for "problem bank intervention" have also been issued. On the whole, the new prudential guidelines are adequate, except for those relating to capital adequacy requirements which are still low by international standards. At present, minimum capital requirements are set at 5 million Soms for local banks and US$1 million for foreign banks, while banks are expected to maintain a minimum ratio of capital to assets of 7%.

51. Under the Reform Program, NBK has: (i) reduced the single borrower lending limit from 30% to (25%) of capital for new banks; (ii) put a (15%) limit on aggregate lending to shareholders and other insiders (special donor credit lines will be exempt from this principle); (iii) raised the minimum capital requirements, from 5 million to 10 million Soms for local banks, and from 10 million to 20 million Soms for foreign banks; and (iv) commenced the implementation of the Basle guidelines for capital adequacy (i.e., 8% of risk-weighted assets).

52. Before the release of Second Tranche, NBK will enforce 25% maximum single borrower limit on <u>all</u> commercial banks.

53. **Bank Supervision**: While the insolvency of most commercial banks and the bad debt problem have obscured the performance of the financial system since 1992, the NBK has successfully managed to stabilize the overall situation and put in place an improved framework for banking. Its policies have been on the right track in preventing further misallocation of new resource flows. In order to minimize distressed borrowing, the NBK has been quite selective in allowing banks to participate in its refinance auctions, and loaned funds with collateral often in the form of treasury bonds and foreign exchange. The NBK has also considerably improved its supervision capabilities and established new procedures for dealing with problem banks. The Bank Supervision Department (BSD) has closed three problem banks and put six others under a special supervision program, thus excluding those from its various windows and asserting its determination to rein in poorly performing banks. Although the quality of bank supervision has improved significantly during the past year, and compares favorably with that of the neighboring countries, BSD is still understaffed and lacks certain skills. The two areas that most require strengthening are on-site inspection and problem bank monitoring and management. Urgent work is also needed to strengthen licensing procedures in order to introduce a qualitative assessment of applications and to improve the quality of prudential reporting from banks.

Enhancing Security in Lending

54. Loan collection is a key problem of banks in the Kyrgyz Republic. This is due not only to unexpected distress of borrowers, but also to willful default. Fundamental to the health of the financial sector will be the restoration, over time, of the social, cultural and business habits of respecting property rights and honoring contracts. These were eroded during the Soviet era when property was collective and contracts were replaced by orders. In practical terms, specific actions will start enhancing security in lending, by facilitating the enforcement of collateral and other contractual rights and by making information about borrowers easily accessible to lenders. The Government will need to strengthen the legal, judicial, and registry framework for the use of pledges, the handling of insolvent borrowers, and the reporting of credit. These specific measures will need to be supplemented by improvements in the broader framework of property, company, and transaction legislation. The Civil Code, after some final harmonization with other laws, will soon be entering into force. A new Company Law, including the Law on Business Partnerships, whose drafting is well advanced, will be adopted, and supplemented by a revised Law on Lease. Security in lending would also be vastly enhanced by private ownership of land and property. However, this issue is still being debated in the Kyrgyz Republic, as noted above.

55. **The New Law on Pledge**. To curtail lending risk, and to do so at low transaction costs, the banking sector needs an effective and efficient framework for enforcing collateral and mortgage rights. In the Kyrgyz Republic, this requires the proper finalization of new legislation, and the establishment of a registry of pledges. Under the Reform Program, a new Law on Pledge has been prepared. The new Law on Pledge introduces an efficient out-of-court process yet gives to the debtor

the right of court appeal prior to execution. The new Law on Pledge creates a central registry in which all pledges shall be registered. One key issue is that the new Civil Code clearly requires the notarization of all mortgage and pledge agreements to be valid. However, the current notary system is costly and not satisfactory. The new Civil Code and the Law on Notaries impose a 5 percent fee on all pledge agreements, based on the value of transaction. The new Law on Pledge suppresses the involvement of notaries in the creation and enforcement of security rights by: (i) stating that the notarization will occur under special conditions derogatory to the Law on Notaries; (ii) reducing notary fees to a special fixed rate; and (iii) specifying a strict regime of personal liability for the notary officers, which could then be enforced in court.

56. The greatest impediment to the efficient implementation of the new Law on Pledge is the technical aspects of creating the central registry of pledges. Given its urgency, the registry could piggy-back on another registry network, such as the existing or emerging registries of enterprises, share, or land-use. Nevertheless, this use of existing registries will be a temporary solution. The Government will then provide a precise time schedule for the creation of the new registry. On the ability to pledge "land" as collateral, it is satisfactory for the banking system to rely on the existing "right to use land" up to 99 years. These land-use rights, which are freely transferable, can also be used as collateral. *Under the Reform Program, the Government has submitted to Parliament the new Law on Pledge, satisfactory to IDA. Before the release of Second Tranche: (i) the Borrower will enact the new Law on Pledge, satisfactory to IDA; and (ii) the Government will create a central registry system for pledges to enforce security rights.*

57. **Resolving the Insolvency of Borrowers**. The current Insolvency Law (1994), together with the Implementation Regulations for Enterprises and Banks, provides a satisfactory basis for the conduct of insolvencies in the Kyrgyz Republic. However, there are two key issues at present. First is the ability of the judiciary to apply the insolvency legislation. This calls for streamlined court procedures, training of judges and other legal experts, and the dedication of adequate budget resources to bankruptcy cases. Second is the inability of the "liquidator" to start the liquidation process without court involvement. This issue is of paramount importance for timely and effective liquidation of insolvent enterprises and banks. At present, it takes months to receive formal court approval. To a maximum extent, procedures should take place between the involved parties out of court. *Under the Reform Program, the Government has submitted to Parliament a Revised Insolvency Law that limits the time period given to courts to "one month" (30 days) to approve NBK's request to start the bank liquidation process. Before the release of Second Tranche, the Borrower will enact the Revised Insolvency Legislation, satisfactory to IDA.*

58. **Strengthening the Judiciary**. Legislation alone will not ensure secure lending if it cannot be effectively and efficiently enforced. Under the Reform Program the Government will take steps to ensure that the judiciary is capable of understanding and complying with the legislation. These steps will include training of the judiciary. The accompanying Financial Sector Technical Assistance Project (FINSAC TA) should be regarded as the preliminary step towards a comprehensive judicial reform program. This future program will include at least an extensive retraining of all judges. In the short term, FINSAC implementation requires at least an intensive retraining of all the 40 Commercial Courts Judges. The trainers responsible for that training program would master all aspects of business law in a civil law country, and should be business oriented. They should also be able to teach the future lawyers at the universities. A modern judiciary relies on a comprehensive, widely open, legal information system. Based on the experience of the database managed by the National Library, the Government will also initiate the creation of a computerized database. This database will make available all legal official

texts and major case-laws in all Rayons and Oblast Courts and all Arbitration Courts, as well as in the two Supreme Courts, the Constitutional Court, and in major Ministries. A Law on Arbitration will be developed as a matter of urgency so as to allow commercial counterparties a means of enforcing their legal rights without recourse to the courts. The system of charging for actions in the courts or for notarial verification of documents is arbitrary and irrational at present, and acts as a tax on these transactions. These will be revised, and the charges be linked to the amount of court time involved or to a notary's actual costs.

59. **Making Continued Progress in Privatization and Enterprise Restructuring.** Besides legal reform, continued progress in privatization and enterprise reform is key for higher security in lending, and virtually a precondition for the success of financial sector reform in general. The key objectives of the PESAC and APEAC reform programs — creating a private sector client base that operates under market incentives and seeks profitability, hardening the budget constraints of firms, improving their governance through privatization, taking nonviable enterprises out of business and liquidating their assets, and restructuring those with good prospects to become competitive and profitable — will need to be pursued with vigor and perseverance. *Before the release of Second Tranche of FINSAC, (i) the Government will complete coupon auctions for **all** enterprises, and reduce state ownership to a minority share in a minimum of (320) enterprises included in the 1996-97 Privatization Program, except in the major utilities that have individual privatization plans aimed at attracting strategic investors; (ii) the Borrower will (a) offer all potentially viable ERRA enterprises for sale, and (b) initiate liquidation procedures for all "old enterprises" and all others slated for liquidation. No funds will be allocated to ERRA enterprises from the 1997 Budget, except for completion of the liquidation process; and, finally, (iii) the Borrower will fulfill all of the Second Tranche conditions of APEAC, thus enabling IDA to release the Second Tranche of the APEAC operation.*

Strengthening Banks Institutionally

60. Poor technical capabilities and poor management are other major constraints to the further development of sound banking. These deficiencies can be traced to: lack of accounting and auditing systems for modern banking; slow development of skills and lack of collaboration with foreign banks; and slow emergence of key sectoral infrastructure, such as appropriate clearing and settlement systems.

61. **Introducing Adequate Bank Accounting and Auditing** Modern accounting and auditing standards that are necessary for the expansion of financial intermediation are being introduced at the NBK and the commercial banks, with technical assistance from various donors. However, the financial statements of some Kyrgyz banks are still being prepared along Russian accounting principles. It is essential that internationally accepted accounting standards (IAS) be adopted as soon as possible. A new chart of accounts was recently finalized with assistance from USAID, but remains to be made operational. Most Kyrgyz banks are still using essentially the old chart of accounts that traces back to the Soviet era. Only some partial and interim improvements have been achieved in this area. NBK has been producing some form of broadly adjusted financial statements about commercial banks; a few banks have adapted, in an *ad hoc* manner, foreign accounting computer software that they use in parallel to the official system; and some banks have sent staff to accounting courses in neighboring countries. The introduction of a new accounting system appropriate for a market economy is needed urgently. *Before the release of Second Tranche, NBK will introduce the new Chart of Accounts based on International Accounting Standards (IAS) for all commercial banks, and enforce the implementation of these accounts in at least five commercial banks.* This will greatly enhance bank management decisions, bank governance, prudential supervision, and the attraction of potential investors.

62. **Improving Clearing and Settlement, and Liquidity Management.** An effective payments system plays a crucial role in market economies, by expediting the settlement of financial obligations among economic agents and regulating the financial conduct of participants. The deficiencies in the country's payments system are putting considerable strain on commercial transactions. Despite progress under the Bank of Japan-sponsored reform program to redesign the payments system, payments delays still amount to about two days within a region and up to 14 days at the inter-regional level. The requirement that settlement accounts be maintained between the bigger banks has resulted in each bank's funds being temporarily blocked in many accounts. Weak in-house facilities for data processing and communication force banks to hold high levels of reserves at each settlement branch separately. The updating and netting of balances at the clearing house in Bishkek are subject to frequent breakdowns of archaic computer equipment. NBK foresees a range of short-term improvements that would include, *inter alia,* the establishment of regional clearing houses which would transmit netted end-of-day positions to NBK where the final settlement would take place. This strategy appears to be in line with a general banking sector reform that rapidly diminishes the importance of the largest banks and invites the newer banks to play a more active role. A longer-term reform strategy for payment and settlement systems is currently being developed with technical assistance from Japan.

63. **Transferring Modern Banking Skills.** The Kyrgyz banking system has major technical training needs. At present, the requisite knowledge and skills in most areas of modern banking are thinly distributed throughout the banking sector. These include, *inter alia*: strategic planning, credit analysis and risk management, international trade finance, and asset and liability management. Currently, training is carried out on an *ad hoc* basis by the banks themselves, as a component of certain aid programs. Under the reform program, a comprehensive, coordinated bankers' training program will be initiated with technical assistance to fulfill both the immediate, short-term needs, and to provide for ongoing training and formal education within the banking profession.

D. Restructuring Old Insolvent Specialized Banks

64. The Big Four specialized banks — Agroprombank, Elbank, Promstroi and AKB Kyrgyzstan — are insolvent. In part, this sad financial state is the legacy of the earlier transition years when these banks were still state-owned and treated like extended arms of the Government; NBK credit was handed out liberally; and the enterprise sector had not even started to adjust. A second part of the loans dates to more recent times. By then, the ownership of the Big Four, except of Agroprombank and Elbank, had shifted largely into private hands; directed credit had given way to auctioned credit; and interest rates were becoming positive. Nonetheless, the Big Four kept accumulating bad loans, albeit at a slower rate. Bad governance and management, political pressures on lending and collection, and the weak condition and unfavorable environment of the enterprise sector all contributed to their worsening loan portfolios.

65. Removal of the overwhelming dominance of these banks is central to creating a more competitive, solvent financial system. Under the Reform Program the Government will: (i) liquidate Agroprombank and replace it in the short term by an emergency farm support program for the provision of farm inputs and working capital, and in the medium term by a commercially viable and sustainable rural banking and cooperative system; (ii) dissolve Elbank (the former Sberbank), with its viable assets sold to the viable commercial banks; and (iii) substantially downsize and restructure, through private recapitalization, the Promstroi and AKB Kyrgyzstan Banks. Bank liquidation and restructuring will be executed in a way that seeks to preserve the provision of basic banking services during the transition. The agreed strategy also addresses the need to avoid moral hazard and the loss of financial discipline that

would result from wholesale, unconditional forgiveness of non-performing loans to the enterprise sector, by suggesting a temporary system for collecting, selling or resolving bad loans. Finally, the proposed reform strategy aims to ensure that bank liquidation and restructuring is financially feasible; the largest part of which would be cost-neutral for the state.

Liquidating Agroprombank

66. Agroprombank is the largest bank in the Kyrgyz Republic and the predominant lender to the agricultural sector. It has 52 branches throughout the country, 1,300 employees, and loans at June 30, 1995 of about 1 billion Soms. The bank has not been effective in collecting its loans, which have been rescheduled on a regular basis pursuant to Government decrees. The loan portfolio has been funded almost exclusively by an overdraft at NBK since the bank has virtually no deposits. If the required loan-loss reserves of approximately 1 billion Soms were to be booked, shareholders' equity would be a negative 1 billion Soms. Agroprombank is technically bankrupt and its role as a distributor of directed credits has largely replaced its role as a bank. Its profitable clients are increasingly turning to the smaller, private banks. The reform strategy for Agroprombank is therefore to liquidate the bank.

67. As is the case in any bank liquidation, there are a number of issues which need to be addressed, of which the most important are: (i) the need to develop an alternative rural finance system which replaces the role of Agroprombank as the primary agricultural credit institution; (ii) the desire to effect an equitable repayment of deposit liabilities; and (iii) the impact on the Government payment system if the nationwide branch network of Agroprombank is closed.

68. **Rural Finance Strategy.** It is clear that neither Agroprombank nor any alternative rural finance institution can be viable and sustainable until the agricultural sector returns to profitability. Farmers need to be profitable to be eligible for seasonal credits and they will require access to longer-term financing for equipment and other purposes if they are to be viable. Farm profitability continues to be low, due primarily to farm gate prices which are below border price equivalents, as well as to low farm efficiency. In these circumstances, it is necessary to make a distinction between "short-term emergency assistance," which is needed to keep a broad spectrum of the agricultural population productive pending further adjustments in the economy, and an efficient "commercial" rural finance scheme, which will be profitable and sustainable in the longer term.

69. Over the past three years, the Kyrgyz Republic has achieved some progress towards reforming the agricultural sector along market economy lines. About 40% of the total land area subject to privatization has actually been distributed to individuals in the form of land-use rights. The right to use land for 99 years has been established, and a new Land Code is under preparation that will transform the right to use land into a property right that can be freely transferred, inherited and used as collateral. Successful and lasting supply response in agriculture, both in the short and medium term, will come primarily from "private" commercial farms. Further reforms are required to accelerate the privatization of state farms and state-owned land, and to encourage "private" farmers to increase production and generate marketable surplus through incentives created by a more active land market, accurate price information, improved efficiency in marketing and processing, and better advice and support to farmers in the form of inputs and credit.

70. The short and medium-term elements of a feasible Rural Finance Strategy are being developed and managed under a separate Rural Finance Credit from IDA. Development of a sustainable rural finance strategy and provision of credit to farmers and other viable off-farm activities are key

priorities for the Government. It plans to rely as much as possible on market-based credit allocation for agriculture. However, it will do so gradually as competitive markets evolve, farmers adjust to the new market environment, and support services improve.

71. During the transition period, the provision of emergency credit to farmers can best be achieved through managed funds, such as a revolving fund for rural finance. There is a Working Group on Rural Finance, established under the Ministry of Agriculture, which is in the process of developing proposals for a more efficient distribution of (i) farm inputs and (ii) working capital, funded from the central Government budget. These budgetary transfers, which are likely to be highly subsidized, will be funded through properly approved budgetary allocations.

72. The modalities of a longer-term commercially viable and sustainable rural finance strategy are yet to be designed and agreed upon, however. Commercial banks typically have difficulty in profitably serving the credit needs of the agricultural sector. The risks are difficult to manage, the size of loans is generally small and transaction costs are high. While commercial banks may be able to mobilize deposits from the rural population, these deposits are frequently used to finance loans in urban markets, where loans are larger and risks more easily manageable. Given the cooperative nature of farming systems in the Kyrgyz Republic, and the need to keep transaction costs down and to establish repayment discipline, consideration is being given to establishing a rural finance system based on rural credit cooperatives or mutual savings societies. The development of a new rural credit system will undergo many variations and changes as new institutions are created to replace the former Agroprombank. It is possible that, over time, a number of key former branches of Agroprombank will re-emerge either as new independent banks, or as rural credit unions, branches of existing banks, or local offices for credit cooperatives.

73. **Deposit Payout Scheme.** In most bank liquidations, depositors are paid out at the inception through available cash, a deposit transfer, or from a deposit insurance scheme. In all cases depositors must be treated as creditors of the bankrupt estate and usually enjoy some privilege in ranking. According to Agroprombank management, there are very few individual depositors, and most accounts are either in the names of agricultural enterprises or are Government ministry accounts. In the case of Government deposits, the deposit balances could be transferred to another financial institution with either a back-up liquidity commitment from the NBK or a Government directive that official deposits would not be precipitously withdrawn. The Government could also support a non-cash depositor payout through the conversion of certain deposit balances into long-term savings instruments. As part of FINSAC preparation, the NBK conservator will form an internal working group, with assistance from the NBK Bank Supervision Department, to initiate a special internal study of the composition of the deposit base and to develop a comprehensive deposit distribution plan. In designing such a distribution plan, distinctions will be made in both the method and the timing of deposit payouts among different classes of depositors.

74. **Branch Network Rationalization**. The Agroprombank branch network has been used by the Kyrgyz Treasury, the Ministry of Labor and Social Security, and the Social Fund to distribute various pension, Government salary, disability, and social services payments to the population. Certain branches have also been used by the Treasury to make remittances of collected taxes back to Bishkek. Similar payments are also being made throughout the country, utilizing Promstroi and AKB Kyrgyzstan banks and, more importantly, the postal system with its network of nationwide offices. One alternative long-term solution to this issue could be to transfer this operational function immediately to another bank and to utilize the postal system for further distribution to the more rural areas. Although officially closed as

a banking institution, selected branches of Agroprombank could continue to act as "Agents of the Treasury" on an interim basis for the purpose of continuing these payment distributions until a new comprehensive system was implemented. Because the Agroprombank branch network is so extensive, and certain branches have a strong potential for sale or conversion into a new financial institution in some manner, a separate analysis is currently being conducted by an international firm to determine which branches of the Agroprombank network will survive, and in what capacity, in the future.

75. *Under the Reform Program, NBK has placed the Agroprombank under the receivership of DEBRA, and started the liquidation process. Before the release of Second Tranche, DEBRA will (i) assess the value of Agroprom's assets; (ii) transfer all recoverable loan assets of Agroprombank into the Debt Recovery Unit (DRU); (iii) reduce staff levels and close or sell bank branches; and (iv) submit a timetable to FINSAC Review Committee[1] and IDA for completion of liquidation of Agroprombank. NBK is due 965 million Soms from Agroprombank. This amount represents a bad debt on the books of NBK. To make the balance sheet of NBK whole again, before the release of Second Tranche, the Government will (v) replace this amount by a long-term bond of 965 million Soms at 5% interest rate, as described in the Letter of Financial Sector Development Policy.*

Liquidating Elbank

76. Elbank, the former Sberbank, is financially insolvent and highly unprofitable. Several factors have contributed to this. First, the bank has never been properly compensated by MOF either for the loss of assets "frozen" in Moscow upon dissolution of the Soviet Union in 1991 or for the revaluation of deposits upon the Ruble/Som conversion in 1993; the bank's claims on MOF have not been formalized and their amount is in dispute. Second, the bank has, in the last two years, engaged in careless lending, based on deposits that it attracted with above-market interest rates. The bank's average funding costs are around 100%. At the same time, NBK examiners classified about 80% of Elbank's loan portfolio as "loss" and the bank has been receiving virtually no interest income. Third, under past disaster relief and housing programs, the bank has long-term, low-interest loans of about 85 million Soms outstanding. Whether it acted in this matter merely as an agent for the Government, or actually took a credit risk, has never been clarified. Fourth, the bank bears high non-interest costs due to its small average deposit size of less than 50 Soms and its large branch network, although under NBK management the bank has now cut the number of its outlets by one sixth. The minute deposit base in the rural areas, and the small volume and value of payment transactions, do not support the largest part of its network. The image of the bank is thoroughly discredited. Most new deposits of the last few years have come from businesses in the Bishkek area which, in a speculative manner, sought to benefit from its high interest rates despite the associated risk. The reform strategy, therefore, is to close the Elbank. The customer loans of Elbank, most of which are non-performing, would be transferred to the central Debt Resolution Agency (DEBRA). This would include, *a priori,* the long-term emergency and housing credits.

77. **Deposit Distribution Plan**. These actions would be accompanied by a deposit distribution plan. This plan will require considerable financial support from the Government. From a legal point of view, the Government has reportedly given an explicit guarantee only for the old, "frozen" deposits of about 16.9 million Soms. However, the bank has over 2 million individual depositors. Under the Reform Program, the Government will offer immediate compensation for only small depositors. The

[1] The FINSAC Review Committee, chaired by the Prime Minister, will have the responsibility of overseeing the implementation of key Government decisions under the FINSAC Reform Program.

highest priority would again be given to the 16.9 million Som deposits that the Government had explicitly guaranteed. One might also consider accrued interest receivable as a lesser priority. The low-priority claims would then be put on a deferred pay-out plan by converting them into time-deposits. Those deposits could be transferred to other banks, together with Government securities of appropriate maturity.

78. Under the Reform Program, Elbank was declared insolvent and its license withdrawn on February 14, 1996 by NBK resolution No.6/1. NBK's resolution 6/1 also approved a household deposit payoff plan to be implemented starting February 15, 1996. Total household deposit obligations to be covered under this plan are 105.7 million Soms for principal of deposits as of December 31, 1995 and 16.7 million Soms interest accrual for 1995 totalling 122 million Soms. The interest accrual calculation was based on the decision to pay 10% for the average balances on the demand deposits and 30% for the average balance on the time deposits for 1995 only, regardless of the final maturity of these time deposits. This way, the unrealistically high-interest-paying long-term time deposits — some up to five years and over — totalling 35% of the deposit base will be compensated only by the current market interest rates. The speculative depositors will thus be asked to face risks, and share part of the financial burden.

79. The average account balance on demand deposits is 78 Soms. The deposit payoff plan gives priority to small depositors, by compensating first the small savers (about 78% of the deposit base) with account balances below 3000 Soms starting February 15, 1996. The large deposit holders (those over 10,000 Soms) will be paid over time, under a definite plan yet to be determined. The public announcement of the orderly payout scheme has assured the public, and no major deposit runs or panic withdrawals have been experienced. The payments since February 1996 have so far been financed under a 50 million Soms from the NBK reserve fund and the bank's liquid assets.

80. The deposit mobilization capability of the banks and the return of public confidence in the newly emerging private banking sector in the Kyrgyz Republic are evolving. The new Kyrgyz and foreign joint-venture banks are entering the market. The banking supervision capability of the NBK is going to be strengthened considerably under the proposed FINSAC, where all banks will be under the supervision of NBK. The insolvency and losses of the banks will become much more transparent after the adoption of internationally acceptable accounting standards. The Law on Banks and Banking will be improved to lay the proper regulatory and legal basis for the safety and soundness of banks. Stronger regulatory framework and supervision, increasing competitiveness and transparency are expected to improve the depositors' confidence in the banking system.

81. *Under the Reform Program, major steps toward the liquidation of Elbank have already been taken. Before the release of Second Tranche, DEBRA will (i) assess the value of Elbank's assets; (ii) transfer all recoverable loan assets into the Debt Recovery Unit (DRU); (iii) reduce staff levels and close or sell bank branches; and (iv) submit a timetable to FINSAC Review Committee and IDA for completion of liquidation of Elbank.*

Restructuring Promstroi and AKB Kyrgyzstan Banks

82. **Promstroi Bank**. Promstroi is the local successor of the Soviet Bank for Industry and Construction. It became a privatized joint stock company in December 1991 and has about 400 shareholders who are some of the largest industrial and construction enterprises in the country. Founded in 1922, the bank has traditionally served as the Government's vehicle for directed credits to support state-owned enterprises in these sectors. Since independence, many of the bank's primary borrowers have become shareholders in the bank. It is of the same size as AKB Kyrgyzstan in terms of branches and

staff, but has only half AKB Kyrgyzstan's volume of gross loans. It seems to have been less aggressive and innovative than AKB Kyrgyzstan, and more reluctant to do new lending.

83. The reform strategy for Promstroi Bank recognizes that the institution, while financially weak, is fundamentally sound on an operational basis. The bank has been operating with a positive net interest margin, and a sizeable proportion of its loan portfolio (40%) is performing. It is believed, primarily because of the relatively small amount of new capital funds required, that the bank can be effectively restructured with private capital with no impact on the central Government's budget.

84. **AKB Kyrgyzstan Bank** AKB originated from the Soviet Housing and Social Commodity Bank, and was re-established as the first joint stock financial institution in 1990. It has 600 staff and 26 branches. It is majority privately owned, although its Supervisory Council remains dominated by state enterprise managers. It has built a leading position in currency and international transactions, and plays an important role in domestic payments. The quality of the bank's portfolio is poor. As of October 1995, NBK classified roughly 84% of AKB's portfolio as non-performing. Of the total loans of 216 million Soms, 143 million Soms is ranked as doubtful and loss, twice the current total equity of the bank. AKB management regards a large part of these loans as "directed." Some portion dates back to before April 1994, when directed credits were officially discontinued. AKB has so far avoided building the 120 million Som loan-loss reserve that is required by NBK's prudential guidelines. Such provisioning would show the bank as insolvent with 95 million Som negative net worth. A recent call for capital increase has been unsuccessful.

85. Since July 1995, AKB has reported some improvement in its balance sheet through the mobilization of new enterprise deposits and the repayment of over 37 million Soms in debt to NBK. Although the overall weaknesses in the bank's loan portfolio remain unchanged, monthly cash flows have shown a slight improvement as well. Based on its recent financial performance, AKB management believes that the bank can restructure itself over time, mainly because of the high level of collateral security on its loan portfolio.

86. **Restructuring Strategy**. The reform strategy for each of these two banks is essentially an internally managed program which will require each bank to finally recognize its loss positions with certain loan assets and the credit risks associated with its remaining portfolio. The program calls for each bank, acting under a "management letter agreement with the NBK," to: (i) write off all loans classified as loss; and (ii) properly fund the NBK required loan-loss reserves on its remaining portfolio. This will result in the banks' reporting negative capital positions. Promstroi and AKB will then have a two-phase, timebound requirement to bring their capital accounts back to "zero," and further to raise additional capital to meet NBK capital adequacy requirements. The reform program requires minimum intervention by the Government in these privately owned banks, at least up until the point that bank managements are unable to raise capital. NBK will formally intervene in the institutions only if they fail to recapitalize themselves up to a "zero" capital level. The banks themselves will absorb the costs of the resolution of their own poor credits as well as the funding and investment costs to bring the institutions into compliance with international banking practices. The restructured banks, with their current nationwide branch networks, while significantly downsized, will remain intact.

87. Should this approach prove unsuccessful, the Government will be faced with two choices: (i) to restructure the banks by issuing bonds to remove bad assets, thus making the banks more attractive for new private investors to acquire the bank and provide new capital; or (ii) to liquidate the banks. Under both choices, in order to impose discipline, the banks would be placed under DEBRA's

receivership, management removed, and losses imposed on existing shareholders to the extent of their investment.

88. *Under the Reform Program, NBK has instructed the managements of Promstroi and AKB Kyrgyzstan Banks to present capital increase plans, satisfactory to NBK and IDA, to bring the capital from negative to "positive," or at least to "zero" level by October 31, 1996, and to reach 8% ongoing capital adequacy requirement by March 31, 1997.*

89. *If the bank(s) has(ve) been successful in raising capital to "positive" or "zero" level by March 31, 1997, NBK will instruct the bank(s) to present another capital increase plan to reach 8% ongoing capital adequacy requirement by September 30, 1997. If the bank(s) has(ve) not been successful in raising capital to "positive" or "zero" level by March 31, 1997, NBK will place the bank(s) under formal receivership, to start the liquidation process — before the release of Second Tranche.*

Financial Costs of Bank Liquidation and Restructuring

90. In order to resolve the insolvency of Big Four banks, their past losses must be formally recognized and financed by the budget, after first imposing losses on the banks' shareholders. The costs to be incurred include payments to depositors, the removal of bad assets from bank balance sheets, an asset swap with the NBK to replace its claim on the insolvent Agroprombank, severance payments, and other costs associated with liquidation and restructuring. To the extent possible, shareholders will be asked to provide new capital to make up losses before Government resources are used. All recapitalization of the surviving banks, to the minimum capital requirements prescribed by the NBK, will come from new capital raised from private sources and retained earnings. Annex C, Tables 1 and 2 provide a summary of the financial costs which could be expected in resolving the failure of these four banks. It is assumed that collection and liquidation costs will be covered by the collections made against bad assets and the sale of assets under liquidation.

91. **Bank Liquidation**. The Government's potential obligation for the protection of *Agroprombank* depositors is estimated at 60 million Soms, as of March 1, 1996. This amount assumes that current liquid assets of 30 million Soms will first be used to pay off an equivalent amount of liabilities and that depositors will be protected for the full amount of their deposits. Severance payments to staff will add an additional 2 million Soms, such that the total cost of resolving this failure will approximate 62 million Soms. In addition, NBK is due 965 million Soms from Agroprombank. This amount represents a bad debt on the books of the NBK. To make the balance sheet of the NBK whole again, this amount would be replaced by a long-term Government bond of 965 million Soms at a nominal interest rate to be determined. A 5% interest rate would result in an annual cost to the budget of 48 million Soms. However, since the NBK is required to remit 70% of its profits back to the budget, the net cost to the budget will be on the order of about 15 million Soms annually. As collections are made from liquidated assets received from Agroprombank, the monies will go to the budget to retire these bonds and reduce the Government's interest payments to NBK.

92. The Government's obligation, as owner of the *Elbank,* is the payout of principal and interest to depositors. In this regard, a deposit payoff plan has been formulated, and implemented beginning in February 1996. Under this deposit payoff plan, principal obligations are 105.1 million Soms and interest obligations 16.9 million Soms totalling 122 million Soms. NBK has provided 50 million Soms from own reserves to bridge this deposit payoff scheme until the counterparts from FINSAC will be available to the budget. If necessary, this support will continue until the first tranche of FINSAC is

disbursed and NBK is reimbursed. There could also be recoveries from the assets of the Elbank that would be used to meet this deposit payoff plan and pay other obligations of Elbank to commercial and Government social institutions and staff layoff costs. These recoveries are estimated to cover all the other liabilities and expenses of the liquidation of the bank. Thus, the final cost to resolve Elbank's insolvency is estimated at 122 million Soms comprising the household deposit payoff plan.

93. **Bank Restructuring**. The *Promstroi* Bank will be recapitalized by its own shareholders and the retention of earnings. If successful, there will be no cost to the Government. This alternative appears attainable and is the preferred option. At present, the Promstroi Bank requires 15 million Soms to bring its capital to a positive level, and 24 million Soms to reach 8% capital adequacy requirements. Provided that the problems with its directed credits to Naryn Hydro and Kyrgyz Gas are resolved, the bank will be able to recapitalize itself by its shareholders. However, should this approach prove unsuccessful, the Government is faced with two choices: (i) to restructure the bank by issuing bonds to remove bad assets, thus making the bank more attractive for new investors to acquire the bank and provide new capital; or (ii) to liquidate the bank. Of the latter two alternatives, the first choice, i.e., restructuring the bank by issuing bonds to remove bad assets, is the least costly alternative. The potential obligation of the Government to restructure the bank and protect depositors would be the interest burden on Government bonds and the cost of retiring the bonds issued. If the Government decides to eliminate the negative capital of 15 million Soms by issuing bonds, then the cost to the Government would be the cost of retiring the bonds plus the interest costs. If a 5-year bond is issued, bearing interest rate at 25%, the cost of the interest and of retiring the bonds for the first year of the program would be 7 million Soms, with a total cost over 5 years of 26 million Soms.

94. If *AKB Kyrgyzstan Bank* is successful in seizing and selling collateral and raising new capital from shareholders and retained earnings, there will be no cost to the Government. If the Bank is unsuccessful in raising capital, the Government will again have two choices: (i) to restructure the bank through a bond issue used to remove bad assets and to recapitalize the bank by new private investors; or (ii) to liquidate the bank. Under the first approach, the cost to the government would be the principal of the bonds of 160 million Soms (the negative capital as at June 30, 1995 reported by the diagnostic audit) plus interest. Assuming that these bonds carry 25% per year interest and are retired in equal installments over the five years, their cost in the first year would be 72 million Soms with a total cost to the Government of 272 million Soms over five years. Instead of the bond issue, if the bank is liquidated, the Government will have to decide whether or not the depositors and the NBK will be protected in full principal amounts payable by the bank instead of waiting for the liquidation proceeds from the bank to be used to pay off these liabilities. The cost to pay off the depositors and NBK immediately and in full principal is estimated to be 138 million Soms (160 million Soms of deposits plus 23 million Soms due to NBK minus 45 million Soms of cash and liquid assets of the bank as of March 1, 1996). The rest of the recoveries from the liquidation of AKB Kyrgyzstan Bank would be used to pay the rest of the liabilities of the bank.

The Fiscal Impact

95. The total budgetary resources needed during the first twelve months of the program are in the range of 300-350 million Soms (a maximum of US$32 million) or about 1.5% of GDP, as initial upfront costs during the first year (July 1996 - June 1997). Thereafter, the program would cost between 15-59 million Soms per annum, mainly as interest on bonds to be issued as part of the bank restructuring program (Annex C, Table 1). The proposed FINSAC would provide total financing of US$45 million, and thus cover the first year's costs, and provide (at least) an additional US$13 million of budget support

during the life of the Credit. The counterpart funds generated under the FINSAC will be made available to the central Government budget. During the annual budget preparation process, funds will be allocated and transferred from the budget to NBK/DEBRA, to finance the bank liquidation and restructuring program. Before finalizing the decision on the amount of counterpart funds to be transferred to NBK/DEBRA, the Minister of Finance and NBK will have consultations with the IMF and IDA, to ensure consistency with the macroeconomic program.

E. Resolving The Bad Debt Problem

96. The non-performing loans that are currently in the portfolios of the Big Four formerly state-owned banks stand around 1.5 billion Soms (or about 10.3% of GDP). The recommended liquidation/restructuring strategy for these big banks will address the largest part of the bad asset problem in the banking sector. Wholesale forgiveness of these debts is not a feasible option, for it would create moral hazard and would be a severe setback for enterprise reform. Enterprises would be encouraged to avoid credit repayment and to waste credit resources. Moreover, the relief might leave most non-viable enterprises in business, without any condition that would force restructuring. Furthermore, the lucky defaulters would perversely gain an advantage over their healthier or less frivolous competitors who keep bearing interest and amortization payments. Therefore, serious loan collection efforts would need to be made, despite the costs and complexities involved.

97. *Under the Reform Program the Government has established a temporary Debt Resolution Agency (DEBRA), to act in the capacity as receiver on behalf of the National Bank of Kyrgyzstan (NBK), to take control over and dispose of the assets and liabilities of intervened commercial banks.*

98. DEBRA's operations will comprise two areas: (i) the receivership function where DEBRA, through its Bank Restructuring Unit (BRU), will act as agent for the NBK in assisting its intervention, receivership, conservatorship, deposit payout, and liquidation activities; and (ii) the debt recovery function where DEBRA, through its Debt Recovery Unit (DRU), will manage, collect, restructure, liquidate, and resolve the non-performing loan portfolios and other assets of the intervened banks. It is envisioned that the scope of DEBRA's activities initially will encompass the ultimate intervention and rationalization by the NBK of at least two of the four banks: Agroprombank and Elbank. The list may be expanded to include AKB Kyrgyzstan and Promstroi banks as discussed above, and any other Kyrgyz banks so identified by NBK during the limited time span of DEBRA.

99. **Organization**. DEBRA's mandate is to be for a period of three years. Operationally, DEBRA will be headed by a Director who will report to the Chairman of NBK and to the FINSAC Review Committee. The Director will manage the day-to-day activities through two deputy directors. The FINSAC Review Committee, established on May 3, 1996 by a Presidential Decree, will have the responsibility of overseeing the implementation of key Government decisions under the FINSAC Reform Program. It will be chaired by the Prime Minister or his designee. The membership of the Committee will be comprised of the Chairman of NBK, Minister of Finance, Minister of Economy, Minister of Agriculture, Minister of Justice, Chairman of State Property Fund, and Director of DEBRA.

100. The Debt Recovery Unit will act as the vehicle through which all recoveries are made by the Government and various other classes of creditors, by collection, loan restructuring, and the innovative use of debt resolution procedures on the outstanding non-performing loan portfolios of the intervened banks. DRU will organize loan work-out teams which will classify loans into pre-established categories and apply a series of "automatic criteria" for debt resolution wherever practicable. DRU will

apply standard debt recovery methodologies including an analysis and review of the borrower's financial condition and debt service capacity as well as an appraisal of the value of collateral, as applicable. In all cases, the concept of cost-effectiveness in debt recovery efforts will be applied, and protracted and time-consuming operations where full recovery is not assured will be avoided.

101. **Debt Recovery Principles**. Certain categories of loans can be treated in various ways to effect debt recovery or resolution. Due to likely personnel and time constraints, debt recovery programs involving standardization and "automatic criteria" which streamline debt recovery actions will be used to the extent possible. It is recognized by NBK management that dealing with hundreds of loans and borrowers on a case-by-case basis may well prove to be a monumental and counterproductive effort, with positive results unattainable within the expected life span of the proposed DEBRA.

102. While full recovery of a loan is the desired result, it is recognized that, for a variety of reasons, this will not be a practical or realistic goal in most cases. Therefore other debt recovery alternatives, such as those described below, will need to be considered:

(a) *Debt Forgiveness*. The Government may decide to forgive some or all of certain portions of debt. Such debt as excessive accumulated interest may be forgiven to give incentive for payment of principal. There may also be certain types of loans, such as peasant farm and small agricultural business loans, and those that are directly attributable to previous Government policies of price intervention for social protection, such as bread subsidy, that may be forgiven totally in the best interest of the economy.

(b) *Discounts*. In order to give borrowers the incentive to pay their debt, discounts should be considered. These could be in the form of "one time" discounts (such as a 25-50% discount for full payment within a certain stated time period, or time sensitive discounts, where a certain percent (such as 10-20%) discount will be accepted for each timely payment made in an agreed series of payments. Profitable privatized enterprises should be likely candidates for this alternative to prevent foreclosure of collateral or possible bankruptcy action.

(c) *Debt Collateral Swap*. There will be instances where a borrower will be willing to swap collateral for all or a portion of debt to prevent bankruptcy. Often this collateral is not marketable in the area of the country where the debtor is located. DEBRA, through its nationwide operations, could transport the collateral to marketable areas. Also, individual collateral may be of such small quantity as to not be very marketable. However, DEBRA would be able to consolidate similar types of collateral from numerous debtors into acceptable marketable sizes.

(d) *Debt/Equity Swap*. There will be opportunities to exchange all or part of outstanding debt for an equity interest in a debtor enterprise. This swap can be negotiated as to price and type of equity instrument. The easiest swap could be for common stock. However, to alleviate concerns over the dilution of ownership wherein the Government could own a substantial or majority part of the enterprise, alternate equity instruments could be exchanged. This could take the form of preferred non-voting stock, subordinated debt, or some type of instrument (such as a warrant or stock coupon) that is convertible into common stock as long as the converter is not a Government entity. Using this approach, DEBRA could take an instrument convertible to common stock and sell it, possibly on the stock exchange, to private individuals, thus overcoming the fear of Government ownership of an otherwise privatized enterprise.

(e) *Restructuring of Debt.* To allow non-performing borrowers to get to performing status, it is often necessary to negotiate a debt restructure. This can take various forms with the most prevalent being restructure of the terms (maturity date(s), interest rate, payment amounts, timing of payments, etc.) and setting up some type of enterprise "cash flow" payment requirements (where the payments are based on the cash flow of the business such as receipt of accounts receivable). In all restructure agreements, it is prudent to attempt to obtain additional collateral, guarantees, etc.

(f) *Auction/Sale of Debt.* Selling loans individually or in packages of several homogeneous loans may be a viable disposition alternative. This can be through either public or sealed bid auctions. Large loans to specialized companies or with distinctive collateral lend themselves to sealed bid auctions involving known potential buyers that are both interested in the particular kind of debt and have the ability to purchase. This will likely be competitor firms looking for a way to expand and feel that the debt can be negotiated for equity. Smaller loans, packaged using similar attributes, (such as type of enterprise, type of collateral, geographic location of borrower/collateral or loan size) are good products for sale through either public or sealed bid auction. Loan collateral, especially movable type, such as cars, equipment, furniture, fixtures, etc., is very conducive to public auction on a cash and carry basis.

(g) *Bankruptcy.* DEBRA management will also recognize the use of bankruptcy proceedings as a tool or threat for collection; particularly in those cases where the borrower has the capacity to repay but refuses to work with DEBRA. Also, the borrower may have other assets that can be obtained through court to use in extinguishing the debt. There will also be instances where analysis shows the borrower is not viable under any scenario and bankruptcy may be the only viable option. However, bankruptcy and the confiscation of collateral is an option that should be carefully considered, as certain types of collateral may not be easily marketed and could be costly to maintain. Costs to maintain and store collateral should also be taken into account. These may indicate that bankruptcy may not be a cost-effective business alternative.

103. **Farm vs. Non-Farm Debt.** Certain types of debt lend themselves to some debt resolution alternatives better than others. In the Kyrgyz case, the most significant division of debt appears to be farm versus non-farm debt. In dealing with farm debt, the most relevant debt resolution alternatives involve any one or a combination of: debt forgiveness, collateral exchange, and/or restructuring of debt. In dealing with the non-farm debt, although debt forgiveness and collateral exchange may be applicable in certain cases, the most practical alternatives are discounts, debt/equity swaps, and restructuring of debt. These methods are also the best methods to be used by Promstroi and AKB Kyrgyzstan Banks, *vis-à-vis* the debtor enterprises. (Annex D: Key Operating Principles of DEBRA).

104. *At an early stage after its establishment, but before the release of Second Tranche of FINSAC, DEBRA will prepare a report, satisfactory to IDA, classifying the non-performing loans under its control into two categories that will be treated differently: (i) those where the work plan for collection will be based on automatic criteria appropriate to the loan category; and (ii) others where a more*

systematic case-by-case approach is practicable. This report, satisfactory to IDA, will be integrated into the Key Operating Principles of DEBRA.

F. Encouraging the Development of NBFIs

105. The capital markets can play an important role in the reform of transition economies, both as a facilitator of the privatization process and in providing alternative investments for enterprises and households. The securities market in the Kyrgyz Republic is still in an early phase of development. In the coming years, however, the supply of securities will increase rapidly due to the corporatization and privatization of state enterprises and due to the advantages of securitizing government borrowing. Thus, it is important that the Government create a framework for the orderly development of these markets, not only to raise efficiency, but to avoid the possible collapse or public distrust of markets which might occur if they are allowed to develop in a haphazard or disorderly way.

106. The Kyrgyz Republic's structural reform program will soon produce a larger supply of securities, namely, equities from privatization and state bonds from the possible exchange against bad loans. There will soon also be secondary trading of T-bills, bonds, and equities. The main problem will be the short supply of savings to these capital markets. This calls for two sets of measures: first, making securities more attractive by removing constraints to their profitability and giving investors confidence in the integrity of the markets; second, laying the basis for efficient and sound contractual savings institutions that will intermediate between small savers and the capital markets. Further efforts will also be made to enhance public interest in mass privatization, reduce excessive taxation and deepen the markets for Government debt instruments.

Making Securities More Attractive

107. So far, many resources have been concentrated on establishing the infrastructure of a well-developed stock exchange. While much has been achieved in this respect, there are no indications that the Kyrgyz Stock Exchange can in the shorter-term be financially self-sustaining, or indeed provide the functions mentioned above. For the medium term, a viability assessment of the exchange would be needed. The volume and fees of listings and of turnover should be estimated, and the resulting income projections should be compared with the expected operating costs of the exchange. While total savings in the economy may take a long time to recover, their mobilization into the capital markets can be stimulated. The attractiveness of capital market investments, especially the use of privatization coupons, could be enhanced; excessively high taxation could be cut back; and the public confidence in the orderly functioning of the markets could be ensured.

108. **Enhancing Public Interest in Mass Privatization**. By mid 1995, 72% (2.3 billion) of issued privatization coupons remained uninvested. An additional 1.0 billion coupons have not even been issued yet, and await sale by the State Property Fund (SPF) when it deems it possible. To stimulate the use of coupons, a greater number of more attractive enterprises would need to be brought forward for privatization. Stronger public education should deepen the understanding of how the coupon system can confer value to coupon-holders, and which rates of return are realistic to expect from investments. Public confidence in investment funds urgently needs to be bolstered, as discussed below; by mid-1995, the investment funds had collected only some 9%, or 0.3 billion, of all coupons issued.

109. **Reducing Excessive Taxation**. Current tax policy, including high corporate taxes, makes tax avoidance dominate many business decisions. This undermines efforts to attract more listings to the

exchange, to properly record securities transactions, to obtain reliable disclosure, and to build fair and transparent markets. The growth of NBFIs remains constrained, and most transactions take place on informal capital markets. One important measure would be a tax credit or pass-through mechanism to avoid double or treble taxation; such treble taxation occurs as taxes are levied on the profits of corporations, then on net income of investment funds earned from post-tax dividends from those firms, and finally again on the personal income from share-holdings in these funds. Other measures that may warrant review are a harmonization of the tax rates on financial institutions with other enterprises and a reduction or waiver of taxes on securities transactions.

110. **Deepening Markets for Debt Instrument**. The rapid widening and deepening of markets for debt securities would hasten capital market development, generate more information fundamental to the functioning of the financial markets, and facilitate the cash management of banks, contractual savings institutions, and corporations. The creation of an organized secondary market in Treasury Bills, to be operated by the Kyrgyz Stock Exchange, is being discussed between representatives of the NBK and the stock exchange. Efforts are also underway to issue government bonds directly to the public through the stock exchange, by introducing longer maturities, smaller denominations etc.

Providing a Framework for Sound Contractual Savings Institutions

111. In mature market economies, contractual savings institutions like investment funds, insurance companies, and pension funds mobilize large amounts of medium and long term savings. Thus they become major sources of financing for the state and enterprises. In the process, they vastly stimulate the capital market through which they invest. As the Kyrgyz Republic's fledgling capital markets gradually gain scale and efficiency, such institutions should play a growing role as well. The basic policy, legal, and taxation framework should be prepared in the meantime. Only investment funds are already significant today, due to their role in privatization. They require careful attention to avoid failures or fraud that could discredit contractual savings institutions at this early stage.

112. **Investment Funds**. Investment funds will have a key role to play if there is to be development of capital markets in the Kyrgyz Republic. The coupon privatization was in fact expected to boost the emergence and growth of such funds. By mid-1995, however, the vast majority of coupons was not yet invested at all, and of those invested, only some 30% had gone through investment funds. Moreover, many of these funds are currently in a poor financial state. Further failures of funds and the attendant loss of public confidence could seriously set back capital market development. The funds' distress stems in part from the limited scope for attracting cash in exchange for shares, which is due to the poor quality of the privatized enterprises, the 25% limit on any fund's stake in an enterprise, and the shortage of investable savings in the economy. Their distress results also, however, from poor fund management and lack of effective prudential supervision. Indicative is the imprudent but widespread practice of paying dividends in excess of earned income. Fund managers need substantial training, and perhaps assistance, in accounting, asset/liability management, enterprise governance, and related subjects. The recently issued Investment Fund Accounting Guidelines, which also regulate reporting and disclosure, need to be implemented. The responsibility for the funds' supervision lies currently with SPF rather than the State Agency for Securities (SAS), since they are "specialized" funds. However, SPF barely exercises this function, and SAS lacks the capacity. The responsibility needs to shift to SAS, once the authority and capabilities of SAS have been boosted under the Reform Program.

113. *Before the release of Second Tranche of FINSAC, the Ministry of Finance to review and amend the prudential regulations for "Investment Funds," satisfactory to IDA, with a view to*

strengthening these regulations; enhance their enforcement; and implement the recently issued Investment Fund Accounting Guidelines.

114. **Insurance Companies**. The insurance industry is currently moving away from credit insurance, where the industry incurred major losses, and instead towards property, accident, life, and voluntary medical insurance. Many transition economies are witnessing a rapid growth in insurance company income and assets, and developed market economies know insurance companies as huge investors in securities. The Kyrgyz Republic's insurance sector, too, could potentially play a major role in the financial markets. How large a role it could play already in the near term is hard to determine. This is because the excess reserves that could be invested in securities escape assessment, due to the continued use of former Soviet accounting practices, the lack of transparent market values of investments, and the likely rapid changes in the nature and maturity profile of insurance company liabilities. Measures to enhance the development of the insurance industry would include, *inter alia*: the passing of a new Law on Insurance, as discussed below; the introduction of new accounting practices; the building up of effective prudential supervision; the transfer of skills through tolerant policies *vis-à-vis* foreign insurers and reinsurers; and the easing of regulations that currently require all reserves to be kept in low interest bank accounts.

115. **Pension Funds**. So far, pension fund activity is still marginal, with only two private funds offering their services. In the long run, however, partially or fully funded pension funds could become major investors of household savings in the capital markets. This will depend to a considerable extent on policies, regulations, and tax arrangements. It hinges on the degree to which they will make membership in funded pension funds mandatory or voluntary; continue to mandate contributions to, and provide pensions from, a public social security system; favor pension fund investments in the capital market versus the employer firms; and so forth. At the current stage in the economic transition, it would be wise to start reviewing some of these fundamental options for the future nature and scope of the country's pensions system. This could be done through technical assistance to be provided. This would then be followed by the development of policies, a Law on Pension Funds and specific regulations. Even in the shorter term, however, the few private funds are competing for scarce savings, and fraud or default on their part could undermine the confidence of the public in the securities markets and the credibility of the regulatory system. The supervisory authority for pension funds therefore needs to be clarified.

116. *Before the release of Second Tranche, a new law on Insurance Companies, and a new Law on Pension Funds would be prepared, and existing legislation on Leasing would be improved, satisfactory to IDA. These three new laws will be submitted to Parliament.*

Safeguarding Investors' Interests

117. Currently, there are no prudential regulations applied to the activities of non-bank financial institutions that deal with general public such as insurance companies and pension funds. These institutions can lead to systemic financial instability in the event of failures. In the case of the securities market, the 1991 Law on Securities and Stock Exchanges has been amended to establish a legal framework which could lead to an open and transparent formal trading market. Although the legal framework is essential, enforcement of the law is also necessary. The enforcement capability of the State Agency for Securities (SAS) is not sufficient to implement this Law. The arbitration courts are equally unsuitable as forums for resolving the types of disputes which would arise under this law.

118. The State Agency for Securities (SAS) is a small agency with huge responsibilities for regulating and supervising capital markets and their NBFIs. It is expected to implement the Laws on Securities and on Joint Stock Companies. Although efforts to upgrade its status and resources have shown some results, SAS is still short of adequate authority, personnel, training, facilities, equipment and budget. One option to address this problem would be to transform SAS into the executive arm of a powerful Securities Commission comprising the heads of MOF, MOJ, NBK, SPF and perhaps the SAS itself, as well as representatives from the stock exchange. The involvement and standing of these top officials, and a strong "ownership" by the Government, would help ensure proper resources and authority for the implementation of securities regulations. After some time, the President could appoint five full time commissioners. It would also help to consolidate the authority for all securities markets regulations and their supervision in one institution. With this accomplished, the SAS could be elevated to a permanent Securities Commission. In parallel, a professional organization of brokers and dealers could be created to promote and represent the interests of this sector.

119. *Under the Reform Program, the status of the SAS would be transformed from an administrative agency into the executive arm of a Securities Commission, with proper resources and authority for the development and implementation of securities regulations.*

PART IV. FEATURES OF THE PROPOSED CREDIT

Borrower and Credit Amount

120. The Borrower is the Kyrgyz Republic. The Credit amount is SDR 31.2 million (US$45 million equivalent). This amount, which is equal to about 7% of total imports of goods required in FY96, is necessary to maintain the momentum of stabilization and adjustment programs and, along with other donor assistance, to help close the financing gaps of the balance of payments and the budget. The Credit would be on standard IDA terms, with a 35-year maturity, including 10 years of grace.

Technical Assistance Requirements

121. The successful implementation of the reform program to be supported by the FINSAC will require substantial technical assistance to help implement bank restructuring and liquidation, resolve problem loans, strengthen bank supervision, establish a national program of skills development in commercial banks, train bankers in international accounting standards and auditing, develop prudential regulations and supervision for non-bank financial institutions, and refine legal and regulatory requirements. The total cost of this assistance has been estimated at around US$7.3 million. The Government has stated its desire to seek grant funding for its technical assistance needs. But, given the substantial size of this assistance and the particular urgency in several key areas of the reform program, the Government has requested a PPF from IDA in an amount equal to US$700,000. The PPF will finance: (i) a senior advisor to the Governor of NBK to help oversee the coordination of the reform program as a whole; (ii) a branch system advisor to assist the NBK in directing the rationalization, merger or sale of the selected Agroprombank and Elbank branches; and (iii) two senior foreign advisors to help establish the Debt Resolution Agency (DEBRA). Other high priority areas which are essential to the success of the reform program include: the continuation of training in the NBK's Department of Bank Supervision; training in international accounting and auditing standards, both within the NBK and in all commercial banks; improvement in payments and clearance systems nationwide; assistance to enhance the implementation and enforcement capabilities of the State Agency for Securities; review of

Pension Fund schemes; and drafting of legislation for insurance companies, pension funds and leasing. Other areas needing assistance are the establishment of a National Bankers Institute and managerial and marketing advice to AKB Kyrgyzstan and Promstroi Bank. USAID, EBRD, ADB, the UK Know-How Fund, and the Governments of Japan and the Netherlands have all been providing technical assistance in the financial sector. Finland, TICA and UNDP have committed technical assistance funds in support of the reform program proposed under FINSAC. The Government has agreed that a comprehensive and fully-funded TA program will accompany the proposed FINSAC operation. At a recent special Donors' Conference on FINSAC TA, chaired by NBK, funding arrangements for the technical assistance were largely firmed up. An IDA Financial Sector Technical Assistance Project for the overall Program, including an IDA credit of US$3.4 million, is being submitted to the Board for consideration, simultaneously with the proposed FINSAC.

Disbursement

122. The proposed Credit would be disbursed in two equal tranches. The First Tranche would become available upon Credit effectiveness, and the Second Tranche twelve months later, based on review by IDA of the implementation of the adjustment program as a whole and the fulfillment of the specific Second Tranche conditions. Once the Credit is approved by the Board, the Borrower will be required to open and maintain a Deposit Account in its central bank (NBK). As each tranche is released, the Borrower will submit a withdrawal application, against which IDA will disburse the Credit proceeds into the Deposit Account for the Borrower's use. If any portion of the credit is used for ineligible purposes as defined in the Credit Agreement, IDA will require the Borrower to either (i) return that amount to the Deposit Account for use for eligible goods and services, or (ii) refund the amount directly to the Association, in which case IDA will cancel an equivalent undisbursed amount of the Credit. The supporting documents, such as invoices and evidence of shipment and payment, will be retained by the Project Management Unit (PMU), already established in the MOF under the PESAC operation, for random review by Bank staff and by the auditors. PMU would be responsible for the coordination and collection of relevant documents from the commercial banks and the foreign exchange bureaus.

Management, Reporting and Auditing

123. The National Bank of Kyrgyzstan (NBK) will have responsibility for the overall management of the program. A FINSAC Monitoring Unit (FMU) will be established in the NBK to facilitate and coordinate implementation of the reform program. The FMU will establish and maintain a Management Information System covering all aspects of project implementation. It will submit reports to IDA one month after the end of each quarter, reporting progress in implementation and identifying bottlenecks. The FMU will maintain records of all transactions under the Credit in accordance with sound accounting practices. The Bank reserves the right to request an audit of the project accounts by international auditors acceptable to IDA, in accordance with Bank Group guidelines.

Monitorable Actions and Tranche Release Conditions

124. **Conditions of Board Presentation.** A number of key actions have been completed prior to Board presentation. These are listed below:

Improving the Policy Environment

(a) Government to achieve satisfactory macroeconomic and fiscal performance, including domestic bank financing of fiscal deficit in FY96.

(b) Government to submit to Parliament a Tax Reform Bill, satisfactory to IDA, which: (i) equalizes profit tax of enterprises and banks; (ii) allows banks to take loan-loss provisions against gross income, before tax; and (iii) clarifies whether and which financial transactions are subject to VAT.

(c) Government to submit to Parliament a Tax Reform Bill, satisfactory to IDA, which: (i) cancels the extraordinary powers given to the Tax Inspectorate in February 1994, including in particular the seizure of deposits; (ii) cancels such powers given to other State organs; and (iii) limits the Tax Inspectorate's and other State organs' rights (except NBK's) to obtain information from banks to instances in which due cause justifies an investigation.

Improving the Legal and Regulatory Environment

(d) Borrower to prepare amendments to the Insolvency Legislation to limit the time period given to courts to "one month" (30 days) to approve NBK's request to start the bank liquidation process. Government to submit to Parliament the revised Insolvency Legislation.

(e) NBK to increase the minimum capital requirements from 5 million soms to (10) million soms for local banks, and from 10 million to (20) million soms for foreign banks.

(f) NBK to adopt and implement gradually the Basle guidelines for ongoing capital adequacy (i.e., 8% of risk weighted assets).

(g) Government to prepare and submit to Parliament the draft Law on Pledge, satisfactory to IDA.

(h) NBK to adopt prudential regulations which reduce the single borrower lending limit from 30% to (25%) of capital for new banks, and put a (15%) limit on aggregate lending to shareholders and other insiders. Special donor credit lines would be exempt from this principle.

Restructuring Old Insolvent Specialized Banks

(i) Government to issue a decree establishing a temporary **Debt Resolution Agency (DEBRA)** to help collect or write- off the non-performing loans of intervened banks.

(j) NBK to place the **Agroprombank** under receivership and start the liquidation process.

(k) NBK to place the **Elbank** under receivership and start the liquidation process.

(l) If the management of Promstroi Bank has been unsuccessful in raising capital from negative to "positive" or "zero" level by mid-May 1996, NBK to instruct the bank to present a capital increase plan to be implemented, satisfactory to NBK and IDA, to bring the capital at least to "zero" level by October 31, 1996 and to reach 8% ongoing capital adequacy requirement by March 31, 1997.

(m) If the management of AKB Kyrgyzstan Bank has been unsuccessful in raising capital from negative to "positive" or "zero" level by mid-May 1996, NBK to instruct the bank to present a capital increase plan to be implemented satisfactory to NBK and IDA, to bring the capital at least to "zero" level by October 31, 1996 and to reach 8% ongoing capital adequacy requirement by March 31, 1997.

125. **Conditions for Second Tranche Release**. Disbursement of the Second Tranche, SDR 15.6 million equivalent (US$22.5 million equivalent), anticipated in twelve months after the disbursement of the First Tranche, would be contingent on a review, satisfactory to IDA, of (i) the successful implementation of the reform program as a whole; and (ii) the fulfillment of the specific Second Tranche conditions listed below:

Improving the Policy Environment

(a) Government to achieve satisfactory macroeconomic and fiscal performance, including domestic bank financing of fiscal deficit in FY97.

Improving the Legal and Regulatory Environment

(b) Government to create a central registry system for pledges, satisfactory to IDA, to enforce security rights.

(c) Borrower to enact the Tax Reform Bill, and the new Banking Law, satisfactory to IDA.

(d) Borrower to enact the Law on Pledge and the Revised Insolvency Legislation, satisfactory to IDA.

(e) NBK to introduce the new Chart of Accounts based on International Accounting Standards (IAS) for all commercial banks, and enforce the implementation of these accounts in at least 5 commercial banks.

(f) NBK to enforce 25% maximum single borrower limit to all banks.

(g) Government to complete coupon auctions for all enterprises included in the 1996-97 Privatization Program; and reduce State ownership to a minority share in a minimum of (320) enterprises included in the 1996-97 Privatization Program, except in the major utilities that have individual privatization plans.

(h) ERRA to (i) offer all potentially viable enterprises for sale; and (ii) initiate liquidation procedures for all "old enterprises", and all others slated for liquidation. No funds will be allocated to ERRA enterprises from the 1997 Budget, except for completion of the liquidation process.

(i) Government to fulfill all of the Second Tranche conditions of APEAC, thus enabling IDA to release the Second Tranche of APEAC operation.

Restructuring Insolvent Old Specialized Banks

(j) DEBRA to (i) assess the value of Elbank and Agroprom's assets; (ii) transfer all recoverable loan assets of both banks into the Debt Recovery Unit (DRU); (iii) reduce staff levels and close or sell bank branches for both banks as recommended by NBK Working Group; and (iv) submit a timetable to FINSAC Review Commission and IDA for completion of liquidation of Elbank and Agroprombank.

(k) NBK is due 965 million Soms from Agroprombank. This amount represents a bad debt on the books of NBK. To make the balance sheet of NBK whole again, this amount would be replaced, at the Government's option, by a long-term bond of 965 million Soms at 5% interest rate, as described in the Letter of Financial Sector Development Policy.

(l) If the management of **Promstroi Bank and AKB Kyrgyzstan** have not been successful in raising capital from negative to "positive" or "zero" level by March 31, 1997, NBK to place the bank(s) under formal receivership, to start the liquidation process. If bank(s) have been successful in raising capital to "positive" or "zero" level by March 31, 1997, NBK to instruct the bank(s) to present another capital increase plan to reach 8% ongoing capital adequacy requirement by September 30, 1997.

Resolving the Non-Performing Loans

(m) DEBRA to prepare a report, satisfactory to IDA, classifying the non-performing loans under its control into two categories that will be treated differently: (i) those loans where the work plan for collection will be based on automatic criteria appropriate to the loan category; and (ii) others where a more systematic case-by-case approach is practicable. This report, satisfactory to IDA, will be integrated into the Key Operating Principles of DEBRA.

Encouraging the Growth of NBFIs

(n) Ministry of Finance to review and amend the prudential regulations for "Investment Funds", satisfactory to IDA, with a view to strengthening these regulations; enhance their enforcement; and implement the recently issued Investment Fund Accounting Guidelines.

(o) Government to prepare and submit to Parliament legislation for "Insurance Companies" and "Pension Funds," and "Leasing," satisfactory to IDA.

PART V. BENEFITS AND RISKS

126. **Benefits**. The reform program to be supported by the proposed FINSAC would help create a competitive, sound and efficient banking system in the Kyrgyz Republic. By liquidating insolvent banks and restructuring the problem banks, a smaller, more efficient, better managed, and privately-owned banking system would emerge. A prudent and efficient banking system, together with a sound

policy and regulatory framework and appropriate prudential standards, would improve public confidence in financial institutions. Enforcement of financial discipline resulting from the proposed reforms within the banking sector would encourage a similar discipline within the enterprise sector, fostering a healthy adjustment and renewed growth in this sector, which in turn could contribute to the stabilization objective. In addition, the development and enforcement of a regulatory and supervisory framework along with a supporting policy environment would encourage the development of sound contractual savings organizations such as insurance companies and pension funds, which would be instrumental in mobilizing additional savings. The provision of substantial technical assistance to the financial system, strengthening of accounting, auditing and bank management and training, will have significant benefits for the development of sound credit policies and managerial decision-making in both the banking and the enterprise sectors, as the Kyrgyz economy continues to move away from the practices and constraints of the former Soviet Union. Finally, the proposed Credit would allow increased production and capacity utilization, through the provision of foreign exchange resources and budget support to help finance purchases of inputs, raw materials, spare parts and services.

127. **Risks**. The Credit faces four major risks. The first is that the Government may not be able to achieve one of its critical macroeconomic objectives, namely to sustain macroeconomic stability. High and sustained budget deficits may continue to threaten macro/financial stability and drive up interest rates further. If price stability is not sustained, the lowering of interest rates would be difficult. Therefore, both the reduction of fiscal deficits and their financing through non-inflationary sources are critical elements to the success of the program. The second risk relates to the complexity of undertaking a massive restructuring of the banking system which requires not only the strong commitment of the Government but also the full cooperation of the banks' management. Third, the liquidation of Agroprombank and Elbank, and the downsizing/restructuring of AKB Kyrgyzstan and Promstroi banks, may proceed more slowly than anticipated, if the bank restructuring component encounters political resistance. Fourth and finally, a slowdown or reversal in enterprise reform would have adverse effects on the loan quality of the banking sector, as would delays in the establishment of a framework for secured lending which is outside the control of NBK. The first, third and the fourth risks would be mitigated largely by the Government's strong commitment to the IMF/IDA supported stabilization and structural adjustment programs. Technical assistance to be provided under the Credit would help to reduce the second risk, although would not fully mitigate it. Finally, proposed improvement of the regulatory framework and strengthening of Central Bank supervisory functions are expected to ensure the competitiveness, efficiency, and soundness of the banking system in the future.

PART VI. RECOMMENDATION

128. I am satisfied that the proposed credit would comply with the Articles of Agreement of the Association and I recommend that the Executive Directors approve it.

James D. Wolfensohn

President

Washington, D.C.
May 31, 1996

KYRGYZ REPUBLIC - FINANCIAL SECTOR ADJUSTMENT CREDIT (FINSAC)
SUMMARY OF GOVERNMENT REFORM PROGRAM

OBJECTIVES	MEASURES ALREADY INTRODUCED	FINSAC ACTION PROGRAM	TIMING	CONDITION FOR
		A. IMPROVING THE ENABLING POLICY AND REGULATORY ENVIRONMENT		
		(a) POLICY ENVIRONMENT		
1. Sustain Macroeconomic Stability.	- Monthly inflation in the March-July 1995 period averaged 1 percent. Annual average inflation rate in 1995 was 30 percent.	- Government to achieve satisfactory macroeconomic and fiscal performance, including domestic bank financing of fiscal deficit in FY96.	6/96	Board Presentation
		- Government to achieve satisfactory macroeconomic performance in FY97.	6/97	Second Tranche Release
2. Remove Policy Induced Barriers to Bank Profitability, Efficiency and Security.		- Government to submit to Parliament the Tax Reform Bill, satisfactory to IDA, which: (a) equalizes profit tax of enterprises and banks; (b) allows banks to take loan-loss provisions against gross income, before tax; and, (c) clarifies whether and which financial transactions are subject to VAT.	6/96	Board Presentation
		- Government to submit to Parliament the Tax Reform Bill which: (i) cancels the extraordinary powers given to the Tax Inspectorate in February 1994, including in particular the seizure of deposits; (ii) cancels such powers given to other State organs; and (iii) limits the Tax Inspectorate's and other State organs' rights (except NBK) to obtain information from banks to instances in which due cause justifies an investigation.	6/96	Board Presentation
3. Encourage the development of a competitive market structure for banks by removing entry and exit barriers; simplifying licensing procedures; and promoting the entry of foreign banks.	-The current Law on Foreign Investment (1991) does not create impediments to entry of foreign banks, and provides 5 year tax holiday to foreign investors. - Under the PESAC Reform Program, the Borrower enacted the Bankruptcy Legislation providing exit mechanisms for insolvent enterprises and banks.			
		(b). LEGAL AND REGULATORY ENVIRONMENT		
1. Establish a legal and regulatory framework to ensure prudent banking, and strengthen the powers of NBK as the supervisory authority.	- Under the PESAC Reform Program, the Government prepared draft laws on Company, Lease, Collateral and Public Procurement.	- Prepare amendments to the new draft Banking Law (a) requiring banks to be exclusively joint stock companies; and (b) entitling NBK to set up limitations on Banks': single currency holdings; real estate holdings; dealings in precious metals or jewelry other than	3/96	Appraisal

OBJECTIVES	MEASURES ALREADY INTRODUCED	FINSAC ACTION PROGRAM	TIMING	CONDITION FOR
	-Under the APEAC Reform Program, the Government will submit to Parliament the draft law on Company; the draft law on Collateral providing in particular that land may be used as collateral; the amendment to the Law on Lease; and the draft law on Public Procurement. In addition, the Government will prepare and submit to Parliament a draft Civil Code (Part I), the contents of which will be consistent with the draft laws listed above. Finally the Government will take all the necessary measures to clarify the rights to land and the procedures under which such rights shall be freely transferable.	bullion or coins of a minimum purity; and, transactions with affiliates and other connected parties.		
		- Borrower to enact the Tax Reform Bill and the new Banking Law, satisfactory to IDA.	6/97	Second Tranche Release
2. Enhance the Security in lending. **(a) Strengthen the legal, judicial, and registry framework for the use of pledges and the handling of insolvent borrowers.**		- Government to submit to Parliament the draft Law on Pledge, satisfactory to IDA.	6/96	Board Presentation
		- Government to prepare amendments to the Insolvency Legislation to limit the time period given to courts to "one month" (30 days) to approve NBK's request to start the bank liquidation process. Government to submit to Parliament the revised Insolvency Legislation.	6/96	Board Presentation
		- Borrower to enact the Law on Pledge, and the Revised Insolvency Legislation, satisfactory to IDA.	6/97	Second Tranche Release
		- Government to create a central registry system for pledges, satisfactory to IDA, to enforce security rights.	6/97	Second Tranche Release
(b) Create a viable private sector client base that operates under market principles and seeks profitability.		- Government to complete coupon auctions for all enterprises included in the 1996-97 Privatization Program, and reduce State ownership to a minority share in a minimum of (320) enterprises included in the 1996-997 Privatization Program, except in the major utilities that have individual privatization plans.	6/97	Second Tranche Release
		- ERRA to (a) offer all potentially viable ERRA enterprises for sale; and (b) initiate liquidation procedures for all "old enterprises", and all others slated for liquidation. No funds will be allocated to ERRA enterprises from the 1997 Budget, except for completion of the liquidation process.	6/97	Second Tranche Release
		- Government to fulfill the Second Tranche conditions of APEAC, thus enabling IDA to release the Second Tranche of APEAC.	6/97	Second Tranche Release
3. Tighten Prudential Regulations of Banks.		- NBK to increase the minimum capital requirements from 5 to (10) million soms for local banks, and from 10 to (20) million soms for foreign banks.	6/96	Board Presentation

OBJECTIVES	MEASURES ALREADY INTRODUCED	FINSAC ACTION PROGRAM	TIMING	CONDITION FOR
	- A number of new prudential regulations have recently been adopted by the NBK. These include minimum and ongoing capital adequacy requirements; liquidity ratios and reserve requirements; loan classification and provisioning guidelines; forex exposure limits; and lending limits including lending to shareholders and to a single borrower. Guidelines for problem-bank intervention have also been issued.	- NBK to adopt and implement gradually the Basle guidelines for ongoing capital adequacy (i.e., 8% of risk weighted assets).	6/96	Board Presentation
		- NBK to reduce the single borrower lending limit from 30 to (25) percent of capital for new banks, and put a (15) percent limit on aggregate lending to shareholders and other insiders. Special donor credit lines would be exempt from this principle.	6/96	Board Presentation
		- NBK to enforce 25 percent maximum single borrower limit to all banks.	6/97	Second Tranche Release
4. Strengthen NBK's Bank Supervision capabilities.	- NBK has considerably improved its bank supervision capabilities. The quality of bank supervision in the Republic compares favorably with that of the neighboring countries.	- Further strengthen Bank Supervision Department's capabilities, particularly in the areas of on-site examinations, and problem bank monitoring.		
5. Strengthen Banks Institutionally				
(a) Introduce adequate Bank accounting and auditing		- NBK to introduce the new Chart of Accounts based on International Accounting Standards (IAS) for all commercial banks, and enforce the implementation of these accounts in at least 5 commercial banks.	6/97	Second Tranche Release
(b) Improve clearing and settlement and liquidity management.		- Establish regional clearing houses which would transmit netted end-of-day positions to NBK where the final settlement would take place.		
		B. RESTRUCTURING INSOLVENT OLD SPECIALIZED BANKS		
1. Liquidating Agroprombank	- A "Specialized Audit" of Agroprombank is currently being conducted by an international auditing firm, financed by IDA. It	- Place Agroprombank into formal NBK conservatorship;	3/96	Appraisal
		- Complete diagnostic audit of loan portfolio, and analyze the composition of deposit base;	3/96	Appraisal

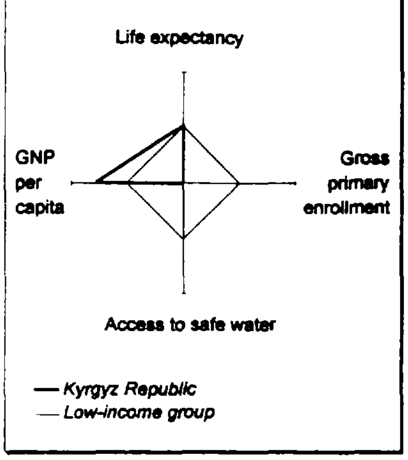
OBJECTIVES	MEASURES ALREADY INTRODUCED	FINSAC ACTION PROGRAM	TIMING	CONDITION FOR
	aims to (a) establish true financial position of the Bank according to IAS; and (b) evaluate its branch network according to criteria specified.	- Establish a Working Group at the NBK to monitor Agroprom branch network analysis carried out by international auditors;	3/96	Appraisal
		- Government to issue a decree establishing the **FINSAC Review Committee**, to be chaired by the Prime Minister, to oversee and coordinate the implementation of the FINSAC Reform Program as a whole.	6/96	Board Presentation
		- NBK to establish the Debt Resolution Agency (DEBRA) to help collect or write-off the old non-performing loans of intervened banks.	6/96	Board Presentation
		- NBK to place Agroprombank under the receivership of Debt Resolution Agency (DEBRA), to start the liquidation process;	6/96	Board Presentation
		- NBK is due 965 million Soms from Agroprombank. This amount represents a bad debt on the books of NBK. To make the balance sheet of NBK whole again, Government to replace this amount by a long-term bond of 965 million Soms at 5 percent interest rate, as described in the Letter of Financial Sector Development Policy (LFSDP).	6/97	Second Tranche Release
		- DEBRA to (a) assess the value of Agroprombank's assets; (b) transfer all recoverable loan assets into the Debt Recovery Unit (DRU); (c) reduce staff levels and close or sell bank branches; and (d) submit a timetable to FINSAC Review Commission and IDA for completion of liquidation of Agroprombank.	6/97	Second Tranche Release
2. Liquidating Elbank	- Elbank is currently under NBK's "Special Care" program, managed by a temporary "NBK Administrator".	- Establish a Task Force in the Elbank to finalize the actual breakdown and amount of deposit liabilities of the bank;	3/96	Appraisal
	- A deposit pay-off scheme is being prepared with TA from British Know-How Fund.	- Complete the design of Deposit Pay-off Scheme;	3/96	Appraisal
		- NBK to place Elbank under the receivership of DEBRA, to start the liquidation process;	6/96	Board Presentation
		- DEBRA to (a) assess the value of Elbank's assets; (b) transfer all recoverable loan assets into the Debt Recovery Unit (DRU); (c) reduce staff levels and close or sell bank branches; and (d) submit a timetable to FINSAC Review Commission and IDA for completion of liquidation of Elbank.	6/97	Second Tranche Release

OBJECTIVES	MEASURES ALREADY INTRODUCED	FINSAC ACTION PROGRAM	TIMING	CONDITION FOR
3. Downsizing and Restructuring Promstroi And AKB Kyrgyzstan Banks	- The Promstroi Bank is currently being audited by International Auditors, financed by ADB.	- Complete the diagnostic audits of Promstroi and AKB Kyrgyzstan Banks;	3/96	Appraisal
	- The AKB Kyrgyzstan Bank is currently being audited by an International Auditing Firm, financed by IDA.	- Banks' Managements (BMs) to enter into a formal letter agreement with NBK to initiate specific actions for the funding of all required loan-loss reserves and write-off of all loss loans against capital account by mid-March 1996;	3/96	Appraisal
		- BMs to write off all loans classified as Loss;		
		- BMs to fund required loan-loss reserves as per NBK classification of remaining loan assets;		
		- BMs and NBK to determine total capital requirements of the bank(s) after above actions are taken to bring bank capital back to at least "zero" level;		
		- If the Management of Promstroi Bank has not been successful in raising capital from negative to "positive" or to "zero" level by mid-May, 1996, NBK to instruct the bank to present a capital increase plan to be implemented. satisfactory to NBK and IDA, to bring the capital at least to "zero" level by October 31, 1996 and to reach 8 percent ongoing capital adequacy requirement by March 31, 1997.	6/96	Board Presentation
		- If the Management of AKB Kyrgyzstan Bank has not been successful in raising capital from negative to "positive" or to "zero" level by mid-May, 1996, NBK to instruct the bank to present a capital increase plan to be implemented. satisfactory to NBK and IDA, to bring the capital at least to "zero" level by October 31, 1996 and to reach 8% ongoing capital adequacy requirement by March 31, 1997.	6/96	Board Presentation
		- If the Managements of Promstroi and AKB Kyrgyzstan Banks have not been successful in raising capital from negative to "positive" or "zero" level by March 31, 1997, NBK to place the bank(s) under formal receivership, to start the liquidation process. If the bank(s) have been successful in raising capital to "positive" or "zero" level by March 31, 1997, NBK to instruct the bank(s) to present another capital increase plan to reach 8% ongoing capital adequacy requirement by September 30, 1997.	6/97	Second Tranche Release

OBJECTIVES	MEASURES ALREADY INTRODUCED	FINSAC ACTION PROGRAM	TIMING	CONDITION FOR
4. Resolving the non-performing loans.		- DEBRA to prepare a report at an early stage, satisfactory to IDA, classifying the non-performing loans under its control into two categories that will be treated differently: (i) those loans where the work plan for collection will be based on automatic criteria appropriate to the loan category; and, (ii) others where a more systematic case-by-case approach is practicable. This report, satisfactory to IDA, will be integrated into the Key Operating Principles of DEBRA.	6/97	Second Tranche Release
		C. ENCOURAGING THE DEVELOPMENT AND GROWTH OF NON-BANK FINANCIAL INSTITUTIONS		
1. Establish Prudential Norms and Regulations for NBFIs.		- Borrower to (a) prepare new legislation for "Insurance Companies" and "Pension Funds"; and (b) improve existing legislation on "Leasing", satisfactory to IDA, and submit these legislation to Parliament.	6/97	Second Tranche Release
		- Ministry of Finance to review and amend the prudential regulations for "Investment Funds", satisfactory to IDA, with a view to strengthening these regulations; enhance their enforcement; and implement the recently issued Investment Fund Accounting Guidelines.	6/97	Second Tranche Release
2. Strengthen Prudential Supervision of NBFIs.	- The state Agency for Securities (SAS) is responsible for regulating and supervising capital markets and their NBFIs.	- Transform SAS into the executive arm of a Securities Commission. Prepare guidelines for its operations, and consolidate the authority for all securities market regulations and their supervision in this institution.		
3. Improve the efficiency and profitability of Kyrgyz Stock Exchange (KSE)		- Encourage Regional cooperation in securities market; - Restore public confidence in Investment Funds. - Create an organized secondary market for T-Bills, to be operated by the KSE; - Issue government bonds directly to the public through the KSE.		

Kyrgyz Republic at a glance

POVERTY and SOCIAL	Kyrgyz Republic	Europe & Central Asia	Low-income
Population mid-1994 *(millions)*	4.5	498	3,176
GNP per capita 1994 *(US$)*	610	2,430	390
GNP 1994 *(billions US$)*	2.7	1,209	1,239
Average annual growth, 1990-94			
Population *(%)*	0.6	0.5	1.8
Labor force *(%)*	..	..	1.8
Most recent estimate *(latest year available since 1989)*			
Poverty: headcount index *(% of population)*	..	..	..
Urban population *(% of total population)*	39	64	28
Life expectancy at birth *(years)*	68	69	65
Infant mortality *(per 1,000 live births)*	36	19	53
Child malnutrition *(% of children under 5)*	..	..	38
Access to safe water *(% of population)*	..	..	67
Illiteracy *(% of population age 15+)*	3	..	41
Gross primary enrollment *(% of school-age population)*	..	97	106
Male	..	97	112
Female	..	97	100

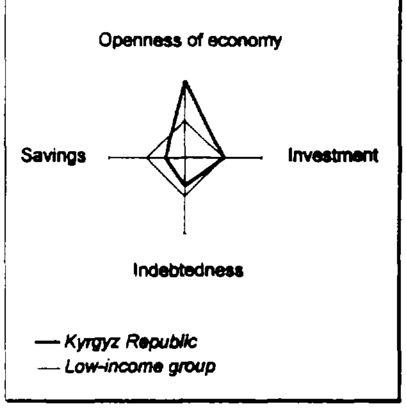


Development diamond*

KEY ECONOMIC RATIOS and LONG-TERM TRENDS

	1975	1985	1994	1995
GDP *(billions US$)*	..	3.0	2.7	..
Gross domestic investment/GDP	..	30.5	..	..
Exports of goods and non-factor services/GDP	..	..	..	..
Gross domestic savings/GDP	..	13.8	..	..
Gross national savings/GDP	..	..	..	..
Current account balance/GDP	..	..	-18.6	-13.5
Interest payments/GDP	..	..	1.6	1.2
Total debt/GDP	..	..	40.6	33.5
Total debt service/exports	..	..	4.9	22.0
Present value of debt/GDP	..	..	..	..
Present value of debt/exports	..	..	122.6	138.4

(average annual growth)	1975-84	1985-95	1994	1995	1996-04
GDP	3.9	-3.7	-26.5	..	..
GNP per capita	..	-4.9	-26.8	..	..
Exports of goods and nfs	..	..	..	..	..



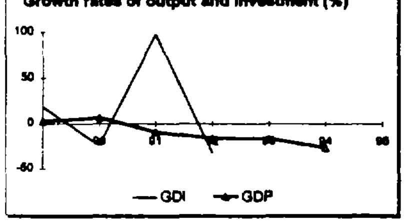
Economic ratios*

STRUCTURE of the ECONOMY

(% of GDP)	1975	1985	1994	1995
Agriculture	..	30.7	37.1	..
Industry	..	..	29.9	..
Manufacturing	..	..	..	..
Services	..	..	33.0	..
Private consumption	..	64.1	..	..
General government consumption	..	22.1	..	..
Imports of goods and non-factor services	..	..	47.7	..

(average annual growth)	1975-84	1985-95	1994	1995
Agriculture	..	..	..	..
Industry	..	..	..	..
Manufacturing	..	..	..	..
Services	..	..	..	..
Private consumption	..	*0.3*	..	..
General government consumption	..	*-1.1*	..	..
Gross domestic investment	..	*8.1*	..	..
Imports of goods and non-factor services	..	..	..	..
Gross national product	..	*-3.7*	-26.5	..

Growth rates of output and investment (%)

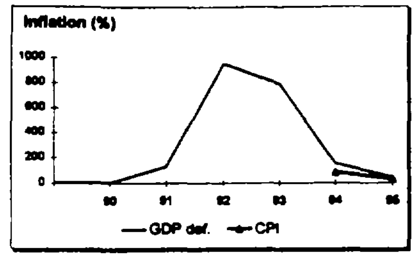


Note: 1995 data are preliminary estimates. Figures in italics are for years other than those specified.

* The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete.

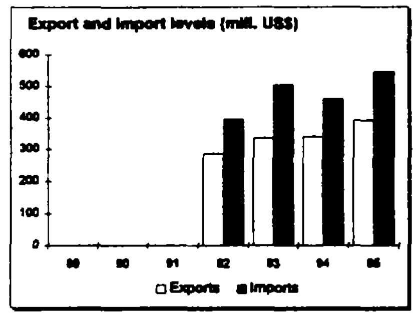
PRICES and GOVERNMENT FINANCE

	1975	1985	1994	1995
Domestic prices				
(% change)				
Consumer prices	..	..	87.2	32.6
Implicit GDP deflator	-2.3	-10.3	155.5	47.6
Government finance				
(% of GDP)				
Current revenue	..	..	21.7	15.7
Current budget balance	..	..	..	..
Overall surplus/deficit	..	..	-8.0	-11.3



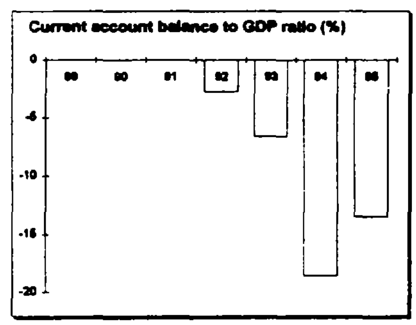
TRADE

	1975	1985	1994	1995
(millions US$)				
Total exports (fob)	..	..	340	391
n.a.	..	..	..	..
n.a.	..	..	..	..
Manufactures	..	..	..	..
Total imports (cif)	..	..	459	546
Food	..	..	..	..
Fuel and energy	..	..	73	39
Capital goods	..	..	..	..
Export price index *(1987=100)*	..	..	..	..
Import price index *(1987=100)*	..	..	..	..
Terms of trade *(1987=100)*	..	..	..	..



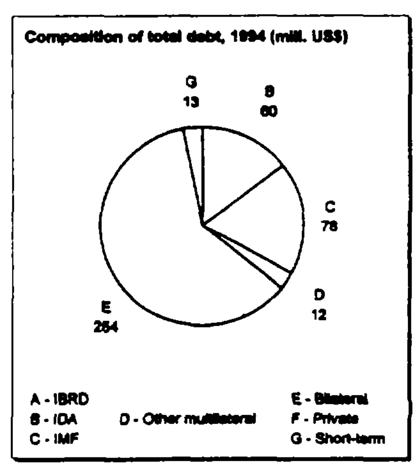
BALANCE of PAYMENTS

	1975	1985	1994	1995
(millions US$)				
Exports of goods and non-factor services	..	..	340	391
Imports of goods and non-factor services	..	..	484	587
Resource balance	..	..	-144	-195
Net factor income	..	..	-17	-22
Net current transfers	..	..	29	79
Current account balance, before official transfers	..	..	-191	-220
Financing items (net)	..	..	227	349
Changes in net reserves	..	..	-18	-45
Memo:				
Reserves including gold *(mill. US$)*	..	..	54	99
Conversion rate *(local/US$)*	..	..	3.9	10.5



EXTERNAL DEBT and RESOURCE FLOWS

	1975	1985	1993	1994
(millions US$)				
Total debt outstanding and disbursed	..	..	291	417
IBRD	..	..	0	0
IDA	..	..	23	60
Total debt service	..	..	5	17
IBRD	..	..	0	0
IDA	..	..	0	0
Composition of net resource flows				
Official grants	..	..	63	77
Official creditors	..	..	94	97
Private creditors	..	..	0	0
Foreign direct investment	..	..	0	45
Portfolio equity	..	..	0	0
World Bank program				
Commitments	..	..	60	95
Disbursements	..	..	23	36
Principal repayments	..	..	0	0
Net flows	..	..	23	36
Interest payments	..	..	0	0
Net transfers	..	..	23	36



Note: Estimates for economies of the former Soviet Union are subject to more than the usual range of uncertainty.

Table A-1. Selected Economic Indicators, 1994-98
(In percent change, unless otherwise indicated)

	1994 Act.	1995 Est.	1996 Proj.	1997 Proj.	1998 Proj.
GDP, nominal (in billions of soms)	11.6	17.4	21.4	24.4	26.5
Real GDP growth	-26.5	1.3	2.4	4.1	5.0
GDP deflator	155.5	47.6	20.3	9.5	3.6
Consumer price inflation (December/December)	87.2	30.3	15.1	8.0	4.0
Average real wage (1992=100)	44.0	51.0	49.0	50.0	50.0
Total revenue (including foreign grants)/GDP	21.7	15.7	17.8	19.1	19.6
Tax revenue/GDP	14.0	13.2	14.5	17.7	18.8
Total expenditure and net lending/ GDP	29.7	27.0	23.3	22.8	22.3
Budget deficit/GDP	-8.0	-11.3	-5.5	-3.7	-2.7
Broad money	125.3	70.1	37.3	28.5	16.2
Net domestic assets of the banking system 1/	83.5	91.4	38.2	25.7	13.8
of which: net credit to Government 2/	45.2	92.1	34.7	15.6	8.5
credit to the economy	62.1	21.1	8.6	12.5	6.4
Velocity of broad money (ratio, end-of-period)	10.2	8.5	7.1	6.3	5.9
Treasury bill rate (per annum, end-of-period)	73.0	29.0	--	--	--
External current account (in millions of U.S. dollars) 3/	-190.6	-219.1	-280.8	-260.6	-251.0
External current account/GDP 3/	-18.6	-13.5	-14.0	-11.4	-10.0
External current account/GDP (incl. off. transfers)	-11.2	-7.2	-9.3	-7.8	-6.8
Gross international reserves (including gold) (in months of imports, end-of-period)	2.6	2.3	3.0	3.4	3.6
External debt outstanding/GDP 4/	40.6	34.0	37.0	40.0	42.6
Debt service (in millions of U.S. dollars) 5/	18.0	88.3	69.4	81.7	89.4
Of which: interest	17.4	21.6	21.3	24.9	28.8
Total debt service/total exports	4.9	22.0	16.9	18.3	18.4

Sources: Policy Framework Paper, 1995-98, Sec M95-1235, Dec. 5, 1995.
1/ As a percent of beginning period broad money.
2/ Includes a credit from Turkey channeled through the NBK to the budget, excludes NBK profit transfers.
3/ Excludes grants.
4/ Includes debt accumulated to fill projected financing gaps.
5/ Includes debt service on financing gap under the assumption of highly concessionary terms.

Table A-2(a). KYRGYZ REPUBLIC: Summary of Government Financial Operations, 1993-96
(In millions of Soms)

	1993 Actual	1994 Actual	1995 Est.	1996 Proj.
Total revenue and grants	1,330.0	2,503.2	2,721.5	3,803.7
Total revenue	868.5	2,200.6	2,624.5	3,537.5
Current revenue	859.9	2,148.0	2,551.4	3,469.9
Tax revenue	771.5	1,615.0	2,291.9	3,109.4
Direct Taxes	300.2	651.3	705.0	1,023.9
Domestic taxes on goods and services	305.3	744.1	1,078.7	1,526.5
Taxes on international trade	30.9	45.5	132.2	--
Other tax revenue	135.2	174.1	375.9	559.1
Nontax revenue	88.4	533.0	259.5	360.5
Capital revenue	8.6	52.6	73.1	67.6
Grants	461.5	302.6	97.0	266.3
Total expenditure	2,103.3	3,431.5	4,685.5	4,983.6
Current expenditure	1,554.6	2,752.3	4,455.0	4,613.2
Wages and salaries	280.9	787.5	1,269.7	1,204.7
Goods and services	350.9	777.8	1,866.3	1,845.2
Subsidies 1/	311.6	319.0	--	--
Transfers 2/	592.5	753.3	1,248.2	1,381.6
Extraordinary fund	18.7	90.5	--	--
Interest on public debt	--	24.2	70.8	181.7
Capital Expenditure	75.0	116.7	108.8	213.0
Net lending	473.7	562.6	121.7	157.5
SURPLUS(+)/DEFICIT(-)	-773.3	-928.4	-1,963.9	-1,179.9
FINANCING	773.3	928.4	1,963.9	1,179.9
External	353.2	515.1	547.9	267.4
New loans	353.2	515.1	1,124.4	745.5
Amortization	--	--	-576.5	-478.1
Domestic	420.1	413.3	1,416.0	912.5
Net Central Bank Credit	373.4	349.1	1,325.0	884.2
New loans	421.3	397.6	1,325.0	884.2
Amortization	-47.9	-48.5	--	--
Net Commercial Bank Credit	46.7	64.2	91.0	28.3
Memo: Grants + New External Loans	814.7	817.7	1221.4	1011.8

Source: IMF, ESAF Board Paper, November 1995

1/ Most direct consumer subsidies were eliminated after 1994. The bread compensation is included in overall transfers.

2/ After 1994, includes budgetary transfers for food or medicine; cash transfers, the bread compensation, supplemental pensions, and social allowances paid from the budgets; and educational stipends.

Table A-2(b). KYRGYZ REPUBLIC: Summary of Government Financial Operations, 1993-96
(In percent of GDP)

	1993 Actual	1994 Actual	1995 Est.	1996 Proj.
Total revenue and grants	23.3	21.7	15.7	17.8
Total revenue	15.2	19.1	15.1	16.5
Current revenue	15.0	18.6	14.7	16.2
Tax revenue	13.5	14.0	13.2	14.5
Direct Taxes	5.2	5.6	4.1	4.8
Domestic taxes on goods and services	5.3	6.4	6.2	7.1
Taxes on international trade	0.5	0.4	0.8	--
Other tax revenue	2.4	1.5	2.2	2.6
Nontax revenue	1.5	4.6	1.5	1.7
Capital revenue	0.1	0.5	0.4	0.3
Grants	8.1	2.6	0.6	1.2
Total expenditure	36.8	29.7	27.0	23.3
Current expenditure	27.2	23.8	25.7	21.6
Wages and salaries	4.9	6.8	7.3	5.6
Goods and services	6.1	6.7	10.7	8.6
Subsidies 1/	5.4	2.8	--	--
Transfers 2/	10.4	6.5	7.2	6.5
Extraordinary fund	0.3	0.8	--	--
Interest on public debt	--	0.2	0.4	0.8
Capital Expenditure	1.3	1.0	0.6	1.0
Net lending	8.3	4.9	0.7	0.7
SURPLUS(+)/DEFICIT(-)	-13.5	-8.0	-11.3	-5.5
FINANCING	13.5	8.0	11.3	5.5
External	6.2	4.5	3.2	1.3
New loans	6.2	4.5	6.5	3.5
Amortization	--	--	-3.3	-2.2
Domestic	7.3	3.6	8.2	4.3
Net Central Bank Credit	6.5	3.0	7.6	4.1
New loans	7.4	3.4	7.6	4.1
Amortization	-0.8	-0.4	--	--
Net Commercial Bank Credit	0.8	0.6	0.5	0.1
Memo: Grants + New External Loans	14.3	7.3	7.1	4.7
(Net of amortization)	(14.3)	(7.3)	(3.8)	(2.5)

Source: IMF, ESAF Board Paper, November 1995

1/ Most direct consumer subsidies were eliminated after 1994. The bread compensation is included in overall transfers.

2/ After 1994, includes budgetary transfers for food or medicine; cash transfers, the bread compensation, supplemental pensions, and social allowances paid from the budgets; and educational stipends.

Table A-3. KYRGYZ REPUBLIC: Balance of Payments Projections, 1994-1998
(In millions of U.S. dollars)

	1994 Actual	1995 Est.	1996 Proj.	1997 Proj.	1998 Proj.
Current account					
(after official grants)	-114.1	-115.9	-186.0	-190.6	-181.0
Trade balance	-119.0	-154.1	-218.2	-220.8	-213.4
Exports	339.9	391.4	418.9	446.0	484.7
Imports	458.9	545.5	637.1	666.8	698.2
Net noninterest services	-7.2	-19.5	-16.1	-1.9	-1.3
Interest payments	-17.4	-21.6	-21.3	-24.9	-28.8
Transfers	29.4	79.3	69.6	57.0	62.5
Capital account	160.5	135.1	196.9	207.0	187.4
Foreign direct investment	44.9	88.2	40.0	42.0	44.1
Commercial banks	4.8	-24.5	--	--	--
Medium- and long-term loans	110.8	71.4	156.9	165.0	143.3
Disbursements (existing and expected)	111.4	138.1	201.0	211.0	191.0
Amortization	-0.6	-66.7	-44.0	-46.0	-47.7
Errors/omissions, short-term capital	9.4	-43.6	--	--	--
Overall balance	55.7	-24.3	10.9	16.4	6.4
Financing	-55.7	24.3	-10.9	-16.	
Increase in gross reserves	-32.1	4.4	-56.3	-30.0	-20.0
IMF	13.8	47.3	45.5	13.5	-12.9
FSU Correspondent accounts	-0.2	--	--	--	--
Change in other liabilities of NBK	-17.7	--	--	--	--
Accumulation of arrears	11.7	-15.1	--	--	--
FSU debt conversion (arrears to stocks)	--	38.7	--	--	--
Inter-FSU enterprises arrears/credit	-31.2	-51.0	--	--	--
Financing gap	--	--	--	--	36.5
Memorandum items					
External debt outstanding	417	542	740	918	1085
Debt/GDP (in percent)	41	33	37	40	43
Debt service ratio (in percent)	4.9	22.0	16.9	18.3	18.4
Gross reserves (months of imports covered)	2.6	2.3	3.0	3.4	3.6
Current account after official grants (in percent of GDP)	-11.2	-7.2	-9.3	-7.8	-6.8
Fiscal balance (in percent of GDP)	-8.0	-11.3	-5.5	-3.7	-2.7
Nongovernment balance (in percent of GDP)	-3.2	4.1	-3.8	-4.1	-4.1

Sources: Kyrgyz authorities; and IMF staff projections.

Table A-4. KYRGYZ REPUBLIC: External Financing Requirements, 1994-98
(In millions of U.S. dollars)

	1994 Actual	1995 Est.	1996 Proj.	1997 Proj.	1998 Proj.
Current account balance, excluding official transfers	-190.6	-219.1	-280.8	-260.6	-251.0
Trade balance	-119.0	-154.1	-218.2	-220.8	-213.4
Exports	339.9	391.4	418.9	446.0	484.7
FSU	222.8	234.2	246.5	263.0	285.2
Non-FSU	117.1	157.2	172.4	182.9	199.5
Imports	-458.9	-545.5	-637.1	-666.8	-698.2
FSU	-264.0	-327.9	-347.1	-363.7	-381.5
Non-FSU	-194.9	-217.6	-290.0	-303.1	-316.7
Net noninterest services	-7.2	-19.5	-16.1	-1.9	-1.3
Net interest	-17.4	-21.6	-21.3	-24.9	-28.8
Net private transfers 1/	-46.0	-20.7	-23.2	-11.0	-5.5
Amortization	-0.6	-66.7	-44.1	-46.0	-47.7
Repurchases	--	--	-4.1	-10.8	-12.9
Change in gross reserves 2/	-45.2	-20.1	-56.3	-30.0	-30.0
Errors, omissions, and short-term capital	9.4	-43.6	--	--	--
Accumulation of arrears 3/	-19.5	-66.1	--	--	--
Debt conversion	--	38.7	--	--	--
Total financing requirements	246.5	376.8	385.3	347.4	341.6
Foreign direct investment	44.9	88.2	40.0	42.0	44.1
Disbursements from existing commitments	246.5	376.8	300.3	184.9	135.6
Grants	76.5	103.2	59.8	--	--
Loans	125.1	185.4	240.5	184.9	135.6
FSU	10.5	--	--	--	--
Non-FSU	114.6	185.4	240.5	184.9	135.6
Bilateral creditors	65.0	40.8	47.1	33.4	20.6
Multilateral creditors	49.6	144.6	193.4	151.5	115.0
Of which: IMF	13.8	47.3	49.6	24.3	--
World Bank	35.8	59.3	64.4	40.9	38.6
Other	--	38.0	79.4	86.3	76.4
Disbursements from expected new commitments 4/	--	--	45.0	120.5	161.8
Grants	--	--	45.0	70.0	70.0
Loans	--	--	--	50.5	91.8
FSU	--	--	--	--	--
Non-FSU	--	--	--	50.5	91.8
Bilateral creditors 5/	--	--	--	--	39.0
Multilateral creditors	--	--	--	50.5	52.8
Of which: IMF	--	--	--	--	--
World Bank 6/	--	--	10.0	50.5	43.5
Other	--	--	--	--	9.3

Source: Policy Framework Paper, 1995-98, Sec. M95-1235, Dec. 5, 1995.
1/ Includes migrants' transfers.
2/ Excluding monetization of gold; including commercial banks.
3/ Includes inter-enterprise arrears
4/ Includes commitments pledged during the May 1995 Consultative Group Meeting
5/ Additional financing required to close financing gap, assumed to be covered by bilateral donor support on concessional terms.
6/ Includes FINSAC ($45 M) and Inter-Governmental Fiscal Relations (FY97 - $30 M)

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ANNEX B: FINANCIAL SECTOR INDICATORS

Table B-1. Monetary Survey

Som (millions)	*1993*			*1994*				*1995*	
	June	*Sept*	*Dec*	*Mar*	*June*	*Sept*	*Dec*	*Mar*	*June*
1. National Bank									
Net foreign assets	-436	-528	-704	-665	-772	-547	-292	-505	-433
Medium-term NBK obligations	-7	-23	-77	-188	-223	-262	-266	-287	-290
Net domestic assets	717	1019	1302	1519	1741	1784	1627	1978	2176
Credit to govt. (net)	395	481	522	725	626	702	871	1250	1387
Credit to other govt. (net)	0	0	-1	-2	-4	-4	-3	-1	0
Counterpart funds	0	-34	-27	-21	-15	-41	-251	-265	-62
Credit to banks	526	813	1082	1281	1342	1265	1262	1271	1218
Other items (net)	-204	-241	-275	-464	-206	-138	-252	-277	-343
Liabilities	273	468	522	668	796	975	1068	1185	1453
Currency in circulation	181	294	405	519	702	862	1022	1036	1313
Reserves	93	174	117	104	92	109	46	149	140
2. Banking System									
Net foreign assets	-354	-422	-580	-524	-560	-417	-181	-303	-298
Medium-term NBK obligations	-7	-23	-77	-188	-223	-262	-268	-287	-290
Net domestic assets	863	1147	1359	1552	1861	1971	1976	2289	2578
Credit to govt. (net)	350	555	559	711	671	747	940	1322	1437
Credit to other govt. (net)	-25	-31	-33	-31	-39	-33	-49	-58	-76
Counterpart funds	0	-34	-27	-21	-15	-41	-251	-265	-62
Credit to the economy	867	1042	1509	1866	2335	2585	1901	2084	2205
Other items (net)	-328	-385	-650	-974	-1091	-1287	-566	-795	-925
Liabilities	502	702	702	840	1079	1293	1529	1699	1990
Currency outside banks	157	287	398	496	692	850	1002	1015	1292
Deposits	345	415	304	344	387	443	527	684	698
Demand deposits	232	214	144	173	168	200	390	480	484
Foreign currency deposits	47	131	72	70	77	76	96	151	148
Time, term and other deposits	66	70	88	101	142	167	41	53	66
Memo items:									
Household deposits	42	47	58	65	107	127	158	n.a.	202
Total deposits as % of GDP	9.5	6.4	3.1	3.4	3.7	4	4.4	5.1	5
Currenty as % of GDP	4.4	4.4	4.1	4.9	6.7	7.7	9.1	7.5	9.3
Real currency	100	88	64	58	70	82	87	76	93
Real MO	100	92	55	46	52	61	80	57	68
GDP at end quarter	3622	6458	9688	10080	10358	10982	11640	13528	13951

Table B-2. Credit Auction and T-Bill Rates

% per annum		NBK Credit Auction		Treasury Bill rates	Real Credit Rate Compound		Real Treasury Bill rate Compound	
		Simple interest	*Compound interest*	*Compound interest*	*Realized*	*Ex ante**	*Realized*	*Ex ante**
	Feb	90.2	125.6		-77	-94		
	Mar							
	Apr							
	May	110.5	165.3	91.7	-63	-72	-73	-80
1993	June	105.5	155.1	98.8	-78	-66	-83	-74
	July			100.1			-91	-71
	Aug	140.5	233.4	105.3	-85	-53	-90	-71
	Sept	190.1	373.7	202.7	-62	-60	-76	-74
	Oct	276.8	719.6	373.2	28	-62	-26	-78
	Nov			373.3			-13	-78
	Dec			272.4			-7	-70
	Jan							
	Feb			358.3			148	-15
	Mar			426.8			230	31
	Apr	158.0	278.7	396.7	158	26	238	65
	May	128.8	205.4	303.4	123	65	194	118
1994	June			287.5			222	143
	July	144.5	243.4	274.3	162	134	186	155
	Aug	178.6	337.8	241.4	215	219	146	149
	Sept	130.5	209.4	248.6	95	157	120	190
	Oct	111.6	167.6	159.7	56	104	51	98
	Nov	77.7	103.4	105.6	3	46	4	48
	Dec	89.5	124.3	73.1	23	41	-5	9
	Jan	87.0	119.7	72.1	54	28	20	0
	Feb	81.9	110.6	68.3	80	7	44	-15
	Mar	90.3	125.7	50.7	100	24	33	-17
	Apr	74.4	97.8	37.4	78	38	23	-4
	May	68.1	87.6	34.7	78	60	28	15
1995	June	67.6	86.7	29.2	75	65	21	14
	July	55.6	68.3	29.1	51	51	16	16
	Aug (first week)	36.3	41.5	28.9	23	34	12	22

Source: IMF; Mission Calculations.
Note: Ex ante rates based on prior 3-months inflation.

Table B-3. Bank Interest Rates and Intermediation Margins
(5/30/95)

Simple Interest	*Lowest*	*Highest*	*Mean*	*Median*	*No. of banks*
Treasury Bill rate (3 months)			29.4		3
Refinance credit rate			67.6		
Lending rates:					
Interbank	70	120	98.0	90.0	5
Industry	63	160	102.8	100.0	7
Commerce	80	200	123.9	125.0	11
Deposit rates:					
Household 3 months	40	80	52.3	50.0	8
Enterprise 3 months	40	66	53.7	50.0	7
US dollar (3 mo hh)	5	35	15.1	14.3	6
Intermediation spread:					
Industry lending (average)			49.1	50.0	
Industry lending (by bank)	3	115	50.8	42.5	4
Commerce lending (by bank)	40	115	73.8	70.0	5

Source: Bankovskiy Vestnik 6/95; Mission Calculations.

Table B-4. The Financial Status of the "Big Four" Banks
as of 3/31/95

(Som million)	Gross Loans (Principal) /a	Thereof: Non-Performing (Doubtful or Loss) /b	Non-Perform. as % of Gross Loans /b	Required Loan Loss Reserve /b	Client Deposits	NBK Credit	Capital (after adjustment for Required Loan Loss Reserve)
Elbank	140	137	98%	134	92	--	-145
AKB	222	115	52%	120	159	94	-94
Promstroi	97	64	66%	50	122	63	-23
Agroprom	1,054	1,030	98%	1,009	140	980	-953
Total Big Four	1,513	1,336	91%	1,313	513	1,137	-1,215
Percent of GDP	11.2%	9.8%		9.7%	3.8%	8.4%	-9.0%
Comparison: All Smaller Banks	356	n.a.	n.a.	149	209	132	-75

/a Interest receivable, to the extent shown in the balance sheet, is counterbooked with an equivalent entry among liabilities. These amounts shown seem to amount to 1/3-1/3 as much as principal; further interest receivable has not yet fallen due or has been kept of the books.

/b Approximate estimates based on the classification, according to NBK methodology, of a large part of the gross loans by 3/95, or of all gross loans by 6/95 (or, in case of AKB by 1/95, for want of recent data).

Table B-5. The Financial Status of the "Big Four" Banks
(as of 10/31/95)

(Som million)	Gross Loans (Principal) /a	Thereof: Non-Performing /b	Non-Perform. as % of Gross Loans /b	Required Loan Loss Reserve /b	Client Deposits	NBK Credit	Capital (after adjustment for Required Loan Loss Reserve) /c
Elbank	179	173	97%	112	98	--	-109
AKB	216	195	90%	139	183	--	-73
Promstroi	101	72	71%	49	159	59	-25
Agroprom	1,036	1,013	98%	1,013	70	965	-971
Total Big Four	1,532	1,453	95%	1,313	510	1,024	-1,178
Percent of GDP							
Comparison: All Smaller Banks	367	n.a	n.a	131	317	106	-44 est.

/a Interest receivable, to the extent shown in the balance sheet, is counterbooked with an equivalent entry among liabilities. These amounts shown seem to amount to 1/3-1/3 as much as principal; further interest receivable has not yet fallen due or has been kept of the books.

/b Approximate estimates based on the classification, according to NBK methodology, of a large part of the gross loans at 10/95.

/c Excluding 1995 losses.

Table B-6. Profile of the New Banks
(as of 3/31/1995; Som million)

	Assets	Loans Gross (a)	LLR Requ'd. by NBK /a (b)	Loans Adj'd. /a (c=a-b)	Cust. Depos.	Due to NBK	Capital Adj'd. (based on c)	Owners upon Founding	Owners by 3/95
Maksat	94	39	9	30	48	5	18	State Enter-prises	Foreign (maj.)
Dyikan	na.	76	50	26	8	12	-48	State ?	Public / Private
Vneshecon	na.	56	32	24	16	31	-16	State ? (USSR)	... (maj.) (under ERRA)
Orient	58	24	1	23	27	0	19	Private	Foreign (maj.)
Auto	29	22	9	13	17	4	1	State (MoTransp.)	Public & Private Firms
Kurulush	31	18	2	16	16	1	4	na.	Foreign (min.)
Akniyet	na.	26	10	16	6	16	-12	State (MoTrade)	Public & Private Firms
Issykul	62	17	2	15	14	0	9	Private	Private (maj)
Kramds	28	18	1	17	8	3	11	Foreign	Foreign (min.?)
Hen Fen	34	20	5	15	16	0	6	Foreign	Foreign (fully)
Adil	na.	24	21	3	13	59	-69	State	Foreign (maj.)
Energo	na.	6	3	3	8	0	-8	State Enter-prises	State Firms (maj.)
Mercury	16	6	3	3	10	0	4	Private	Private (maj.)
Kyrgjer	15	4	1	3	2	1	6	Foreign (?)	Foreign ? (maj)
TOTAL	>500	356	149	207	209	132	-75		
% Sector	n.a.	19%	10%	51%	30%	10%	n.a.		
% GDP	>3.7%	2.6%	1.1%	1.5%	1.5%	1.0%	0.5%		

/a Based on the loss loan provisioning required by NBK. The loan classification is based on the loan repayment record. The extent to which interest receivable, loan collateral quality, reserve requirements for contingent liabilities, and interbank loans and their quality are taken into account remains to be clarified.

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ANNEX C

Table C-1: Estimated First Year Costs
If Banks Other Than Elbank Were to be Restructured by Government Bonds
(Som millions)

Bank Name	Deposit Payout/a	NBK Assistance	Government Bonds	Interest Burden of Bonds /c	Severance Payments /d	Central Budget Resources (1st year)
Agrombank	60		965 /e	15	2	77
Elbank	122 /b	50				122
Promstroi Bank			15	4		7 /f
AKB Kyrgyzstan			160	40		72 /f
Total	182	50	1,574	59	2	278

/a The cost of the deposit payout will be net of liquid assets.

/b The approved deposit payout plan for Elbank includes 105 million soms of principal and 17 million soms of accrued interest.

/c In the case of Agroprombank, interest payable in the first year of the program is calculated at a simple interest rate of 5%; the interest burden is reduced by the remittance to the budget of 70% of NBK's profit. For the other banks the interest rate is calculated at 25%.

/d Estimated at 750 soms per month for two months for each staff member.

/e Amount placed with NBK to remove bad debt due from Agroprombank.

/f The resources required in the first year for both Promstroi and AKB include both interest and the cost of amortizing the bond.

Table C-2: Estimated First Year Costs if Three Banks Were To Be Liquidated
(Som millions)

Bank Name	Deposit Payout/a	NBK Assistance	Government Bonds	Interest Burden of Bonds /c	Severance Payments /d	Central Budget Resources (1st year)
Agrombank	60		965 /e	15	2	77
Elbank	122 /b	50			2	124
AKB Kyrgyzstan	138					138
Total	320	50	965	15	4	339

/a The cost of the deposit payout will be net of liquid assets.

/b The approved deposit payout plan for Elbank includes 105 million soms of principal and 17 million soms of accrued interest.

/c Amount of interest payable in the first year of the program at a simple interest rate of 5% for Agroprombank will amount to 48 million soms; since NBK remits to the budget 70% of its profits, 34 million soms will be remitted for a net interest burden on the budget of 15 million soms.

/d Estimated at 750 soms per month for two months for each staff member.

/e Amount placed with NBK to remove bad debt due from Agroprombank.

Financial Costs of Bank Liquidation and Restructuring
Explanatory Notes to Table C-1

Bank Liquidation. The Government's potential obligation for the protection of *Agroprombank* depositors is estimated at 60 million Soms, as of March 1, 1996. This amount assumes that current liquid assets of 30 million Soms will first be used to pay off an equivalent amount of liabilities and that depositors will be protected for the full amount of their deposits. Severance payments to staff will add an additional 2 million Soms, such that the total cost of resolving this failure will approximate 62 million Soms. In addition, NBK is due 965 million Soms from Agroprombank. This amount represents a bad debt on the books of the NBK. To make the balance sheet of the NBK whole again, this amount would be replaced, by a long-term Government bond of 965 million Soms at a nominal interest rate to be determined. A 5% interest rate would result in an annual cost to the budget of 48 million Soms. However, since the NBK is required to remit 70% of its profits back to the budget, the net cost to the budget will be on the order of about 15 million Soms annually. As collections are made from liquidated assets received from Agroprombank, the monies will go to the budget to retire these bonds and reduce the Government's interest payments to NBK.

The Government's obligation, as owner of the *Elbank*, is the payout of principal and interest to depositors. In this regard, a deposit payoff plan will be formulated and implemented, beginning in February 1996. Under this deposit payoff plan, principal obligations are 105.1 million Soms and interest obligations 16.9 million Soms totalling 122 million Soms.NBK has provided 50 million Soms from own reserves to bridge this deposit payoff scheme until the counterparts from FINSAC will be available to the budget. If necessary, this support will continue until the first tranche of FINSAC is disbursed and NBK is reimbursed. There could also be recoveries from the assets of the Elbank that would be used to meet this deposit payoff plan, pay other obligations of Elbank to commercial and Government social institutions and staff layoff costs. These recoveries are estimated to cover all the other liabilities and expenses of the liquidation of the bank. Thus, the final cost to resolve Elbank's insolvency is estimated at 122 million Soms comprising of the household deposit payoff plan.

Bank Restructuring. The *Promstroi* Bank will be recapitalized by its own shareholders and the retention of earnings. If successful, there will be no cost to the Government. This alternative appears attainable and is the preferred option. At present, the Promstroi Bank requires 15 million Soms to bring its capital to a positive level, and 24 million Soms to reach 8% capital adequacy requirements. Provided that the problems with its directed credits to Naryn Hydro and Kyrgyz Gas are resolved, the bank will be able to recapitalize itself by its shareholders. However, should this approach prove unsuccessful, the Government is faced with two choices: (i) to restructure the bank by issuing bonds to remove bad assets, thus making the bank more attractive for new investors to acquire the bank and provide new capital; or (ii) to liquidate the bank. Of the latter two alternatives, the first choice, i.e., restructuring the bank by issuing bonds to remove bad assets, is the least costly alternative. The potential obligation of the Government to restructure the bank and protect depositors would be the interest burden on Government bonds and the cost of retiring the bonds issued. If the Government decides to eliminate the negative capital of 15 million Soms by issuing bonds, then the cost to the Government would be the cost of retiring the bonds plus the interest costs. If a 5-year bond is issued, bearing interest rate at 25%, the cost of the interest and of retiring the bonds for the first year of the program would be 7 million Soms, with a total cost over 5 years of 26 million Soms (See Annex C, Table 1).

If *AKB* is successful in seizing and selling collateral and raising new capital from shareholders and retained earnings, there will be no cost to the Government. If the Bank is unsuccessful in raising capital, the Government will again have two choices: (i) to restructure the bank through a bond issue used to remove bad assets and to recapitalize the bank by new private investors; or (ii) to liquidate the bank. Under the first approach, the cost to the government would be the principal of the bonds of 160 million Soms (the negative capital as at June 30, 1995 reported by the diagnostic audit) plus interest. Assuming that these bonds carry 25% per year interest and are retired in equal installments over the five years, their cost in the first year would be 72 million Soms with a total cost to the Government of 272 million Soms over five years. Instead of the bond issue, if the bank is liquidated, the Government will have to decide whether or not the depositors and the NBK will be protected in full principal amounts payable by the bank instead of waiting for the liquidation proceeds from the bank to be used to pay off these liabilities. The cost to pay off the depositors and NBK immediately and in full principal is estimated to be 138 million Soms (160 million Soms of deposits plus 23 million Soms due to NBK minus 45 million Soms of cash and liquid assets of the bank as of March 1, 1996). The rest of the recoveries from the liquidation of AKB Kyrghzstan Bank would be used to pay the rest of the liabilities of the bank. (See Annex C, Tables 1 and 2).

April 12, 1996
Bishkek

KYRGYZ REPUBLIC
Financial Sector Adjustment Credit

ANNEX D: DEBT RESOLUTION AGENCY (DEBRA): KEY OPERATING PRINCIPLES

Introduction

1. Under the Financial Sector Reform Program to be supported by FINSAC, the Government will establish the Debt Resolution Agency (DEBRA), to act in the capacity as receiver on behalf of the National Bank of Kyrgyzstan (NBK) to take control over and dispose of the assets and liabilities of some of the former Kyrgyz state-controlled commercial banks. The banks so identified will have been deemed insolvent by the NBK and their assets, primarily non-performing loans (classified as doubtful or loss by the NBK), will be subject to resolution and ultimate disposition, while their liabilities, primarily deposits, will be subject to scheduled payout programs.

2. DEBRA's primary tasks, as agent of the NBK, will be: a) to act as receiver to take possession of the assets and liabilities of the intervened banks, and to dispose of them in accordance with insolvency legislation; and b) to take title of and control over the non-performing loan portfolios and other assets deemed appropriate of these banks, by transferring these portfolios and assets to DEBRA's Debt Recovery Unit (DRU).

3. It is envisioned that the scope of DEBRA's activities initially will encompass the ultimate intervention and rationalization by the NBK of at least two of the four largest formerly state owned or controlled commercial banks in the Kyrgyz Republic. The list could be expanded to include any other Kyrgyz banks or specific loan assets of other banks, so identified by NBK during the finite life of DEBRA. The DEBRA mandate is to be for a maximum period of three years from May 1996, in accordance with a presidential decree.

Working Assumptions

4. As referenced above, DEBRA's operations will comprise two areas: a) the receivership function where DEBRA, through its Bank Restructuring Unit (BRU), will act as agent for the NBK (which has the legal authority to intervene in a bank as a receiver) in assisting its intervention, receivership, conservatorship, deposit payout, and liquidation activities; and b) the debt recovery function where DEBRA, through its Debt Recovery Unit (DRU) will manage, collect, restructure, liquidate, and resolve the non-performing loan portfolios and other assets assigned of the intervened banks.

5. DEBRA's BRU may be comprised primarily of the current NBK liquidation personnel, either through transfer or temporary assignment, as determined by the NBK. Additional staff, if needed, would be recruited from outside banking and financial sources at the commencement of DEBRA's operations. Two foreign advisors, experienced in debt recovery methodologies, receivership procedures, and bank liquidations, will be recruited under the FINSAC TA Program to assist the NBK staff.

6. DEBRA's DRU may be comprised of available, qualified NBK and Ministry of Finance (MOF) staff. Additional staff, as needed, would be recruited from outside banking and financial sources at the commencement of DEBRA's operations. Two foreign advisors, experienced in debt work outs and debt recovery, will be recruited under the FINSAC TA Program to assist the DRU staff.

7. DEBRA will have authority to contract for personnel resources and office quarters as needed to perform orderly liquidation and asset recovery operations. This would include contracting with former bank employees and leasing former bank quarters from the Receiver as needed.

Organizational Responsibilities

8. Operationally, DEBRA will be headed by a Director who will report to the Chairman of NBK. The Director will manage the day-to-day activities through two deputy directors. The first Deputy will represent DEBRA in the absence of the Director.

9. Decision(s) as to which banks will be liquidated will rest solely with the NBK. Assets to be transferred to DEBRA will be determined by joint efforts of NBK and the MOF, and approved by the FINSAC Review Committee, in accordance with established policies and procedures.

10. The FINSAC Review Committee, to be established by a Presidential Decree, will have the responsibility of overseeing the implementation of key Government decisions under the FINSAC Reform Program. It will be chaired by the Prime Minister or his designee. The membership of the Committee will be comprised of the Chairman of NBK, Minister of Finance, Minister of Economy, Minister of Agriculture, Minister of Justice, Chairman of State Property Fund, and Director of DEBRA.

11. It is vitally important to the effective operation of DEBRA that the BRU and the DRU work together in a totally integrated manner at least until the loan records are sufficiently organized and administrative arrangements are in place to allow active negotiations with borrowers to commence. An extended period of no less than 6 months of integrated operations is essential in order to prepare the way for an effective debt recovery program. After this period if the BRU and DRU wish to proceed with somewhat more autonomy, prior approval of the FINSAC Review Committee will be required. The FINSAC Review Committee should first satisfy itself that the following tasks have been completed:

- Identify and locate loans and assets to be transferred to the DRU;
- Locate and take control of appropriate loan files (including credit, collateral, legal etc.);
- Identify other needed records such as accounting, payment, etc.;
- Determine office facilities to be maintained to accommodate borrowers in certain regional locations;
- Interview bank management and loan personnel who have knowledge of the loans, assets and associated borrowers;
- Contract or make other firm arrangements as appropriate with specific bank personnel to be retained as contractors/employees of DEBRA due to their knowledge of loans/borrowers or collection expertise;
- Identify and locate collateral; and
- Identify specialized equipment held by the bank that may be needed in the loan/asset disposition process.

12. The Committee should also satisfy itself that, if necessary, an appropriate coordinating mechanism is in place to ensure the continued operation of the debt recovery program in the most effective and cost efficient manner.

13. DEBRA will cooperate in any required audit of its operations and submit periodic reports required by NBK's Board and the Government in accordance with existing laws and regulations covering such activity.

Operations

14. **Bank Restructuring Unit. (BRU).** The BRU, through its appointment as agent for the NBK, will act in the capacity of Receiver for all of the assets and liabilities of the intervened banks, in conformance with Kyrgyz insolvency legislation and regulations. It will coordinate its activities with the Bank Supervision Department of the NBK to:

Prepare orderly liquidation procedures, in accordance with established NBK guidelines, including deposit payouts, conversion of liquid assets to cash, disposal of fixed assets, etc.;
Effect the transfer of non-performing loans and other selected assets to the DRU;
Initiate such legal actions as are appropriate in its role as Receiver;
Conduct such other receivership activities as called for in established liquidation policies and procedures.

15. The Receiver, as agent of the National Bank, will replace the former management of the intervened bank, have sole responsibility for the continued operations of the intervened bank, and oversee the orderly liquidation of that bank until final resolution.

16. **Debt Recovery Unit (DRU).** The DRU will act as the vehicle through which all recoveries are made by the Government, and various other classes of creditors, by collection, restructuring, and resolution of outstanding balances of the intervened banks' non-performing loan portfolios and other assets assigned.

17. The primary debt collection philosophy of DRU will be to seek to the most expeditious and cost effective methods practicable and utilize pre-determined criteria for debt resolution wherever possible. Initially DRU will need to establish work-out teams for different types of credits and develop an analysis base from which credits can be placed into selected categories for resolution. To the maximum extend possible, loans will be classified and placed into categories which will allow the application of pre-determined "automatic" methodologies for restructure, and resolution under a variety of programs.

18. The "automatic" criteria to be applied to the loans assigned to DRU will include such concepts as the ability to negotiate with the borrower in a flexible manner including the extension of repayment terms, the possible forgiveness of accrued interest, and/or a partial or total forgiveness of loan balance principal, an acceptance of collateral as total repayment of debt, and/or a combination of debt for equity swaps. DRU management will be innovative and flexible in its application of "automatic" criteria.

19. The analysis and review techniques of the DRU would include, as applicable:

A familiarization with the borrower and its operations;

A review and assessment of the borrower's financial statements, tax returns and any other available relevant data;

An evaluation of collateral, and personal and/or third party guarantees;

Any cash flow projections available to assess realistic repayment prospects of some or all debt (principal and interest).

20. In keeping with the primary principle of following the most cost effective policies for debt recovery, certain debt collection and disposition principles would be established:

Certain loan debt may be forgiven as appropriate and in accordance with outstanding Government decrees or in the best interest of the economy, such as small farmer agricultural loans;

Certain loan debtors may be given discount for timely payment, such as privatized enterprises that can make short term periodic payments (such as a 25% discount for total payoff within a set time period, or a 5% to 10% discount for each payment made on a timely basis over a set number of loan payment periods that will totally liquidate the debt);

Debt for equity swaps could be considered for debtors deemed to be viable for long term growth but who do not have the ability to pay high interest loans on a current periodic basis and could be profitable if relieved from heavy bank debt burden;

Certain loan debtors could be required to pay full debt, such as newly privatized firms that assumed the bank debt as part of the auction/bidding investment process. To relieve this debt could be viewed as showing preferential treatment as other investors may have paid more for the enterprise if they knew debt relief would be forthcoming;

Negotiation with Government entities, for payment of guaranteed or directed debt;

Swap of collateral for debt, for those enterprises that have marketable collateral that can be sold easily (for example, a firm in a traditional agricultural region that has computers which can't be sold easily in that region, but which the DRU could easily sell in an urban area such as Bishkek);

Restructure of debt. This would include the following options:

a) Rescheduling of debt, i.e. extension of loan maturities, balloon payments, interest rate relief, etc.;

b) Requesting additional collateral, guarantees, setting up of accounts receivable, financing, etc.;

c) Negotiating payments and compromise of principal and/or interest through performance discounts, partial debt forgiveness, etc.

These recovery options could be considered for enterprises which are having trouble meeting current debt payment requirements but which could perform some other commitment which may not generate full debt recovery: Restructured recovery of non-performing debts would benefit the economy and yield more than could can be expected through recovery in a bankruptcy action. This type of action may be appropriate for large agricultural farming enterprises that can only pay when crops are harvested and sold; foreclosure of the property would most likely yield less as there is no market for the vast amount of land and equipment that would have to be sold in an already saturated market.

Bankruptcy of the debtor. Although this should usually be a last alternative, it is certainly appropriate in those cases where a debtor refuses to work with the DRU to settle the debt in any other way. Also, this may be appropriate when this is the only way to obtain control of marketable collateral (such as commodities like food products or seasonal harvest product, and easily moved items such as automobiles, office equipment and farm equipment) in a timely manner.

21. It should be noted that a combination of two or more of the above alternatives may be used in a given situation, (such as some partial debt relief, some collateral swap, and a restructure of remaining debt).

22. After a loan has been identified and classified by the DRU staff, a recommended course of action will be developed for presentation to DEBRA management in accordance with established delegations of authority for consideration and final disposition.

23. Even in the instances of those state-enterprise loans and other directed credits where no recovery potential exists, a recommendation will be made and approved in accordance with established delegations of authority to write off uncollectable principal and interest.

24. It will be a condition of second tranche release of the FINSAC credit that DEBRA management will submit, for approval by the NBK, FINSAC Review Committee, and IDA a comprehensive report of its findings, initial loan classifications, and recommendations for the recovery of loans under either a case-by-case or "automatic criteria" approach. It has been agreed with NBK management that in fact, this report will be prepared and submitted as soon as possible after the inauguration of DEBRA. Further DEBRA will provide periodic reports as to its progress in debt collection and recovery to both the FINSAC Review Committee and IDA.

Liquidation and Asset Disposition Policies

25. Appropriate policies for liquidation and disposition of assets will, as established by the NBK, include the following guidelines and principles:

Those assets which remain in the receivership, i.e. liquid assets such as cash, investments, securities, etc., and fixed assets such as buildings, equipment, etc., will be disposed of as expeditiously as possible in accordance with agreed upon timetables and liquidation procedures established in connection with the Bank Supervision Department of the NBK and the Receiver. The disposition of the fixed assets may be accomplished through sealed bids, public auctions, packaged asset-sales, or any such other means as appropriate. However, these assets are not to be retained within the Receivership beyond a time frame considered to be reasonable and proper. In any event, all receivership assets are to be liquidated and the proceeds remitted to the proper authorities by the termination date of DEBRA's mandate.

Those assets in the form of non-performing loans and other assets assigned to the DRU will be dealt with in the most cost effective method possible, including:

restructuring which places the loan on a performing basis;

a partial forgiveness of either interest and/or loan principal and the restructuring of the remaining loan balance;

liquidation through collection efforts and/or sale of collateral; or sold through the sealed-bid process, auctions, or packaged sale mechanism to interested buyers or investors;

write-off of all uncollectable principal and interest.

Those loans which are restructured to become performing will be offered for sale either to other financial institutions or public/private investors under terms to be established by the DEBRA management, in consultation with the NBK and IDA. In any event, all DRU assets are to be recovered, sold, or written off and the proceeds remitted to the central Government budget authorities by the termination date of DEBRA s mandate.

Debt Recovery Principles

26. Certain categories of loans can be treated in various ways to effect debt recovery or resolution. Due to likely personnel and time constraints, debt recovery programs involving standardization and "automatic criteria" which streamline debt recovery actions will be used to the extent possible. It is recognized by NBK management that dealing with hundreds of loans and borrowers on a case-by-case basis may well prove to be a monumental and counterproductive effort, with positive results unattainable within the expected life span of the proposed Debt Resolution Agency (DEBRA).

27. In any instance where the loan is not performing according to terms, the NBK/DEBRA will need to issue instructions telling debtors they will **not** be allowed to borrow from other banks until some acceptable debt resolution is worked out on the current outstanding bank debt. Debt recovery principles will include a combination of the following actions:

Full Payment. This should be the primary objective in all borrower negotiation efforts. However, for various reasons, it will not be practical in most cases because of the actual collectability of the credit and the current economic situation. Therefore other alternatives, such as those described below, will need to be considered.

Debt Forgiveness. In accordance with outstanding or future Government decrees, the Government may decide to forgive some or all of certain portions of debt. Such debt as excessive accumulated interest may be forgiven to give incentive for payment of principal. There may also be certain types of loans, such as peasant farm and small agricultural business loans, and those that are directly attributable to previous Government policies of price intervention for social protection, such as bread subsidy, that may be forgiven totally in the best interest of the economy.

Discounts. In order to give borrowers an immediate incentive to pay their debt, discounts against outstanding principal should be considered. These could be in the form of one time discounts (such as a 25-50% discount against principal, for full payment within a certain stated time period, or time sensitive discounts, where a certain percent (such as 10-20%) discount will be accepted for each timely payment made in an agreed series of payments. Profitable privatized enterprises should be likely candidates for this alternative to prevent foreclosure of collateral or possible bankruptcy action.

Debt Collateral Swap. There will be instances where a borrower will be willing to swap collateral for all or a portion of debt to prevent bankruptcy. Often this collateral is not marketable in the area of the country where the debtor is located. DEBRA, through its nationwide operations, could transport the collateral to marketable areas. Also, individual collateral may be of such small quantity as to not be very marketable. However, DEBRA would be able to consolidate similar types of collateral from numerous debtors into acceptable marketable sizes.

Debt/Equity Swap. There will be opportunities to exchange all or part of outstanding debt for an equity interest in a debtor enterprise. This swap can be negotiated as to price and type of equity instrument. The easiest swap could be for common stock. However, to alleviate concerns over the dilution of ownership wherein the Government could own a substantial or majority part of the enterprise, alternate equity instruments could be exchanged.

This could take the form of preferred non-voting stock, subordinated debt, or some type of instrument (such as a warrant or stock coupon) that is convertible into common stock as long as the converter is not a Government entity. Using this approach, DEBRA could take an instrument convertible to common stock and sell it, possibly on the stock exchange, to private individuals, thus overcoming the fear of Government ownership of an otherwise privatized enterprise.

Restructuring of Debt. To allow non-performing borrowers return to performing status, it is often necessary to negotiate a debt restructure. This can take various forms with the most prevalent being restructure of the terms (maturity date(s), interest rate, payment amounts, timing of payments, etc.) and setting up some type of enterprise cash flow and payment requirements (where the payments are based on the cash flow of the business such as receipt of accounts receivable). In all restructure agreements, it is prudent to attempt to obtain additional collateral, guarantees, etc.

Auction/Sale of Debt. Selling loans individually or in packages of several homogeneous loans may be a viable disposition alternative. This can be through either public or sealed bid auctions. Large loans to specialized companies or with distinctive collateral lend themselves to sealed bid auctions involving known potential buyers that are both interested in the particular kind of debt and have the ability to purchase. This will likely be competitor firms looking for a way to expand and feel that the debt can be negotiated for equity. Smaller loans, packaged using similar attributes, (such as type of enterprise, type of collateral, geographic location of borrower/collateral or loan size) are good products for sale through either public or sealed bid auction. Loan collateral, especially movable type, such as cars, equipment, furniture, fixtures, etc., is very conducive to public auction on a cash and carry basis.

Bankruptcy. DEBRA management will also recognize that bankruptcy proceedings can be a useful tool and even a positive threat in certain debt recovery cases. In the event a borrower, who has been determined to have the capacity to perform, refuses to pay or negotiate some form of payment, bankruptcy could be threatened to force negotiations. Also, bankruptcy could be instituted immediately to prevent possible loss or destruction of collateral. There will also be instances where analysis shows the borrower is not viable under any scenario and bankruptcy may be the only viable option.

However, bankruptcy and the confiscation of collateral is an option that will be carefully considered for its overall cost effectiveness. While the recovery of collateral will not be the driving force for instituting bankruptcy, DEBRA management will also be take into account that certain types of collateral may not be easily marketed and could be costly to maintain. These considerations may indicate that bankruptcy may not be a cost effective business alternative.

28. **Farm vs. Non-Farm Debt.** Certain types of debt lend themselves to some debt resolution alternatives better than others. Full payment, while desired, may be impossible to attain in many situations and bankruptcy may prove more costly than other alternatives available. In the Kyrgyz case, the most significant division of debt appears to be farm versus non-farm debt.

Farm Debt. In dealing with farm debt, the most relevant debt resolution alternatives involve any or a combination of debt forgiveness, collateral exchange and/or restructuring of debt.

a) Debt forgiveness may be considered appropriate, especially for small farmers, when the farmer cannot earn enough to pay the debt and meet operating expenses. Although forgiveness could arguably create a moral hazard situation, it may also give the farmer the incentive to produce at capacity and ultimately in a profitable manner. Also, close monitoring of the farmer s operations could possibly bring about collection of taxes that currently are not being paid as the farmers are in a loss-making situation.

b) Collateral exchange can be especially useful when small farmers do not have direct access to distribution markets. For instance, a sugar beet farmer may sell to a combine that produces sugar. An exchange of debt for a portion of the completed sugar would be a good alternative, as the debt collector (DEBRA) may have easier access to sell the product through established distribution markets.

c) Restructuring of debt is one of the most appropriate alternatives. Restructuring should be performed in such a manner as to match the operations of the farmer. Farm activity is typically based on a crop or livestock cycle, none of which is in step with three-month loans. Restructuring should allow the farmer time to plant, harvest and sell the product before significant payments are due. Extending terms to yearly payments based on a percentage of earnings received by the farmer should be considered. Restructuring combined with debt forgiveness and/or collateral exchange will likely bring higher net income to the Government (through loan and tax payments) than will be realized through full payment demands or bankruptcy.

Non-Farm Debt. In the non-farm debt, although debt forgiveness and collateral exchange may be applicable in certain situations, the most practical alternatives are discounts, debt/equity swaps, and restructuring of debt. These methods are also the best methods to be used by Promstroi and AKB Kyrgyzstan Banks, *vis-à-vis* the debtor enterprises.

a) Discounts could be a primary alternative when acquiring a large portfolio. To offer a discount for early payment of debt can help to reduce the number of debtors that must be dealt with and bring about receipt of cash payments that otherwise may take extended periods of time to receive. This option must be carefully considered to style it in a manner that does not increase the possibility for moral hazard. However, it will often be the case that a negotiated payment of full loan proceeds over an extended period of time will be less than a discounted payoff when consideration is given to the reinvestment alternatives of current cash. Enterprises with excess cash or liquidity, maybe some of the newly privatized and capitalized enterprises (such as some of the meat or tinned goods enterprises from Tamakash Holding or certain bread or bakery enterprises from Kyrgyz-Dan-Azyk), might be candidates for taking advantage of a discount debt plan.

b) Debt/equity swap is a viable alternative for stock equity enterprises. Often, enforcement of debt provisions might force the enterprise into bankruptcy where the recovery against the debt could be minimal and there could be significant negative impact on a local economic area through loss of jobs and loss of needed product and/or services. By taking an equity position, through any of several types of equity instruments, the enterprise is released from large debt payments and may be in a position to expand and become more profitable. The equity position should give a return through dividends, capital appreciation or both. It can be argued that the equity position is a lesser position than debt, such that if the company is not profitable all equity could be lost. However, the equity position will allow monitoring of operations, through statements to equity holders, and positive input into operations that may not be attainable as a debt holder. In any case, the equity should be easier to sell than the loan. This alternative should also be especially useful for other banks, such as Promstroi Bank and AKB Kyrgyzstan Bank, that hold large portfolios of non-performing debt to stock enterprises .

c) Restructuring of debt, similar to farm debt, restructuring of debt is often the most viable alternative for dealing with enterprises that cannot pay debt under the current structure. This may certainly be the case for newly privatized companies that inherited debt, such as those affiliated with Kyrgyz-Dan-Azyk and Tamakash Holding. Restructuring debt to coincide with operational earnings should be pursued. This will allow the company to pay its debt as it receives income and still keep some income to cover administrative and operational expenses, and some income to fund capital growth or fixed capital assets.

29. In working with a large portion of the Agroprom debt, DEBRA management will cooperate with the Ministry of Agriculture which has already effected two separate long-term debt recovery programs. Certain loans to reorganized state and collective farms as well as certain reorganized agricultural enterprises have been rescheduled for repayment over the long term. DEBRA will take over the administrative aspects of these loan restructuring and ensure that the remaining loan repayments are received and accounted for in an efficient manner.

THE KYRGYZ REPUBLIC
Financial Sector Adjustment Credit (FINSAC)

ANNEX E: RECENT DEVELOPMENTS IN BIG FOUR BANKS

AGROPROM BANK

1. The draft report of the specialized audit has been completed and confirms the severity of the bank's insolvency and the poor state of its financial records. As at June 30, 1995 the bank had negative capital of just over 1 billion Soms, and the IAS loan provision was 99.8% of the gross portfolio. In addition to confirming the dire state of the bank and its loan portfolio, the auditors found that it was not possible to reconcile loan records to the books of account, to obtain complete listings of collateral, to reconcile interbranch accounts, to obtain a complete list of deposits and current accounts, or to obtain management's agreement with the result of the review. The bank has virtually ceased operating. A limited amount of new lending is restricted to a few branches with excess current accounts. Agroprom has, however, continued to act as payment agent for government accounts; it earns fees from this activity and interest from loans.

2. Of the total loan portfolio (930 million Soms), about 40% is to various farms and farm enterprises that were previously kolkhozes and sovkhozes. The loans appear to be subject to a Government resolution issued in August 1994 which provides for the rescheduling of farm enterprises' debts over a 40-year period. A further resolution, dated February 16, 1995 appears to provide for the debts of the re-organized enterprises to be assumed under preferential terms by the acquiring enterprises. A further 43% of the portfolio is comprised of loans in the names of various holding companies. These loans were made to numerous individual enterprises which have since been converted to joint stock companies in which generally the State has a 75% interest. In the case of reorganized collectives, the government's intentions with respect to various decrees will influence the approach to debt recovery. Similarly, the extent to which privatized enterprises have assumed the debts of their predecessors will need to be determined.

3. Since November, the bank has been working on documenting and recovering collateral. Perhaps because collateral proceeds are one of the primary sources of funds for paying salaries, branch personnel are devoting considerable effort to this work. Loan agreements rarely include a precise description of collateral and branch personnel have been visiting each borrower to make a listing of the specific collateral available. Most of the realizations have been from the sale of cars and farm equipment, but branch personnel have also been successful in negotiating to receive a portion of a farmer's output and in pursuing collateral through the courts. There have been few sales of real estate since, particularly in cases of loans to enterprises, control over property rests with the State Property Fund and the bank does not have the ability to take possession. Control over collateral — and collateral proceeds — appears weak, with little central control or assurance that the value of collateral has been removed from the records when realized. However, notwithstanding the various obstacles, 9 million soms was realized from collateral in the second half of 1995. Although the bank's listing indicates a gross value for collateral of 242 million soms, this reflects the book value of assets according to the borrowers' records, not market value, and the likely realizable value must be substantially less.

4. The auditors' analysis of individual depositors indicates about 10,000 accounts totaling 15 million soms. Because of the small deposit total there appears to be little potential for offsetting deposits against loans.

5. An important part of the liquidation planning process is the analysis of Agroprom's 49-branch network. This will be facilitated by Ernst & Young's review which is to be completed by May, 1996. Preliminary information indicates that there are approximately 30 branches in rayons not served by other operating banks. Only three branches are "profitable" according to Agroprom's branch records. Further analysis will be required to determine those branches most likely to be capable of surviving as free-standing entities, those most likely to be marketable to other financial institutions, and those that might be needed to make treasury payments on behalf of Government and to act as collection agents for DEBRA.

6. On November 28, 1995 the Board of NBK passed a resolution finding Agroprom insolvent. Application to the court to appoint NBK as liquidator is expected in April.

Table E-1: Agroprombank Categories of Borrowers

The major groups of defaulting borrowers can be broadly categorized as follows (soms in millions):

BORROWER	AMOUNT	NOTE
Min of Agriculture & Food:	**406**	Loans to reorganized state & collective farms
Of which:		are subject to decree #42 which transferred
Kolkhozes	163	25-50% to the state budget and deferred the
Sovkhozes	123	balance over 15 years starting Jan, 1997
Industry	59	Loans to reorganized agricultural enterprises
Supply organizations	39	are subject to decree #632 which deferred
Other	22	them over 40 years starting Jan, 2004
Tamakash Holding:	**59**	Loans are outstanding to about 130
Of which:		individual enterprises at 48 branches. They
Meat enterprises	21	include: Likoro-Vodochny, Plant Tattu,
Dairy produce	4	Tokmak, JSC May. Most of the enterprises
Tobacco	15	are now joint stock companies 75% owned
Tinned goods	11	by the state
Other	8	
AS Kyrgyz-Dan-Azyk	**149**	Loans are outstanding to small & large bread & food enterprises (inc 35 million to 1 plant) which have been privatized
Kyrgyz Potribsojuz	**127**	Loans are outstanding to various privatized
Of which:		enterprises including JSC Kyrgyzbakaleya,
Trade	84	Shamaly Sayskoe, and Manas RASC
Procurement	32	
Other	11	
PA Kyrgyzmunyzat	**98**	2 large loans to oil industry enterprises (Issyk-Kul Nefteproduct, and Association Kyrgyzmunyzat) account for 26 mill soms
Peasant farms	70	
Small business enterprises	79	
Ministries of Government	23	
Other	9	
Variance	(90)	
Total	930	

PROMSTROI BANK

7. As at December 31, 1995, the diagnostic audit prepared by DFC indicates that, although management has been successful in raising much needed capital, structural problems and the undue concentration of loans to the industrial sector continue to make Promstroi's position precarious.

8. The IAS financial statements indicate that the bank earned net profit (before loan loss provisions) of 8.5 million Soms, and achieved an increase in paid up capital of 8 million soms with 5 million of this increase sourced from employees. Progress has also been made in repayments from the largest borrower, Kyrgyzgas, which constitutes 42% of the entire portfolio; 30% of the company's revenues have been assigned to the bank resulting in repayments of 29 million soms. The number of loans under PESAC has declined from 18 to 5 and the bank has achieved some success in persuading these enterprises to start repayments.

9. Loans made at the direction of Government (i.e., those made prior to April 1, 1994) constitute two thirds of the entire portfolio and account for 85% of all non-performing loans. The dominance of large loans is such that 9 loans infringe the single borrower limit set by NBK. Attempts to negotiate resolution of these loans with Government continue to preoccupy management but have not been successful. After Kyrgyzgas, the second largest directed credit is Naryn Hydro, which was the subject of a decree transferring its assets and liabilities to Kyrgyz Energy Holding (KEH). However, only the assets were transferred, leaving Naryn unable to meet its liabilities to the bank. Discussions with Naryn and the Government have so far failed to resolve the problem.

10. Promstroi's problems are not all attributable to the directed credits; many are of its own making. For example, new loans made in 1995 have not been made with the required care; of 11 million Soms of loans made in the first 9 months of 1995 and still outstanding at year end, slightly more than half are non-performing. (In total only 20% of the total portfolio is performing.) Moreover, the bank has a severe mismatch problem as a result of its reliance on settlement accounts for funding. These current accounts are volatile, and fund a portfolio of Treasury bills and the loan portfolio which is essentially long term by virtue of its non-performing nature. Further, management has allowed expenses to increase: personnel costs alone have increased more than 50% in the year. Only one branch has been closed.

11. The bank's capital deficiency continues to be its most urgent problem. The diagnostic audit indicates a negative capital of 15 million Soms. The only option open to the bank to address this problem in the short term is the sale and leaseback of its property assets in order to realize a revaluation credit of 14 millions soms. In the longer term, resolution of the Naryn Hydro loan would also improve capital, as the assessment of capital under IAS is heavily dependent on the classification of this loan: if it were to be upgraded from loss to substandard, the bank's capital would be negative 3 million Soms only.

12. Since January 9, 1996, Promstroi has been operating under a management letter agreement with NBK which required the bank to stop accepting deposits, desist from lending to non-performing accounts, write off all losses by March 31, continue working on recovering problem loans, and find ways to eliminate negative capital by May 15. In the 2 months to March 1, 1996 the bank earned net profit (before loan losses and taxes) of 2.4 million soms and paid down its loan from the National Bank from 58 million soms to 20 million soms. However, there is no evidence that management has specific plans to bring about change or to exploit the opportunity presented by the demise of Agroprombank and Elbank. Plans to raise new capital depend entirely on subscriptions from staff and leave the bank without significant shareholders able to initiate the necessary management and structural changes.

13. In order to encourage the bank to correct its mismatch of assets and liabilities and to capitalize on the opportunities occasioned by the demise of Agroprom and Elbank, it is recommended that NBK should lift the restriction on accepting deposits as soon as a positive level of capital is achieved.

AKB KYRGYZSTAN BANK

14. As of June 30, 1995, the draft diagnostic audit under IAS by Ernst and Young has classified 85% of the bank's loans as "loss," six times the bank's paid-in capital. Due to the large volume of doubtful and loss loans, the bank has been operating with losses since 1994. Taking into account recoveries by the bank during June-December 1995, the auditors have calculated the negative capital of the bank at 160 million Soms as of December 31, 1995.

15. The management of the bank is not in full agreement with the draft diagnostic audit. The majority of the loans classified as loss are claimed to be under government guarantee or "direction." The management has been appealing to the Prime Ministry for a governmental debt-bond swap for all of the guaranteed and/or directed loans on its books (140 million Soms as of June 30, 1995, 66% of total loans). During January 1996, the Ministry of Finance issued bonds of 18.5 million Soms to the bank in exchange for 8 million Soms of outstanding government guaranteed loans to the light industry enterprises on the books of the bank. The bank has recognized these bonds as mainly recovery of past interest due — i.e., as interest income without any offset to the principal due. Part of these bonds were used (13.5 million Soms) to repay the bank's liabilities to NBK.

16. The management of the bank also claim to have collateral against the non-performing loans valued at 170 million Soms (versus total loans of 205 million Soms). The draft audit report indicates that the majority of this collateral is not registered with relevant notaries and therefore the bank does not have legal claim to seize it. Furthermore, the auditors' assessment of the market value of the immovable collateral claimed by the bank differs significantly from the bank's valuation. Because of the different opinions on the value of the collateral and on the legal basis for its seizure, the bank management and the draft audit differ extensively on the classification of the loan portfolio. The bank's loan loss provision requirement is 50 million less than the audit, creating a significant difference on the calculation of the negative capital. The bank management also does not agree with the IAS capital definition. The auditors estimate the insolvency of the bank at 160 million Soms whereas the bank's own estimate is 35 million Soms.

17. During June 30, 1995-March 1, 1996, the bank management indicates total recoveries against loans of 38.5 million Soms (including the Government bond issue). There have also been efforts to increase capital and one new shareholder has indicated a commitment to pay US Dollars 600,000(6.6 million Soms) by May 1996.

18. The bank appears to have made positive net interest income during the first two months of 1996. Adjusting the figures to international accounting standards show that the bank continues to lose around 1 million Soms per month on net interest income. There have been no significant improvements in the bank's operating performance on a monthly basis since December 1995.

ELBANK

19. Elbank was declared insolvent and its license withdrawn on February 14, 1996 by NBK. The application to the court for liquidation of the bank was made in February 1996 and on April 2, 1996 the court was expected to approve the liquidation proposal of NBK.

20. NBK's resolution also approved a household-deposit payoff plan to be implemented starting February 15, 1996. Those deposits below 3000 Soms were to be paid-off from February 15, 1996; below 5000 Soms from April 1, 1996; below 10,000 Soms from May 1, 1996 and above 10,000 Soms when all of the previous payments were made.

21. During the first two months of 1996, 30 million Soms were paid to the depositors, funded through advances from NBK (29 million), as well as liquid assets, loan collections, and recoveries of the bank. The deposit payoff is expected to continue with NBK funding support. The funding for this deposit payoff is expected to come from the following sources: 30 million Soms from the Ministry of Finance due to Elbank from past deposit compensations made on the instructions of the Government; 5-6 million Soms from loan recoveries and other liquid assets; and 30 million Soms from the Budget.

22. The liquidation plan of Elbank foresee closure of 102 branches out of 164 by May 1, 1996. Pension payments now made through the downsized branches are expected to be transferred to other banks and/or post office by July 1, 1996. The outstanding housing and emergency loans fully funded by the budget are expected to be transferred to a unit designated by the Government. The deposit payoff will continue through the downsized branches of the bank where the liquidator appointed by the court will decide on the timing of the closure of further branches of the bank. All of the branch premises not rented belong to the State Property Fund. The inventory for the fixed assets of the bank is being prepared to be transferred to the State Property Fund by the liquidator to be appointed by the court. Elbank branches will cease to collect utility and budget payments as they close.

23. All of the commercial loan portfolio of Elbank (61.7 million Soms as of March 1, 1996) has been transferred to the courts by NBK. The Ministry of Interior is providing support to the court investigation to identify the borrowers. Some recovery is expected from this portfolio (about 10%) although none of these loans have collateral and many of the borrowers listed cannot be identified. Elbank also had 16 million Soms outstanding to other banks end-1995. The NBK administratorship has recovered 9 million Soms of these loans and hopes to recover another 3 million Soms from Akniyet Bank in April 1996. No recovery is foreseen for the 5 million Soms loaned to the liquidated Adil Bank.

April 12,1996
Bishkek

КЫРГЫЗ РЕСПУБЛИКАСЫНЫН ПРЕМЬЕР-МИНИСТРИ

ПРЕМЬЕР-МИНИСТР КЫРГЫЗСКОЙ РЕСПУБЛИКИ

БИШКЕК ш., ӨКМӨТ ҮЙҮ

г. БИШКЕК, ДОМ ПРАВИТЕЛЬСТВА

«24» 05 1996 ж. г.

№ 1-487

Жооп кайтарууда биздин № жана дата көрсөтүлсүн
При ответе обязательно ссылайтесь на наш № и дату

LETTER OF FINANCIAL SECTOR DEVELOPMENT POLICY (LFSDP)

Mr. James D. Wolfensohn
President
International Development Association
1818 H Street, N.W.
Washington, D.C. 20433

Dear Mr. Wolfensohn:

1. The Kyrgyz Republic is one of the most rapidly reforming countries in the former Soviet Union (FSU). Since its independence in 1991, the Government has made significant progress in achieving greater macroeconomic stability and transforming its economy into a market-oriented one. Over the past three years, the economy has followed a path of sustained stabilization. The rate of inflation has been brought down from an annual average of over 1000 percent in 1992 to less than 30 percent at present. In 1994, deposit and credit interest rates were liberalized, directed credits were discontinued, and the financing of the budget deficit by the republican banks was sharply curtailed. As part of its stabilization program, the NBK has also established a foreign exchange auction market, a floating exchange rate, and a fully liberalized exchange regime with no restrictions on current or capital account transactions. A major liberalization of the trade regime has also occurred. Non-tariff barriers were removed, and export taxes have been eliminated on all goods. In addition, the Government worked out and is implementing a comprehensive privatization and enterprise sector adjustment program aimed at passing productive assets into private hands, and liquidating or restructuring large loss-making state enterprises which were a heavy burden on the economy. These reforms have been supported by the Rehabilitation Credit (FY93), resources disbursed by the International Development Association (IDA) to support reforms, as well as by a successful disbursement of first tranches of the IMF loan.

2. To enhance and develop the reforms already undertaken, the Government is currently in the process of implementing a comprehensive reform of the financial sector. At this stage of economic transformation, a more stable and efficient financial sector, with a reliable banking system at its core, will be absolutely essential to help sustain macroeconomic stability, stimulate savings mobilization, support enterprise recovery and expansion, and to enhance the development of the private sector. The basic objectives of the Financial Sector Reform Program being pursued by the Government are: (i) to improve legislative and regulatory principles of the development of a sound, competitive and market-oriented banking system; (ii) to liquidate two biggest insolvent specialized banks, Agroprom and Elbank, which through their practices, prevent growth of their new private competitors, and to restructure, through private recapitalization, two others: Promstroi and AKB Kyrgyzstan Banks; (iii) to help collect or write-off part of the non-performing loans extended by these banks, thereby accelerating the process of enterprise restructuring or liquidation; and, (iv) to promote the development of newly emerging non-bank financial institutions.

3. By this letter, the Government requests continued IDA support in the form of the Financial Sector Adjustment Credit (FINSAC), and the subsequent Financial Sector Technical Assistance Credit (FINSAC TA). Below is the recapitulation of the progress already made in reforming the financial sector, as well as measures planned in the near future, with emphasis on those which will be monitored under the given FINSAC.

I. CREATION OF THE ENABLING POLICY ENVIRONMENT

Sustaining Macroeconomic Stability

4. The Government recognizes that sound macroeconomic policies are essential if the financial sector is to be effective. Despite considerable success achieved in reducing inflation, there remains uncertainty about future inflation projections and its movements. We have confirmed our intention to continue to reduce both the size of the fiscal deficit and its financing through the domestic banking system. Due to importance of macroeconomic stability for the success of financial sector reforms, we will continue to maintain satisfactory macroeconomic and fiscal performance in FY96 and FY97.

Removal of Earlier Policy-Induced Barriers to Bank Profitability and Non-Intervention in Banking Activities

5. At present, the banking system is characterized by a heavy tax burden. The tax currently includes a 45% corporate tax, that is higher that a 30% tax on non-financial enterprises, and a transaction tax on the basis of gross income. Furthermore, the banks are not allowed to take loan-loss provisions against their gross income, before tax. Thus, pretax profit is artificially inflated and taxed away with the tax being significantly increased. Such an ill-founded leakage of funds drains the banking capital and discourages bank management from full accounting for all the likely loan-losses thereby preventing from presenting fairly the financial position of the bank. There is also a lack of clarity about VAT administration and tax treatment in general.

6. Under the Reform Program, the Government has submitted to the Parliament a Tax Reform Bill as a result of which: (i) banks will be allowed to take loan loss provisions against their gross income, before tax; (ii) the rate of profit tax on financial institutions (45%) will be harmonized with the productive sectors but not more than 30% in order to allow the banks to build up their capital, and to lower substantially the costs of financial intermediation; and (iii) the current tax treatment will be clarified to avoid confusion concerning tax exemptions, as well as which financial transactions are VAT exempt.

7. To build depositor confidence in the financial system, all state organs will need to desist from practices that are not appropriate in an economy striving towards secure private contract relations and those which discourage the public from using banks for deposits and transactions. This applies in particular to the tax collection throughout the year at the source, and seizure of bank deposits of those believed to be in arrears on tax or loan payments, by the Tax Inspectorate. Current legislation does not provide adequate safeguards against potential abuse of access to restricted financial information. A sharper legal definition of the scope, reasons for, and nature of information disclosure on clients accounts and transactions to various investigate organs will help in bringing savings and transfers into the formal banking sector.

8. Under the Reform Program, we have already submitted to Parliament a new Tax Code which: (i) cancels the extraordinary powers given to the Tax Inspectorate in February 1994, including in particular the seizure of deposits; (ii) cancels such powers given to other State organs; and (iii) limits the Tax Inspectorate's and other State organs' rights (except those of NBK) to obtain information from banks to instances in which due cause justifies an investigation, thereby barring the current practice of obtaining information from banks on a mass scale without specific justification. Before the release of the second tranche of FINSAC, we will enact the new Tax Code, satisfactory to IDA.

Building a Competitive Market Structure

9. At present, there is a high degree of market concentration in the banking system. The Big Four specialized banks dominate the financial sector. These banks are able to outbid, at a loss, their more efficient young competitors in the competition for resources and business, and to continue operating, also at a loss, their large branch networks that dominate almost every area outside Bishkek. To raise efficiency among banks, as reflected in performance indicators such as improved productivity, reduced intermediation costs and increased profitability, the Government will take actions to encourage competition among banks and to reduce its own participation in the financial system. The liquidation/restructuring and privatization of state-owned banks will receive top priority in the proposed financial sector Reform Program. The Government will promote the entry of foreign and domestic banks. To avoid an excessive proliferation of small banks, the Government has already increased the minimum and ongoing capital adequacy requirements for new and existing banks.

II. STRENGTHENING THE LEGAL AND REGULATORY FRAMEWORK

10. A sound legal and regulatory framework is essential to improve financial sector efficiency and to set up prudential norms. Since 1992, significant progress has been achieved in stipulating prudential norms and phasing in their implementation, giving NBK enforcement powers, and developing NBK's supervision capabilities. Nonetheless, further progress is warranted, especially in the implementation of the new Banking Law and further improvement of NBK prudential regulations.

11. The New Banking Law: The first Banking Law was adopted in 1991. The new Banking Law prepared as part of the FINSAC Reform Agenda, will contribute significantly to ensuring bank prudence. The new Banking Law will further strengthen NBK's powers to set up limits to banking activities, including: foreign exchange exposure limit, Banks'; real estate holdings; and limits of credits extended to affiliated companies and other connected parties by branches and other involved parties. To prevent a sudden withdrawal of capital by bank owners, the new Law will require banks to be exclusively joint stock companies. The new Banking Law will also provide with a wide range of legal powers and sufficiently high ceilings for sanctions; both are reflected inadequately in the present Banking Law. Before the release of Second Tranche of FINSAC, we will enact the new Banking Law, satisfactory to IDA.

12. Prudential Regulations: A number of new prudential regulations for banks have recently been adopted by NBK. These include minimum and ongoing capital adequacy requirements; liquidity ratios and reserve requirements; loan classification and provisioning guidelines; restrictions on foreign exchange transactions; and lending limits including lending to shareholders and to a single borrower. Guidelines for "problem bank intervention" have also been issued. NBK will continue to make improvements in these regulations to bring them in line with international standards. Under the Reform Program, NBK has already: (i) reduced the single borrower lending limit from 30% to (25%) of capital for new banks; (ii) put a (15%) limit on aggregate lending to shareholders and other insiders (Special donor credit lines will be exempt from this principle); (iii) raised the minimum capital requirements, from 5 million to 10 million Soms for local banks, and from 10 million to 20 million Soms for foreign banks; and, (iv) commenced the implementation of the Basle guidelines for capital adequacy (i.e., 8% of risk-weighted assets). Before the release of the Second Tranche of FINSAC, NBK will enforce 25% maximum single borrower limit on all commercial banks.

Enhancing Security in Lending

13. Loan collection is a key problem of banks in the Kyrgyz Republic. In order to enhance security in lending, by facilitating the enforcement of collateral and other contractual rights, we are contemplating strengthening the legal, judicial, and registry framework for the use of pledges, the handling of insolvent borrowers, and the reporting of credit. These specific measures will be supplemented by improvements in the broader framework of property, company, and transaction legislation. The first part of the Civil Code will become effective in the near future. New draft Law on Companies and draft Addendum to the Law on Lease and Leasing Relations are currently being completed.

14. The New Law on Pledge. To curtail lending risk, and to reduce transaction costs, the banking sector needs an effective and efficient law setting up the rights to use the collateral and mortgage credit. In the Kyrgyz Republic, this requires the finalization of new legislation, and the establishment of a registry of pledges. Under the Reform Program, President of the Kyrgyz Republic has submitted to Parliament, a new Law on Pledge, satisfactory to IDA. The new Law on Pledge introduces an efficient out-of-court process yet gives to the debtor the right of court appeal prior to execution. Before the release of the Second Tranche of FINSAC, we will: (i) enact the new Law on Pledge, satisfactory to IDA; and (ii) create a central registry system for pledges, satisfactory to IDA, to enforce the rights to use collateral.

15. Resolving Insolvency of Borrowers. The current Insolvency Legislation (1994) together with the implementation Regulations for Enterprises and Banks, provides a satisfactory basis for the conduct of insolvencies in the Kyrgyz Republic. However, there are two key issues at present. First is the ability of the judiciary to apply the insolvency legislation is limited. This calls for simplified court procedures, training of judges and other legal experts, and the dedication of adequate budget resources to bankruptcy cases. Second is the inability of "the liquidator" to start the liquidation process without court involvement. This issue is of paramount importance for timely and effective liquidation of insolvent enterprises and banks. At present, it takes months to receive formal court approval. To the extent possible a permit should be given by involved parties without court intervention. Under the Reform Program, the Government has submitted to Parliament a Revised

Insolvency Legislation that limits the time period given to courts to one month (30 days) to approve NBK's request to start the bank liquidation process. The same time limit will also apply to other liquidation processes. Before the release of the Second Tranche of FINSAC, we will enact the Revised Insolvency Legislation, satisfactory to IDA.

16. Strengthening the Judiciary. Legislation alone will not ensure lending if it is not effectively and efficiently enforced. Under the Reform Program the Government will take steps to ensure that the judiciary is capable of understanding and complying with the legislation. These steps will include training of the judiciary, through financial and technical support to be provided under the accompanying Financial Sector Technical Assistance Project (FINSAC TA).

17. Creating a Viable Private Sector Client Base. Besides legal reform, continued progress in privatization and enterprise reform is crucial for higher security in lending, and virtually a precondition for the success of financial sector reform in general. The key objectives of the PESAC and APEAC reform program - creating a private sector client base that operates under market incentives and seeks profitability, hardening the budget constraints of firms, improving their governance through privatization, taking of nonviable enterprises out of business, and liquidating their assets, and restructuring those with good prospects to become competitive and profitable - will be pursued with vigor and perseverance. Before the release of the Second Tranche of FINSAC, we will (i) complete coupon auctions for all enterprises included in the 1996-97 Privatization Program, and reduce state ownership to a minority share in a minimum of (320) enterprises included in the 1996-97 Privatization Program, except those in the major utilities that have individual privatization plans aimed at attracting strategic investors; (ii) offer all potentially viable ERRA enterprises for sale, and initiate liquidation procedures for all the old ERRA enterprises and all others slated for liquidation. No funds will be allocated to ERRA enterprises from the 1997 Budget, except for completion of the liquidation process; and, finally, (iii) fulfill all of the Second Tranche conditions of APEAC.

Strengthening Institutional Capabilities of Banks

18. Poor technical capabilities and poor management are other major constraints to the further development of sound banking. These deficiencies can be traced to: lack of accounting and auditing systems appropriate for modern banking; slow development of skills and lack of collaboration with foreign banks; and slow emergence of key sectoral infrastructure, such as appropriate clearing and settlement systems.

19. Introducing Adequate Bank Accounting and Auditing. Modern accounting and auditing standards that are necessary for the expansion of financial intermediation are being introduced at the NBK and the commercial banks, with technical assistance from various donors. However, the financial statements of some Kyrgyz banks are still being prepared along Russian accounting principles. It is essential that internationally accepted accounting standards (IAS) be adopted as soon as possible. A new chart of accounts has recently been finalized, but it remains inoperative. Before the release of the Second Tranche of FINSAC, we will introduce the new Chart of Accounts based on International Accounting Standards (IAS) for all commercial banks, and enforce the implementation of these accounts in at least 5 commercial banks.

20. Improving Payments and Settlement Systems, and Liquidity Management. The Government understands that an effective payments system plays a crucial role in market economies by expediting the settlement of financial obligations among economic agents and regulating the financial relations between participants. The deficiencies in the Kyrgyz Republic's payments system are putting considerable strain on commercial transactions. Despite some progress made, payments delays still amount to about two days within a region and up to 14 days at the inter-regional level. NBK foresees a range of short-term improvements that would include, inter alia, the establishment of regional clearing houses which would transmit netted end-of-day positions to NBK where the final settlement would take place. This strategy complies with the general line in the reforms of the banking sector which results in a prompt lessening of the role of big banks and in involving new banks to a more active participation. Under the Reform Program, a longer-term reform strategy for payment and settlement system will be developed and implemented with technical assistance from Japan and IDA.

21. Teaching Modern Banking Skills. The Kyrgyz banking system has urgent technical training needs. At present, the requisite knowledge and skills in most areas of modern banking are thinly distributed through the banking sector. These include, inter alia: strategic planning, credit analysis and risk management, international trade finance, and asset and liability management. Currently, training is carried out on an ad hoc basis by the banks themselves, as a component of certain aid programs. Under the Reform Program, a comprehensive, coordinated bankers training program will be

initiated with technical assistance to fulfill both the immediate, short-term needs, and to provide for ongoing training and formal education within the banking profession.

III. RESTRUCTURING OLD INSOLVENT SPECIALIZED BANKS

22. The Big Four specialized banks - Agroprombank, Elbank, Promstroi and AKB Kyrgyzstan - are insolvent. In part, this sad financial state is the legacy of the earlier transition years when these banks were state owned banks and operated on instructions of the Government. Bad governance and management, political pressures on lending and collection, and the weak condition and unfavorable environment of the enterprise sector all contributed to their worsening loan portfolios. Under the Reform Program, the Government has decided to: (i) liquidate Agroprombank and replace it in the short term by an emergency farm support program for the provision of farm inputs and working capital, and, subsequently, by a commercially viable and sustainable rural banking and cooperative system; (ii) dissolve the Elbank (the former Sberbank), to sell its viable assets to commercial banks with good prospects; and (iii) substantially downsize and restructure, through private recapitalization, the Promstroi and AKB Kyrgyzstan Banks. Bank liquidation and restructuring will be executed in a way that seeks to preserve the provision of basic banking service during the transition.

Liquidation of Agroprombank

23. Agroprombank is considered to be the largest bank in the Kyrgyz Republic and the predominant lender to the agriculture sector. It has 52 branches throughout the country, 1,300 employees, and its loan portfolio as of June 30, 1995 was more than 1 billion Soms. The bank has not been effective in collecting its loans, which have been rescheduled on a regular basis pursuant to Government decrees. The loan portfolio has been funded almost exclusively by an overdraft at NBK since the bank had virtually no deposits. If the required loan-loss reserves of 1 billion Soms were to be booked, shareholders equity would be a negative 1 billion Soms. Agroprombank is technically bankrupt and its role as a distributor of directed credits has largely replaced its role as a bank. Its profitable clients applied for services more and more often to smaller private banks. The agreed reform strategy for Agroprombank was therefore to liquidate the bank.

24. As is the case in any bank liquidation, there is a number of issues which need to be addressed, of which the most important are: (i) the need to develop an alternative rural finance system which replaces the role of Agroprombank as the primary agricultural credit institution; and (ii) the need to clear debts on deposits; and (iii) impact on the Government payment system if the nationwide branch network of Agroprombank is closed.

25. Rural Finance Strategy. It is clear that neither Agroprombank nor any alternative rural finance institution will be viable and sustainable unless the agricultural sector becomes profitable. Farmers need to be profitable to be eligible for seasonal credits and they will require access to longer-term financing for equipment and other purposes if they are to be viable. Farm profitability continues to be low, due primarily to farm gate prices which are below border price equivalents, as well as to low farm efficiency. In these circumstances, it is necessary to make a distinction between "short-term emergency assistance", which is needed to keep a broad spectrum of the agricultural population productive pending further adjustments in the economy, and an efficient "commercial" rural finance scheme, which will be profitable and sustainable in the longer term.

26. Over the past three years, the Government has achieved some progress towards reforming the agricultural sector along market economy lines. About 40% of the total land area subject to privatization has actually been distributed to individuals in the form of land-use rights. The right to use land for 99 years has been established, and a new Land Code has been submitted to Parliament. In accordance with this Code the right to use land will be transformed into a property right that can be freely transferred, inherited and used as collateral.

27. Development of a viable rural finance strategy and provision of credit to farmers and other viable off-farm processing activities are key priorities for the Government. The short and medium-term elements of a feasible Rural Finance Strategy are being developed and managed under a separate Rural Finance Credit from IDA. There is a Working Group on Rural Finance, established in the Ministry of Agriculture, which is in process of developing proposals for a more efficient distribution of (i) farm inputs, and (ii) working capital, funded from the central Government budget. These budget funds more likely to be subsidized will be extended in the form of budget allocations approved appropriately. However, the modalities of a longer-term commercially viable and sustainable rural finance strategy are yet to be designed and agreed upon.

28. Branch Network Rationalization. The Agroprombank branch network has been used by the Kyrgyz Treasury, and the Ministry of Labor and Social Security, and the Social Fund to distribute various pension, Government salary, disability, and social services payments to the population. Certain branches have also been used to be Treasury to make remittances of collected taxes back to Bishkek. Similar payments were made throughout the whole country through Promstroibank and AKB Kyrgyzstan and, more often, through a system of post offices being a widely spread network in the whole country. Some of the branches of Agroprombank could continue to act as " Agents of Treasury" on an interim basis for the purposes of continuing these payment distributions until a new comprehensive system is implemented. Because the Agroprombank branch network is very developed, and certain branches have a strong potential for sale or conversion into a new financial institution in some manner, an independent analysis is currently being conducted by the international firm to determine which branches of the Agroprombank network and in what capacity will survive in future.

29. Under the Reform Program, NBK has placed the Agroprombank under the receivership of DEBRA, and started the liquidation process. Before the release of the Second Tranche of FINSAC, DEBRA will (i) assess the value of Agroprom's assets; (ii) transfer all recoverable loan assets of Agroprombank into the Debt Recovery Unit (DRU); (iii) reduce staff levels and close or sell bank branches; and (iv) submit a timetable to FINSAC Review Committee and IDA for completion of liquidation of Agroprombank.
The debt of Agroprombank due to NBK is 965 million Soms. This amount represents a bad debt on the books of NBK. To make the balance sheet of NBK whole again, before the release of the Second Tranche, the Government will (iv) replace this amount by a long-term bond of 965 million Soms at 5% interest rate.

Liquidation of Elbank

30. Elbank, the former Sberbank, is financially insolvent and highly unprofitable. Several factors have contributed to this. First, the bank has never been properly compensated by MOF either for the loss of assets "frozen" in Moscow upon the breakup of the Soviet Union in 1991 or for the revaluation of deposits upon the Ruble/Som conversion in 1993; the banks claims on MOF have not been formalized and their amount is still in dispute. Second, the bank has, in the last two years, engaged in careless lending, based on deposits that it attracted with above-market interest rates. At the same time, NBK examiners classified about 80% of Elbank's loan portfolio as "loss" and the bank has been receiving virtually no interest income. Third, under past disaster relief and housing programs, the bank has long-term, low-interest loans of about 85 million Soms outstanding. Whether it acted in this matter merely as an agent for the Government, or actually took a credit risk, has never been clarified. Fourth, the bank bears high non-interest costs due to its small average deposit size of less than 50 Soms and its large branch network, although under NBK management the bank has now cut the number of its outlets by one sixth. The minute deposit base in the rural areas, and the small volume and value of payment transactions, are not sufficient to support the largest part of its network. The image of the bank is fully discredited. A substantial part of new deposits during last two years has been received from Bishkek enterprises which speculated to make profit from high interest rates despite risks involved. discredited. The reform strategy, therefore, is to close the Elbank.

31. Deposit Distribution Plan. The bank has over 2 million individual depositors. Under the Reform Program, the Government has decided to offer an immediate compensation for depositors.

32. Under the Reform Program, Elbank was declared insolvent and its license withdrawn on February 14, 1996 by NBK resolution No.6/1. NBK's resolution 6/1 also approved a household deposit pay off plan to be implemented starting February 15, 1996. Total household deposit obligations to be covered under this plan are 105.1 million Soms for principal of deposits as of December 31, 1995 and 16.9 million Soms interest accrual for 1995 totaling 122 million Soms. The interest accrual calculation was based on the decision to pay 10% for the average balances on the demand deposits and 30% for the average balance on the time deposits for 1995 only, regardless of the final maturity of these time deposits. This way, the unrealistically high interest on long-term time deposits - some of them up to five years and over - totaling 35% of the deposit base will be compensated only by the current market interest rates. The speculative depositors will thus be asked to face risks, and share part of the financial burden.

33. Major steps toward the liquidation of Elbank have already been taken. Before the release of the Second Tranche of FINSAC, DEBRA will (i) assess the value of Elbank's assets; (ii) transfer all recoverable loan assets into the Debt Recovery Unit (DRU); (iii) reduce staff levels and close or sell

bank branches; and (iv) submit a timetable to FINSAC Review Committee and IDA for completion of liquidation of Elbank.

Restructuring Promstroi and AKB Kyrgyzstan Banks.

34. Promstroi Bank. Promstroi is the local successor of the Soviet Bank for Industry and Construction. It became a privatized joint stock company in December 1991 and has 400 shareholders who are some of the largest industrial and construction enterprises in the country. Founded in 1922, the bank has traditionally served as the Government s vehicle for directed credits to support state-owned enterprises in these sectors. Since independence, many of the banks primary borrowers have become shareholders in the bank. The agreed reform strategy for Promstroi Bank recognizes that the institution, while financially weak, is fundamentally sound on an operational basis. The bank has been operating with a positive net interest margin, and a sizable proportion of its loan portfolio (40%) is performing. It is believed, primarily because of the relatively small amount of new capital funds required, that the bank can be effectively restructured with private capital attraction and without any allocation of centralized state budgetary funds.

35. AKB Kyrgyzstan Bank. AKB originated from the Soviet Housing and Social Commodity Bank, and was reestablished as the first joint stock financial institution in 1990. It has 600 staff and 26 branches. It is mainly in private ownership, although its Supervisory Council remains dominated by state enterprise managers. It has build a leading position in foreign exchange transactions and plays an important role in domestic payments. The quality of the bank's portfolio is poor. As of October 1995, NBK classified roughly 84% of AKB s portfolio as non-performing. Of the total loans of 216 million Soms, 143 million is ranked as doubtful and loss, twice the current total equity of the bank. AKB management regards a large part of these loans as "directed". Some portion of loans dates back to before April 1994, when directed credits were officially discontinued. AKB has so far avoided building the 120 million Som loan-less reserve that is required by NBK s prudential guidelines. Such loan-loss reserve will result in insolvency of the bank with a negative equity position of 95 mln. Soms. Since July 1995, AKB has reported some improvement in its balance sheet trough the mobilization of new enterprise deposits and the repayment of over 37 million Soms in debt to NBK. Although the overall weaknesses in the banks loan portfolio remains unchanged, monthly cash flows have shown a slight improvement as well. Based on its recent financial performance, AKB management believes that the bank can restructure itself over time, mainly because of the high level of collateral security on its loan portfolio.

36. Restructuring Strategy. The reform strategy for each of these two banks is essentially an internally managed program which will require each bank to recognize its loss positions with certain loan assets and the credit risks associated with its remaining portfolio. In accordance with the program for each bank, which will be acting under a "management letter agreement with the NBK", they should: (i) write off loans classified as loss, and (ii) properly fund the NBK required loan-loss reserves on its remaining portfolio. This will result in the banks reporting negative capital positions. Promstroi and AKB will then have a two-phase, time-bound requirement to bring their capital accounts back to "zero", and further to raise additional capital to meet NBK capital adequacy requirements. The reform program requires minimum intervention by the Government in these privately owned banks, at least up until the point that bank managements are unable to raise capital. NBK will formally intervene in the institutions only if they fail to recapitalize themselves up to a "zero" capital level. The banks themselves will absorb the costs of the resolution of their own poor credits as well as the funding and investments costs to bring the institutions into compliance with international banking practices. The restructured banks, with their current nationwide branch networks significantly downsized will continue operating.

37. Should this approach prove unsuccessful, the Government will be faced with two choices: (i) to restructure the banks by issuing bonds to remove bad assets, thus making the banks more attractive for new private investors to acquire the bank and provide new capital; or (ii) to liquidate the banks. In both cases, for the disciplinary purposes the banks will be placed under the receivership of DEBRA, the management will be relieved, and losses will be distributed among shareholders in accordance with the size of their investments.

38. Under the Reform Program, NBK has instructed the managements of Promstroi and AKB Kyrgyzstan Banks to present capital increase plans, satisfactory to NBK and IDA, to bring the capital from negative to "positive", or at least to "zero" level by October 31, 1996, and to reach 8% working capital adequacy requirement by March 31, 1997. If the bank(s) are successful in raising capital to "positive" or "zero" level by March 31, 1997, NBK will instruct the bank(s) to present another capital increase plan to reach 8% working capital adequacy requirement by September 30, 1997. If the bank(s)

are not successful in raising capital to "positive" or "zero" level by March 31, 1997, NBK will announce official liquidation and start the liquidation process - before the release of the Second Tranche.

Financial Costs of Bank Liquidation and Restructuring

39. In order to resolve the problem of insolvency of Big Four banks, their past losses should be charged with the shareholders of the banks, then officially recognized and financed by the budget. These costs will include payments to depositors, the removal of bad assets from bank balance sheets, an asset swap with the NBK to replace its claim on the insolvent Agroprombank, severance payments, and other costs associated with liquidation and restructuring. To the extent possible, shareholders will be asked to provide new capital to make up losses before Government resources are used. Recapitalization of the surviving banks, adjustment of capital to the minimum requirements prescribed by the NBK, will come from new capital raised from private sources and retained earnings.

40. Bank Liquidation. The Government's potential obligations to protect Agroprombank depositors is estimated at 60 million Soms, as of March 1, 1996. This amount assumes that current liquid assets of 30 million Soms will first be used to pay off an amount of equivalent liabilities and interests of depositors will be protected for the full amount of their deposits. Severance payments to staff will add an additional 2 million Soms, thus, the total costs of resolving this case of bankruptcy will approximate 62 million Soms. In addition, the debt of Agroprombank of 965 million Soms is due to NBK. This amount represents a bad debt on the books of the NBK. To make the balance sheet of the NBK whole again, this amount will be replaced by a long-term Government bond of 965 million Soms at a certain nominal interest rate. At a 5% interest rate annual costs to the budget will amount to 48 million Soms. However, since the NBK is required to transfer 70% of its profits to the budget, the net cost to the budget will be about 15 million Soms annually. As collections are made from liquidated assets of Agroprombank, these funds will be transferred to the budget to retire these bonds and reduce the Government's interest payments to NBK.

41. The Government's obligation, as owner of the Elbank, is the payout of principal and interest to depositors. In this regard, a deposit payoff plan has been worked out and its implementation started in February 1996. NBK has provided 50 million Soms from own reserves to start implementing this deposit payoff scheme until the counterparts from FINSAC will be available to the budget. If necessary, this support will be extended until the first tranche of FINSAC is disbursed after which the NBK costs will be reimbursed from the budget. There could also be receipts from sales of the assets of Elbank that will be used to meet this deposit payoff plan, pay other obligations of Elbank to commercial and Government social institutions and staff layoff costs. Thus the final costs to resolve Elbank's insolvency is estimated at 122 million Soms and will be financed by FINSAC.

42. Bank Restructuring. The Promstroi Bank will be recapitalized by its own shareholders and the use of retained earnings. If this process is successful, there will not be costs to the Government. This alternative appears to be feasible and preferable. However, should this approach prove unsuccessful, the Government will have two choices: (i) to restructure the bank by issuing bonds to remove bad assets from its portfolio, thus making the bank more attractive for new investors intending to acquire the bank and provide new capital; or (ii) to liquidate the bank. Of the two alternatives, the first, i.e., restructuring the bank by issuing bonds to remove bad assets from the portfolio, is the least costly alternative. Potential obligations of the Government to restructure the bank and protect depositors will include interest payments on Government bonds and the costs of retiring the bonds issued.

43. If AKB Kyrgyzstan Bank is successful in seizing and selling collateral and raising new capital from shareholders and retained earnings, there will be no cost to the Government. If the Bank is unsuccessful in raising capital, the Government will again have two choices: (i) to restructure the bank through a bond issue aimed at removing bad assets from its portfolio in order to make the bank attractive for new private investors intending to acquire the bank and provide new capital; and (ii) to liquidate the bank. In the first case, the cost to the government will be principal of the bonds of 160 million Soms (the negative capital as of June 30, 1995 reported by the diagnostic audit) plus interest. Assuming that these bonds carry 25% per year interest and are retired in equal installments over the five years, their cost in the first year would be 72 million Soms with a total cost to the Government of 272 million Soms over five years. Instead of the bond issue, if the bank is liquidated, the Government will have to decide whether or not the depositors and the NBK will be protected in full principal amounts payable by the bank instead of waiting for the liquidation proceeds from the bank to be used to pay off these liabilities. The cost of the payoff to the depositors and NBK immediately and in full principal is estimated to be 138 million Soms (160 million Soms of deposits plus 23 million Soms due to NBK minus 45 million Soms of cash and liquid assets of the bank as of March 1, 1996). The rest of

the receipts from the liquidation of AKB Kyrgyzstan Bank will be used to pay the rest of the liabilities of the bank.

Required Budgetary Resources

44. The total need for budgetary resources required during the first twelve months of the program will be in the range of 300-350 million Soms (a maximum of US$ 32 million) or about 1.5% of GDP, as initial up-front costs during the first year (July 1996-June 1997). Thereafter, the program will cost between 15-59 million Soms per annum, mainly as interest on bonds to be issued as part of the bank restructuring program. The proposed FINSAC will provide total financing of US$ 45 million, and thus cover the first year's costs, and provide (at least) an additional US$ 13 million of budget support during the life of the Credit. The counterpart funds generated under the FINSAC will be made available to the central Government budget. During the annual budget preparation process, funds will be allocated and transferred from the budget to NBK/DEBRA, to finance the bank liquidation and restructuring program. Before finalizing the decision on the amount of counterpart funds to be transferred to NBK/DEBRA, the Minister of Finance and NBK will have consultations with the IMF and IDA, to ensure consistency with the macroeconomic program.

IV. RESOLVING THE BAD DEBT PROBLEM

45. The non-performing loans that are currently in the portfolios of the Big Four formerly state-owned banks are around 1.5 billion Soms (or about 10.3% of GNP). The recommended liquidation/restructuring strategy has been worked out from the point of view of bad assets in the banking sector. Full forgiveness of these bad debts is an unacceptable option so far as it will create moral hazard and will significantly push the enterprise reform process back.

46. Under the Reform Program the Government has established a temporary Debt Resolution Agency (DEBRA), which should act as the receiver on behalf of the National Bank of Kyrgyzstan (NBK), and exert control over and dispose of the assets and liabilities of restructured commercial banks. DEBRA's operations will comprise two areas: (i) the receivership function when DEBRA, through its Bank Restructuring Unit (BRU), will act as an agent for the NBK and be engaged in its intervention, receivership, conservatorship, deposit payout, and liquidation activities; and (ii) the debt recovery function when DEBRA, through its Debt Restructuring and Recovery Unit (DRU) will manage, collect, restructure, liquidate, and resolve the non-performing loan portfolios and other assets of the intervened banks. It is envisioned that the scope of DEBRA's activities will initially encompass intervention and rationalization by the NBK of at least two of the four banks: Agroprombank and Elbank. This list may be expanded to include AKB Kyrgyzstan and Promstroi banks as discussed above, and any other Kyrgyz banks so identified by NBK during the limited time span of DEBRA.

47. Organization. DEBRA's mandate is set up for a period of three years. Operationally, DEBRA will be headed by a Director who will report to the Chairman of NBK. The Director will manage daily activities through deputy directors. The FINSAC state Review Committee will have the responsibility of overseeing the implementation of key Government decisions under the FINSAC Reform Program. It will be chaired by the Prime Minister. The membership of the Committee will be comprised of the Chairman of NBK, Minister of Finance, Minister of Economy, Minister of Justice, Chairman of State Property Fund, Director od State Agency for Securities of the Government of the Kyrgyz Republic, and Director of DEBRA.

48. The Debt Restructuring and Recovery Unit will act as the vehicle through which all recoveries are made to the Government and various other classes of creditors by collection of debts, loan restructuring, and the innovative use of debt resolution procedures on the outstanding non-performing loan portfolios of restructured banks. DRU will organize activities of working teams which will classify loans into pre-established categories and apply a series of "automatic criteria" to identify debt resolution wherever practicable. DRU will apply standard debt recovery methodologies including an analysis and review of the borrower's financial position as well as an appraisal of the value of collateral, as applicable. In all cases, the concept of cost-effectiveness and duration in debt recovery efforts will be applied; and operations where full recovery is not assured will be avoided.

49. Debt Recovery Principles. Certain categories of loans can be treated in various ways to effect final debt recovery or resolution. Due to likely personnel and time constraints, debt recovery programs involving standardization and automatic criteria which streamline debt recovery actions will be widely used. It is recognized by NBK management that dealing with hundreds of loans and borrowers on a case-by-case basis may well prove to be a monumental and counterproductive effort, with positive results unattainable within the expected life span of the proposed DEBRA.

50. While full recovery of a loan is the desired result, the Government recognizes that, for a variety of reasons, this will not be a practical or realistic goal in most cases. Therefore other debt recovery alternatives, such as those described below, will be considered:

A. Debt Forgiveness. The Government may decide that it is useful to forgive some or all of certain portions of debt. Such debt as excessive accumulated interest may be forgiven to give incentives for payment of principal. There may also be certain types of loans, such as peasant farm and small agricultural business loans, and those that are directly attributable to previous Government policies of price intervention for the purposes of social protection, such as bread subsidy, may be forgiven totally in the best interests of the economy.

B. Discounts. In order to give borrowers the incentive to pay their debt, a possibility of discounts will be considered. These could be in the form of one time discounts (such as a 25-50% discount for full payment within a certain fixed time period, or discounts ensuring timely payments, where a certain percent (such as 10-20%) discount is applied for each timely payment divided into a series of payments by equal installments. Profitable privatized enterprises would be likely candidates for this alternative to prevent foreclosure of collateral or possible bankruptcy measures.

C. Debt Collateral Swap. Sometimes there may be instances when a borrower will be willing to swap collateral for all or a portion of debt to prevent bankruptcy. Often such collateral is not marketable in the area of the country where the debtor is located. DEBRA, through its nationwide operations, could transport the collateral to marketable areas. However, DEBRA would be able to consolidate similar types of collateral from numerous debtors into acceptable marketable sizes.

D. Debt/Equity Swap. There may be opportunities to exchange all or part of outstanding debt for an equity interest in a debtor enterprise. Both the price and the type of the equity may be agreed during such a swap. The easiest swap could be for common stock. However, to alleviate concerns over the dilution of ownership wherein the Government could own a substantial or majority part of the enterprise, alternative equity instruments could be swapped. This could take the form of preferred non-voting stock, subordinated debt, or some type of instrument (such as a warrant or stock coupon) that is convertible into common stock as long as the converter is not a Government entity. Using this approach, DEBRA could take an instrument convertible to common stock and sell it, possibly on the stock exchange, to private individuals thereby avoiding the transfer of privatized enterprises into state ownership.

E. Restructuring of Debt. So that non-performing borrowers could start paying their debts it may often be necessary to change a debt structure. This may take various forms, most often restructuring of the terms (maturity date(s), interest rate, payment amounts, timing of payments, etc.) and setting up some type of enterprise "cash flow" payment requirements (when payments are based on the cash flow of the business such as receipt of accounts receivable). When negotiating the terms of debt restructuring it is recommended to obtain additional collateral, or other forms of guarantees, etc.

F. Auction/Sale of Debt. Selling loans individually or in packages of several homogeneous loans may be a viable disposition alternative. This can be through either public or sealed bid auctions. Large loans to specialized companies or with distinctive collateral lend themselves to sealed bid auctions. Smaller loans, packaged using similar attributes, such as type of enterprise, type of collateral, geographic location of borrower/collateral or loan size are good products for sale through either public or sealed bid auction. Loan collateral, especially movable type, such as cars, equipment, furniture, fixtures, etc., is conducive to public auction on a cash and carry basis.

G. Bankruptcy. DEBRA management will also recognize the use of bankruptcy proceedings as a tool or threat for collection; particularly in those cases where the borrower has the capacity to repay but refuses to work with DEBRA. Also, the borrower may have other assets that can be obtained through court to use in extinguishing the debt. There will also be instances where analysis shows the borrower is not viable under any scenario and bankruptcy may be the only viable option. However, bankruptcy and the confiscation of collateral is an option that should be carefully considered, as certain types of collateral may not be easily marketed and could be costly to maintain. Costs to maintain and store collateral should also be taken into account. These may indicate that bankruptcy may not be a cost effective business alternative.

51. Farm vs. Non-Farm Debt. Certain types of debt lend themselves to some debt resolution alternatives better than others. In the Kyrgyz case, the most significant division of debt appears to be farm versus non-farm debt. In dealing with farm debt, the most relevant debt resolution alternatives involve any or a combination of debt forgiveness, collateral exchange and/or restructuring of debt. In the non-farm debt, although debt forgiveness and collateral exchange may be applicable in certain cases, the most practical alternatives are discounts, debt/equity swaps, and restructuring of debt. These methods are also the best methods to be used by Promstroi and AKB Kyrgyzstan Banks, *vis-à-vis* the debtor enterprises.

52. At an early stage after its establishment, but before the release of Second Tranche of FINSAC, DEBRA will prepare a report, satisfactory to IDA, classifying the non-performing loans under its control into two categories that will be treated differently: (i) those where the work plan for collection will be based on "automatic criteria" appropriate to the loan category; and, (ii) others where a more systematic case-by-case approach is practicable. This report, satisfactory to IDA, will be integrated into the Key Operating Principles of DEBRA.

V. ENCOURAGING THE DEVELOPMENT OF NON-BANK FINANCIAL INSTITUTIONS

53. The securities market in the Kyrgyz Republic is still in an early development. In the coming years, however, the supply of securities will increase rapidly due to the conversion into joint-stock companies and privatization of state enterprises and due to advantages of conversion into securities of government borrowing. To cope with this challenges, the Government will create a framework for the orderly development of these markets, not only to raise efficiency, but to avoid the possible collapse or public distract of markets which might occur if they are allowed to develop in a haphazard or disorderly way. The Structural Reform Program of the Kyrgyz Republic will also result in an increase in entry of securities to the securities markets, particularly, shares of privatized enterprises and state bonds issued as a result of the debt/equity swap. Soon there will be also secondary markets of Treasury bills, bonds and shares. The main problem will be in a deficient demand of savings on these capital markets. To solve these problems, Government will introduce two sets of measures: first, making securities more attractive by removing constraints to their profitability and giving investors confidence in the integrity of the markets; second, laying the basis for efficient and sound contractual savings institutions that will intermediate between small savers and the capital markets. Further efforts will also be made to enhance public interests in mass privatization, reduce excessive taxation, and deepen markets for Government debt instruments.

How to Make Securities More Attractive

54. The Kyrgyz Stock Exchange. So far, many resources have been concentrated on establishing the infrastructure of a well-developed stock exchange. While much has been achieved in this respect, there are no indications that the Kyrgyz Stock Exchange will in the short-term be financially self-sustaining and be able to render the above-described services. For a long-term perspective, a viability assessment of the stock exchange will be made. The volume and fees of listing and of turnover will be estimated, and the resulting income projections will be compared with the expected operating costs of the stock exchange. While the total savings in the economy may take a long time to recover, their mobilization in the capital markets can be stimulated. The attractiveness of capital market investments may be enhanced, especially through the use of privatization coupons; excessively high taxation will need to be cut back; and the public confidence in the orderly functioning of the markets may be ensured.

55. Enhancing Public Interest in Mass Privatization. By mid 1995, 52% (i. e., 1,8 billion) of issued privatization coupons remained uninvested. An additional 901 million coupons have not even been placed yet, and await sale by the State Property Fund (SPF) when it deems it possible. To create favorable conditions for the use of coupons, a greater number of more attractive enterprises will be brought forward for privatization. In addition, public confidence in investment funds will be enhanced, as discussed below.

56. Reducing Excessive Taxation. Current tax policy, including high corporate taxes, makes tax avoidance dominate in many business decisions. This undermines efforts to attract more listings to the exchange, to properly record securities transactions, to obtain reliable financial information, and to build fair and transparent markets. The growth of NBFIs remains constrained, and most

transactions take place on informal capital markets. One important measure would be a tax credit or pass-through mechanism to avoid double or treble taxation; such treble taxation occurs as taxes are levied on the profit of corporations, then on net income of investment funds earned from post-tax dividends from those firms, and finally again on the personal income from share-holdings in these funds. Other measures may include a contingent reduction or elimination of taxes on securities transactions.

57. Deepening Markets for Various Debt Instruments. The rapid widening and deepening of markets for debt securities will hasten capital market development, generate more information fundamental to the functioning of the financial markets, and facilitate the cash management of banks, develop contractual savings institutions, and corporations. The creation of an organized secondary treasury bills market which will operate within the framework of the Kyrgyz Stock Exchange has already been discussed between representatives of the NBK and stock exchange. Efforts are also underway to issue Government bonds directly to the public through the stock exchange, by introducing longer maturities and smaller denominations.

Providing a Framework for Sound Contractual Savings Institutions

58. As the Kyrgyz Republic's fledgling capital markets gradually gain scale and efficiency, contractual savings institutions should play a growing role as well. The basic policy, legal, and taxation framework needs to be prepared in the meantime. Only investment funds are somehow significant today, due to their role in privatization. Their activities require thorough control to avoid failures or fraud that could discredit contractual savings institutions at this early stage of development.

59. Investment Funds. Investment funds which were established mainly to deal in privatization coupons have so far had mixed results. The coupon privatization was in fact expected to boost the emergence and growth of such funds. By mid-1995, however, the vast majority of coupons was not yet invested at all, and of those invested, only some 30% had gone through investment funds. Moreover, many of these funds are currently in a poor financial state. Further failures in the work of funds and the attendant loss of public confidence could seriously set back capital market development. The funds distress stems mainly from the following: (a) limited amounts of cash earned in exchanges for shares, which is due to the poor quality of the privatized enterprises; (b) the 25% limit on any fund s stake in an enterprise, and the shortage of investable savings in the economy; (c) poor fund management; (d) not skilled fund management; and (e) lack of effective prudential supervision. Fund management needs substantial training, and perhaps assistance, in accounting, asset/liability management, enterprise governance, and related subjects. The recently issued investment Fund Accounting Guidelines, which also regulate reporting and disclosure, needs to be implemented. The responsibility for the funds supervision lies currently with SPF rather than the State Agency for Securities (SAS), since they are "specialized" funds. However, SPF barely exercises this function, and SAS lacks the powers. This responsibility will shift to SAS, once the authority and capabilities of SAS have been boosted under the Reform Program.

60. Before the release of the Second Tranche of FINSAC, the Ministry of Finance will review and amend the prudential regulations for "Investment Funds", satisfactory to IDA, from the point of view of strengthening these regulations; and implement the recently issued Investment Fund Accounting Guidelines.

61. Insurance Companies. Insurance companies are currently moving away from credit insurance practices, because in this area companies have major losses, and instead of this they are more actively involved in property, accident, life and voluntary medical insurance. It is thus developing a potential for playing a major role in the country's financial market. However, a continued use of former Soviet accounting practices inhibits the assessment of the following: (a) cash reserves that could be invested in securities; (b) transparent market values of investments; and (c) nature and maturity profiles of liabilities. Measures to enhance the development of insurance companies will include, inter alia: the preparation and passing of a new Law on Insurance, as indicated below; the introduction of new accounting practices; the building up of effective prudential supervision; the transfer of skills through tolerant policies vis-à-vis foreign insurers and reinsurers.

62. Pension Funds. Pension fund activity in the Kyrgyz Republic is still marginal. In the long run, however, partially or fully funded pension funds will become major investors of household savings in the capital markets. Given this potential, the Government is obtaining full technical assistance to review the fundamental options for the future nature and scope of the country s pension system.

policies, regulations and tax arrangements. This will be followed by the development of policies, a Law on Pension Funds and specific regulations.

63. Before the release of the Second Tranche of FINSAC, a new law on Insurance Companies, and a new Law on Pension Funds will be prepared, and existing legislation on Leasing will be improved. These three new legislations will be submitted to Parliament.

Safeguarding Investor's Interests

64. Currently, there are no prudential regulations applied to the activities of non-bank financial institutions that deal with general public such as Insurance Companies and Pension Funds. These institutions can lead to systemic financial instability of the event of failures. In the case of securities market, the 1991 Law on Securities and Stock Exchanges has been amended to establish a legal framework for creating open and transparent formal trading relations. Although the legal framework is very essential, enforcement of the law is also necessary. The enforcement capability of the State Agency for Securities (SAS) is not sufficient to implement this LAW. The SAS is a small agency with huge responsibilities for regulating and supervising capital markets and their NBFIs. Soon it is assumed to enforce the Law on Securities and Joint Stock Companies. Although efforts to upgrade its status and resources have shown some results, SAS is still short of adequate authority, personnel, training, facilities, equipment and budget.

65. Under the Reform Program, the status of the SAS will be transformed from an administrative agency into the executive arm of a Securities Commission, comprising the heads of MOF, MOJ, NBK, SPF and SAS itself, as well as a representative of the stock exchange. The involvement and standing of these ministries and agencies and a strong influence of the Government will help to attract the required resources and to obtain authority for implementation of securities regulations. It will also help to consolidate the authority for all securities markets regulations and their supervision in one institution. After some time, the President will appoint a number of full-time commissioners. In parallel, a professional organization of brokers and dealers will be created to represent the interests of this sector and to promote its development.

Sincerely,

A. DZHUMAGULOV
Prime Minister

KYRGYZ REPUBLIC
Financial Sector Adjustment Credit

ANNEX G: TIMETABLE OF KEY PROJECT PROCESSING EVENTS

Time for Preparation:	7 months
Identification Mission:	July 17, 1995
Pre-Appraisal Mission:	December 4, 1995
Appraisal Mission:	March 26, 1996
Negotiations:	May 9, 1996
Board Presentation:	June 25, 1996
Expected Effectiveness:	July/August 1996

KYRGYZ REPUBLIC
Financial Sector Adjustment Credit

STATUS OF BANK GROUP AND IFC OPERATIONS IN THE KYRGYZ REPUBLIC

STATUS OF BANK GROUP OPERATIONS IN THE KYRGYZ REPUBLIC

A. STATEMENT OF IDA CREDITS [a/]
(As of April 30, 1996)

Credit No.	Fiscal Year	Borrower	Project	US$ Million (Less Cancellations) Credit	Undisbursed [b/]
24910	1993	Kyrgyz Republic	Rehabilitation	60.00	0.48
26390 [c/]	1994	Kyrgyz Republic	Private & Ent. SAC (PESAC)	60.00	0.00
26340	1994	Kyrgyz Republic	Telecommunications	18.00	17.97
26430	1995	Kyrgyz Republic	Social Safety Net	17.00	14.66
27170	1995	Kyrgyz Republic	Private Enterprise Support	15.00	14.31
27500 [c/]	1995	Kyrgyz Republic	APEAC	45.00	20.85
28590	1996	Kyrgyz Republic	Sheep Development	11.6	11.6
28680	1996	Kyrgyz Republic	Power and District Heating Rehab	20.0	20.0
Total number of Credits = 8				246.6	99.87
			Total [d/]	246.6	
			Of Which: Repaid	-	
			Total Now Held by IDA	246.6	
			Total Amount Sold	0.0	
			Of Which: Repaid	0.0	
			Total Undisbursed		99.87

a/ The status of these projects is described in a separate report on all Bank/IDA financed projects in execution, which is updated twice yearly and circulated to the Executive Directors on April 30 and October 31.

b/ The Undisbursed amounts are the US$ equivalent of the amount in SDR.

c/ SAL/SECAL Credit.

d/ Total approved, repayments, and outstanding balance represent both active and inactive Credits.

B. STATEMENT OF IFC INVESTMENTS
(As of February 29, 1996)
(US$ Millions)

FY Appr.	FY Committed	Description	Sector	Loan	Equity	Total	Other	Undisbursed
A. Approved and Committed (Signed) Projects								
95	95	Kumtor Gold Company	Mining & Extraction	40.00	0.00	40.00	0.00	9.00
Total Gross commitments				40.00	0.00	40.00	0.00	9.00
Less cancellations, terminations, repayments & sales								
Total commitments now held				40.00	0.00	40.00	0.00	9.00
B. Approved Projects Pending Commitment								
Total pending commitments								
Total commitments held and pending commitments								
Total undisbursed commitments				9.00	0.00	9.00		

KYRGYZ REPUBLIC
Financial Sector Adjustment Credit

ANNEX I: SUPERVISION PLAN

IDA Supervision Input

1. It is envisaged that about 65 staff weeks (four review missions) will be required for supervision of FINSAC — 45 SW in FY97, and 20 SW in FY98. Supervision will involve in-country review of the reform program; a review of progress reports provided by the Borrower; and review of procurement and disbursement actions, correspondence, and donor coordination.

Organization and Timing of Supervision Missions

2. Review missions will be led by the FINSAC Task Manager and will include staff and/or consultants who are specialists in areas of commercial banking, bank liquidation and restructuring, prudential regulation, international accounting and auditing standards, debt resolution, payments and settlements systems, and non-bank financial institutions. Because of the importance attached to satisfactory macroeconomic performance as a condition of tranche release, a macroeconomist from the Country Operations Division will be invited to participate in the review mission preceding the second tranche release. Close cooperation will also be maintained with the IMF. The Supervision Missions will leave behind detailed Aide-Memoires with specific suggestions on the next steps to be followed by the Borrower for successful implementation of each component. The Second Supervision Mission (second in FY97, to be held in November/December 1996), will be called Mid-term Implementation Review (MIR) and be conducted jointly with IDA and the Borrower. At the end of this review, a "Timetable of Tranche Release" will be prepared and signed by the Governor of the National Bank of the Kyrgyz Republic and the FINSAC Task Manager. This timetable will specify clearly the actions to be taken by the Borrower between the mid-term review and the release of the Second Tranche. Implementation advice, including matters of accounting and auditing, based on experience with the ongoing adjustment operations, will also be provided on a continuous basis by the Bank's Resident Mission in the Kyrgyz Republic.

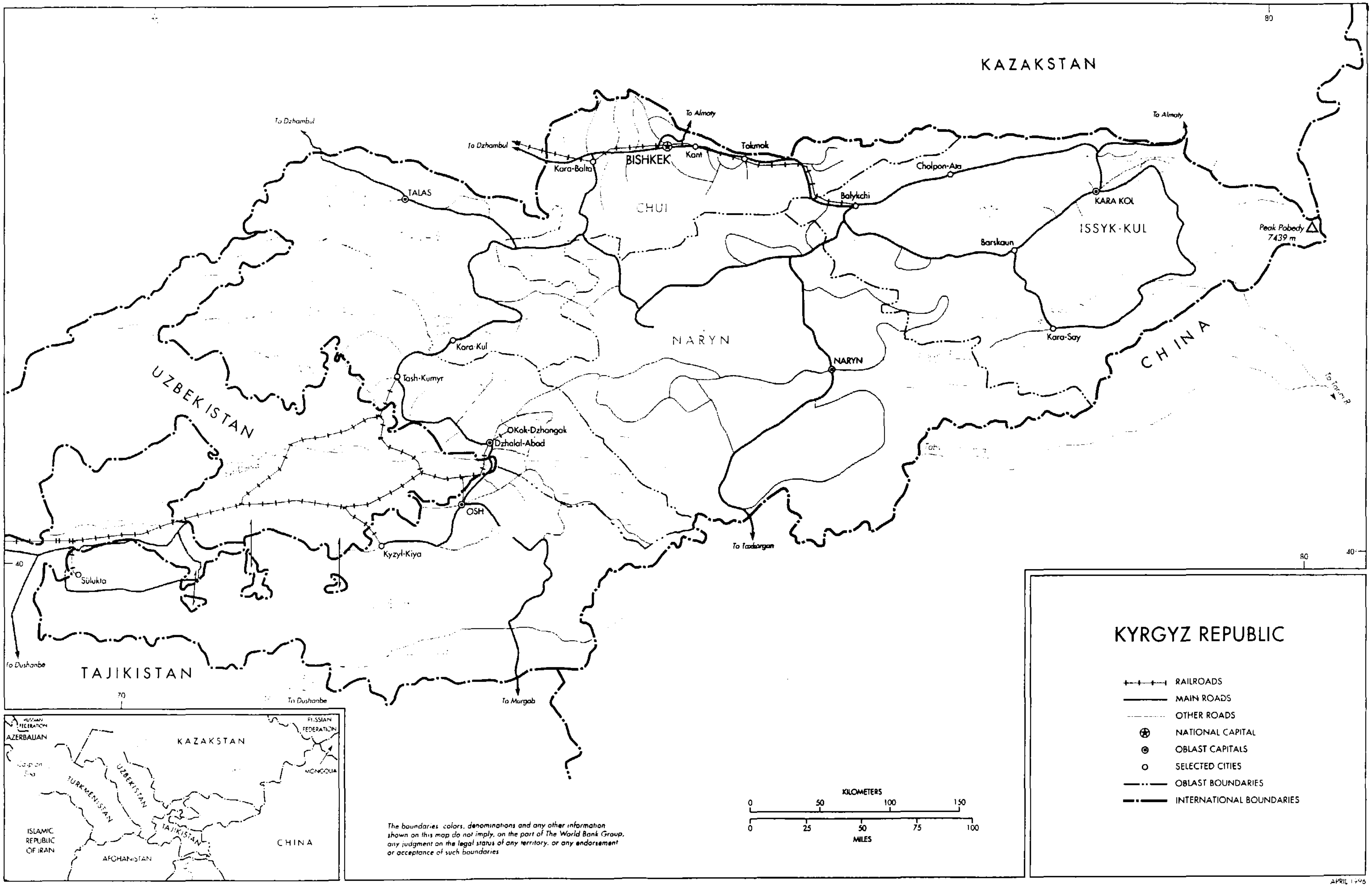
Borrower's Contribution to Supervision

3. The National Bank of Kyrgyzstan, with assistance from the Ministry of Finance, State Agency for Securities (SAS) and DEBRA, will be responsible for implementing the overall Financial Sector Adjustment Program. The National Bank of Kyrgyzstan will have the primary management responsibility for the reform program as a whole. The bank liquidation and restructuring component and the resolution of the bad debt problem will be implemented by DEBRA. The program to encourage the growth of NBFIs will be carried out under the leadership of the Ministry of Finance with the assistance of NBK and the SAS.

4. The FINSAC Management Unit (FMU) will be established in the National Bank of Kyrgyzstan. On matters of disbursement the FMU will be assisted by the Project Management Unit (PMU) already established in the Ministry of Finance under previous IDA adjustment operations. The FMU will report

implementation progress periodically to the FINSAC REVIEW COMMITTEE, led by the Prime Minister or his designee, and submit quarterly reports to IDA, within one month of the quarter's close. The quarterly reports will monitor: (a) progress in creating and sustaining an enabling policy environment; (b) progress in establishing and sustaining an enabling legal and regulatory environment; (c) progress in liquidation and restructuring of the "Big Four" state/formerly state-owned banks (d) progress in encouraging the growth and development of NBFI's. Responsibility for coordinating arrangements with IDA Supervision Missions and for the timely transmittal of quarterly progress reports, other documents, and information would rest with the National Bank of the Kyrgyz Republic.

IBRD 26822



APRIL 1996

IMAGING

Report No: P- 6891 KG
Type: PR