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IMPLEMENTATION COMPLETION REPORT

KYRGYZ REPUBLIC

FINANCIAL SECTOR ADJUSTMENT CREDIT (FINSAC)

(Credit No. 2890-KG)

June 30, 2000

Private and Financial Sector Development
Europe and Central Asia Region

CURRENCY EQUIVALENTS
(as of April 3, 2000)

Currency Unit	=	Som
1 Som	=	US$ 0.021
US$1	=	47.8 Som

WEIGHTS AND MEASURES
Metric System

ABBREVIATIONS AND ACRONYMS

APEAC	-	Agricultural Privatization and Enterprise Adjustment Credit
ADB	-	Asian Development Bank
DEBRA	-	Debt Resolution Agency
FINSAC	-	Financial Sector Adjustment Credit
FINSAC-TA	-	Financial Sector Technical Assistance Project
IBRD	-	International Bank for Reconstruction and Development
ICR	-	Implementation Completion Report
IDA	-	International Development Association
IMF	-	International Monetary Fund
MOF	-	Ministry of Finance
NBFI	-	Non-Bank Financial Institution
NBK	-	National Bank of Kyrgyzstan
NSC	-	National Securities Commission
PESAC	-	Privatization and Enterprise Sector Adjustment Credit
SDR	-	Special Drawing Right
SOE	-	State-Owned Enterprise
SOSAC	-	Social Sector Adjustment Credit
SPF	-	Social Property Fund

KYRGYZ REPUBLIC'S FISCAL YEAR

January 1 – December 31

Vice President:	Johannes F. Linn, ECA
Country Director:	Kiyoshi Kodera, ECC08
Sector Manager:	Ira Lieberman, ECSPF
Program Team Leader:	F. Aynur Sumer, ECSPF
Mission Leader:	Hans O. Moritz, ECSPF

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(CREDIT No. 2890-KG)

Preface

This is the Implementation Completion Report (ICR) for the Financial Sector Adjustment Credit (FINSAC) to the Kyrgyz Republic, for which a credit (No. 2890-KG) in the amount of SDR31.2 million (US$45 million) equivalent was approved on June 25, 1996 and made effective on September 3, 1996.

The first tranche of SDR15.6 million (US$22.5 million) equivalent was released upon effectiveness on September 27, 1996; and the second tranche, of an equal amount, was released upon full implementation of the reform program supported by the FINSAC on November 18, 1997. Extensive supervision was carried out during the implementation of the Reform Program supported by the FINSAC, as described in the Supervision Plan of the President's Report (Report No. P-6891-KG). The credit was closed on June 30, 1998, according to schedule.

The Implementation Completion Report (ICR) was prepared by Hans O. Moritz, Mission Leader, Financial and Private Sector Development Unit of the Europe and Central Asia Region (ECSPF). The report was updated by F. Aynur Sumer, Principal Financial Sector Specialist and Michael Gascoyne, Financial Sector Specialist (ECSPF), and reviewed by Ira Lieberman, Sector Manager and Kiyoshi Kodera, Director (ECC08). Preparation of the report began during the Completion Mission of April 1999 and has been updated during this past year to reflect developments in the banking sector. It is based on material in the project files, discussions held with relevant government agencies involved in project implementation, and the findings of the Completion Mission.

The Borrower contributed to the ICR by preparing its own Completion Report (Annex B). After reviewing the draft ICR, the Government provided comments, which have been incorporated in the final report.

IMPLEMENTATION COMPLETION REPORT

KYRGYZ REPUBLIC

FINANCIAL SECTOR ADJUSTMENT CREDIT (FINSAC)

(Credit No. 2890-KG)

Evaluation Summary

Introduction

1. After gaining independence in 1991, the Kyrgyz Republic experienced a sharp contraction of economic activity and very high levels of inflation caused by the breakdown in FSU trade and budget support arrangements. In 1995 production was still 45 percent below its 1991 level and the budget deficit remained high. However, the Government had liberalized prices, interest rates, exchange rates, and the trade regime. It had also engaged in a far-reaching program of structural reforms, including farm restructuring and agrarian reforms, enterprise privatization and restructuring, aimed at creating a market economy. From 1995, GDP started to recover and significant progress was made in stabilizing the economy. GDP advanced by 7 and 10 percent in 1996 and 1997 respectively, and inflation fell to 14 percent at the end of 1997. However, following the regional financial crisis in 1998 that hit the economy in the latter half of 1998, combined with the low price of gold and the disruption of power exports , put a halt to the recovery of growth, which fell to 3.2 percent in 1998 and further in 1999 to near zero growth. This contributed to a substantial worsening of the fiscal deficit and a correction in the real exchange rate. The correction of the real exchange rate by 67 percent vis-à-vis the dollar between 1997 and 1999, was effective in reducing external imbalances, it has had a substantial adverse effect on enterprises with foreign currency denominated debt and, through this route the banking sector.

2. During the early years of transition, financial sector development was stymied by State ownership of commercial banks and enterprises, government-directed banking, and widespread interference in financial market mechanisms. Starting in June 1991, financial sector reforms were initiated, which included the establishment of: a two-tier banking system; a Commercial Banking Law and a Central Bank Law giving independence to the National Bank of Kyrgyzstan (NBK); a liberal currency law, and; a full range of indirect monetary policy instruments. Between 1995 and 1998, the authorities took over the task of reducing the large non-performing portfolio of the banking sector, most of which was due to earlier policies of directed credit towards loss making State owned enterprises (SOEs). By the beginning of 1998, the liquidation of the two worse State owned banks had been completed (Agroprom and Elbank), while two other banks had been capitalized with private funds . A debt restructuring agency was created and it took over and restructured a large number of bad loans, auctioned collateral won a number of arbitration cases and made partial payouts to creditors. By this time the number of private banks had grown to 23 and the prospects for the sector appeared quite encouraging, although most of these banks were very small, focused mainly on financing short-term trade and working capital requirements, were highly exposed to foreign exchange risks, and were far from developing a capacity to appraise project and overall credit risks. Also, during this period the basic features of banking supervision had been laid out, but supervisors clearly lacked sufficient supervisory experience. The regional financial crisis, which started in the second half of 1998, revealed the fragility of the sector and brought to the surface a number of instituional development problems within the sector, primarily the weakness of supervisory capacity. By the end of 1999, the country's largest banks were forced to close,

the Government had to intervene and re-capitalize two smaller banks In short, the country is confronting its first major banking crisis and the Borrower now finds itself facing many of the problems which it had tried to resolve under the FINSAC program.

Project Objectives

3. The FINSAC program focused on two broad areas. The first three objectives of the program aimed at curtailing the flow of budgetary resources flowing through the banking sector used to subsidize inefficient and non-viable manufacturing and agricultural production. Its purpose was to reduce the threat to macroeconomic stability that these subsidies were posing. These objectives were: (i) the liquidation of the dominant and insolvent state banks; (ii) the downsizing and financial restructuring of two other banks; (iii) the establishment of a temporary debt Resolution Agency to acquire, collect or write-off the old non-performing loans. The second set of objectives aimed at introducing a policy and regulatory environment conducive to: (i) a competitive and efficient banking system; and (ii) non-bank financial institutions. In hindsight it is clear that these objectives were too ambitious.

Implementation Experience and Results

4. The policy and institutional measures introduced under the FINSAC were appropriate for achieving its objectives, and the Program's achievements have been substantial in most areas. Nevertheless, there were problems in developing effective supervisory capacity for the banking system which eventually undermined some of these reforms when the regional financial crisis hit Krygyzstan in the second half of 1998. Under the legal reform component, amendments were made to the tax code, a Law on Banks and Banking Activity and a Law on Pledge were passed, and a Central Pledge Registry was established. Regulatory reforms adjusted prudential norms to Western standards. Two insolvent state-owned banks were liquidated and two others were successfully restructured and a Debt Resolution Agency (DEBRA) was established to resolve the bad debt problem. Success in encouraging the development of NBFIs was limited; a new Law on the Organization of Insurance Activities was enacted and provisions were added in the Civil Law concerning Leasing. A new law on Investment Funds was enacted in June 1999 but the law on Private Pension Funds, though submitted to parliament, did not pass into law.

5. Progress made towards securing the FINSAC's objectives, as stated above, is expected to be largely sustained. A reversal of the measures taken is not possible in some areas (e.g. liquidation of banks) and highly unlikely in all other areas, given the Government's strong commitment to the reforms. However, since mid 1998, some 6-8 months following the completion of the FINSAC reform agenda, the country faced highly adverse developments due mainly to the regional financial crisis and financial irregularities surrounding Kyrgyz Gas Munaizat (KGM), the State-owned gas supply company. As a result of these shocks, which were outside the scope of the FINSAC program, the economy has deteriorated substantially and the banking system has fallen into serious difficulty, with five of the Republic's largest banks being affected. The effect on the banking system was exacerbated by weak banking supervision.

6. The NBK's performance in dealing with the recent difficulties in the financial sector has been mixed. The NBK initially reacted very quickly, taking a number of drastic actions to deal with some insolvent banks and strengthening some of the key prudential regulations, however, the scale of the problems in the sector severely strained the resources of the NBK. A bridge bank was established by the NBK to take over the good assets of the recently failed banks, however, an independent audit of the

bridge bank confirmed that the bank is holding a large volume of non-performing assets -- many of which are connected to the owners of the failed banks -- and is insolvent.

7. Financial sector deepening can occur, and the country will be able to reap the full and sustained benefits from the FINSAC reforms, only after relative economic stability and public confidence in the banking system have been regained. Until then, the financial system will remain extremely small and financial intermediation will remain at a low level.

Summary of Findings, Future Operations, and Key Lessons Learned

8. Project preparation and implementation were characterized by a cooperative and constructive approach between IDA and the client. The project was well designed and sequenced, considering that the Government's overall reform program included a number of complementary actions and other donor agencies provided assistance in various areas. During appraisal, a major effort was made to ensure full accord with and Government ownership of the Project, and implementation was facilitated by preparing and agreeing upon a number of implementation guidelines, as well as by an IDA Technical Assistance Credit. The Borrower's commitment to the Project, active cooperation in preparing it and receptivity for technical assistance to implement it is noteworthy.

9. With regard to FINSAC's core objectives, the program was effective; insolvent State banks were liquidated or restructured and a sound regulatory framework was established for the banking sector. The recent difficulties in the banking sector are mainly the result of external shocks and the fraudulent behavior of some bankers and their clients, however, a stronger banking supervision department would have contributed to an earlier detection of the impending crisis. The progress in establishing prudential norms and effective supervisory authorities for NBFIs has not been fully satisfactory, however, given the country's position in the transformation process this has probably had little effect on its rate of economic development. Though achieving the numerical targets set for the privatization of SOE's, the program did not significantly expand the universe of creditworthy customers available to the banking sector because few of the newly privatized entities have undertaken the structural reforms needed to transform them into market oriented businesses. The FINSAC is rated satisfactory overall.

10. While IDA and the Government were effective in preparing the project, the ICR Mission found that the policy dialogue lessened substantially after the release of the second tranche and a number of agreed actions remain unimplemented. Although the supervision of related projects (PESP and FINSAC-TA) ensured some degree of continuity, a continued intensive policy dialogue -- probably in the context of formal or informal financial sector work -- or the preparation of a successor project, could have helped to strengthen the Borrower's capabilities in analyzing and countering the developments that resulted in the recent difficulties. Considering that the Kyrgyz Republic is still in the midst of transition, this Report proposes some of the areas in which support could be provided through such operations.

11. The lessons to be learned from the preparation and implementation of the FINSAC relate to the importance of Government commitment and project ownership, the benefits of intensive monitoring and implementation support and of a comprehensive reform approach with complementary and well-sequenced operations in related sectors, the need for the early establishment of strong supervisory and enforcement institutions, and the importance of macroeconomic stability for sustainable reforms in the financial sector.

12. A banking sector note is currently under preparation and continuing involvement in the financial sector will be managed through the supervision of the PESP and FINSAC TA programs. IDA is cooperating closely with the ADB, which has recently launched its Financial Intermediation and

Resource Mobilization (FIRM) program, a USD 35 million sectoral adjustment credit which builds on the foundations laid under the FINSAC. The FIRM has 4 broad objectives: (i) restructure and consolidate the banking sector; (ii) develop the Government securities market; (iii) facilitate the development of the equities market; and (iv) promote the institutional investor sector.

IMPLEMENTATION COMPLETION REPORT

KYRGYZ REPUBLIC

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Part I. Project Implementation Assessment

A. Introduction

1. The Kyrgyz Republic has been one of the most rapidly reforming countries in the former Soviet Union. Since 1992, it has made significant progress in achieving macroeconomic stability, eliminating market imperfections inherited from the previous centrally planned economy and transforming the economy into a market-oriented system. These reforms have been supported by a Rehabilitation Credit (FY93), five successive IDA adjustment operations, and various IMF arrangements. The Rehabilitation Credit (FY93) supported the foundation of the structural reform agenda and served as a bridge to future sector adjustment operations. The Privatization and Enterprise Sector Adjustment Credit (PESAC, FY94) was the first of these operations and was designed to support the Government's key objectives for private sector development. It was followed by the Agricultural Privatization and Enterprise Adjustment Credit (APEAC, FY95), which aimed at establishing an enabling environment for recovery of the agricultural sector, and the FINSAC (FY96), which supported the Government's program for financial sector reform. A Public Sector Management Adjustment Credit (PSRMAC, FY97) introduced reforms of intergovernmental finances and budgeting systems, and a Social Sector Adjustment Credit (SOSAC, FY98) is supporting reforms in the pension and social assistance systems.

2. The FINSAC was appraised in March 1996, and approved by the Board in June 1996. The Development Credit Agreement was signed in July 1996, and became effective on September 3, 1996, with release of the first tranche of SDR15.6 million (US$22.5 million) equivalent, which was disbursed by September 1996. The second tranche of an equal amount, released upon full implementation of the FINSAC Program, was disbursed by November 1997. The credit was closed on June 30, 1998, according to schedule.

B. Project Origin and Objectives

Macroeconomic Context

3. The Kyrgyz Republic's macroeconomic performance after the break up of the Soviet Union was much in line with that of other FSU countries. GDP fell by almost 50 percent between 1991 and 1995, and per capita income declined sharply. The accompanying collapse in public revenues was further exacerbated by the loss of budgetary transfers from Russia, which had reached as high as 13 percent of GDP in 1991. This triggered large fiscal deficits, most of which ended up being financed by National Bank resources. As a result, inflation exploded, as happened in most other CIS countries.

4. By 1996, the macroeconomic situation had turned around. GDP grew by 7 percent in 1996 and by 9.9 percent in 1997. While the resurgence of growth was partially due to the ambitious public investment program and the coming on stream of the Kumtor gold mine (Kumtor contributed 4.6 percent to GDP growth in 1997), the recovery was broader than just mining; agriculture and services also rebounded strongly.

5. During this period, the Kyrgyz Republic also improved its fiscal performance. Over the period 1995-1997, the cash deficit went down from 17 to 9 percent of GDP. As a result of favorable fiscal developments and an increasingly tight monetary policy, inflation declined rapidly and stabilized around 15 percent per year towards the end of 1997. In response to the substantial decline in investment associated with the completion of the Kumtor mine project and the continued improvement of fiscal performance, there was a substantial improvement in external imbalances; the non-interest current account deficit narrowed from an average of around 17 percent of GDP in 1995 to 5 percent in 1997.

6. As a result of favorable developments in fiscal and external balances, and the relatively tight monetary policy, stability was restored to the exchange rate. The value of the Som stabilized at around 11 Soms to the dollar, in nominal terms, at the beginning of 1994 and stayed there until late 1996, at which time a sharp depreciation took place. The Som thereafter remained stable, however, at around 17-20 Soms per dollar until mid 1998. The macroeconomic stability, which is an essential prerequisite for savings mobilization as well as for the development of the financial system, was therefore secured and sustained throughout project implementation.

7. The FINSAC primarily supported the following key elements of the Government's Financial Sector Reform Program: (i) creation of a policy and regulatory environment conducive to the sound growth of a competitive and efficient banking system; (ii) liquidation of two dominant and insolvent State-owned banks, which through their practices stifled the growth of their young private competitors, and downsizing and financial restructuring of two other former State-owned specialized banks which had survived only because of preferential treatment and support by the NBK; and (iii) creation of a regulatory and supervisory framework for the development and growth of emerging NBFI's. These objectives were consistent with the high-case scenario of the Country Assistance Strategy, approved by the Board on June 28, 1995, and they were generally well conceived. The need to further strengthen the NBK's banking supervision capabilities was noted in the FINSAC policy matrix but no specific measures were prescribed, since it was found that considerable improvements had already been made and technical assistance from other donor agencies was in place to ensure further progress.

C. Implementation and Achievement of Objectives

8. Before appraising the Project and entering into the Development Credit Agreement, IDA had to be satisfied that the Borrower had met the conditions of appraisal and of Board presentation (Table 5). According to the Development Credit Agreement, second tranche release was dependent on: (i) the progress achieved in carrying out the overall Program for Financial Sector Reform, described in the "Letter of Financial Sector Development Policy" of May 24, 1996 (Annex F of the President's Report), and (ii) on meeting the specific conditions related to second tranche release (Table 5).

Overall Program for Financial Sector Reform

9. At the time of project preparation, the financial sector of Kyrgyzstan was characterized by a serious lack of confidence in the banking system, the oligopolistic nature and insolvency of commercial banks, and a substantial bad-debt problem, largely a legacy of the past. To address these problems, the Government's overall Reform Program pioneered a bold and comprehensive approach to reforming a fledgling financial sector in the context of rapid economic transformation. By achieving satisfactory macroeconomic and fiscal performance in the second half of 1996 and in 1997 and by building a more competitive market structure, the Government created a favorable enabling policy environment. The implementation of the Reform Program proceeded well with impressive achievements in legal and regulatory reforms. The program also involved liquidating or restructuring the problem banks, whose

financial weaknesses jeopardized systemic stability, and bad debt resolution. As a result, a core of small private commercial banks has emerged, several of which appear well managed. In the rural areas, the country's poorly managed directed credit schemes have been superseded by a more efficient rural finance system, funded by budgetary resources and donor assistance. The progress in developing effective banking supervision capabilities and a regulatory and supervisory framework for NBFIs has been less impressive.

10. The implementation of the Reform Program was complemented and facilitated by the Financial Sector Technical Assistance Credit (FINSAC-TA) of SDR2.4 million (US$3.4 million) equivalent, which became effective in September 1996 and includes: (i) technical assistance for the strengthening of the Judiciary through the training of judges and improvement of the legal information system to enhance the understanding of the new legislation issued under the FINSAC; (ii) equipment and software for the establishment of a Central Registry of Pledges; and (iii) support for the institutional strengthening of DEBRA, the Payments and Clearing System, the Department for NBFIs in the Ministry of Finance (MOF), the National Securities Commission (NSC), the State Supervision Agency on Insurance Companies, government agencies dealing with government debt instruments, and the Social Fund. At the beginning of program implementation, IDA also organized trust fund-financed short-term technical support to help NBK manage the Financial Sector Reform Program and assist a commercial bank in its restructuring efforts. Substantial additional technical assistance in support of the Reform Program was provided by several multilateral and bilateral donor agencies.

Implementation of Agreed Policy Action and Institutional Reforms

11. The design of the FINSAC Program was appropriate for achieving its objectives, and the achievements have been substantial. NBK had the responsibility for the overall management of the Program. To this end, it established a "FINSAC Monitoring Unit" and a "FINSAC Review Committee", chaired by the Prime Minister his designee, to facilitate and coordinate the implementation of the Program on the highest level. The Government complied with all conditions of appraisal, Board presentation, first tranche release and, after agreeing to some minor modifications, second tranche release.

12. **Enabling Macroeconomic Environment.** At the time of project appraisal, the Government had made significant progress in stabilizing the economy and had remained essentially in compliance with IMF programs, as discussed above. It had 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. By the time of second tranche release, there had been continued significant progress in macroeconomic stabilization, consistent with the performance targets agreed under the third-year ESAF Program. The fiscal deficit was reduced to targeted levels with minimal financing from the domestic banking system. In 1996 and 1997, inflation remained below 20 percent and the exchange rate was stable.

13. **Legal Reforms.** The objective of the FINSAC in this area was to ensure prudent banking and to strengthen the powers of NBK as a supervisory authority. The *Law on Banks and Banking Activity*, enacted in July 1997, strengthened NBK's powers to impose and enforce restrictions on banks' activities. The *Tax Code*, enacted in 1996, removed a number of policy-induced barriers to bank profitability and security by equalizing the profit tax rate for financial institutions with that of non-financial enterprises at 30 percent and allowing banks to make loan-loss provisions against their gross income before tax. The *Tax Code* also clarified questions concerning the application of Value Added Tax on bank transactions and eliminated the Tax Inspectorate's and other State organs' rights (except those of NBK) to seize deposits and to obtain information from banks on a mass scale without specific justification. The *Law on Pledge,* which includes out-of-court procedures, and the revised Insolvency Legislation, both enacted in

May 1997, as well as the establishment of a *Central Pledge Registry,* strengthened further the arsenal of instruments needed for effective banking operations. The Government complemented the measures required under the FINSAC by enacting a new Law on the National Bank of the Kyrgyz Republic and a Mortgage Law in May 1997.

14. **Regulatory Reforms.** The authorities also took important steps to adjust *prudential banking regulations.* The minimum capital requirements were increased from Som 5 million to Som 10 million for local banks, and from Som 10 million to Som 20 million for foreign banks. They were recently further increased to Som 100 million for new banks; for existing banks, this requirement will be phased in over a period ending in March 2001. A capital adequacy ratio of 8 percent was established, in line with the Guidelines of the Basle Committee. This ratio was later increased to 12 percent (6% for tier-one capital) thus exceeding the guidelines set forth in the Basle Accord. The limit for lending to single non-related borrowers was reduced from 30 to 25 percent of capital, and, again, this requirement was later surpassed by decreasing the limit to 20 percent. In addition, a limit of 15 percent for lending to single related borrowers was introduced. Furthermore, a new Chart of Accounts, based on International Accounting Standards (IAS) was introduced, and all banks shifted to IAS on July 1997, thus surpassing the second tranche requirement. Apart from its general merits, the latter measure helped to create the basis for bank restructuring, since it made transparent the banks' losses and insolvency.

15. **Creating a Viable Private Sector Client Base.** The deepening of the financial system has been constrained above all by developments in the real sector and by the resulting shortage of bankable projects and creditworthy bank clients. Therefore, the FINSAC continued the support to the mass privatization program for medium- and large-scale enterprises, started under the PESAC in 1994 and supported also by the APEAC. Between 1996 and 1998, 663 entities were restructured, including 281 entities earmarked in the 1996-97 Privatization program. Of the 166 enterprises offered at coupon auctions during implementation of the FINSAC Program, 149 entities were sold and the remaining 17 entities were withdrawn from the auction.

16. The FINSAC Program identified 320 enterprises in which the State's shareholding should be reduced below 50%. In 264 enterprises the State's shareholding was reduced below 50% and a further 36 enterprises were put into the liquidation process; the process was completed in 13 enterprises. All potentially viable ERRA enterprises were offered for sale; 13 enterprises were sold and potential investors for the 6 remaining enterprises are still being sought.

17. While the overwhelming majority of FINSAC reform objectives were fully achieved, the privatization program was suspended in 1997 and since its re-launch in 1998, only a small number of enterprises have been sold. Also, there has been little restructuring in the majority of privatized enterprises; with ownership passing to the management and employees there is a lack of will to undertake the painful reforms needed to turn these enterprises into viable businesses. The number of creditworthy enterprises is therefore still relatively small, which is one of the explanations of the low level of financial intermediation in the country. The privatization of state monopolies is progressing very slowly and there appears to be a lack of political will to complete the privatization process.

18. **Resolution of Insolvent Specialized Banks.** At the time of project preparation, the "Big Four" specialized banks, which accounted for 80 percent of the banking system's assets, were insolvent. They continued to accumulate bad loans, although ownership in two of them had shifted largely to private hands. Directed credit provided by these banks had given way to auctioned credit, and real interest rates were becoming positive. To remove the overwhelming dominance of these banks, and their negative impact on the new private banks, drastic restructuring measures were taken. This included, as a first step, the establishment of a temporary *Debt Resolution Agency (DEBRA)* under the umbrella of NBK, which

became operational in October 1996. It acts as a receiver on behalf of NBK, taking control over and disposing of, the assets and liabilities of intervened banks.

19. **Liquidation of Banks.** A detailed liquidation program was designed and implemented for *Agroprom Bank*, which was the largest bank in the country and the predominant lender to the agricultural sector, and for *Elbank*, the country's main savings institution that had also been used for the provision of disaster relief and housing programs. Both banks were placed under the receivership of DEBRA to start the liquidation process. DEBRA assessed the value of their assets and started loan collection. It sold or closed the branches of Agroprom and reduced the bank's staff of originally 1,134 persons to a minimum needed during liquidation. The Government compensated NBK for a Som 965 million non-performing loan to Agroprom with 25 year/5 percent bonds. In line with an agreed Deposit Payoff Plan, Elbank's small deposits were fully paid off, while the larger ones were transferred to the Savings and Settlement Corporation; its branches were transferred to the MOF and its staff was laid off. According to the timetable submitted by DEBRA at the time of second tranche release, the liquidation of Elbank was to be completed during the first half of 1998 and that of Agroprom by December 1999. Elbank was liquidated in the second half of 1997. The liquidation of Agroprom is still ongoing.

20. **Restructuring of Banks.** The two other "big" banks; *Promstroi Bank*, the local successor of the Soviet Bank for Industry and Construction, and *AKB Kyrgyzstan Bank*, which originated from the Soviet Housing and Social Commodity Bank, had previously been privatized. They were financially weak, but fundamentally sound on an operational basis (Promstroi), or showing improving financial performance (AKB). Therefore, under the Restructuring Strategy of the FINSAC, diagnostic audits were prepared for both banks, and an internally managed program was implemented under a Management Letter Agreement with NBK, which provided for strong loan collection efforts, write offs and adequate loan-loss provisions, as well as downsizing and rationalization measures. A part of their bad loans portfolio was transferred to DEBRA. Since the two banks did not succeed in raising sufficient additional capital from private sources, the Government made a substantial contribution to their recapitalization through the placement of bonds. By the time of the second tranche release, the banks had fully recovered. According to NBK's prudential reports, they have since then consistently exceeded the prudential requirements.

21. **Resolving the Bad Debt Problem.** In early 1995, only eight percent of the banking system's loan portfolio was performing and, in addition to the four "big" banks, several smaller banks were insolvent. In addition to the bad loans of Agroprom (Som 1,105 million) and Elbank (Som 168 million), the non-performing loans of eight other commercial banks (Som 269 million) and of the Fund for Agrarian and Land Reform (Som 31 million) were transferred to DEBRA for collection, restructuring or write off, resulting in a total portfolio of Som 1,573 million. Rather than develop automatic criteria, applicable to the collection of certain categories of loans, DEBRA found that an individual action plan for each debtor was more effective. Although this did not fully meet the initial understanding with IDA, it was accepted, since it provided a useful method of tracking progress. As of April 1, 1999, DEBRA had collected about Som 189 million or 12 percent of the debt transferred to.it. An amount of Som 232 million or 14 percent has been written off or rescheduled, and debts amounting to Som 1,152 million (73%) remain to be resolved.

22. The resolution of the "old" bad loans problem has proven to be a difficult and protracted process. DEBRA attributes this mainly to problems arising in the work of court appointed executors and the extremely bad quality of the portfolios transferred to it. Taking this into consideration, as well as the fact that DEBRA has been self-financing (its budget is funded by an allocation of 5 percent of the debts it recovers), NBK is satisfied with DEBRA's services. DEBRA has been appointed as liquidator of Bishkek Bank (or more precisely its Director has been appointed as, under the bankruptcy law, a

liquidator must be a natural person) and hence the institution's original three-year mandate has been extended to May 3, 2002.

23. **Encouraging the Development of NBFIs.** The securities market in the Kyrgyz Republic is still in an early stage of development. The supply of securities has increased rapidly during the past few years, due to the corporatization and privatization of SOEs and the securitisation of Government borrowing. Therefore, it was necessary to establish the basis for the development of efficient and sound contractual savings institutions to intermediate between small savers and the securities markets. In line with FINSAC requirements, the Government submitted a *new Law on the Organization of Insurance Activities* to Parliament. Since then, the Law has been approved, and the regulatory and institutional framework for the insurance sector has been further developed through the adoption of regulations on licensing and supervision procedures, the preparation of draft laws on mandatory insurance, and the establishment of a State Insurance Supervision Agency.

24. The Government also submitted a new *Law on Private Pension Funds* to Parliament, thus satisfying a tranche release requirement. The Law passed its first reading, but did not progress further, since the Social Fund and the MOF prepared a competing draft. A special working group, comprising representatives of the Parliament, Social Fund and MOF, prepared a second draft with the support of an Asian Development Bank TA grant which was submitted to Parliament in 1999. This draft was not considered by Parliament. At the same time, with the banking failures that followed the Russian crisis, the general lack of supervisory capacity in the financial sector, and given the high levels of poverty (over 60 percent in 1998) and high payroll tax rates currently in place, the Government determined, with some reason, that private pension funds would likely receive little in the way of voluntary contributions. The administrative supervisory apparatus would cost a lot to set up with little in the way of positive results anticipated with respect to national savings rates. For now, the one existing "private pension fund" might be supervised under the framework of the current regulatory system, and the question of voluntary private pensions deferred until other priority financial sector issues are addressed, until payroll taxes are reduced (projected in the medium term as a result of the state pension reform), and until it is deemed likely that a satisfactory minimum level of contributions would be made to private pension funds should they be established.

25. Investment Funds were expected to play a key role in the development of the securities market but they have been in financial distress for a number of reasons, including poor regulation and supervision, and a lack of public confidence. The National Securities Commission (NSC) is responsible for the supervision of the Investment Funds, but the legal basis and the institutional capacity to exercise this responsibility are weak. Therefore, the authorities supplemented the draft of a new *Law on Investment Funds* with implementing regulations and submitted it to Parliament. The Investment Funds Law was approved by Parliament in June 1999 and was signed by the President shortly thereafter. NSC is presently drafting a regulation on strengthening the Funds' investment activities and protecting investors' rights. Another FINSAC requirement, to improve the existing *legislation on leasing,* was satisfied through inclusion of provisions in the Civil Law. The NBK initiated preparation of a new Law on Leasing; to this end, a working group was created and in January 2000 a first draft of the new law was prepared.

D. Major Factors Affecting the Project

26. The Borrower implemented the Program in compliance with the agreed measures. However, following completion of the FINSAC Program, a number of negative factors, both internal and external, have had a major adverse impact on the financial sector. More details are given in Annex A, "Recent Developments in the Financial Sector".

E. Project Sustainability

27. Progress attained towards securing the FINSAC's objectives of establishing an effective legal and regulatory framework for the financial sector and restructuring/liquidating insolvent banks, and encouraging the development of NBFIs is expected to be sustainable in a number of areas, for example, bank liquidations. But there are doubts about the sustainability of the banking system at present due to the regional financial crisis which hit the country soon after these reforms were implemented and before some of these reforms, such as improved banking supervision, really had time to take root. A reversal of the measures taken is not possible in some areas (e.g. liquidation of banks) and highly unlikely in many other areas, given the Government's strong commitment to the reforms and its continued efforts to develop a well-functioning market economy. Also, one of the distinguishing characteristics of this operation was the effort made to build into the Program a number of safeguards to ensure sustainability from the beginning: (i) to ensure the provision of banking services after the closure of Agroprombank, the bank was replaced by the Kyrgyz Agricultural Finance Corporation (KAFC), which is being supported by IDA and Credit Unions in the rural areas, supported by ADB; (ii) Deposit Payoff Plans were recommended for the two banks to be liquidated; and (iii) special efforts were made to estimate the financial costs and the fiscal impact of bank liquidation and restructuring to ensure their financial feasibility. The agreed strategy also addressed the need to avoid moral hazard and the loss of financial discipline that would result from wholesale, unconditional forgiveness of non-performing loans by suggesting a system for collecting, selling or resolving bad loans (DEBRA). However, the achilles heel of these reforms turned out to be the lack of adequate capacity and experience in banking supervision. Mostly this was a timing issue due to the fact that the financial crisis hit while the supervising agency was being strengthened. The question whether the economy can fully benefit from, and sustain the impact of the reforms is discussed in Section H, Assessment of Outcome.

F. IDA Performance

28. Project preparation and implementation were characterized by a cooperative and constructive approach between IDA and the client. Project preparation took about eight months from initiation through appraisal, and IDA's staff input through to completion was 175 staff weeks. As discussed above, the project was correctly sequenced and well designed, with its main components supporting priority adjustments to which the authorities were fully committed. The operation was also consistent with the objectives of the Country Assistance Strategy. A major effort was made before appraisal to promote full accord with, and Government ownership of the Project, through preparation of a series of "Informal Discussion Notes", a "Strategy for Financial Sector Reform in Kyrgyzstan", and a three-day workshop in Washington for managers of NBK to discuss the Strategy and the proposed Project. In addition, the Program was presented at two Donors' Conferences held in April 1996 in Bishkek and in October in Tokyo, and a US$650,000 Project Preparation Facility was made available.

29. Project implementation was also well organized. For the most difficult project components, implementation guidelines were prepared and agreed upon with the Government. The President's Report includes a "Bank Restructuring and Liquidation Strategy" for the banks that were restructured or liquidated under the Project; a "Deposit Payoff Program" for the liquidated banks; "Key Operating Principles for DEBRA"; "Debt Recovery Principles"; and a detailed estimate of the financial costs and the fiscal impact of the Project. All laws and regulations issued as a condition of the credit were reviewed to check their acceptability to IDA. The implementation of the FINSAC Program was facilitated by the FINSAC-TA, three trust fund operations for short-term consulting services and training (financed by the Swiss, Dutch and Australian governments) and intensive coordination with other donor agencies that provided technical assistance in support of the Program. The quality and quantity of staff analysis and effective communication contributed to the positive outcome of the Program.

30. IDA's highly satisfactory performance was somewhat tempered by its failure to closely monitor progress on strengthening *banking supervision,* for which it placed considerable reliance on support from other donor agencies. Neither the Project nor the associated TA Credit included a direct contribution to bank supervision. Analysis done at appraisal showed that NBK had already made considerable progress in improving its supervision capabilities and technical assistance from other donors was in place to ensure further improvement. With hindsight, FINSAC should have included the objective of, and suitable actions for developing and maintaining a strong and stable Banking Supervision Department, particularly high-quality on-site examination. Furthermore, IDA should have continued an intensive dialogue through the FINSAC TA supervision about the functioning of the system after the FINSAC program had been fully implemented.

31. Concerning the *policy dialogue* on financial sector reforms in general, there is a discrepancy between the strong and constructive follow up during the period September 1996 (effectiveness) to November 1997 (second tranche release) and IDA's policy-related activities during the time following the release of the second tranche. Although the supervision of the FINSAC-TA ensured some degree of continuity, sector developments were less intensively monitored during the 14 months following the second tranche release. Considering that Kyrgyzstan is still in the midst of transition, Bank support for financial sector reform should not be viewed as an isolated program on which the Bank is following up only during a limited time span. This is a process of change that will take a number of years to complete and IDA should maintain a consistent involvement in the sector.

G. Borrower Performance

32. The Borrower generally performed well under the Program. Criticism mainly arises in respect of the strengthening of banking supervision and the establishment of a regulatory and supervisory framework for NBFIs, both of which were important objectives of the Government's overall reform program, and the latter was also a requirement under the FINSAC. The Government's cooperation with IDA has been constructive and effective throughout project preparation and implementation. Its strong interest in, and support for, the Program was demonstrated by the establishment of a "FINSAC Review Committee" and the high level of Government representation in the Committee, which, in addition to being chaired by the Prime Minister or his designee, included the Governor of NBK, the ministers of finance, economy, agriculture and justice, and the chairman of the State Property Fund. Furthermore, a "FINSAC Monitoring Unit" was established in NBK, which monitored the implementation of the Program at the working level. The strong commitment on the Government's side, combined with the determination and leadership provided by NBK's management, resulted in a smooth preparation and implementation of the Program.

33. The Borrower responded reasonably well to the recent crisis in the financial sector; the NBK took a number of swift actions to deal with insolvent banks and strengthened some of the key prudential regulations for the remaining banks. However, the vulnerability of financial intermediation, particularly in small economies, to external shocks and to shifts in market expectations, raises the stakes for the development of effective and preventive banking supervision. While the recent events in the domestic banking sector are largely the result of inexperienced, and in some cases fraudulent, management of banks and their clients, and while it is understood that banking supervision cannot exclude fraud, it must be assumed that full and up-to-date disclosure of enterprise affiliations and bank/enterprise relationships, of lending to single borrowers and related parties, as well as frequent and intensive on-site examinations by experienced examiners and systematic analysis of on-site findings, might have resulted in earlier remedial action and in the possible prevention of bank failures.

H. Assessment of Outcome and Recommendations

34. **Impact of the Project.** The reforms carried out under the FINSAC have contributed to a number of positive developments in the financial sector. Above all, a legal and regulatory framework was created which provides a favorable environment for the growth of an efficient financial system. In addition, the decisive action on four problem banks, whose financial condition constituted a heavy burden for the budget and affected the other banks, contributed to stabilizing and strengthening the banking system. Initial progress was also made in encouraging the development of NBFIs. On the basis of the review of the Program, *the FINSAC is rated satisfactory*.

35. The highly adverse developments during 1998, caused by the regional crisis, resulted in a severe economic deterioration and the impact that this had on public confidence in the banking sector has affected the prospects for a deepening of the financial system. While the policy and institutional improvements instituted under FINSAC have helped the Government deal with the problems created by the crisis, financial sector deepening can occur only after relative economic stability and public confidence in the banking system have been regained. In the meantime, the banking system of the Kyrgyz Republic will remain extremely small, potentially fragile and financial intermediation will persist at a very low level. Perhaps the size of the Kyrgyz banking sector can best be placed in perspective by comparing its total assets of about US$ 99 million (September 1999) with those of a single small-sized American bank. Though an improvement over the figures for 1995 to 1997, M2 still amounted to only about 14 percent of GDP at the end of 1998.

36. A large percentage of the economy has passed into private ownership. However, few of the privatized companies have made the transformation into truly commercial enterprises and hence the objective of the privatization, from the perspective of the banking system, of creating a client base of viable commercial borrowers has not been fully achieved.

37. **Recommendations.** To protect the system from further deterioration, the President of the Republic asked the Economic Department of the Presidency, MOF and NBK to join in an effort of *reviewing the legal and regulatory framework* with a view of increasing depositor security. Furthermore, a *Deposit Insurance Law* has been completed; its design and the timing of its approval should carefully take into consideration the Government's fiscal limitations and the psychological impact on depositors. It is recommended that the review of the regulatory framework, noted above, take up a previous initiative to design prudential rules on sectoral loan concentration and consider the need for rules requiring the provisioning of loans guaranteed by the State or SOEs. Furthermore, the irresponsible behavior of some of the problem banks indicates that much emphasis needs to be placed on the procedures for bank licensing and for examining the integrity and professional aptitude of bank managers and owners ("fit

and proper" rules). Insider lending and lending to "connected" parties should be closely monitored and high standards of transparency and accuracy in reporting and disclosing information enforced.

38. While it is important to close gaps in the regulatory and procedural system, more benefit would be gained by enforcing existing rules. IDA therefore welcomes NBK's decision to *strengthen banking supervision*, especially on-site examinations. The Banking Supervision Department suffers from high staff turnover and it is not uncommon for 25% of the positions in the Department to be vacant. The situation has been exacerbated recently by the need to place experienced staff as administrators in problem banks. The available expertise and experience is inadequate to carry out frequent and effective on-site examinations and to reliably analyze the collected data.

39. The IMF and other agencies have recently placed a number of foreign experts in the Supervision Department. In addition to assisting in supervision activities, they will help develop and implement an intensive, formal, staff development program for the Banking Supervision Department. NBK should also consider ways of making staff compensation levels and career opportunities attractive enough to retain trained staff in the public private sector.

40. Another more forward looking task is the *training of bank managers and staff.* There is a need for improved coordination of training programs offered by local and international agencies. All efforts should converge towards the development of a strong domestic training institute. More importantly, the motivation of bank managers to free their employees for training need to be strengthened. The management of NBK may have to take a leading role in this effort.

I. Future Operations

41. An objective of the ADB's FIRM loan is to substantially adjust the composition of the banking sector by encouraging the merger of the smaller, less well capitalized banks. Financial intermediation through the remaining banks can be expanded and made more efficient through new credit enhancement mechanisms, such as strengthening the use of collateral and of the transferability of property rights, the establishment of credit information schemes and the development of the banks' risk assessment capabilities. Banking regulations should place greater emphasis on licensing, portfolio concentration and other early-warning criteria and adequate penalties for misconduct. Banking supervision should focus more on the enforcement of prudential regulations. The training of bank managers and staff needs strengthening and the judiciary has to become more responsive to the needs of the financial sector. For example, it has proven difficult for the Banks to enforce their collateral rights through the courts. The development of NBFIs and the capital market, as well as of leasing activities, including their regulation and supervision, needs continued support; the ADB's FIRM program places much emphasis on the further development of the non bank sector.

42. Action is already being taken with regards to some of these issues. As mentioned above, NBK has strengthened a number of prudential requirements and the legal and regulatory framework is being reviewed with the intention to further improve it.and a new regulation on sectoral portfolio concentration. The procurement of technical assistance for on-site bank examination has been initiated and judges are being trained to further their understanding of the new legislation. IDA will commence work on a governance structural adjustment credit next fiscal year. Some analytical work on the judiciary may be included, however, at this point the exact areas to be included have not yet been determined.

J. Key Lessons Learned

43. **Importance of Government Commitment.** The importance of Borrower commitment cannot be over-emphasized. In addition, the FINSAC had high visibility and extensive press coverage, which broadened the level of understanding and public support. Where there is strong Government commitment to, and ownership of a reform program -- as in the case of the FINSAC -- progress can be achieved relatively quickly and without frictions.

44. **Monitoring and Implementation Support.** During the early stages of reforms in transitional economies, intensive monitoring and support in program implementation are essential. Since external shocks and internal events can derail the reform process at any time, an intensive sector policy dialogue between the Borrower and IDA should continue after implementation of an agreed reform program. Simultaneous implementation of a technical assistance project can ensure continuity and implementation support, but additional follow-up activities, such as formal or informal sector work, or direct successor projects ("FINSAC II") should be considered in each case.

45. **Early Establishment of Enforcement Powers.** In small financial systems, actions of individual players or single events can directly affect the whole sector or even the entire economy. Therefore, it is doubly important that an effective system of banking regulation, a preventive early-warning system, and instruments for the direct protection of depositors are firmly in place at an early stage of financial sector development. However, creation of regulatory and supervisory instruments is only a necessary, not a sufficient prerequisite for financial sector stability and development. There can be no strong financial system without strong enforcement. In many FSU countries, enforcement, rather than lack of rules, is the weak spot in the safety net against financial instability. Enforcement through effective on-site examination and off-site surveillance are of equal importance.

46. **Comprehensiveness of Reform Approach.** As discussed earlier, the FINSAC was designed as part of a reform package comprising a series of well-sequenced and interrelated operations aimed at addressing macroeconomic, financial and enterprise sector issues. Experience with the implementation of this package has shown that, in particular, consistency and correct sequencing of enterprise and financial sector reforms are essential for the success of such programs.

47. **The Importance of Macroeconomic Stability.** A stable macroeconomic environment is a necessary condition for sustainable reform of the financial sector. Stable prices tend to reduce uncertainty and thus the willingness of investors to trade off liquidity for return. Sustained economic growth facilitates the management of credit risks, since the growing level of economic activity bodes well for the cash flow position of borrowers. And a steady currency reduces the volatility of capital flows and thus enhances the capabilities of the financial sector to safely manage their global liquidity position. The good performance of the Kyrgyz macroeconomic policy management during the period of preparation and implementation of the FINSAC was instrumental in the success of the project. This, as well as the impact of the more recent deterioration of the economic situation, demonstrates the validity of the above argument.

Part II. Statistical Tables

Table 1: Summary of Assessments

A. Achievement of Objectives	Substantial (✓)	Partial (✓)	Negligible (✓)	Not applicable (✓)
Macro Policies	☐	☒	☐	☐
Sector Policies	☐	☒	☐	☐
Financial Objectives	☐	☒	☐	☐
Institutional Development	☐	☒	☐	☐
Physical Objectives	☐	☐	☐	☒
Poverty Reduction	☐	☐	☐	☒
Gender Issues	☐	☐	☐	☒
Other Social Objectives	☐	☐	☐	☒
Environmental Objectives	☐	☐	☐	☒
Public Sector Management	☐	☒	☐	☐
Private Sector Development	☐	☒	☐	☐
Other (specify)	☐	☐	☐	☒

(*Continued*)

B. Project Sustainability	Likely (✓)	Unlikely (✓)	Uncertain (✓)
	☐	☐	☒

C. Bank Performance	Highly Satisfactory (✓)	Satisfactory (✓)	Deficient (✓)
Identification	☐	☒	☐
Preparation Assistance	☐	☒	☐
Appraisal	☐	☒	☐
Supervision	☐	☒	☐

D. Borrower Performance	Highly Satisfactory (✓)	Satisfactory (✓)	Deficient (✓)
Preparation	☐	☒	☐
Implementation	☐	☒	☐
Covenant Compliance	☐	☒	☐
Operation (if applicable)	☐	☐	☐

E. Assessment of Outcome	Highly Satisfactory (✓)	Satisfactory (✓)	Unsatisfactory (✓)	Highly unsatisfactory (✓)
	☐	☒	☐	☐

Table 2: Related IDA Credits

Credit title	Purpose	Year of approval	Status
1. REHAB Rehabilitation Credit	Support for stabilization and structural reform and provision of foreign exchange for vital imports.	FY93	Completed
2. PESAC Privatization, state enterprise reform and restructuring, price and trade liberalization	Support for a new privatization strategy (1994-95); state enterprise reform and restructuring; and price and trade liberalization.	FY94	Completed
3. APEAC Continuation of Privatization Program and agricultural sector restructuring	Support for restructuring/privatization of the 1994-1995 privatization program.	FY95	Completed
4. FINSAC Financial sector reform and continuation of Privatization Program	Support for a comprehensive financial sector reform program and support for (1996-1997) privatization program.	FY96	Completed
5. PSRMAC Reform of budget preparation and inter-governmental finances	Reform of intergovernmental finances and budgeting systems.	FY97	Completed
6. SOSAC Social Sector Adjustment Credit	Reforms in pensions, social assistance and sectoral financing.	FY98	Completed

Table 3: Project Timetable

Steps in Project Cycle	Date Planned	Date Actual/ Latest Estimate
Identification (Executive Project Summary)		7/7/95
Preparation		11/28/95
Appraisal		3/22/96
Negotiations		5/9/96
Letter of Development/Sector Policy		5/24/96
Board Presentation		6/25/96
Signing		7/3/96
Effectiveness		9/3/96
First Tranche Release		9/27/96
Midterm review		10/97
Second Tranche Release		11/14/97
Project Completion		11/14/97
Loan Closing		6/30/98

Table 4: Credit Disbursements: Cumulative Estimated and Actual
(US$ thousands)

	FY1997	FY1998
Appraisal estimate	22,500	45,000
Actual	22,602	44,108
Date of final disbursement		11/18/97

Table 5: Key Indicators For Project Implementation

POLICY OBJECTIVES	AGREED ACTIONS	TIMING	CONDITION FOR	IMPLEMENTATION RECORD
A. Improving the Enabling Policy and Regulatory Environment (a) Policy Environment				
1. Sustain macro-economic stability.	Government to achieve satisfactory macroeconomic and fiscal performance, including domestic bank financing of fiscal deficit in FY96.	6/96	Board Presentation	Condition met.
	Government to achieve satisfactory macroeconomic performance in FY97.	6/97	Second Tranche Release	Condition met.
2. Remove policy induced barriers to bank profit-ability, efficiency and security.	Government to submit to Parliament the Tax Reform Bill, satisfactory to IDA, which: (a) equalize profit tax of enterprises and banks; (b) allow 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	Condition met; profit tax rate equalized at 30%; VAT applies now to very few financial transactions.
	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	Condition met; through adjustments to the Law on Banks and Banking activities.

POLICY OBJECTIVES	AGREED ACTIONS	TIMING	CONDITION FOR	IMPLEMENTATION RECORD
(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.	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 Bank's 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.	3/96	Appraisal	Condition met.
	Borrower to enact the Tax Reform Bill and the new Banking Law, satisfactory to IDA.	6/97	Second Tranche Release	Condition met; laws enacted by May 1997.

POLICY OBJECTIVES	AGREED ACTIONS	TIMING	CONDITION FOR	IMPLEMENTATION RECORD
2. Enhance the security in lending.	Government to submit to Parliament the draft Law on Pledge, satisfactory to IDA.	6/96	Board Presentation	Condition met.
(a) Strengthen the legal, judicial and registry framework for the use of pledges and the handling of insolvent borrowers.	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 requests to start a bank liquidation process. Government to submit to Parliament the revised insolvency legislation.	6/96	Board Presentation	Condition met.
	Borrower to enact the Law on Pledge, and the revised insolvency legislation, satisfactory to IDA.	6/97	Second Tranche Release	Condition met; law enacted on May 20, 1997.
	Government to create a central registry system for pledges, satisfactory to IDA to enforce security rights.	6/97	Second Tranche Release	Condition met.
(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 1996-97 Privatization Program, except in the major utilities that have individual privatization plans.	6/97	Second Tranche Release	Condition met after agreed adjustments in the universe of SOEs to be privatized.
	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	Condition met in modified form agreed with IDA.
	Government to fulfill the second tranche conditions of APEAC, thus enabling IDA to release the second tranche of APEAC.	6/97	Second Tranche Release	Condition met.

POLICY OBJECTIVES	AGREED ACTIONS	TIMING	CONDITION FOR	IMPLEMENTATION RECORD
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	Condition met and later exceeded.
	NBK to adopt and implement gradually the Basle guidelines for ongoing capital adequacy (i.e. 8% of risk weighted assets).	6/96	Board Presentation	Condition met and later exceeded.
	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	Condition met and later exceeded.
	NBK to enforce 25 percent maximum single borrower limit to all banks.	6/97	Second Tranche Release	Condition met.
4. Strengthen banks institutionally.				
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 five commercial banks.	6/97	Second Tranche Release	Condition met; all banks adopted IAS by July 1997.
B. <u>Restructuring Insolvent Old Specialized Banks</u>				
1. Liquidating Agroprombank	Place Agroprombank into formal NBK conservatorship.	3/96	Appraisal	Condition met.
	Complete diagnostic audit of loan portfolio, and analyze the composition of deposit base.	3/96	Appraisal	Condition met.
	Establish a Working Group at the NBK to monitor Agroprom branch network analysis carried out by international auditors.	3/96	Appraisal	Condition met.
	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	Condition met.

POLICY OBJECTIVES	AGREED ACTIONS	TIMING	CONDITION FOR	IMPLEMENTATION RECORD
	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	Condition met. DEBRA became fully operational in October 1996.
	NBK to place Agroprombank under the receivership of Debt Resolution Agency (DEBRA), to start the liquidation process.	6/96	Board Presentation	Condition met. DEBRA appointed as liquidator in October 1996.
	NBK is due 965 million soms from Agroprombank. This amount presents 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 (LPSDP).	6/97	Second Tranche Release	Condition met.
	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.	6/96	Second Tranche Release	Condition met.
2. Liquidating Elbank	Establish a Task Force in the Elbank to finalize the actual breakdown and amount of deposit liabilities of the bank.	3/96	Appraisal	Condition met.
	Complete the design of Deposit Pay-off Scheme.	3/96	Appraisal	Condition met.
	NBK to place Elbank under the receivership of DEBRA, to start the liquidation process.	6/96	Board Presentation	Condition met.
	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	Condition met; Elbank was not liquidated by DEBRA, but by another court appointed liquidator.

POLICY OBJECTIVES	AGREED ACTIONS	TIMING	CONDITION FOR	IMPLEMENTATION RECORD
3. Downsizing and restructuring Promstroi and AKB Kyrgyzstan banks.	Complete the diagnostic audits of Promstroi and AKB Kyrgyzstan Banks	3/96	Appraisal	Condition met.
	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	Condition met.
	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	Condition met with respect to capital increase (by Sept. 1996). Condition not met with respect to capital adequacy requirement.
	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	Condition not met. AKB was unable to raise additional capital.
	If the management 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	Condition met through capital injection by Government and the banks' own efforts.
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)	6/97	Second Tranche Release	Condition met in modified form.

POLICY OBJECTIVES	AGREED ACTIONS	TIMING	CONDITION FOR	IMPLEMENTATION RECORD
	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.			
C. Encouraging the Development and Growth of Non-Bank Financial Institutions				
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 this legislation to Parliament.	6/97	Second Tranche Release	Condition met; Law on Insurance Activities enacted, Law on Pension Funds rejected by Parliament, leasing legislation improved through changes in Civil Law.
	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	Condition not met; instead of amending regulations, a new Law on Investment Funds was submitted to Parliament; approved in June 1999.

Table 6: Status of Legal Covenants

Covenant	Compliance
Section 3.01	
(a) The Borrower and the Association shall from time to time, at the request of either party, exchange views on the progress achieved in carrying out the Program and the actions specified in Schedule 2 to this Agreement.	Action carried out satisfactorily.
(b) Prior to each such exchange of views, the Borrower shall furnish to the Association for its review and comment a report on the progress achieved in carrying out the Program, in such detail as the Association shall reasonably request.	Action carried out satisfactorily.
(c) Without limitation upon the provisions of paragraph (a) of this Section, the Borrower shall exchange views with the Association on any proposed action to be taken after the disbursement of the Credit which would have the effect of materially reversing the objectives of the Program, or any action taken under the Program, including any action specified in Schedule 2 to this Agreement.	Complied
Section 3.02	
Upon the Association's request, the Borrower shall:	
(a) have the Deposit Account audited, in accordance with appropriate auditing principles consistently applied, by independent auditors acceptable to the Association.	n.a
(b) furnish to the Association as soon as available, but in any case not later than six (6) months after the date of the Association's request for such audit, a certified copy of the report of such audit by said auditors, of such scope and in such detail as the Association shall have reasonably requested.	n.a
(c) furnish to the Association such other information concerning the Deposit Account and the audit thereof as the Association shall have reasonably requested.	n.a

Table 7: Bank Resources: Staff Inputs

Stage of project cycle	Actual Weeks	Actual US$ '000
Preparation to Appraisal	111.2	264.9
Appraisal	11.4	28.8
Negotiations through Board approval	1.2	4.2
Supervision	43.2	101.6
Completion	7.9	20.4
Total	174.9	419.9

Table 8: Bank Resources: Missions

Stage of project cycle	Month/ Year	No. of Persons	Days in Field	Specialization	Performance Rating: Implem. Status	Performance Rating: Developm. objectives	Types of Problems
Through Appraisal	3/96	15	36	B/E/F/T/L			
Appraisal through Board approval	6/96	5	6	T/E/F			
Supervision	10/96	2	10	T/E/F	S	S	
	4/97	5	29	T/E/F	S	S	
	7/97	4	18	T/E/F	S	S	
	10/97	3	12	T/E/F	S	S	
Completion	4/99	2	10	F/P			
Total							

Specialization:

B	=	Banking Specialist
E	=	Economist
En	=	Environment Specialist
F	=	Financial Specialist
L	=	Lawyer
P	=	Privatization Specialist
Pr	=	Procurement Specialist
T	=	Task Manager

Performance Rating:

S	=	Satisfactory

Types of Problems:

P	=	Policy-based
F	=	Financial
T	=	Technical
M	=	Managerial

Annex A: Banking Sector Developments 1998-1999

1. The impact of the FINSAC Program, i.e. the extent to which the economy has been able to benefit from the improved framework for financial sector development, was severely affected by a number of unfavorable factors **following the closure of FINSAC operation in June 1998.**

2. **Financial Crisis in Russia and Neighboring CIS Countries.** The crisis has had severe repercussions on the Kyrgyz currency and banking system since August 1998. Although the banking system as a whole had a small long position in foreign currency, many banks suffered some valuation losses from the depreciation of the Som. In addition, the depreciation has had a significant impact on the quality of the banks' loan portfolios denominated in foreign currency. Also, exporters with markets in Russia and other CIS countries have been facing increased difficulties in servicing their loans because of reduced demand and the resurrection of some trade barriers. Furthermore,.the crisis, including renewed inflation, triggered a drop in the public's confidence in the Som and a repatriation of deposits of nonresidents, resulting in a temporary contraction of deposits.

3. **Emerging Macroeconomic Imbalances.** After two years of robust growth, and significant progress in macroeconomic stability, the financial turmoil in Russia and neighboring CIS countries, together with slippage in fiscal policy, severely affected macroeconomic performance in 1998. Notwithstanding generally tight monetary and fiscal policies, the suddenness and magnitude of the external shocks, and currency depreciation in August and November of 1998 led to a noticeable slowdown in economic activity, a sharp deterioration in the external current account deficit, added pressures on domestic prices and the exchange rate, an attendant loss of international reserves, mounting budgetary expenditure arrears, a slowdown in privatization, and asset quality problems in the banking system. The domestic inflation rate, which remained under 20 percent through 1998, exceeded 40 percent in 1999. Weak macroeconomic performance in 1998 adversely affected developments in the financial sector development of the financial system.

4. **Impact of the Gas Sector Losses on the Banking System.** The performance of the banking system was also affected in 1999 by the difficulties caused by Kyrgyz Gas Munaizat (KGM), the state oil and gas distribution company. The gas distribution industry generated substantial losses in 1998 due to lack of a cost reflective pricing policy, particularly in light of the sharp depreciation of the Som throughout the year. Between September and December the cost of gas increased by 43% due to exchange rate depreciation (all gas is imported), while its sale price increased by only 15%. The Government was reluctant to increase domestic prices or compensate the company for its losses. It did, however, provide collateral for the company's borrowing from domestic and foreign banks by issuing State bonds in the amount of USD 18.5 million. In late 1998, the bonds were withdrawn for legal reasons creating substantial uncertainty for the banking sector. These events directly contributed to the insolvency of the country's largest commercial bank and created severe financial difficulties for three others.

5. **Failure of Banks.** NBK's prudential reports show that, for the whole sector, those loans classified as "less than satisfactory" increased from 9 percent at end-1997 to 34 percent at end-September 1999. Towards the end of 1998, some banks had already started experiencing difficulties in meeting minimum reserve requirements. The absolute amount of less than satisfactory loans of Som 802 million is alarming, given the banks' total paid-in capital of Som 620 million as of September 30, 1999.

6. The KGM issue, unfolding in early 1999, resulted then in a sudden and substantial deterioration of the loan portfolios of four large banks, due to their high concentration of loans to KGM, its affiliates and other indirectly "connected" companies. Four of the country's largest banks were placed into liquidation by NBK or have had NBK special administrators appointed and part of the their assets and liabilities transferred to the newly created, and wholly NBK owned Bank.. The four larger banks accounted for

about 60 percent of the system's loan portfolio and about 56 percent of its deposits at the end of 1998. Although the intervention into these banks has been managed well by NBK, the economic cost of the additional bank failures, including the impact on public confidence, is substantial.

7. Reported non-performing loans nearly doubled following on-site inspections in early 1999. The second largest bank's lending to KGM exceeded its paid-up capital but the full extent of the bank's problems was only detected by a November 1998 examination. The largest bank had 80 percent of its portfolio invested in 17 companies involved in fuel and oil products retailing (all guaranteed by KGM) and had concealed the existence of substantial off-balance sheet obligations from guarantees to a multilateral bank for lending to KGM. Two other banks had also been lending to enterprises associated with KGM. Risk management in financial institutions was weak and in some cases considerations other than risk management guided the banks' lending decisions. NBK's on-site examiners found that banks were significantly under-reporting non-performing loans and that reporting is inaccurate in other respects (e.g. the impact of the sharp depreciation of the Som on assets quality may not be taken fully into account and the value of the Government bonds issued in connection with KGM may be overstated). The banks' prudential reports were not consistently verified, as NBK had fallen behind in conducting on-site inspections. As a result of this situation, NBK's compliance reports of March 1999 still exhibited the picture of a well-capitalized and liquid banking system; only two banks were shown to be in minor non-compliance with relevant prudential requirements.

8. **Weaknesses in Banking Supervision.** In addition to the above direct interventions, NBK responded to the severe developments in the banking sector with a number of regulatory measures. Minimum capital requirements were increased far above the level required under the FINSAC and will be phased in until 2003; capital adequacy requirements were set at 12 percent in total and 6 percent for tier-one capital (higher than the 8%/4% ratios required under the FINSAC); the single borrower lending limit was reduced from 30 percent to 20 percent (lower than the 25% required under the FINSAC) and the limit for single related borrowers was set at 15%. A new regulation limiting the banks' foreign exchange position in one currency to 10 percent of capital was issued and a new portfolio classification was introduced. An additional set of policy measures was agreed upon with the IMF to enhance compliance with reserve requirements: effective mid-November 1999, banks missing reserve requirements three times in a row were placed under direct supervision by NBK, while banks not observing such requirements six times in a row will be subject to temporary administration. Furthermore, given the volatility in the foreign exchange market and the high inflation rate, the IMF stressed the need for requiring the banks to hold reserves on foreign currency deposits in foreign currency.

9. **Other Donor Intervention.** ADB's recently launched FIRM program, a USD 35 million sectoral adjustment credit, carries on many of the reforms initiated under FINSAC. The objectives of the program are: (i) to recapitalise, rehabilitate, consolidate or close problem banks; (ii) establish a depositor protection scheme; (iii) tighten entry norms and capital requirements for banks; (iv) enhance transparency and improve corporate governance in the banking sector; (v) strengthen banking supervision; (vi) strengthen legal and regulatory framework for domestic debt management; (vii) enhance transparency and governance of equities market; (viii) prevent off-market equity trading; (ix) reduce tax burden on equities trading; (x) mandate sale of SOE's through the Kyrgyz Stock Exchange; (xi) establish legal framework for establishment of investment funds; (xii) strengthen regulatory framework for the insurance industry; and (xiii) reduce tax burden on insurance transactions.

Annex B: Project Implementation Assessment Prepared

by the Borrower (December 1999)

Introduction

1. Upon declaration of independence, certain problems in the process of formation of the banking system of the Kyrgyz Republic became obvious. According to an evaluations made at that time, more than half of the banks were considered insolvent. There were several reasons for that situation; one of the reasons was the granting of subsidised credits through the State banks mainly to the agricultural sector and to agro-processing enterprises. The general decline in production after the collapse of the Soviet Union and the nationalization of large farms, under conditions where the new owners did not take on the debt obligations to the banks, resulted in the formation of a considerable volume of bad loans with these banks. The difficult economic situation in 1993 and 1994 as well as the shortcomings in banks' management led to considerable problems in the banking system, especially for the former State banks which had been used by the Government to give general financial support to the economy.

2. Banks appeared unready to work under conditions of high inflation and failed to restructure, on a timely basis, their interest rate policies to reflect the decrease of inflation rates in 1994. The high rates of inflation in 1992-1993 created the illusion of huge revenues and constant increases in the profitability of the banks. When the banks were finally obliged to recognize the reality of the situation, i.e. that their credits were not fully recoverable, they incurred considerable expenses writing off or provisioning against problem loans in their portfolios. At the same time, they suffered a decrease in interest income and an increase in interest expenses, which in turn led to the problems with the banks' liquidity and led to a collapse in the profitability of the banks.

3. The following factors also significantly contributed to the difficulties suffered by the former State banks:

1) absence of reliable management system in banks and their affiliates;
2) absence of effective credit and interest rate policies;
3) absence of reliable internal control systems;
4) lack of will on the part of management to rationalize operations and reduce costs.

The above led to an increase in the volume of high risk, non-performing assets and an increasing concentration of credits with large borrowers, whose worsening financial situation eventually led to the insolvency of some banks.

4. In the beginning of 1995 the former State banks dominated the market. These banks had accumulated most of nominal assets of the banking system and controlled 90% of the branch network of the Republic. At the same time, the smaller, privately owned, banks operating under commercial conditions, remained highly vulnerable and could not seriously influence the direction of the market. In this connection, at the end of 1995 the National bank started preparatory work on the reorganization of insolvent banks and had taken a number of measures to strengthen and develop the banking system:

a) The debts of the banks to the National Bank were restructured into mid-term loans and the crisis of liquidity in banking system ameliorated, giving the National Bank breathing space to develop a program of financial improvement and restructuring of the banking system;

b) A degree of economic stability had been achieved, i.e. the inflation rate had been reduced to 30-35%, real interest rates became positive, and the rate of devaluation of the national currency had slowed down significantly;

c) The system of centralized directed credits had been eliminated totally;

d) The following legal framework had been provided:

- The laws "On National Bank" and "On banks and banking activity" had provided relative independence of the National Bank as the institution of monetary-credit regulation and banking supervision;
- The law "On bankruptcy" had provided sufficient legal framework to perform bankruptcy procedures in respect of insolvent banks;

e) The National Bank, as the banking supervisory body:

- had developed and introduced the normative framework for banking supervision and commercial bank reporting, bringing the regulatory requirements close to the corresponding international standards and to the requirements of the Basle committee, making it possible to improve the evaluation of the banks' activities and their financial state;
- had prepared banking supervisory inspectors and checked their qualifications and skills in practice. The results of audits performed by Ernst & Young (an international audit company) and reports of the banking supervisory inspectors, confirmed the insolvency of the former State banks. A number of banks, considered too small to be viable, were closed;
- had carried out expert examination of all the banks jointly with the experts of the World Bank;

f) Agreement had been achieved with the President, the Government, Jogorku Kenesh of the Kyrgyz Republic and international organizations (World Bank and International Monetary Fund) on the necessity and urgency of restructuring of the banking system.

5. An effective financial sector, whose core is a rational and efficient banking system, plays an important role in supporting and broadening the efforts on stabilization and restructuring. The purpose of the reforms is to develop and strengthen the financial system, to restore public trust in that system and to form, in the medium term; an effective system of resource mobilization and allocation which gradually must become more liberal and market-like, and also to offer diversified instruments both to borrowers and to depositors. In order to carry out reforms in the financial sector, the Republic needed assistance from international organizations, and in this connection on May 24, 1996 the Prime-minister of the Kyrgyz Republic sent a letter to the President of IDA, Mr. James D. Wolfensohn, asking IDA to render assistance in the form of a credit aimed at reforming the financial sector of the Kyrgyz Republic. On May 31 1996 the request was considered by the Board of Directors of the World Bank. On July 3, 1996 the Agreement between the Government of the Kyrgyz Republic and the World Bank on the provision of a Credit for restructuring the financial sector of the Kyrgyz Republic (FinSAC) was signed for the total amount of 31.2 million SDR (equivalent to USD 45 million) under standard IDA terms and conditions. The Credit was provided in two tranches, each of 15.6 million SDR (equivalent to USD 22.5 million). The first tranche of the Credit was received in September 1996 after the Credit Agreement became effective, and the second tranche was received in November 1997 after successful fulfillment by the Government and the NBKR of certain conditions.

6. In order to provide coordination, control and effective realization of the program the State commission of the Kyrgyz Republic on reorganization of the financial and banking systems was formed under Presidential Decree # 160 dated May 3, 1996. The Commission was headed by the Prime-minister and included the First vice-prime-minister, the Minister of Finance, the Chairman of NBKR, the Minister of Economy, the Chairman of the State Property Fund, the Director of the State Agency on securities supervision and the Director of the Agency on bank reorganization and debt restructuring.

7. In order to strengthen efforts to successfully realize the goals of the program, Resolution # 336 of the Government of the Kyrgyz Republic, "Measures of the Government of the Kyrgyz Republic and the National Bank of the Kyrgyz Republic on realization of FINSAC Program", was enacted on July 22,1997.

8. **The main purposes of the Program** of reforms which was supported by the FinSAC were as follows:

a) Development of the policies and formation of the legal framework which would promote the stable growth of a competitive and effective banking system;
b) Liquidation of two insolvent State banks, Kyrgyzagroprombank and Kyrgyzelbank (Savings bank), which by their activity prevented the growth and development of new private competitive banks;
c) Financial reorganization of two other banks, Kyrgyzpromstroibank and Kyrgyzstanbank, whose survival was possible only with the support of the National Bank;
d) Formation of the Agency on bank reorganization and debt restructuring (DEBRA) in order to promote repayment of problem loans and to facilitate the process of reorganization or liquidation of insolvent enterprises;
e) Formation of the legal framework for the regulation and supervision of non-bank financial institutions.

9. The FinSAC Program had a positive effect on the development of the financial sector of the Kyrgyz Republic and improved its viability. Strict monetary policy reduced inflation to 25.4% in 1997 and to 18.4% in 1998. The Som, the national currency, strengthened and the refinancing interest rate had been reduced to 23.5% by the end of 1997. GDP grew by 7.1 % in 1996, 9.9% in 1997 and 1.8% in 1998.

10. The FinSAC program and the Plan of measures of the Government of the Kyrgyz Republic and the National bank of the Kyrgyz Republic addressed the most urgent problems that had to be solved within the shortest possible period of time.

Results achieved in the course of realization of FinSAC project

A. Improvement of the enabling policy and regulatory environment:

11. On July 29, 1997 new versions of Law # 59 "On National Bank of the Kyrgyz Republic" and Law # 60 "On banks and banking activity in the Kyrgyz Republic " were enacted. New versions of the Law # 40 "On Pledge" dated June 27, 1997, Law # 74 "On bankruptcy (insolvency)" dated October 15, 1997 and Law # 36 "On restoration and protection of savings" dated June 2, 1997 were also enacted and on June 26, 1996 the Tax Code of the Kyrgyz Republic became effective. Law # 95 "On securities market" dated July 21, 1998 and Law # 96 "On organization of insurance in the Kyrgyz Republic" dated July 23, 1998 were enacted. The draft Law "On non-governmental pension funds in the Kyrgyz Republic

" has been developed and submitted for consideration to Jogorku Kenesh of the Kyrgyz Republic but it has not yet been enacted. In order to provide the legal framework for the development of credit unions, Law # 117 "On credit unions" was enacted on October 28, 1999. A draft law "On insurance of deposits" has been prepared and is being discussed with the corresponding ministries and departments.

Comparisons of the results of the Program:

a) the new version of the Law "On the National bank of the Kyrgyz Republic " provides a clearer definition of the basic mission and functions of the National bank. It describes in detail the relationship between the NBKR and the banks in respect of credit transactions, issues of regulation and supervision, licensing of the banking activity, the requirements provide information and regulatory limits (capital adequacy etc.). A number of new articles in the law regulate the preparation of balance of payments data for the Republic, the relationships with the international financial organizations and the role of NBKR as the government body responsible for the implementation of foreign currency policy in accordance with the law "On transactions in foreign currency". Moreover, the National bank is forbidden to extend credit to the Government of the Kyrgyz Republic;

b) the new version of the law "On banks and banking activity in the Kyrgyz Republic" clearly sets out the requirements in respect of the capital of a bank; the procedure for its formation and use, and the requirements to conform to international banking standards. The law requires that all the banks be joint-stock companies in order to prevent the rapid withdrawal of capital;

c) the new version of the Law "On pledge" provides a system of pledge registration in the corresponding Registry which enables the pledgeholder to receive information on the pledged property and its encumbrances. The law provides for considerable simplification of the procedure for execution against pledged property in case the borrower defaults. The realization of pledged property, in order to clear off the secured debts, is not considered a trade transaction and is exempt from taxation. The central pledge registry was also formed in accordance with that law. The Central Lien Registry (CLR) has been formed and is acting under the Ministry of Justice of the Kyrgyz Republic; and this Registry has offices in each oblast of the Republic.

d) the emergency powers of tax bodies on access to the information on bank accounts of enterprises were canceled by the amendments to the Tax Code; also the enterprises were permitted to form the reserves to be referred as expenses in order to cover the potential losses. Another important step which will help to increase the liquidity of the banks is the creation of equal conditions of income taxation both for business entities and for the banks;

e) the Law "On restoration and protection of savings of the citizens of the Kyrgyz Republic" establishes the obligation of the State in respect of the restoration, and provision of safety, of the value of savings of Kyrgyz citizens. The State guarantees restoration of the value of the savings of citizens: (1) placed on deposit in Elbank prior to January 1, 1992; (2) placed on deposit in State insurance organizations under long-term (accumulation) insurance contracts prior to January 1, 1992; and (3) invested in bonds of the "State interest-free loan of 1990" and in bonds of the "State internal lottery loan of USSR of 1982", which were replaced by the bonds of the "State 15 % internal lottery loan of the Kyrgyz Republic of 1993", and in bonds of the "State treasury obligations of USSR of 1990";

f) the new version of the Law "On bankruptcy" enables the NBKR to initiate liquidation procedures against a bank without referring to the Courts.

12. By June 1997, the coupon auction of those enterprises included in the program of privatization for 1996-1998, had been successfully completed. Many citizens participated in the coupon auctions and received free shares in Kyrgyz enterprises. The coupons were freely circulated and were registered at the Stock Exchange giving a boost to the development of the securities market. Between 1996 and 1998 some 663 enterprises were corporatized, including 281 earmarked under the privatization program. Of the

166 enterprises offered for coupon auctions, in accordance with the conditions of FinSAC Program, 149 objects were transferred in to private ownership. The State was required to reduce its holding below 50% in 320 enterprises; the State reduced its holding below 50% in 264 enterprises, liquidated 13 enterprises and initiated liquidation proceedings against a further 23 enterprises. Privatization of enterprises included into the Program of privatization for 1998-2000 was carried out using the following methods:

a) transformation into joint-stock company with subsequent privatization;
b) sale of the whole property or part of that property at an auction or under a tender;
c) transformation into limited liability company with subsequent privatization;
d) direct sale of property;
e) lease of an property with subsequent purchase thereof;

In addition, blocks of shares belonging to the State may be realized through investment or commercial tenders, at an auction, by direct sale under a business plan to the management of the enterprise or to the suppliers and partners, may be offered for sale at the Stock Exchange, or transferred to a trust manager.

13. Case by case privatization programs have been developed and approved for most large, strategic enterprises. The State retains a controlling interest in such strategic enterprises as "Kyrgyzenergo" JSC, "Kyrgyztelekom" JSC, "Kyrgyzgazmunaizat" JSC, "Bishkek mashzavod" JSC and "Kyrgyz mining complex" ("Kyrgyzski gornorudni kombinat") JSC.

14. The program for privatization and restructuring of the enterprises sector (PESAC) was completed. By December 1995 a diagnostic examination of all the enterprises included in the PESAC program had been completed; thereafter 5 of the enterprises were liquidated, 4 enterprises were withdrawn from the program without use of the program funds and 19 enterprises were restructured, i.e. their viable assets were into a separate entity in which production activity was recommenced. Working capital loans were extended to these enterprises from program funds. All the potentially viable ERRA enterprises were offered for sale; 13 enterprises were sold and the search for potential investors for the remaining 7 enterprises continues These are: "Mailuu-Sui bulb factory" JSC, "Textilschik" JSC, "Kristal" JSC, Khaidarkan mercury JSC, "Almalyk" mine, "Tash-Kumyr" mining department, Tokmak meat products factory (subject to reorganization).

15. As a result of realization of the Program for privatization and reorganization of agricultural enterprises (APEAC) 92 enterprises in "Kyrgyz-Dan-Azyk" GK were corporatized forming 44 JSC's. In 27 JSC's the State's shareholding was reduced to zero, 2 JSC's have a State shareholding below than 5%, 15 JSC's have a State shareholding below 15%, and 8 JSC's have a State shareholding below 50%. 7 JSC's were offered for auction but were not sold and 3 JSC's ("Osh Gul Azyk" SJSC, "Unaa Nan" SJSC, "Jalal-Abad Nan" SJSC) were sold but, as the purchasers failed to pay in time for their shares, the said shares have been returned to the State. Individual projects on 16 KHP were considered and adopted; of these, projects 8 projects have been returned due to insolvency of the clients. The State's share has been reduced in 3 corporations selected to maintain the State grain reserves. All KHP and 13 food processing enterprises were included in "Program-100". 114 enterprises in "Kyrgyz-Tamak-Ash" GK were corporatized to form 83 JSC's; the State's share in 56 of these companies has been reduced to zero.

16. In order to provide an effective, safe and reliable banking system and to protect the interests of bank depositors and other creditors, all banking activity is regulated. The NBKR has issued a series of regulations obliging the banks to change their credit policies, to form credit committees, to maintain credit portfolios, to classify loans according to their recoverability and to set aside reserves to cover the potential losses in accordance with that classification. NBKR has also issued regulations governing transactions with insiders and affiliates, problem bank resolution, the procedures for direct banking

supervision and temporary administration, the professional fitness of bank managers, the format of regulatory reports to be submitted by the banks, the procedure for revision of the activity of the banks and the procedure for the calculation of compulsory reserves. In order to reduce the risk of bank failure, to ensure banks maintained sufficient capital and liquidity, the NBKR established the "Rules of banking activity regulation binding for all the banks" in accordance with the banking legislation of the Kyrgyz Republic and international norms.

At present the banks must observe the following types of financial limits:

a) Maximum exposure to one borrower and to insiders - (K1.1, K1.2).
b) Minimum tier 1 and total capital adequacy - (K2.1, K2.2).
c) Minimum liquidity - (K3).
d) Maximum open foreign currency position - (K4).
e) Maximum exposure to one correspondence bank - (K5).

Banks must also maintain their paid in capital above the established minimum level. Calculation of the above limits is specified in the Regulations on (i) preparing regular banking reports; (ii) keeping records of the limit of the open foreign currency position; (iii) determining the capital adequacy standard (iv) the procedure for calculation of the open foreign currency position; (v) the procedure for calculation of the total capital and net total capital; and (vi) the criteria by which assets are evaluated against potential risks

17. The development and introduction of an accounting system corresponding to international standards and the introduction of an effective system of mutual settlements and payments, both carried out under the auspices of the FinSAC Program, contributed significantly to the institutional strengthening of banks. The absence of proper systems of accounting and auditing, the lack of qualified staff with knowledge of modern banking business, the slow development of such key infrastructure as the clearing and settlement system, poor information technology and bad management all served to impede the development of a viable banking system. The new accounting standards, based on IAS, were introduced in the National Bank and in some commercial banks from April 1, 1997. From June 1, 1997 all commercial banks were required to use the new accounting standards and the new accounting plan. As a result of the reforms carried out by the National Bank, all commercial banks prepare and publish financial statements in compliance with international standards, understandable to all the potential users. Because of these measures, in addition to the strengthening of banking supervision by the National Bank and the requirement to undergo an annual audit, it possible to assert that the financial statements published by the banks are true and fair and properly reflect the financial condition of the banks. Support and assistance in this direction was provided by consultants funded by the United States Agency for International Development (USAID).

18. Modernization of the payments system was carried out by the National Bank within the framework of FinSAC Program. In 1997, the regional clearing centers were opened and payment clearing was done manually. In 1998, automated clearing was introduced making it possible to provide "same day" settlements. Settlement is carried out by the National Bank on the basis of net balances transmitted at the end of a clearing session. International settlements are made by commercial banks by way of direct correspondence relations with foreign banks.

19. In order to raise the qualification of banking employees, a comprehensive and coordinated training program for banking specialists was designed to both satisfy the urgent short-term needs of the sector and to build continuing education in the field of banking activity. In particular, great attention was paid to such fields as accounting and internal audit, banking supervision, payment systems, foreign currency transactions, securities transactions, centralized pledge systems, etc. A considerable amount of

support and technical assistance was provided by the donor community in the form of long-term resident advisers, by evaluation, control and technical IMF missions, WB project missions, by ADB, German society on technical cooperation (GTZ) and by other donors. Banking experts helped to prepare training programs and conducted training courses both for instructors and for specialists. In addition, the banking consulting center had been formed within the framework of EU-TACIS program, giving all commercial banks access to qualified consultants and support for institutional improvement. The banking training center (BTC), supported by the Government of Finland, was established under the National Bank. Training in various fields of banking activity is provided in this center, for example, strategic planning, credit analysis, risk management, international trade, asset and liability management, etc.

B. Restructuring of insolvent obsolete specialized banks

20. The following provisions of the Program deal with the largest and most important part of the Program aimed at the rehabilitation of the banking system, specifically, the liquidation of insolvent specialized banks such as Kyrgyzagroprombank and Kyrgyzelbank and the division and restructuring of Promstroibank and Kyrgyzstan bank.

21. To improve the situation in the financial and banking sector, a large volume of loans extended by Kyrgyzagroprombank, Kyrgyzstanbank, Promstroibank and Amanbank between 1992 and 1994 in compliance with the Government's directed credit policies, were transformed into the internal debt of the State i.e. the State issued securities to the banks in exchange for their problem loan portfolios.

22. Within the framework of the Program under the Resolution of the Board of the NBKR # 17/1 dated May 30, 1996 the Agency on bank reorganization and debt restructuring (DEBRA) was formed. The functions of the Agency, which continues to operate, included the following: resolution of problem loans held by the banks earmarked for reorganization, reorganization and rescheduling of the debts exchanged for government securities, recovery of debts from enterprises and organizations and the liquidation, temporary closure or reorganization of the commercial banks which fell under the jurisdiction of the Agency in accordance with the Law of the Kyrgyz Republic "On bankruptcy (insolvency)". The Agency carried out the task of recovering amounts due to the Government and other creditors by the collection of debts and by debt restructuring and reduction programs negotiated with the individual debtors. In order to create a proper framework for performing its duties, the Agency developed the following methodological materials:

a) Instruction materials on the assignment of the debts of rural producers incurred under the government directed credits scheme between 1994 and 1996;
b) Instruction material on classification and restructuring of credits within the period of banks' liquidation within the framework of FinSAC Program approved by the Resolution of the Government of the Kyrgyz Republic # 412 dated August 28, 1996;
c) Regulations on sale of the enterprises;
d) Leasing: procedures and sample documents.

The Agency functioned as the banks' liquidator, paying off the banks' debts by reorganization, liquidation and settlement of problems loans and by disposing of the assets of the banks. DEBRA used various approaches to recover assets including the following:

- Negotiating principal and accrued interest write-offs in exchange for partial debt repayment;
- Debt for equity swaps;
- Sale of debt s at auction;
- Change of the debt structure (terms and conditions of repayment, interest rate, amount of payment, etc.).

In order to speed up the sale of pledged property, a new method of asset disposal – the leasing auction – was introduced with the first auction taking place on May 14, 1997. The Agency has also negotiated new contracts with the debtors; contract revisions were prepared and delivered to the Agency offices in each oblast. In remote territories, agricultural products were exchanged for debts.

23. In accordance with the Resolution of the Government of the Kyrgyz Republic # 43 "On re-registration of the debts of enterprises to the commercial banks into the internal governmental debt" dated January 30, 1997 the credit files of Kyrgyzstanbank, Promstroibank, Amanbank and Kyrgyzelbank were transferred to DEBRA.

As a result of measures taken in accordance with the Program:

a) Promstroibank and Kyrgyzstanbank have improved their financial situation after restructuring problem loans and taking other measures. They achieved a degree of success in their own re-capitalization; the paid in capital of the banks changed from negative to positive and the minimum level of regulatory capital was reached.
b) Kyrgyzagroprombank and Kyrgyzelbank were recognized under judicial order as bankrupt and were liquidated in accordance with the established legal procedure.
c) The outstanding deposits of the population were assigned to the Settlement and Savings Company.

Liquidation of Kyrgyzagroprombank

24. Kyrgyzagroprombank's banking licence was revoked by the Resolution of the Board of the National Bank # 17/2 dated May 3, 1996. On July 30, 1996 the Supreme Court of Arbitration of the Kyrgyz Republic, at the request of the National bank, declared Kyrgyzagroprombank to be bankrupt and ordered it to be liquidated. The Court assigned a representative of NBKR as the liquidator.

25. When DEBRA took over the case of Kyrgyzagroprombank the bank had on its books short term loans of 826.9 million som and long term loans of 68.0 million som (a total of 894.9 million som). At the same time, the bank owed 1,023.0 million som to its creditors. An evaluation of the credit portfolio, real estate and pledged property was performed and an agreement on the assignment of the loans, credit files and collateral was entered into. As of January 1, 1999 the Agency had recovered loans totaling 162.5 million som and the proceeds from the sale of the bank's assets totaled 21.5 million som (a total of 184.0 million som). The amount of outstanding short term loans is 692.6 million som and long term loans is 41.1 million som. In the course of liquidation of the bank, 44 of its 50 offices were closed. The number of staff at the bank was reduced from 1134 to 159. A number of bank premises have been leased to the Settlements and Savings Company. On 1 December 1999, the Agency transferred buildings valued at 25,342,236 som to the Kyrgyz Agricultural Finance Corporation to reduce the debt to the Ministry of Finance of the Kyrgyz Republic.

Liquidation of Kyrgyzelbank

26. The license of Kyrgyzelbank for banking activity had been revoked by the Resolution of the Board of the National bank # 6/1 dated February 14, 1996. Kyrgyzelbank had been declared insolvent under decision # 9/2 of the Supreme Court of Arbitration of the Kyrgyz Republic dated May 24, 1996. On 5 June 1998, the Bishkek Arbitration tribunal declared the process of liquidation of Kyrgyzelbank to be completed, and the liquidation balance was approved. Following that decision, the Order of the Ministry of Justice # 2556 dated June 25, 1998 was issued registering the termination of the activity of Kyrgyzelbank.

27. In accordance with agreement #1 "On assignment of the loans provided for commercial purposes" and agreement #2 "On assignment of Kyrgyzelbank loans arisen as a result of embezzlements and other violations", DEBRA accepted the assets of Kyrgyzelbank. The total amount of the loans taken by the Agency was 168.1 million som under Agreements #1 and #2, and 1.3 million som and 8.7 million US dollars under Agreement #4. DEBRA has recovered 1.95 million som from the loan portfolio and bad debts totaling 1.24 million som have been written off under resolutions of the State commission dated April 10, 1998 and January 25, 1999.

28. Proceeding from the terms and conditions of the FinSAC Program, the liquidation and reorganization of the banks has been carried out in such a way that the basic banking services and the payment system in all the regions of the Republic have been preserved during the course of the reforms. For this purpose the Settlements and Savings Company had been formed under Resolution of the Board of the National Bank #24/20 dated July 22, 1996. From January 1, 1998 in accordance with the law "On restoration and protection of savings of citizens of the Kyrgyz Republic", the Settlements and Savings Company started to accept deposit statements from citizens for deposit indexation. The statements are registered in the savings cash office in Bishkek. It is one of the measures which are being taken at present in the field of banking system reorganization, in continuation of FinSAC Program reforms.

C. Development and growth of non-bank financial institutions

29. To help develop non-bank financial institutions, the Government of the Kyrgyz Republic, the National Bank and the Ministry of Finance, with the participation of the State Agency on securities and the Kyrgyz Stock Exchange, prepared plans to achieve the following:

a) increase the profitability of the Kyrgyz Stock Exchange;
b) promote the formation of the secondary securities market;
c) draft the "Procedures for sale of Government Treasury Bills at KSE";
d) formation of the National Commission on securities market.

As a result of the these and other measures, the investment and pension funds, insurance and trust companies, securities market operators, stock exchange and pawnshops have developed further.

30. The draft laws on securities market and on investment funds, the coupon auctions, the development of the legal framework for the sale of government securities at the secondary market and the use of new government debt instruments make it possible to stimulate the participation of potential investors in securities transactions. With the appearance of the Settlements and Savings Company, the GTN (Government Treasury Notes) market has increased its activity.

31. The operation of the electronic trade system on GTN transactions at the secondary market has started. The Procedures for GTN secondary trading at KSE, which were drafted by KSE and agreed with NBKR, have been approved by Resolution of the Board of KSE. Also, the Ministry of Finance and NBKR have prepared Regulations on the issue and circulation of government medium term bonds (with the term of repayment from 2 to 5 years).

32. The executive board of the National Commission on Securities Market has drafted a new version of the Law # 95 "On securities and Stock exchange", which was enacted on June 21, 1998. The Resolution of the Government of the Kyrgyz Republic "On changes and amendments to be made in the Regulations on investment funds in the Kyrgyz Republic" has been enacted. The work on the formation of an efficient securities market continues in accordance with the Decree of the President of the Kyrgyz Republic "On measures to further develop the organized securities market" dated May 10, 1999. A draft

law on changes and amendments to be made in the Tax Code has been prepared and the mechanism to sell the government held shares through the Stock Exchange is being developed.

33. Work is being carried out in order to develop a mechanism for the securitization of debts with the subsequent sale of the securities under market conditions. The National Commission on Securities Market is working on the formation of a single securities market; there are currently separate structures for government and corporate securities.

34. Investment funds are potentially large investors and active participants in the securities market and have a major role to play in the development of the market in Kyrgyzstan. As of January 1, 1999 15 investment funds have been licensed by the National Commission on Securities Market.

35. The Ministry of Labor and social protection has currently licensed only one private pension fund; "Kyrgyzstan". The functions of the State pension fund were assigned to the Social Fund. In future, the pension funds may become the largest conduit of household savings into the capital markets; such a development will be strongly influenced by the legal and regulatory policies governing the market and taxation policies. The critical issues, however, are whether membership in the financed pension funds is compulsory or voluntary, the level of the funds' control over the pension assets and whether contributions will be redirected from the State social insurance system.

36. Certain progress has been achieved in the development of insurance companies which deal mainly with property, accident, life and medical insurance. The legal basis to promote the development of insurance companies is the Law of the Kyrgyz Republic "On organization of insurance in the Kyrgyz Republic" enacted July 23, 1998. As of January 1, 1999 34 insurance companies have been licensed by the State insurance supervisor. The draft laws "On governmental compulsory insurance of air, water, automobile and railway transportation", "On compulsory insurance of general civil liability of senders of explosive, inflammable, chemical and other harmful substances" and "On compulsory insurance of civil liability of the owners of transport facilities" are presently being considered by parliament. Changes have been made to the Tax Code of the Kyrgyz Republic, in particular: VAT has been removed from insurance premiums, insurance premiums paid by enterprises are tax deductible and a tax of 5% on gross insurance premiums has been introduced.

37. The Kyrgyz Agricultural Finance Corporation (KAFC) and the financial company on support of the credit unions were formed, within the framework of the financial system reformation program, to provide credit to the rural population, to render assistance in the development of agricultural production, to promote the efficient use of available credit resources in rural areas and to form financial cooperative organizations etc. Specifically:

a) The main purpose KAFC is to provide credit to the agricultural and agro-processing sectors which at present have no access to credit from commercial banks. KAFC provides services to rural producers and agricultural enterprises, and extends credits for working capital and investment to small and medium private agricultural businesses dealing with the processing and storage of agricultural products, to enterprises dealing with the lease of agricultural machinery and to trade organizations dealing with the procurement of agricultural products. The financing covers the peasant farms dealing with plant growing, live stock breading and agricultural products processing. The average amount of a credit per borrower is 60–70 thousand som.

b) **The main purpose of the financial company on support and development of credit unions** is to promote the formation of a new independent and sustainable financial system in rural areas. The main activities of the Company are as follows:

- assisting individuals wishing to form credit unions, to prepare founding documents and obtain registration;
- rendering methodological assistance in training credit union employees in the fields of lending and accounting;
- Explaining the functions and benefits of the credit unions (CUs) to the rural population;
- monitoring of CU activity;
- taking necessary measures and sanctions against CUs which do not observe the NBKR requirements;
- supervision over the use and repayment of loans;
- performance of lease, factoring, forfeit, trust and other financial transactions which contradict neither the purposes of the Company nor the law of the Kyrgyz Republic.

At present the credit unions practice has gained its development in all the regions of the Kyrgyz Republic. Thus, under the financial support of the Asian Bank of Development more than 100 credit unions are registered and successfully act on the territory of Kyrgyzstan.

Conclusions and recommendations

38. The restructuring of the financial sector (FinSAC) was a logical continuation of the earlier economic reforms undertaken in the Kyrgyz Republic. The successful completion of the previous programs such as the program of privatization and reorganization of agricultural enterprises (APEAC) and the program of privatization and restructuring of the enterprise sector (PESAC) supported by the World Bank and the three year economic stabilization program (ESAF) supported by the International Monetary Fund and the preparatory measures taken by the National Bank on the reorganization of insolvent banks, laid the groundwork for the successful realization of the FinSAC program. FinSAC created the basis for the subsequent public sector reform program (PSRMAC), as well as for the realization of other programs being undertaken in Kyrgyzstan.

39. FinSAC paved the way for the further development of the financial sector by rendering assistance in the formation of the banking system and other financial institutions. Closer cooperation between various departments and institutions, banks, businessmen and private investors is needed to provide for the harmonious development of market relations and to promote the conditions stimulating further development of the economy. It is necessary to solve problems taking into account the interests of all the participants. The FinSAC program has brought positive results and has been successfully fulfilled. Moreover, the program made it possible to develop a road map for the further reorganization of the financial system of the Republic.

40. The substantial improvements that have been achieved in the banking system as a result of the reforms are evidence of the successful realization of the program. At the start of the reform program the capital of the banking system minus 1 billion som; now it is plus 0.8 billion som (it is worth noting that the NBKR has mandated that the banks increase their paid in capital on a stage-by-stage basis). In addition, all banks must observe the minimum capital adequacy standards recommended by the Basle committee on banking supervision (NBKR has in fact set more stringent requirements: tier 1 capital adequacy – 6 %, total capital adequacy – 12 %). The net profit of banks is gradually increasing, and the amounts set aside to cover problem loans are decreasing, testifying to the substantial improvement in the quality of credit portfolios. The mentality of the management of commercial banks is changing, the structures of the banks have been improved and they have become more customer focused. Each year, the commercial banks are becoming more and more attractive to their customers. The banks are now looking to extend their involvement in the capital markets, to increase investment and trade activity, to

develop transactions with derivatives and undertake trust activities. Almost all Kyrgyz banks are in compliance with the NBKR's prudential standards.

41. DEBRA has achieved very positive results. Good experience has been gained in debt restructuring and bank liquidation and reorganization. The principal consent of the World Bank has been received for the prolongation of the activity of the Agency for another three years, in order to continue and complete the reorganization and restructuring of problem banks and the restructuring of the debts assigned to the Agency. Under Resolution of the Board of the National Bank of the Kyrgyz Republic #44/6 dated June 3, 1999 "On extension of the powers of the Agency on banks' reorganization and debts' restructuring" and under the Resolution of the Government Commission of the Kyrgyz Republic on reorganization of the finance and banking system # 17-7 dated September 6, 1999 "On activity of the Agency on banks' reorganization and debts' restructuring" the powers of the Agency on banks' reorganization and debts' restructuring had been extended for another three years, that is, till May 3, 2002.

42. Banking supervisory activity, conducted by qualified specialists of the banking supervisory department who passed the corresponding professional training, has been intensified. However, despite the measures taken, there is still a high turnover of banking supervisory specialists.

43. The non-banking financial institutions received further development.

44. The program loan of the Asian Development Bank for the development of the financial sector and attraction of investments continues the major themes of the FinSAC program. The main purpose of the program is to improve the efficiency of financial intermediation by creating a viable, well functioning and flexible banking system, as well as to widen and deepen the capital markets in order to actively use the alternative financial sources. To achieve this goal the program will concentrate its efforts on the following:

a) restructuring, consolidation and strengthening of the banking sector;
b) development of the government securities market;
c) promotion of the development of the stock-exchange market; and
d) formation of the institutional investors.