

**Kyrgyz Republic: Financial System Stability Assessment,  
including Reports on the Observance of Standards and Codes on  
the following topics: Monetary and Financial Policy Transparency,  
Banking Supervision, and Payment Systems**

This Financial System Stability Assessment on the **Kyrgyz Republic** was prepared by a staff team of the International Monetary Fund and the World Bank as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on **February 19, 2003**. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of **Kyrgyz Republic** or the Executive Board of the IMF.

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KYRGYZ REPUBLIC

**Financial System Stability Assessment**

Prepared by the Monetary and Exchange Affairs and the European II Departments

Approved by Stefan Ingves and John Odling-Smee

January 30, 2003

- The Financial System Stability Assessment is based on a joint IMF/World Bank mission that visited the Kyrgyz Republic from May 15–28, 2002 and August 26–September 9, 2002 as part of the Financial Sector Assessment Program (FSAP). The mission met with the Office of the President, the National Bank of the Kyrgyz Republic (NBKR), the Ministries of Finance and Justice, the State Commissions on Securities Markets and on Standards of Financial Accounting and Auditing, members of the Parliament, and members of the financial community. The FSAP findings were discussed during the FSAP missions and Article IV mission in October/November 2002.
- The mission consisted of Richard Abrams (Head, IMF), Tunc Uyanik (Deputy Head, World Bank), Gianni De Nicoló, George Iden, P. Moni Sengupta, Joerg Zeuner, Delrene Alvis, and Roxana Nikdjou (all IMF); Hormoz Aghdaey, Nagavalli Annamalai, Zeynep Kantur, Serap Gonulal, Robert Gourley, Adolfo Rouillon, Mehnaz Safavian, Carlo Segni, Rimas Survila, Sanjay Vani (all World Bank); and Richard Breeden (Federal Deposit Insurance Corporation, United States), Niels Larsen (formerly Federal Reserve Bank of Boston), and Martin Ohms (Austrian National Bank). The IMF Representative, Bhaswar Mukhopadhyay, and the World Bank Representative, Mohinder Mudahar, participated in some of the meetings with the Kyrgyz authorities.
- Though the Kyrgyz Republic has made progress in addressing macroeconomic imbalances in recent years, its financial system remains very small and at a fairly low level of development. Thus, most financial vulnerabilities should be viewed more in terms of their threat to financial sector development than their threat to macroeconomic stability. The financial condition of the banking system remains fragile, making it vulnerable to risks associated with recession and the level of dollarization. There is a need to resolve the state-owned Kairat Bank and the NBKR-owned Savings and Settlement Corporation (SSC). In addition, there are weaknesses in the judicial and legal system and in accounting and audit that pose important barriers to financial sector development.
- The report is divided into two sections. The first presents the main findings and overall assessments, while the second provides a summary assessment of standards and codes in the areas of banking supervision, payment systems, and monetary and financial policy transparency. The FSAP report on which this report is based, includes the background analysis and detailed assessments of standards and codes.

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## GLOSSARY

AML	Anti-Money Laundering
BCP	Basel Core Principles
CFT	Combating the Financing of Terrorism
CIS	Commonwealth of Independent States
CPSS	Committee on Payment and Settlement Systems
CPSIPS	CPSS's Core Principles for Systemically Important Payment Systems
CU	Credit Union
DEBRA	Debt Recovery Agency
EBRD	European Bank for Reconstruction and Development
FATF	Financial Action Task Force
FCD	Foreign Currency Deposit
FCSDCU	Financial Company on Support and Development of Credit Unions
FINCA	Foundation for International Community Assistance
FSAP	Financial Sector Assessment Program
GDP	Gross Domestic Product
IAS	International Accounting Standards
IDA	International Development Agency
IFAD	International Fund for Agricultural Development
IFC	International Finance Corporation
IFI	International Financial Institutions
IMF	International Monetary Fund
KAFC	Kyrgyz Agriculture Finance Corporation
KSE	Kyrgyz Stock Exchange
MAE	Monetary and Exchange Affairs Department
MFI	Micro-Finance Institution
MOF	Ministry of Finance
NACH	National Automated Clearing House
NBKR	National Bank of the Kyrgyz Republic
NBFI	Nonbank Financial Institution
NBS	Nonbank Supervision
NPL	Non Performing Loan
OMO	Open Market Operations
PIP	Public Investment Program
PRSP	Poverty Reduction Strategy Paper
SCSM	State Commission on Securities Markets
SFAA	Standard on Financial Auditing and Accounting
SSC	Savings and Settlement Corporation
SSIF	State Social Insurance Fund
TA	Technical Assistance
UNCITRAL	United Nations Commission on International Trade Law
USAID	U.S. Agency for International Development
WB	World Bank
WTO	World Trade Organization

## I. OVERALL STABILITY ASSESSMENT

1. **The Kyrgyz financial system is very small and at a fairly low level of development.** As a result, most financial vulnerabilities should be seen more in terms of their threats to financial sector development than their potential threat to macroeconomic stability. However, the high level of foreign-denominated external debt does potentially pose a significant macroeconomic risk.
2. **The banking sector and the banking supervision function are the most developed parts of the system, while other financial institutions and their supervisory bodies are at a lesser stage of development and are not systemically important.** However, even the banking sector is small, with total assets equivalent to 7 percent of GDP. This is largely the result of a lack of confidence in banks, and a weak demand for transactions accounts because of a narrow range of payment services. The contribution of the banking sector to economic development is also limited.
3. **The financial condition of the banking sector remains somewhat fragile.** Banks are vulnerable to risks associated with recession, the level of dollarization, and exports to its main trading partners in the Commonwealth of Independent States (CIS). While banks have returned to profitability and bank capitalization has risen, asset quality remains a concern with about 14 percent of loans classified as nonperforming. Stress tests also reveal vulnerabilities in several large- and medium-sized banks. In addition, there are concerns that some banks are overstating their capital and their financial condition through the use of cross shareholdings, roll-overs, the overstatement of assets, and other techniques. However, the NBKR has been taking strong steps to ensure accurate reporting by banks.
4. **There is a need to resolve the state-owned Kairat Bank and the National Bank of Kyrgyz Republic (NBKR)-owned Savings and Settlement Corporation (SSC), and to put the Debt Recovery Agency (DEBRA) on a sustainable footing.** To this end, the staff worked with the authorities to formulate plans for divestiture/resolution of both banks, as well as to develop a sustainable strategy for addressing DEBRA's problems.
5. **Considerable efforts and resources have been expended to strengthen the NBKR's banking supervision function, and these have yielded some positive results.** However, further improvements are needed. Some of the weaknesses relate to a lack of regulations, such as in risk management, but others are rooted in the legislation. For example, the Law on Audit prevents the NBKR from qualifying bank auditors or contacting them without the permission of the bank. In addition, supervisory enforcement efforts have frequently been hampered by the courts.
6. **Domestic payment systems are slow and inefficient, but this does not pose a systemic risk.** Furthermore, the authorities are finalizing plans for modernizing the system to bring it in line with international best practices.
7. **There are important weaknesses in the judicial and legal system.** First, judicial outcomes are unpredictable, and judges sometimes take actions beyond their authority.

Second, the passage of laws is slow and non-transparent, and may result in direct conflicts between laws. These weaknesses pose important barriers to the enforcement of financial contracts, and the development and implementation of effective financial supervision.

8. **Nonbank financial institutions (NBFIs) are playing an increasingly important role by providing credit to micro- and small-enterprises and rural borrowers, but the sector is not without its risks.** The most important risk is that the state-owned Kyrgyz Agriculture Finance Corporation (KAFC) will succeed in its efforts to become a bank. It is the largest agricultural lender, but the quality of its loan portfolio is worsening and its profitability is primarily the result of subsidized funding.

9. **The capital markets, insurance, and pension sectors are all extremely small, not systemically significant, and suffer from weak supervisory oversight.** They are unlikely to play a significant role in the period ahead, so it may be desirable for each sector to formulate a medium-term development plan with outside assistance.

10. **The framework for anti-money laundering/combating the financing of terrorism (AML/CFT) is very weak.** Realizing the importance of this issue, the NBKR has taken the lead by preparing a draft AML/CFT law. The draft is generally satisfactory, and incorporates comments provided by the FSAP mission.

11. **There are pressures to introduce a deposit insurance scheme, but this is premature.** Key preconditions are not in place, including concerns about the health of some banks, the transparency of banks' financial statements, and judicial uncertainty.

12. **The framework for accounting and audit raises several concerns.** The accounting framework needs to be improved. To this end, legislation has been enacted requiring all enterprises to implement International Accounting Standards (IAS) by fiscal year 2004. However, this timetable does not seem feasible since the country does not have many accountants with expertise in implementing IAS. Domestic audit skills are also limited, particularly with respect to audits of IAS-based financial statements.

13. **A review of NBKR transparency practices in monetary policy, banking supervision, and payment system supervision and oversight found that NBKR practices were good in most respects.** However, areas for improvements were identified.

14. **The main FSSA recommendations are divided into those that relate more to short-term vulnerabilities which can be addressed more quickly, and those that are more medium-term and developmental in nature—but in some cases ultimately more important—and may take longer to address.** While a number of recommendations are made, they cover a range of policy areas, and their implementation can be carried out by a diverse set of agencies. As a result, capacity constraints are not expected to pose a major problem. Furthermore, while attempts were made to make the recommendations as specific as possible, the mission lacked the time—and in some cases the expertise—to detail certain recommendations in certain areas, such as judicial shortcomings, and more detailed solutions were left for the relevant authorities and their technical assistance advisors.

### Shorter-term vulnerabilities

- **Improve bank governance and strengthen the banking system:** (1) to encourage strategic investors, eliminate the 15 percent ownership limit for legal entities; (2) gradually increase minimum Tier 1 capital; and (3) phase out the category of specialized banks.
- The **resolution plans for Kairat and SSC** need to be finalized and implemented.
- **DEBRA** needs to be strengthened in terms of its organizational structure and operations, including development of a sustainable strategy.
- In **banking supervision**, some measures may be implemented more quickly than others. Near-term measures include: (1) making the Law on Banks and Banking of Kyrgyz Republic (the Banking Law) the sole legal source for bank licensing; (2) amending the NBKR accounting policy guidelines to conform with IAS; and (3) introducing a detailed framework for risk management. Longer-term measures include: (1) providing legal protection for NBKR employees and third parties working for the NBKR; (2) enabling the NBKR to share confidential information with domestic financial sector supervisors; and (3) empowering the NBKR to oppose the appointment of, or require the replacement of external auditors.
- For **monetary policy and liquidity management:** (1) improve liquidity projections; and (2) introduce a Lombard facility.
- For the **payment system:** complete and formally adopt the National Program for the Payment System; and ensure that the resources and trained professionals are available to execute that program.

### Medium-term and development issues

- **Key legal and judicial measures:** (1) make the lawmaking process more efficient, open and transparent; (2) strengthen the judiciary, and make it more efficient, effective, independent and accountable; and (3) have financial sector supervisory authorities start the process of rationalizing the legal framework it administers to avoid inconsistencies and gaps.
- Regarding the NBFIs: (1) KAFC should not become a bank; and (2) weaknesses that can undermine the oversight and monitoring of credit unions (CUs) should be addressed.
- On the **capital markets**, take steps to (1) make them more efficient and transparent, (2) strengthen market supervision, and (3) formulate a medium-term strategy for market development.
- In the area of **insurance:** (1) the supervisor needs increased funding and more trained staff; and (2) authorities need to formulate a medium-term development strategy.
- A **deposit insurance scheme** should not be introduced until the preconditions for its successful introduction are in place.
- On **accounting and audit:** the feasibility of introducing IAS in all enterprises needs to be reevaluated, and the audit process should be made transparent and objective.



- The Kyrgyz Ministry of Finance (MOF) should develop a domestic **debt management strategy**.
- In AML/CFT: the draft AML/CFT law should be passed, and sufficient resources made available to ensure its effective implementation; and law enforcement bodies should implement criminal, investigative, and prosecutorial measures for ML/FT.

## II. MACROECONOMIC AND FINANCIAL CONTEXT

### A. Macroeconomic Environment

15. **The Kyrgyz Republic is a small, open transition economy.** It is heavily dependent on gold and agriculture output. It is among the poorest CIS countries, with per capita GDP of \$308 in 2001. Progress has been made in alleviating poverty, and it is among the more advanced transition economies in Central Asia in terms of market reforms, but weak state and corporate governance, legal uncertainty, and corruption impede the pace of development.

16. **The Kyrgyz Republic's macroeconomic performance has improved markedly in recent years, although external debt is a source of concern.** Real GDP grew at an average rate of 5.3 percent per annum from 1997–2001 (Table 1). However, growth is expected to slow to 0.8 percent in 2002, mainly due to an accident at Kumtor goldmine. The 12-month average inflation rate has slowed from 23.5 percent in 1997 to a projected 2.3 percent in 2002. Over the same period, the external current account deficit narrowed from 8.3 percent of GDP to a projected 2.8 percent. However, public external debt rose from 54 percent of GDP in 1997 to 111 percent in 2000. The debt level is the source of macroeconomic risk.

17. **The decline in inflation has reflected a gradual tightening of monetary conditions accompanied by a narrowing of the fiscal deficit.** While remonetization continues, the growth of broad money declined from 25 percent in 1997 to 13 percent in 2001. The fiscal deficit fell from 9 percent of GDP in 2000 to 5 percent in 2001 and is expected to remain at this level in 2002.

18. **The NBKR maintains a managed floating exchange rate regime.** The som stabilized in 2001 at an average of som 48.4 per U.S. dollar, after losing almost half of its value in 1999 following the Russian financial crisis, and another 20 percent in 2000. Nominal and real interest rates have declined steadily in 2001 and the first half of 2002. Improved confidence also led to a decline in the spread between som and U.S. dollar interest rates.

### B. Financial System Structure

19. **The Kyrgyz financial system, which includes both banks and nonbank intermediaries is at a low level of development** (Table 2). The banking sector shrank after the Russian crisis in 1998 and remains very small, with assets and deposits equivalent to 7 percent and 4 percent of GDP, respectively. The deposit-to-GDP ratio is the lowest among

Table 1. Kyrgyz Republic: Selected Economic Indicators, 1997–2002

	1997	1998	1999	2000	2001	2002 New Proj.
<b>GDP</b>						
Nominal GDP (in billions of soms)	30.7	34.2	48.7	65.4	73.9	77.5
Nominal GDP (in millions of U.S. dollars)	1,767	1,630	1,243	1,368	1,525	1,649
Real GDP (growth in percent)	9.9	2.1	3.7	5.4	5.3	0.8
GDP per capita (in U.S. dollars)	374	340	255	278	308	330
<b>Prices and wages</b>						
Consumer prices (percent change, eop)	13.0	16.8	39.9	9.6	3.7	3.6
Consumer prices (percent change, avg)	23.5	10.5	35.9	18.7	7.0	2.3
Nominal exchange rate (eop)	17.4	29.4	45.3	48.9	47.7	...
Exchange rate (soms per U.S. dollar, average)	17.4	21.0	39.1	47.8	48.4	...
Average real wage (1994=100)	114.6	129.7	118.0	120.8	133.6	140.3
Average monthly wage (in U.S. dollars)	36.1	37.4	24.7	24.7	28.8	31.9
			(In percent of GDP)			
<b>State government finances</b>						
Total revenue and grants	16.2	18.0	17.7	15.1	17.0	18.4
Tax revenue	12.5	14.2	12.3	11.7	12.4	13.4
Total expenditure (including net lending)	25.3	28.8	30.4	24.9	22.2	23.7
Non-interest current expenditure	19.9	20.6	17.3	14.9	15.9	16.4
Public Investment Program (PIP)	3.1	5.7	9.4	6.8	4.4	5.1
Overall fiscal balance (cash basis)	-9.2	-9.5	-11.9	-9.2	-5.0	-5.6
Primary balance 1/	-7.5	-7.4	-9.0	-6.9	-3.3	-3.7
Primary balance (excl. PIP)	-4.4	-1.7	0.4	-0.2	1.1	1.4
			(Percent change, unless stated otherwise)			
<b>Money and credit 2/</b>						
Reserve money (end-of-period)	21.1	6.8	23.4	12.3	11.3	38.7
Broad money (end-of-period)	25.4	17.2	33.9	12.1	11.3	29.8
Velocity of broad money 3/	8.4	8.6	8.5	10.0	9.4	7.6
Money multiplier	1.4	1.5	1.6	1.6	1.5	1.4
<b>External sector</b>						
Export growth (goods and services, in U.S. dollars, percent change)	20.1	-11.5	-11.8	8.6	-2.1	5.8
Import growth (goods and services, in U.S. dollars, percent change)	-20.8	14.0	-24.7	-7.2	-13.1	15.5
Current account balance (in percent of GDP)	-8.3	-22.9	-15.7	-7.5	-3.3	-2.8
Gross international reserves (months of imports, end-period) 4/	1.8	2.2	3.4	4.4	4.1	4.5
External debt outstanding in percent of GDP 5/	54.2	72.3	109.3	111.1	99.7	96.1

Sources: Kyrgyz authorities; and Fund staff estimates and projections.

1/ Overall balance less accrued interest payments.

2/ Projections use program exchange rate.

3/ For 1997-2000, annualized quarterly GDP/end-of-period broad money, for 2001-2003, 12-month GDP/average broad money for last two quarters.

4/ Gross reserves exclude international reserves of NBKR that are pledged or blocked.

5/ Excluding Kumtor.

Table 2. Financial System Structure, 1998–2002  
(in million soms)

	Dec-98		Dec-99		Dec-00		Dec-01		July-02	
	No.	Assets	No.	Assets	No.	Assets	No.	Assets	No.	Assets
Commercial Banks	24	4,365.3	23	4,340.5	23	4,385.6	21	4,628.1	19	5,897.9
Bank exits	0		2		1		4		2	
Branches	143		150		156		143		140	
Assets-to-GDP	12.8		8.9		6.7		6.3		7.4	
Deposits-to-GDP	6.2		5.4		4.3		3.8		3.5	
Special credit institutions 1/	4		4		4		10		10	
of which: KAFC		217.1		385.4		661.6		783.0		1,005.9
Credit unions	83	14.9	165	53.3	191	103.9	275	242.3	355	310.5
Insurance companies	35	96.3	36	119.8	29	124.2	24	129.6	24	124.0
State-owned	1		1		1		1		-	
Private	34		35		28		23		24	

Sources: National Bank of the Kyrgyz Republic, Ministry of Finance, Securities State Supervision, and Ministry of Labor.  
1/ Specialized credit institutions include micro-finance organizations.

transition economies.<sup>1</sup> There are 19 commercial banks, 2 of which are state-owned and 2 are subsidiaries of foreign banks.<sup>2</sup> There are no financial conglomerates in Kyrgyz Republic. NBFIs channel donor funds to finance credit to the micro- and small-enterprise sector, especially in rural areas. The largest NBFIs is KAFC, which is the dominant lender to agriculture. There are 357 credit unions (CUs) and their size is small but growing. NBFIs are not as a competitive threat to the banking system.

**20. The securities market, and the insurance and the pension fund sectors are all very small and underdeveloped.**

**21. The Kyrgyz financial system faces both short-term vulnerabilities and medium term risks.** Most short term vulnerabilities do not threaten macroeconomic stability, because of the small size of the financial sector. However, if they persist or result in disorderly bank

<sup>1</sup> As of end 2001, the deposit-to-GDP ratio was 17 percent in Russia, 20 percent in Ukraine, 35 percent in Estonia, 16 percent in Kazakhstan and 31 percent in Albania.

<sup>2</sup> The asset share of state-owned banks was about 12 percent as of end-July 2002.

exits, they would endanger the restoration of confidence in banks, as well as the sector's ability to contribute to economic development. Medium term risks arise from the continuing weaknesses in the financial system's infrastructure.

### III. SHORT-TERM VULNERABILITIES

#### A. The Banking Sector

##### Financial soundness

22. **Although considerable progress has been made in restructuring the Kyrgyz banking sector, its financial situation remains fragile** (Table 3). Most of the weakest banks have been eliminated, although one medium-size problem bank remains and the credit quality of several bank portfolios appears poor, as a result of high levels of non-performing loans (NPLs) and sectoral concentrations.<sup>3</sup> While most banks report profitability, in some cases profits could be overstated as a result of roll-overs of nonperforming credits. The NBKR is aware of this problem and it has intensified its efforts to verify financial reporting. As shown in the stress testing exercise, bank resilience to sudden declines in the quality of their loan portfolio is less than that suggested by their capital ratios. In addition, the total capital of some banks may be overstated owing to cross-shareholding.

23. **In the past three years, the capital of the banking system has risen, partly as a result of higher minimum capital requirements.** Minimum statutory capital requirements for existing banks rose from som 25 million to som 50 million in July 2000, and to som 100 million in July 2001. Tier 1 requirements were raised to som 25 million in April 2002.<sup>4</sup> This contributed to a rise in the total capital-asset ratio from 22 percent at end-1998 to 27 percent in June 2002. As of July 2002, large banks had a capital-to-asset ratio of about 20 percent, while small- and medium-size banks had ratios slightly above 40 percent. The authorities recognize the need to both increase bank capital and to eliminate the 15 percent limit on bank ownership by legal entities, in order to encourage stronger banks and strategic investors.

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<sup>3</sup> Large banks are defined as banks that have a market share (in terms of total assets) greater than or equal to 7 percent, medium-size banks have a market share between 3 and 7 percent, and small banks have a market share less than or equal to 3 percent.

<sup>4</sup> Some banks which meet the Tier 1 capital requirement but not the statutory requirement are allowed to operate as specialized banks. These banks cannot deal in precious metals, act as trust managers, trade in securities or derivatives or lend without collateral.

Table 3. Financial Soundness Indicators for the Banking Sector,  
December 1998–June 2002  
(In percent)

	Dec 98	Dec -99	Dec-00	Dec- 01	Jun-02
<i>Capital Adequacy</i>					
Regulatory capital to risk-weighted assets 1/	30.9	23.9	30.5	52.2	43.4
Equity capital to total assets	22.1	15.5	20.5	31.5	27.7
<i>Asset Composition and Quality</i>					
Sectoral distribution of loans to total loans					
Industry	7.1	13.8	14.9	16.5	20.9
Agriculture	0.8	1.9	2.9	4.4	3.4
Trade	31.8	24.0	14.8	16.9	23.0
Construction	13.2	7.5	4.9	2.4	3.3
Private citizens	15.3	20.4	21.9	21.8	20.0
Other 2/	31.8	32.4	40.6	38.1	29.4
Non-performing loans (NPLs) to total loans	10.1	30.9	13.4	13.4	13.8
Total provisions to NPLs	56.9	52.0	68.6	63.5	69.2
<i>Profitability</i>					
Return on Assets	1.5	-8.8	-1.1	1.5	1.0 3/
Return on Equity	6.8	-56.7	-5.3	4.8	11.9 3/
Net interest income to gross income	38.2	10.8	18.8	33.3	35.1
Non-interest expenses to gross income	62.4	61.6	59.1	60.5	63.1
<i>Liquidity</i>					
Liquid assets to total assets	24.1	38.2	30.0	27.0	33.6
Liquid assets to total short-term liabilities	90.7	111.2	132.8	91.6	98.9
Credits to deposits in foreign currency	113.4	75.9	71.5	70.5	84.6
<i>Sensitivity to market risk</i>					
Net open positions in FX to capital	5.4	-0.7	3.9	29.9	29.1

Sources: National Bank of the Kyrgyz Republic, Banking Supervision.

1/ Regulatory capital is composed in each year almost entirely by Tier I capital.

2/ Includes Transport and Communication and Procurement and Processing.

3/ Annualized.

24. **The Russian crisis of 1998 led to a substantial decline in asset quality in 1998 and 1999.** Despite more prudent lending policies and the exit of failed banks, asset quality is a cause for concern, with 14 percent of loans classified as nonperforming as of June 2002. The ratio of NPLs to total loans is generally higher for larger banks. As of June 2002, large banks had on average 17 percent NPLs, while NPLs were 10 percent for medium-size banks and 4 percent for small banks.

25. **Despite the return to profitability in 2001, several factors limit banks' earning capacity.** Banks have difficulty in generating income in the face of declining interest rates, which are currently accompanied by declining interest rate margins, although the profitability of some banks has been enhanced by rising fee-based income. Owing to the lack of firms' transparency and judicial uncertainty, lending is risky, primarily short term and heavily collateralized. These factors led to a decline in bank lending as a percent of GDP, from about 6.5 percent in 1995 to about 3.8 percent in 2001. Banks currently invest about one-third of

their assets in short-term securities and correspondent bank accounts, whose returns are declining with interest rates. Banks costs are also high. The average cost-to-income ratio was about 77 percent as of end-2001, although it is declining slowly.

**26. The exposures of Kyrgyz banks to interest rate and exchange rate risk appear limited, while their liquidity position is fairly strong.** Most domestic and foreign fixed income securities have short maturities, and the maturity gaps in the short end of the yield curve are generally small. The net foreign exchange open position is also rather small, although it has risen in the past few years. Excluding government securities, liquid assets were 44 percent of total assets, and the ratio of short-term liquid assets to short-term liquid liabilities was about 96 percent as of end-June 2002.

**27. The financial dollarization of the Kyrgyz economy makes the banking sector potentially vulnerable to adverse external developments.** Since export performance is strongly linked to Russia and other CIS countries, a significant slowdown in these countries could open a sizable current account deficit, which could lead to a devaluation of the som. As in the recent Russian crisis, this would have the potential to increase credit risk both directly and indirectly, through the inability of firms whose revenues are in soms to service their foreign currency debt.

#### **Sources of risk**

**28. A sharp slowdown in growth or a recession could undermine banking system stability owing to the poor quality of the loan portfolios of some of the larger banks.** Several banks' loan portfolios are not diversified, while others have their loans concentrated in cyclical sectors, such as construction and real estate. The financial difficulties of a few key enterprises and affiliated companies, as well as clusters of small- and medium-size enterprises in the services sector, could also jeopardize the financial position of some banks.

**29. Further declines in interest rates could hurt the earning capacity of Kyrgyz banks.** The current decline in deposit rates is slower than the fall in nominal interest rates on bank loans and treasury bills, owing to the desire of banks to retain deposits. Declining interest rates are also causing banks to experience pressure on their profitability owing to the significant dependence of their earnings on the return on short-term fixed income securities and correspondent bank accounts.

#### **Stress tests**

**30. The NBKR, with assistance from the FSAP mission, has developed a stress testing procedure to monitor market and credit risks.** The model allows the NBKR to gauge banking system vulnerabilities on a monthly basis and support off-site surveillance and prompt corrective actions as envisioned in the NBKR's Regulatory Response Policy.

**31. Stress tests of liquidity and equity risk were not judged necessary.** The liquidity of the banking system is high with banks' highly liquid assets cover all their liquid liabilities, while banks' investment in and lending against equity instruments are minuscule.

32. **Stress tests were used to quantify banking sector losses under several scenarios.** The scenarios took account of the joint occurrence of interest rate risks associated with changes in domestic and foreign short-term interest rates and the exchange rate, as well as the decline in credit quality. The impact of shocks was measured by losses in terms of the capital-asset ratio, and by the number of banks that become either undercapitalized or insolvent after shocks.<sup>5</sup> The severity of the shocks for each scenario was calibrated by considering sets of small shocks and large shocks. Small (large) shocks were represented by one standard deviation (two standard deviations) changes in interest rates and exchange rates, and one-notch (two-notch) downgrades in the NBKR's risk classification of all classes of bank loans. Losses associated with such downgrades were computed based on the NBKR's provisioning requirements for each loan category.

33. **Two scenarios are presented (Table 4):**<sup>6</sup> Scenario A represents a growth slowdown or recession with a drop in interest rates, while Scenario B represents a shock similar to the Russian crisis. Scenario A includes the simultaneous worsening of loan quality in the sectors perceived as having high repayment risk, a decline in interest rates, and a slight revaluation of the som.<sup>7</sup> Scenario B includes an increase in domestic and foreign interest rates, a devaluation of the som, and downgrades across all assets' classification scales. To capture indirect credit risk arising from financial dollarization, downgrades of loans in foreign currency are one-notch higher than those made in domestic currency.

34. **The results for scenario A indicate that some large and medium-size banks are vulnerable to a growth slowdown, although the banking system as a whole appears to be able to withstand this set of shocks.** For most banks, the small-shock scenario results in relatively modest losses as a percent of capital. Large banks experience the largest losses, with two medium-size banks becoming undercapitalized. In the large shock scenario, two large banks, which hold about 20 percent of bank assets, become undercapitalized, while one medium-size bank becomes insolvent. The weaknesses of large and some medium-size banks are mainly due to loan concentrations in the most vulnerable economic sectors.

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<sup>5</sup> In these stress tests a bank is considered under-capitalized if its capital ratio falls below 12 percent, and insolvent if this ratio is below 3 percent. Capital cushion is defined as the sum of a bank's own funds, profit or losses during the stress-test, and loan loss provisions.

<sup>6</sup> These scenarios are assumed not to be related to production at the Kumtor goldmine. Although it is a major contributor to economic growth, shocks to the mine's revenues cannot be assumed to be highly correlated with the shocks considered in the stress tests, and such declines would have little impact on the domestic financial sector.

<sup>7</sup> The high risk sectors are defined as the sectors with above average lending spreads. NBKR data show those sectors to be in domestic and foreign currency loans for trade, construction and real estate, household, and individual enterprise sectors, and foreign currency loans to agriculture.

35. **Scenario B reveals that several large and medium-size banks are vulnerable to a Russian crisis-type scenario, which could have systemic implications for the banking system.** The small shock scenario results in four undercapitalized banks, two large and two medium-size, and one large insolvent bank. The large shock results in three undercapitalized banks, two large and one medium-size, and three insolvent banks, two large and one medium-size. The asset share of undercapitalized banks is about 29 percent, while the share of insolvent banks is about 23 percent. In a worst-case scenario, restoring bank capital to the regulatory minimum would cost only ½ percent of GDP. However, the costs to the banking system in terms of lost confidence and the sector's potential contribution to economic development could be quite high.

#### **B. State-Owned Banks**

36. **The Kyrgyz State owns two major banks: SSC and Kairat.** SSC was established by the NBKR in 1996 with a limited banking license. Its activities are restricted to interbank lending, government securities transactions, deposit taking, and payments services for budgetary entities. NBKR ownership of SSC is in violation of the 1999 Banking Law.

37. **SSC is the only bank with a branch network capable of providing banking and quasi-fiscal services throughout Kyrgyz Republic, particularly in rural areas.** It has the largest bank branch network in the country, 48 branches in all. As of end-May 2002, SSC had total assets of som 410 million, or 7.5 percent of total banking sector assets, while its capital was som 101 million. Its main source of revenue is interest on government securities.

38. **Kairat was established by the NBKR in 1999 to facilitate the resolution of two failed banks by taking over their performing assets and deposits.** It too has a restricted banking license, and its lending operations are restricted to investment in government paper. In May 2002, Kairat had som 292 million in total assets. Kairat is solvent, liquid, and its foreign exchange position is balanced.

39. **SSC and Kairat both operate as narrow banks, with their solvency and liquidity depending on the income from government securities.** Against this background, the government is developing a strategy for resolution of SSC and Kairat.

40. **The authorities plan to transfer the ownership of SSC to the government, to keep it as a narrow bank, and use its branch network to perform economically and socially important activities.** The future activities of SSC will be determined in consultation with the IMF and the WB based on the findings of a feasibility study. SSC will rationalize its branch network and operations with a view to enhancing efficiency and effectiveness (although this may not insure profitability in the near term). In this process, consideration will be given to using post offices for improved outreach to the remote areas of the country.



Table 4. Results of Banking Sector Stress Tests

	Number Of banks	Capital buffer ratio (in percent of assets)	Losses as a percent of capital buffer (in percent)	Capital buffer ratio after shocks (in percent of assets)	Number of under- capitalized banks/ Share of total assets (in percent)	Number of Insolvent banks/ Share of total assets (in percent)
<b>SCENARIO A</b>						
<b>SMALL SHOCK</b>						
Large banks 3/	6	20.6	8.9	19.1	0	0
Medium-size banks	7	42.3	3.4	41.5	2/8.2	0
Small banks	5	42.1	4.8	40.9	0	0
<b>BANKING SYSTEM</b>	<b>18</b>	<b>29.4</b>	<b>5.9</b>	<b>28.2</b>	<b>2/8.2</b>	<b>0</b>
<b>LARGE SHOCK</b>						
Large banks	6	20.6	28.2	15.7	2/20.4	0
Medium-size banks	7	42.3	12.1	39.2	1/1.5	1/3.1
Small banks	5	42.1	21.4	36.4	0	0
<b>BANKING SYSTEM</b>	<b>18</b>	<b>29.4</b>	<b>20.0</b>	<b>25.0</b>	<b>3/25.5</b>	<b>1/3.1</b>
<b>SCENARIO B</b>						
<b>SMALL SHOCK</b>						
Large banks	6	20.6	51.6	11.2	2/25.4	1/7.8
Medium-size banks	7	42.3	14.8	38.4	2/8.2	0
Small banks	5	42.1	13.7	38.6	0	0
<b>BANKING SYSTEM</b>	<b>18</b>	<b>29.4</b>	<b>29.9</b>	<b>22.6</b>	<b>4/33.6</b>	<b>1/7.8</b>
<b>LARGE SHOCK</b>						
Large banks	6	20.6	67.3	7.8	2/23.5	2/20.4
Medium-size banks	7	42.3	21.2	36.6	1/5.1	1/3.1
Small banks	5	42.1	26.0	35.0	0	0
<b>BANKING SYSTEM</b>	<b>18</b>	<b>29.4</b>	<b>41.0</b>	<b>19.7</b>	<b>3/28.6</b>	<b>3/23.5</b>

Source: National Bank of the Kyrgyz Republic, Bank Supervision Department.

41. The resolution plan for Kairat includes as a first priority its privatization. The privatization must be based on a transparent and carefully designed procedure to ensure fit and proper private ownership. Kairat should not be allowed to start lending operations until after its resolution plan has been implemented.

### C. DEBRA

42. **DEBRA was created in 1996 to:** (1) facilitate the resolution of failed banks through asset conservation and liquidation; (2) pursue restitution from shareholders, directors, and managers who had contributed to the bankruptcy of their banks; and (3) recover assets of failed banks. The MOF owns DEBRA, and it is funded by a combination of fees, and transfers from the MOF and the NBKR. Since 1996, DEBRA has taken over the asset recovery for 13 banks. It performed well during its first years, but recoveries have since dropped sharply. Data on recoveries in 2001 and 2002 are unavailable.

43. **DEBRA's weak performance appears tied to a number of problems,** including those involving its funding, legal status, and its technical and operational capacity. Moreover, specific areas for improvement include staffing, business planning, management information systems, accounting, and resolution and investigation methodology.

44. **DEBRA should act as an independent legal entity and not as a department of the MOF, with its only role being a liquidator of failed banks.**<sup>8</sup> This would allow it to better define the appropriate form of management, procedures, and guidelines to carry out its function. This would also resolve a conflict of interest for the MOF, since under current legislation, the MOF is simultaneously the creditor and liquidator of failed banks. DEBRA should act only on an agency basis, and should finance its operations from fees.

### D. Banking Supervision

45. **The supervisory authority is an integrated part of the NBKR, which is the sole supervisor and licensor of banks under the Law on the National Bank of the Kyrgyz Republic (the National Bank Law).** The NBKR conducts on-site inspections of all banks annually, and performs off-site analysis monthly. Individual inspectors/employees are not protected by law, or other measures.

46. **The National Bank Law and the Banking Law provide the NBKR with extensive powers to issue both general and specific regulations and instructions to banks.** Should a bank fail to comply with these regulations and instructions, the NBKR can impose a full range of corrective measures and penalties, including revoking a bank's license. While the legal framework for banking supervision is largely satisfactory, the appeals process is often protracted. In addition, NBKR decisions can be challenged in an ordinary civil court, where outcomes have been unpredictable.

47. **The provisions covering professional secrecy are flawed.** Although they are set forth in the National Bank Law, the Banking Law and the Law on Bank Secrecy, all three provisions are different in scope. The National Bank Law has the widest span, but only

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<sup>8</sup> DEBRA was granted the status of sole liquidator of failed banks in the revised Law on Bankruptcy, enacted in June 2002.

NBKR employees are bound by the confidentiality of information. Equivalent rules do not apply to NBKR board members who are regarded as public servants, or third parties carrying out tasks on behalf of the NBKR. In line with best international practices, the National Bank Law should be the sole source governing the NBKR's statutory issues.

48. **Domestic supervisory cooperation and cooperation with external auditors is virtually impossible.** Supervised banks must consent before confidential information can be shared with domestic nonbank financial sector supervisory authorities. The Law on Auditing also prohibits external auditors from disclosing information to third parties, including the NBKR, without the bank's prior written consent. The NBKR does not have the authority to oppose the appointment of, or require replacement of external auditors.

49. **The Banking Law outlines permissible activities for banks and states that applications for a bank license must include all supporting documentation.** In addition, foreign banks wishing to establish a branch must submit written approval from their home supervisor. The NBKR may reject any application if the licensing criteria are not met, including a fit-and-proper test for founding shareholders and executives. However, the Law on Licensing prohibits the NBKR from denying a license based on personal qualities, business reputation, and past criminal convictions. The NBKR has submitted a draft amendment to the Law on Licensing that would remove this inconsistency.

50. **The acquisition of a controlling stake in a bank requires NBKR approval.** A controlling stake is defined as 5 percent or more of the bank's capital. However, if no decision is made within a period of 30 days in the case of a resident applicant or within a period of 60 days in the case of a nonresident, the acquisition is deemed authorized.

51. **There is no NBKR approval requirement for major acquisitions or investments.** The Banking Law limits banks' acquisitions and investments in nonbank entities to 15 percent of the bank's capital for each single investment, with a total limit of 60 percent.

52. **The NBKR, through the National Bank Law, has the authority to issue regulations for capital standards** such as minimum authorized capital, own funds, capital adequacy ratio, maximum exposures, and liquidity ratios. It has issued regulations on these topics and it requires the submission of periodic standardized reports. However, the information systems to identify concentration risks should be enhanced.

53. **Current legislation does not define requirements for risk management in general, nor has the NBKR developed such guidelines.** Individual banks are responsible for developing risk management systems. A new draft of the Banking Law addresses these issues. However, there is no regulatory guidance on market risk, interest rate risk, operational risk, country risk, or transfer risk.

54. **While the annual on-site inspection program is largely satisfactory, off-site supervision has room for improvement.** On-site inspections benefit from free access to banks' books, accounts, documents, and employees, is granted to the NBKR by the Banking Law. The NBKR requires banks to provide monthly and quarterly reports, which are used to

assess changes in a bank's condition. However, given the number of tasks required of off-site examiners, it appears there is limited time available for analysis. On the positive side, the NBKR is automating data collecting and analysis, which should improve off-site supervision.

55. **The NBKR has a variety of remedial measures at its disposal, but the fines for executives and board members are low.** The NBKR may require a bank to improve its financial condition (increased capital or reserves), introduce new management, suspend or revoke licenses, impose fines, or take informal or formal corrective action. According to the Administrative Liability Law, the NBKR can fine executives and board members up to 20 times the minimum monthly wage, which appears inadequate.

56. **The NBKR may enter into Memoranda of Understanding and share confidential information with foreign banking supervisors.** It has the authority to cooperate with foreign banking supervisory authorities on the principle of reciprocity regarding supervision and licensing banks operating, or intending to operate, in their jurisdiction.

57. **The NBKR is empowered to supervise internationally active banks on a consolidated basis.** It has issued a temporary regulation on conducting such consolidated supervision, which states that the NBKR must ensure that they observe the relevant prudential rules regarding activities. However, the implementing regulations are not in place. At present, there are no internationally active banks incorporated in the Kyrgyz Republic.

### **E. Monetary Policy and Liquidity Management**

#### **Framework for monetary policy and liquidity projections**

58. **The National Bank Law states that the principal goal of monetary policy is to attain and maintain price stability.** The specific objectives of monetary policy are presented in the annual "Joint Statement of the Kyrgyz Republic Government and the NBKR on Financial and Social-Economic Policy" and in the NBKR's "Main Directions of the Monetary Policy." A principal objective for 2002 is to keep the inflation in the 6–8 percent range (December 2001–December 2002). The NBKR and the government are committed to take all measures necessary to keep the inflation rate in that range. (Box 1 discusses overall transparency in monetary and financial policies.)

59. **The NBKR uses broad money, including foreign currency deposits, as its intermediate target and liquidity (excess reserves) as its operational target.** The monetary aggregates are targeted on a quarterly basis, while targets for excess reserves are set and maintained weekly. The trend in monetary aggregates, including the monetary base, is tracked on a weekly basis to ensure that substantial deviations from targets are avoided.

60. **The key element of the decision making process is the comparison of the liquidity forecast with the target level of liquidity.** Government cash flows are a major factor affecting liquidity and projecting them is difficult. While the MOF makes quarterly projections for revenues and expenditures, it does not make monthly or weekly projections. While there is consultation between the staffs of the NBKR and the MOF, and a coordination

### **Box 1. Transparency in Monetary and Financial Policies**

An assessment of observance of the Transparency Code of Monetary and Financial Policies found that in most respects, the NBKR observed good transparency practices in monetary policy, banking supervision, and supervision and oversight of the payment systems. The institutional framework for these activities is clearly established in the National Bank Law, and the NBKR makes great efforts to inform relevant parties and the general public in these areas, as evidenced by its extensive publications, high-quality Annual Report, and comprehensive and up-to-date website. The NBKR also makes an effort to be accountable in these areas through its Annual Report, and appearance of officials before parliament.

There is room for improvement, however. For example, with respect to monetary policy, it would be helpful for the NBKR to more clearly explain the principles underlying its involvement in the economy. In addition, more complete and systematic explanations of the reasons for policy changes would be helpful. With respect to the payment system, the role of NBKR bank supervision in the oversight of the National Automated Clearing House (NACH) operations should be clearly defined. A more formalized process of seeking public comments on proposed changes in all types of policies would also be useful.

committee meets monthly, deriving short-term projections of government cash flows remains difficult. To correct this problem, the NBKR and the MOF should work together more closely to develop better projections.

#### **Monetary instruments**

61. **The NBKR's monetary instruments include reserve requirements, Open Market Operations (OMO), and standing facilities.** Banks are required to maintain a reserve requirement on both soms and foreign exchange, although foreign currency deposits with a maturity of one year and over are exempt. Reserves on foreign currency deposits must be kept in soms, using an exchange rate that is adjusted twice a year. Only deposits with the NBKR count toward the reserve requirement, and reserves are remunerated. Banks must meet the reserve requirement on average over a two-week holding period. In 2001, the required reserve ratio was reduced from 20 percent to 10 percent, in two stages.<sup>9</sup>

62. **Each bank is remunerated at the average rate it pays to its depositors.** It would, however, be preferable to link the rate paid on required reserves to a market rate, such as the auction rate on NBKR notes, rather than to individual banks' cost of funds.

63. **There is a shortage of suitable domestic financial assets with which to conduct OMO.** In part this is because most public debt is held in non-marketable form by the NBKR,

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<sup>9</sup> A few years ago, the banking system was characterized by chronic excess liquidity, and the NBKR focused on developing instruments to absorb liquidity. More recently, however, this is no longer the case and liquidity injections are sometimes required.

and the stock of NBKR notes is small (see section IV.F). Securities issued by the NBKR amounted to about som 16 million, or less than 0.1 percent of GDP. However, the NBKR's public debt is to be restructured over a ten-year period, beginning at end-2002. Initially, part of the non-marketable debt (about som 350 million out of a total of about som 2.5 billion) would be converted into marketable treasury bills with current market yields, and the remainder consisting of longer-term bonds would be converted into interest-bearing bonds (indexed to inflation plus a modest real yield) and gradually redeemed.

64. **The NBKR has at times used the foreign exchange market to conduct its OMO, because the foreign exchange market is more developed and has more depth than the market for government and central bank securities.** In 2001, the NBKR conducted swap transactions totaling \$38.2 million. The average maturity of the swap operations in 2001 was five days. In addition, the NBKR intervenes in the spot market to smooth fluctuations in the som exchange rate.

65. **The NBKR conducts weekly auctions of its bank bills, mostly 28-day bills, and of treasury bills, with the latter based on MOF instructions.** Both auctions use the variable price model in which bidders pay the prices that they bid. However, the volume of these offerings has been very low. For example, for the four months ending in February 2002, the average weekly offering of NBKR bills was approximately som 4 million (about \$85,000).

66. **The NBKR also buys and sells government securities outright, or more often, on a repo or reverse repo basis.** However, the volume of repo operations has also been quite low. For the 12-months period ending September 2002, the NBKR engaged in 21 repo transactions (som 240 million), and 49 reverse repo transactions (som 194 million).

67. **One obstacle to conducting OMO is the shallowness of the markets for government securities and central bank bills.** In the event that it becomes necessary to sterilize substantial liquidity, the NBKR may need to increase the scale of its auctions of central bank bills, bearing in mind the limitations in demand for treasury and NBKR bills. The drawback of this approach, however, is that it can entail a substantial financial burden on the NBKR, which is moderately profitable with net income in 2001 of approximately som 400 million.<sup>10</sup> Alternatively, the government might issue and auction treasury bills in excess of its funding needs, with the proceeds sterilized in a special account with the NBKR. Tight budget conditions, however, make this approach seem problematic at present.

68. **The NBKR maintains a standing, overnight lending facility for banks.** In principle, the facility is available only for meeting reserve requirements, and not for clearing. The interest rate on the facility is 1.2 times the NBKR rate, which is the weighted average rate at the auction for 28-day NBKR bills the previous week. No collateral is required on this

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<sup>10</sup> The National Bank Law states that the government would recapitalize the NBKR if necessary.

lending; however, it is operated in a way that minimizes NBKR risk. The entering of credit funds in a bank's account is the last transaction with its correspondent account for that day, while repayment of credit is the first transaction the next day. However, should a bank be declared bankrupt at the end of the day, the NBKR may have difficulty recovering its loan. Credits extended rose sharply from som 9 million in 2000 to som 1.1 billion in 2001.

69. **The NBKR should develop a Lombard type facility where collateralized loans, at penal rates, could be made for one business day,** although the scope of this instrument will be limited due to the modest availability of collateral. Such lending could also provide clearing and settlement credit during the day. While the NBKR sometimes makes loans at the initiative of the banks, a Lombard facility would simplify and streamline the process.

70. **In exceptional cases, the NBKR provides commercial banks with credits for longer periods—up to six months—intended for fulfilling the bank's rehabilitation program.** No bank applied for these credits in 2001, although one bank was granted a loan under this facility during the first quarter of 2002. However, these longer term credits are not automatic, and are negotiated on a case-by-case basis. A bank wishing to qualify must submit a plan to the NBKR Board, and the loan depends on approval by the Board.

#### F. Payment System

71. **The payment system of the Kyrgyz Republic consists of a gross interbank settlement system and a net clearing system.** In both cases, interbank clearing relies on paper payment documents, but with settlement information for the clearing system calculated based on electronic files of payment details. Five banks have adopted forms of electronic interbranch funds transfers between their own customers.

72. **The gross interbank settlement system processes financial market transactions and large and urgent interbank funds transfers.** Settlement is made upon receipt for each payment through NBKR correspondent accounts, if the sending bank's account can cover the payment. Only head offices have access to this service. This system handles an average of 80 payments a day representing 4 percent of the volume of interbank payments and 67 percent of the value. A project is nearing completion to allow banks to submit payment instructions electronically and to automate the entry into the correspondent account.

73. **The clearing system is operated by an affiliate of the NBKR, the NACH.** It is a net settlement system, which handles all other interbank payments. Payment documents are accumulated during the clearing cycle. At the end of the day the net positions, constrained by a net debit cap set by the NBKR, are settled in the gross settlement system. Branches of commercial banks access this system directly through NACH regional centers which forward files to the NACH Bishkek office for calculation of each bank's single net position. This system clears approximately 1,500 payments a day representing 96 percent of all interbank payments volume and 33 percent of the value. The NACH has made considerable progress toward a purely electronic clearing. Card payment services are in their infancy.

74. **The payment system was reviewed using the CPSS's (Committee on Payment and Settlement Systems) Core Principles for Systemically Important Payment Systems (CPSIPS).** The assessment found the main deficiencies of the current payment services to be: (1) the systems rely on paper documents; (2) there are no affordable, convenient payment services; (3) the legal framework contains inconsistencies that may be confusing to banks and the judiciary; (4) there are no documented plans and backup facilities for either system; and (5) there is a need to review the procedures to inform banks and other interested parties of pending changes.

75. **The NBKR has nearly completed a comprehensive strategy for payment system reform from 2003–05 which will address the weaknesses identified during the FSAP.** It has also worked to coordinate the planning process with the government, both as a principal user of payment services and in its role of creating conditions for a healthy market economy, and commercial banks to make banking services attractive to the general public. The draft is comprehensive, addresses the deficiencies detailed above relating to consumer payments, and lays out an action plan with target dates and estimates of resources needed for execution. The NBKR will also prepare a comprehensive legal framework for electronic payments, and develop business continuity plans and rectify the above noted organizational weaknesses.

76. **The project is complex and, unless carefully planned and executed, carries political risks because the program will affect every citizen of the country.** If successful, the project should greatly contribute to the rebuilding of confidence in the banking sector. Thus, each step must be seen to have tangible benefits to the users of these new services and be thoroughly tested. To succeed, sufficient management and staff resources will be needed.

77. **To complete the strategy development phase, the NBKR will need to:** (1) complete the development of the National Program, which must then be formally adopted by the NBKR, the government of the Kyrgyz Republic, and the banking sector; (2) finalize funding and technical assistance needs to ensure that the resources and trained professionals are available for the timely execution of the program; and (3) formalize the process of management oversight and departmental responsibilities for executing the plan.

#### **IV. MEDIUM-TERM RISKS AND DEVELOPMENTAL ISSUES**

##### **A. Legal and Judicial Issues**

78. **Legal and judicial weaknesses pose major institutional impediments to financial sector development (Box 2).** Judicial uncertainty largely emanates from the lack of clear division of power between the Executive and the Legislature. It is exacerbated by unpredictable judicial outcomes that do not appear to be based on the facts or the law. For example, a recent court action forced the NBKR to return a banking license to a deeply



## Box 2. Legal and Judicial Problems

A transparent and consistently applied legal framework and an independent judiciary are preconditions for financial sector development, and effective financial sector supervision. However, significant legislative, regulatory, and judicial problems exist in the Kyrgyz Republic. The deficiencies are manifested in two primary areas.

**Judicial uncertainty:** Article 79 of the Constitution guarantees the independence of judiciary. In reality, the presidency selects and appoints most judges, controls their budgets, their assignments, and their discipline. These factors may undermine their independence. Judges are also poorly trained in financial matters. Protracted processes in the courts, overloaded courts that delay decisions, slow and ineffective enforcement department, and excessive costs in debt recovery, render courts in Kyrgyz Republic ineffective and troublesome to many, especially creditors. Furthermore, its courts sometimes act outside their jurisdictions. The foregoing, accompanied by incidences of courts ignoring existing laws, and inconsistent interpretation of laws breeds widespread judicial uncertainty and unreliability. The Supreme Court is limited to supervision of the judicial system and is unable to review decisions and act as final arbiter of the Constitution. These factors also undermine the integrity and authority of regulatory agencies in the eyes of the public.

**Lawmaking Process:** The lawmaking process is opaque and inefficient. Laws take a long time to be passed, and some are obsolete at the time of passage. In addition, though some laws are formulated in consultation with relevant stakeholders, laws are generally not made public until passage, often with little or no opportunity for comment. As a result, laws are susceptible to manipulation by self-serving interests. The lack of a proper process for lawmaking is reflected in numerous direct conflicts in existing legislation. Also, laws are passed without cross-references, and laws have no codification process, which makes it difficult to know which law applies. These problems add to the uncertainty in the legal system.

insolvent bank with no recapitalization prospects. Dubious and/or improper court decisions not only undermine the authority of the central bank, they also jeopardize economic development and foreign investment.

79. **The legal and institutional frameworks supporting credit and creditor rights are inadequate and inefficient.** In general, creditor rights are weak, collateral systems are poorly developed (other than the traditional mortgage), and the enforcement procedures of the courts are slow and unreliable. As a result, lenders have require fully secured loans for nearly all corporate transactions, with collateral typically set at twice the value of the loan.

80. **The ineffectiveness and inefficiency of the judiciary and the costs of some judicial practices weakens creditor rights and provides incentives for unsound bank practices.** For example, if banks go to court to enforce a contract and seize collateral, court proceedings may take years before a final decision. On average, it takes 15 court proceedings and almost two years to repossess collateral. Banks also have limited legal tools to preserve the value of collateral. This together with court fees of up to 10 percent of the collateral's par value make it unprofitable for banks to try to enforce contracts. Hence, bank managers have incentives to extend maturities, accept partial repayments, and roll over credits.

81. **Although Kyrgyz law provides for the enforcement of foreign bankruptcy judgments, most of the international dimensions of the insolvency process are ignored by the Kyrgyz legal system.** This does not pose problems currently, since Kyrgyz lawyers and courts are rarely involved with foreign proceedings or cross-border insolvencies. However, to facilitate the flow of private capital, the government will eventually need to draft new legal provisions, such as the ones developed in the (United Nations Commission on International Trade Law) UNCITRAL Model Law for Cross-Border Insolvencies, to properly integrate the Kyrgyz Republic into the global marketplace.

82. **The Arbitration Courts are overloaded as a result of the limited number of courts with bankruptcy jurisdiction and an appeals process that refers cases back to the lower court.** Judges are generally poorly equipped to handle bankruptcy cases and corporate restructurings. Little or no specialist training is offered to the judiciary, so they often fail to understand the law which they administer. As a result, public confidence in the integrity and competence of administrators in bankruptcy is low, with the predominant view being that administrators do not always act in the creditor's interests.

83. **The new law establishing private arbitration (Law on the Arbitral Tribunal in the Kyrgyz Republic) is a positive step in developing alternative dispute settlement.** However, it is still uncertain whether the arbitration awards will encounter the same difficulties of judicial decisions in the execution stage.

84. **Given the foregoing, there is a clear need for decisive steps to reduce judicial uncertainty and improve the efficiency of the judiciary.** The government should seek to improve and streamline the lawmaking process and strengthening the legislature to ensure that laws are consistent and do not contradict one another. The formation of the Constitutional Reform Commission and Legal and Judicial Reform Commission is commendable and could go a long way toward addressing many of these issues. An adequately trained judiciary is crucial to improve judicial uncertainty and improve its efficiency.

85. **All of the proposed legal and judicial measures would greatly benefit by bringing legal clarity to the framework to lawyers and lawmakers.** The lack of transparency in the lawmaking process should be addressed through a codification process. At minimum, the Government should be obliged, upon any enactment of a law amendment, to publish (in the Gazette and on a government website) a consolidated version of that law reflecting all amendments.

86. **The impact on financial sector development and effectiveness of financial supervision should be considered in evaluating structural reforms of the legal and judicial systems.** A system-level assessment of the legal and judicial weaknesses would be appropriate to identify specific remedial measures and priorities.

87. **Financial sector regulatory authorities need to start the process of rationalizing the previously approved regulations to avoid inconsistencies and gaps, and ensure that**

**their rules and regulations are anchored on the laws under which they are issued.** This will in turn help remove judicial interference on the grounds of supervisory noncompliance with one's own procedures or exceeding authority. It is, however, important that stakeholders are consulted before the draft laws are sent to parliament. Efforts must also be taken to better inform the legislature on the underlying policy and rationale for amendments or new laws.

## **B. Nonbank Financial Institutions**

**88. NBFIs are playing an increasingly important role in the financial sector by providing the bulk of credit flowing to medium- and small-enterprises and rural borrowers.** NBFIs now have approximately 72,000 clients with credit, underscoring the role they play in financial deepening on the lending side of the market. The key players include the KAFC, CUs, and a number of micro-finance institutions (MFIs) with links to international donors. These institutions are supervised directly or indirectly by the NBKR.

**89. Micro-finance programs in the Kyrgyz Republic currently have approximately 33,000 customers.** Their loan sizes vary, but are generally below \$2,000 per borrower. The principal problems associated with continued growth and sustainability of these institutions include the following issues.

**90. First, interest rate subsidies from competing institutions are causing distortions in the credit market.** Most domestic MFIs have achieved financial and operational sustainability, in part, by charging market interest rates. However, their market share may be undermined by subsidized institutions offering softer terms and conditions. In the long run, this could lead to a reduction of services for the target borrowers because pervasive, subsidized rates discourage new entrants, reduce outreach, and may, in the extreme, induce the exit of market-driven MFIs.

**91. Second, the draft law on collateral stipulates that all collateral must be registered in the central registry office, but given the small loan sizes of these institutions, fees associated with registration could prove to be burdensome for borrowers.** In addition, the poor institutional infrastructure of the registry may render it unable to accommodate the demand.

**92. The new micro-finance law may prove burdensome to the NBKR and to MFIs,** because of the additional supervisory resources that may be requested for the registration, auditing, and examination of credit activities. Therefore, the implementing regulations of the Law on Micro-finance should be drafted to ensure that the law does not repress activities of nondeposit-taking MFIs, and to minimize the supervisory burden on the NBKR.

**93. KAFC is a government owned, nondeposit-taking NBFIs providing credit to private farms and agribusiness enterprises.** It has the most extensive branch network of all Kyrgyz financial institutions, with a particularly strong presence in the rural areas. Since it began operation in 1996, it has extended loans to more than 21,000 borrowers. Its funding is provided by the MOF, mainly through International Development Agency (IDA) and International Fund for Agricultural Development (IFAD) credits, and is channeled to the

rural and agriculture sector through som-denominated loans with maturities of up to 18 months. In May 2002, K AFC's assets were equivalent to about 16.4 percent of total banking sector assets.

94. **Transforming K AFC into a bank would be risky and should not be considered.** It relies on funding from IFIs, which are priced well below market interest rates and the government assumes the foreign exchange risk on these funds. In turn, K AFC provides loans to the agricultural sector at below-market rates, as a matter of government social policy, while being ensured a profit margin. Its operations would not be sustainable if it was subject to market rates on both sides of its balance sheet.

95. **K AFC should seek to achieve growth rates of its loan portfolio consistent with the maintenance of high credit quality.** As a result of the rapid expansion of its portfolio, its NPLs have increased in the last year and it is becoming vulnerable despite its preferential operating conditions. In addition, it should consider raising interest rates on its new products to improve its performance and reduce its reliance on subsidies.

96. **Credit unions (CUs) are not allowed to mobilize members' deposits, although the NBKR has started a pilot project allowing 10 CUs to do so.** However, this should be done cautiously, since the weak institutional capacity of CUs is threatening their growth and sustainability. A major problem is that CU managers often do not have backgrounds in banking or finance, and they tend to view the institutions as social, rather than financial organizations.

97. **The weakness of the Financial Company on Support and Development of Credit Unions (FCSDCU) undermines the health of CUs.** The FCSDCU lacks the qualified staff and needs to build its supervisory capacity. In addition, if the FCSDCU becomes the oversight body for CUs, the incentives for strong supervision may be undercut by its corporate governance structure characterized by each member having a single vote.

98. **The shortcomings in the regulatory and institutional structure for CUs should be addressed either by adopting a new Law on Central Credit Unions or through amendments to the existing Law on Credit Unions.** These measures would define terms and conditions of the membership in the Central CU, its establishment, management, reorganization, and liquidation procedures.

### **C. Capital Markets, Pensions, and Insurance**

#### **Capital markets**

99. **Capital markets in the Kyrgyz Republic are very small and underdeveloped.** Capitalization of the Kyrgyz Stock Exchange (KSE) index is som 189 million (0.3 percent of

GDP) while the transaction volume was som 848 million in 2001.<sup>11</sup> Corporate bonds were introduced in 2001, and the volume at the end-2001 was som 110 million (\$2.25 million). The government securities market consists of 3-, 6-, and 12-month treasury bills with an outstanding volume of som 545 million (less than 1 percent of GDP) as of August 2002. Almost 90 percent of these securities are held by banks and no secondary market trading takes place. There are no long-term public bonds in the market (see Section IV.F). Foreign participation in the domestic financial markets is minimal.

100. **The State Commission on Securities Markets (SCSM), which is under the government, is responsible for the oversight of corporate securities markets.** The main laws governing the market are the Law on Securities Markets and the Law on Joint Stock Companies and on Investment Funds. The SCSM and professional market participants have carried out considerable review of the legislation, and submitted new laws and amendments to the government. However the outcome is unclear.

101. **SCSM has limited financial and operational autonomy and its technical and professional capacity is weak.** Its authority over the various participants needs to be stated clearly. The commission should be empowered to license market operators, and conduct examinations. It should also have clear examination powers in the case of a new issues. It should be made accountable to an independent body that will ensure that it carries out its functions in an efficient and transparent manner.

102. **The development of domestic capital markets is dependent on building confidence in the sector through increased transparency and accountability of all involved parties, and the monitoring of market participants.** Given the level of financial sector development and shortage of domestic resources, there is a need to develop a medium-term strategy prioritizing and sequencing reforms to address the most important issues.

#### **Insurance and pensions**

103. **The insurance market in the Kyrgyz Republic is very small and at an early stage of development.** There are 24 insurance companies with total assets of som 124 million (0.2 percent of GDP), and life insurance is not developed. The insurance market is undercapitalized and most of the risk is reinsured abroad. There is no compulsory insurance, although efforts are underway to introduce compulsory auto insurance.

104. **The State Social Insurance Fund (SSIF), established in 1996, is the only government-owned pension fund; it covers contributions to both pension payments and other social security benefits.** The Law on Non-Government Pension Funds was adopted in July 2001, but the supervisory agency for such funds is not clear, although the MOF is expected to carry out the function. There is only one Non-Government Pension Fund, which

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<sup>11</sup> The highest estimate of stock market capitalization is som 1.5 billion (2 percent of GDP) by the KSE as of May 2001.

covers some 600 pensioners. There are discussions on introducing a second pillar pension scheme in the Kyrgyz Republic, but without an effective supervisory function and a developed securities market, such a step would be risky.

105. **The Department of Nonbank Supervision (NBS) in the MOF is the regulatory body for the insurance, non-government pension funds, and gambling.** The insurance sector is regulated under the 1998 Law on the Organization of Insurance. The NBS needs sufficient funds to maintain its present level of staffing and to train its staff, if it is to effectively carry out its mandate.

#### **D. Deposit Insurance**

106. **The introduction of deposit insurance is being considered as a step to restore confidence in the banking system.** However, a successful deposit insurance system requires that certain preconditions be met, including healthy banks, a strong bank supervision system, and a strong institutional framework including judicial certainty and enforcement of contracts, and a strong accounting and auditing system. At present, these preconditions are largely not met in the Kyrgyz Republic, so it is premature to introduce deposit insurance.

107. **The introduction of deposit insurance should be a medium-term objective to be achieved through decisive and timely steps to meet the above preconditions.** Of primary importance is the need to have a generally sound banking system, and bank supervisors capable of effectively and quickly limiting the risks to the insurance scheme. At present, these risks are too great, and the NBKR should make further strides to improve supervision and enforcement. With regard to the latter, the legislative framework and the courts need to support the efforts of the NBKR in bank supervision (section IV.A). Concerns about the auditing and accounting professions also remain (section IV.E).

108. **International best practices calls for deposit insurances schemes to be mandatory to avoid the problem of adverse selection (only the weaker banks joining).** However, before the scheme is launched, the responsible supervisor should carry out a program of intensive prescreening to ensure the banks fully meet prudential standards. As part of the inspection, a bank needs to have applied international accounting standards, and to have been audited by a reputable and experienced auditing firm. Banks should have in place strong internal controls to manage risk and detect fraud and incompetence.

109. **To help insure success, the deposit insurance scheme needs to be carefully designed.** Suggested features include: (1) adequate and sound funding; (2) bailouts or subsidies from the government or the NBKR should be prohibited; and (3) strict limits should be made on the size and aggregate amount of deposits insured for each depositor.

#### **E. Accounting and Auditing**

110. **The NBKR requires all banks to prepare financial statements in accordance with its accounting policy guidelines.** Although these guidelines to are largely based on IAS, there are some important variations, for example, in the valuation of fixed assets.

111. **A new Law on Accounting, enacted in April 2002, included steep financial reporting requirements for all business entities irrespective of size or public interest in their financial reporting.** The timetable envisages switchover to IAS by all banking and financial institutions in fiscal year 2002, and all other enterprises, in fiscal year 2004. This timetable is very ambitious, particularly for nonbanks, since the Kyrgyz Republic lacks a mass of accountants capable of implementing IAS across the spectrum of business enterprises. While the NBKR believes that the timetable is feasible for banks, it should monitor this closely and be prepared to act should it prove infeasible. As a related matter, in the medium term, the Law on Audit Activity should be amended to enable the NBKR to determine eligibility criteria for bank auditors or require audits of banks to be conducted by an international firm.

112. **The Kyrgyz Republic's audit profession is in its infancy, and audit firms are struggling to grow in size and to gain professional reputations.** The domestic skill base is limited, particularly regarding audits of IAS-based financial statements following International Standards on Auditing. In addition, the regulatory authority for the audit profession, the Standard on Financial Auditing and Accounting (SFAA), has weak disciplinary and governance arrangements, and its capacity to oversee the profession should be strengthened. The audit examination process also needs to be made more transparent and objective.

113. **Given the shortage of IAS-trained accountants, the SFAA should determine the feasibility of implementing IAS within the given time frame.** The Law on Accounting should then be amended based on a more feasible timetable, prioritizing the transition to IAS for the most strategic enterprises. Exempting small enterprises might also be considered.

#### **F. Public Debt Management**

114. **The Kyrgyz Republic faces a potential vulnerability due to the high level of its public debt.** Most public debt is externally held and foreign currency-denominated and hence subject to exchange rate risk. The authorities have taken steps to improve management of the foreign public debt and reduce the burden of this debt over time. However, management of domestic public debt, which is small by comparison, has lagged behind.

115. **External public debt (excluding Kumtor) rose in terms of GDP from 36 percent in 1995 to 100 percent in 2001.** The main reasons for the rapid accumulation of foreign debt include: (1) the relatively large borrowing for the Public Investment Program (PIP); (2) the accumulation of a large stock of contingent liabilities through government guarantees of state-owned-enterprise borrowing; and (3) the Russian financial crisis of 1998 and the subsequent devaluation of the som. In March 2002, the government reached a debt relief agreement with the participating creditors of the Paris Club, which includes flow rescheduling in the current program, with a stock rescheduling envisaged for 2004. The MOF has taken steps to limit the growth of foreign public borrowing.

116. **Kyrgyz Republic has made strides in developing the institutional framework for, and transparency of public debt management.** The institutional framework was recently strengthened by the passage of a Law of the Kyrgyz Republic on Public and Non-Public Debt, which defines the authority, obligations and responsibilities of Kyrgyz institutions in debt matters. Considerable progress has been made in developing a database for domestic and foreign public debt, and in transparency. However, the database can be improved further, especially with regard to domestic debt, and foreign non-public borrowing.

#### **G. Anti-Money Laundering/Counter-Financing of Terrorism**

117. **The AML/CFT framework is very weak.** Significant efforts are needed to build a robust AML/CFT regime in compliance with the FATF 40+8, and other international standards incorporated in the AML/CFT Methodology.<sup>12</sup> Thus far, the measures in place for AML/CFT are limited to provisions found in the Criminal Code, the National Bank Law and the Banking Law. The regulatory measures attempted by the NBKR have been largely ineffective, and current measures are neither properly designed nor enforced to detect or prevent AML/CFT.

118. **The legal framework:** (1) lacks criminal provisions that meet international standards for ML and FT offenses; (2) does not provide for mandatory suspicious transaction reporting to a financial intelligence unit (FIU); (3) has limited provisions for confiscation, freezing or provisional measures; (4) does not require sufficient minimum requirements for customer identification or application of fit-and-proper tests; (5) discourages early involvement of law enforcement in investigations because the system itself severely restricts any disclosure of banking secrets; and (6) under the Law on Licensing, the NBKR cannot deny a banking license based solely on concerns about the fitness and propriety of the applicant.

119. **The NBKR framework for banking supervision for AML/CFT is weak, implementation has been uneven, and enforcement tools are either unavailable or are not given effect by the courts.** The NBKR also has supervisory authority over most NBFIs, but the supervisory framework for these entities is generally rudimentary.

120. **There are other factors that contribute to the ineffective AML/CFT framework, including a lack of understanding of the risks of ML/FT within government and among financial institutions.** One notable risk arises because the Law on Licensing appears to override the mandatory fit-and-proper tests in the Law on Banks and Banking (see section III.D). This undermines the NBKR's ability to prevent improper persons/entities from becoming shareholders, directors, and/or senior managers of financial institutions.

121. **The NBKR has proposed a draft AML law which incorporates recommendations of the FSAP missions.** The draft Law envisages enhancements to financial supervision,

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<sup>12</sup> The assessment was made using the April 2002 draft of the Fund and Bank Methodology for Assessing Legal, Institutional, and Supervisory/Regulatory Aspects of AML and CFT.



mandatory customer due diligence measures, reporting of suspicious transactions, establishing an FIU and authorizing dissemination of pertinent financial intelligence to domestic law enforcement and foreign counterpart FIUs. Enactment of the AML law would be a strong first step towards addressing many of the weaknesses identified.

122. **Nonetheless, an AML law cannot operate without an effective public infrastructure.** Judicial uncertainty, conflicts of laws and lack of enforcement tools for supervisors undermine legislative and regulatory efforts (see section IV.A). Until the preconditions for an effective public infrastructure are in place, measures to address ML/FT will be ineffective. Without support by each branch of the government, it will be difficult to implement a comprehensive legal and institutional framework for AML/CFT.

123. **Key steps needed to strengthen the AML/CFT framework include:** (1) the AML law should be passed; (2) the NBKR and other supervisors should establish sufficient supervisory measures to detect and prevent ML/FT, and require financial institutions to have internal control policies for AML/CFT and effective monitoring systems for suspicious transaction reporting; and (3) supervisors should have appropriate sanctions and enforcement tools to ensure compliance and should have adequate resources, intensive staff training program, and effective monitoring system.

## SECTION II—OBSERVANCE OF FINANCIAL SECTOR STANDARDS AND CODES: SUMMARY ASSESSMENTS

- This section reviews the observance of and consistency with major international standards and codes relevant for the financial sector. The assessment has helped to identify the extent to which supervisory and regulatory frameworks have been adequate to address the potential risks in the financial system.
- Detailed assessments were based on peer review process under the supervision of Richard Abrams (Mission Chief, IMF) and Tunc Uyanik (Deputy Mission Chief, World Bank), as part of the Financial Sector Assessment Program (FSAP). The assessments were prepared using information provided by the Kyrgyz authorities, including self-assessments and fieldwork during missions in May 15–28, 2002 and August 26–September 9, 2002. The assessor teams comprised Richard Breeden (consultant, United States Federal Deposit Insurance Corporation) and Martin Ohms (consultant, Oesterreichische Nationalbank) for the Basel Core Principles for Effective Banking Supervision; and Niels Larsen (consultant, Federal Reserve Bank of Boston, retired) for the Core Principles for Systemically Important Payment Systems (CPSIPS); and George Iden, Gianni De Nicoló (both IMF/MAE), and Niels Larsen for the Code of Good Practices on Transparency in Monetary and Financial Policies.
- The Kyrgyz Republic has made considerable progress in strengthening financial system supervision and regulation, and efforts are under way to further strengthen these areas. In addition, the review of NBKR transparency practices in monetary policy, banking supervision, and oversight of the payment system found these practices to be generally good, although some specific areas needing improvement were identified.
- The Kyrgyz authorities indicated broad agreement with these assessments and are preparing to implement many of the recommendations made by the mission.

## **V. BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION**

### **A. General**

124. A joint IMF/World Bank mission visited the Kyrgyz Republic from May 15–28, 2002, and August 26–September 9, 2002 as part of the Financial Sector Assessment Program (FSAP). The FSAP included an assessment of compliance with the Basel Core Principles for Effective Banking Supervision.<sup>13</sup>

### **B. Information and Methodology Used for Assessment**

125. The assessment focused on the legal framework for banking supervision and the actual methods used to supervise banks. The National Bank of the Kyrgyz Republic (NBKR) conducts an extensive annual on-site inspections of all banks, which is combined with an off-site supervision program that assesses banks on a monthly basis.

126. The assessment was primarily based on information provided by the NBKR Banking Supervision Department. Further information was derived from a review of the Law on the National Bank of the Kyrgyz Republic (National Bank Law), the Law on Banks and Banking of the Kyrgyz Republic (Banking Law), the Law on Bank Secrecy, the Law on Licensing, and numerous NBKR regulations and instructions. The assessment also benefited from interviews with officials from several domestic banks, and one local external auditing firm.

### **C. Institutional and Macprudential Setting, Market Structure—Overview**

127. The main features of banking supervision in the Kyrgyz Republic are described in the National Bank Law and the Banking Law. These laws give the NBKR full responsibility for banking supervision and grant it powers to issue regulations and instructions to oversee banks' activities. The NBKR is the sole supervisor of banks, and it has the sole authority to license banking institutions. The NBKR permits two banking categories—universal banks and specialized banks, but all banks are supervised in the same manner.

### **D. General Preconditions for Effective Banking Supervision**

128. The legal system appears to be the most serious constraint relating to the public infrastructure. In some instances, laws are inconsistent and contradictory, and the judicial outcomes have at times been unpredictable. In addition, there are numerous reports by banks and others of suspicious political influence within the judiciary.

129. The National Bank and the Banking Laws provide the NBKR with extensive powers to issue regulations and instructions of both a general and specific nature to banks. Should a

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<sup>13</sup> The assessment was conducted by Richard Breeden of the United States Federal Deposit Insurance Corporation and Martin Ohms of the Oesterreichische Nationalbank.

bank fail to comply with these regulations and instructions, the NBKR can impose a full range of corrective measures and penalties, including revoking a bank's license. In addition the Regulatory Response Policy, approved on October 31, 2001, provides a range of procedures for resolving problem banks, either through a rehabilitation or liquidation.

#### **E. Main Findings**

130. The Banking Supervision Department has 49 employees, of which 17 work on methodology and licensing, 17 on on-site examinations and eight off-site examiners. The primary source of training is provided through on-the-job examination participation.

131. The Basel Core Principles can be grouped in the following categories:

##### **Legal framework (CP 1)**

132. The National Bank Law gives the NBKR the sole authority for supervising and licensing banks, and states that the NBKR should act without governmental interference. The NBKR may issue regulations and instructions pertaining to the activities of banks. The Banking Law grants NBKR employees the right to examine and analyze bank information, but inspectors/employees are not protected for actions taken while discharging their duties; the risk of legal action may undermine the NBKR's operational independence. Should a bank fail to comply with NBKR regulations and instructions, the Banking Law gives the NBKR authority to impose sanctions. While the legal framework for banking supervision is largely satisfactory, NBKR decisions can be challenged in an ordinary civil court, where outcomes have been unpredictable.

133. The Law on Licensing is the general legislation governing licensing requirements. The Banking Law states that banks need a license issued by the NBKR for their activities and sets forth the provisions for the licensing process. However, there are some inconsistencies between the Law on Licensing and the Banking Law. The NBKR has submitted a draft amendment to the Law on Licensing that will remove these inconsistencies.

134. Provisions covering professional secrecy are set forth in the National Bank Law, the Banking Law and the Law on Bank Secrecy. All three provisions have a different scope. The National Bank Law has the widest scope, but only NBKR employees are bound to the confidentiality of information. Neither NBKR board members, who are regarded as public servants, nor third parties acting on behalf of the NBKR must observe equivalent rules.

135. Supervised banks must consent before any confidential information can be shared with domestic nonbank financial sector supervisory authorities.

##### **Licensing and structure (CP 2–5)**

136. The Banking Law defines "banks" and outlines the activities in which they may engage. The Banking Law also states that applications for a bank license must include all supporting documentation. Foreign banks wishing to establish a branch must also submit

written approval from their home country supervisor. The NBKR may reject any application if the licensing criteria are not met. However, the Law on Licensing prohibits the NBKR from denying a license based on personal qualities, business reputation, and past convictions.

137. The NBKR permits two banking categories. Universal banks, which may carry out all types of banking operations, must have paid-in-capital criteria of som 300 million for newly established banks and som 100 million for existing banks. Specialized banks can only be existing banks that do not meet the paid-in-capital criteria of som 100 million and conduct limited scope banking operations. In the case of existing banks, paid-in-capital can consist of cash and shareholder guarantees as long as their Tier 1 capital meets the minimum requirement of som 25 million. All banks are supervised in the same manner.

138. Anyone desiring to acquire a controlling stake in a bank (5 percent or more of the bank's capital) must apply to the NBKR. The NBKR can use discretion in this decision, but must provide reasons for rejection. The NBKR has 30 days to make a decision for resident applicants, and 60 days for non-resident applicants.

139. The Banking Law limits banks' acquisitions and investments in nonbank entities to 15 percent of the bank's capital for each single investment, with a total limit of 60 percent. However, there is no requirement for NBKR approval for major acquisitions or investments.

#### **Prudential regulations and requirements (CP 6–15)**

140. The NBKR, under the National Bank Law, may issue regulations for capital standards such as minimal authorized capital, own funds, capital adequacy ratio, maximum exposures, and liquidity ratios. However, no specific legislation deals with country and transfer risk or risk management in general. There is no regulatory guidance on market, interest rate or operational risk.

141. The National Bank Law stipulates that the NBKR may issue regulations on the detection and prevention money laundering. The Banking Law prohibits using bank accounts for criminal purposes, including money laundering. The NBKR has also issued instructions dealing with the prevention of illegal money transfers. However, the legal framework is inadequate and there are no sanctions for banks that fail to comply. The NBKR does not review the observance of "know-your-customer" guidelines during on-site examinations.

#### **Methods of ongoing supervision (CP 16–20)**

142. The annual on-site supervision program is combined with off-site supervision that assesses banks on a monthly basis. The effectiveness of these inspections benefits from unhindered access to banks' books, accounts, documents, and employees, granted to the NBKR by the Banking Law. The on- and off-site inspection programs assure regular contact between supervisors and bank management.

143. The NBKR requires banks to provide monthly and quarterly reports. At present, limited time is available for thorough analysis, but the NBKR is taking steps to address this

shortcoming. On-site inspections are used to form an overall assessment of a given bank. Both reporting and supervision are conducted on a consolidated basis.

144. The Law on Auditing prohibits external auditors from disclosing information to third parties, including the NBKR, without the bank's prior written consent. The NBKR does not have the authority to oppose the appointment of or dismiss an external auditor.

**Accounting standards (CP 21)**

145. The new Law on Accounting has introduced steep financial reporting requirements for all business entities, and the timetable envisages switchover to IAS by banking and financial institutions in fiscal year 2002. The NBKR requires all banks to prepare financial statements in accordance with its accounting guidelines, which are largely but not completely based on IAS. The NBKR is taking steps to address these shortcomings.

**Financial powers of supervisors (CP 22)**

146. The NBKR may require a bank to improve its financial condition (increased capital or reserves), introduce new management, suspend or revoke licenses, impose fines, or take informal or formal corrective action. According to the Administrative Liability Law, the NBKR can fine executives and board members, but the fines appear inadequate.

**Cross-border banking (CP 23–25)**

147. The NBKR may cooperate with foreign banking supervisory authorities regarding supervision and licensing of banks in their jurisdiction. It may also enter into Memoranda of Understandings and share confidential information with foreign banking supervisors. The NBKR also has a temporary regulation on conducting the consolidated supervision of international banking activities that states the NBKR must properly oversee internationally active banks. This regulation is inadequate, but there are no internationally active banks incorporated in the Kyrgyz Republic.

Table 5. Summary of Main Findings of Assessment of Implementation of the Basel Core Principles for Effective Banking Supervision

CPs Main Categories	Main Findings
Objectives, Autonomy, Powers, and Resources (CP 1)	The NBKR is the sole banking supervisor and has the legal rights to perform its duties. However, shortcomings appear in the areas of licensing, professional secrecy and information sharing with domestic nonbank financial sector supervisors. Unpredictable court findings and the lack of protection for NBKR employees also impede effective banking supervision.
Licensing and Structure (CPs 2–5)	New banks have higher capital requirements than existing banks. While a bank's acquisition of a controlling stake in another bank needs NBKR approval, acquisition of nonbank entities is only limited in terms of bank capital.
Prudential Regulations and	The NBKR has issued regulations on capital standards and reporting, but

Requirements (CPs 6–15)	legislation/ regulation on internal control and risk management is needed. The legal framework against money laundering is minimal and provides no sanctions for noncompliance.
Methods of Ongoing Supervision (CPs 16–20)	On-site inspection seems to be satisfactory, although there is some room for improvement in the case of off-site supervision. The NBKR can only receive confidential information from external auditors with the consent of the bank, and is unable to reject the appointment of or dismiss external auditors.
Information Requirements (CP 21)	While the NBKR issued various accounting policy guidelines based largely on IAS guidelines, there are some important variations (valuation of fixed assets); however, these inconsistencies are being eliminated.
Formal Powers of Supervisors (CP 22)	The NBKR can take steps to expedite financial rehabilitation by introducing caretaker management, suspending or revoking licenses, or imposing fines or by suspending or limiting banking operations. The penalties that can be imposed by the Administrative Liability Law have proven inadequate.
Cross-border Banking (CPs 23–25)	The NBKR can exchange information with foreign supervisory authorities on a reciprocal basis but there is no adequate legal and regulatory framework for the consolidated supervision of internationally active banks.

## F. Supervisory Response and Recommended Next Steps

### Authorities' response

148. Supervisors have drawn up a prioritized action plan based in large part on this assessment. The plan is awaiting management approval.

### Recommended action plan

149. Over the near term, the NBKR should give priority to the following actions:

- Make the Banking Law the sole legal source for bank licensing (CP 1(3)).
- Implement a complete AML legal framework that meets international standards (CP 15).
- Issue practical guidelines for the implementation of IAS (CP 21).
- Introduce a new regulatory framework for risk management (CP 9) market risk (CP 12), and interest rate risk (CP 13).
- Empower the NBKR to be pre-notified and to oppose banks' investments (CP 5).

150. Over the medium-term, the NBKR should give top priority completing following actions:

- Provide legal protection for NBKR employees, and third parties doing work for the NBKR (CP 1(5) and CP 22).
- Enable the NBKR to share confidential information with other domestic financial sector supervisors and external auditors on a reciprocal basis (CP 1(6) and CP 19).

- Empower the NBKR to directly appoint, oppose the appointment of or dismiss external auditors, and request a special supervisory report from external auditors should substantial events occur (CP 19).
- Introduce a confidentiality regime for NBKR directors and third parties working for the NBKR (CP 1(6)).

## **VI. THE CPSS CORE PRINCIPLES**

### **A. General**

151. The assessment is based on two documents prepared by the NBKR: (1) a comprehensive self-assessment; and (2) a summary of status relative to the core principles. It also incorporates the results of three previous IMF/MAE payment systems technical assistance missions and one IMF/MAE legal expert mission, and extensive interviews and consultation with NBKR officials, commercial bank management, and ministries and government agencies.

### **B. Institutional and Market Structure**

152. As of September 1, 2002 the payment system participants included the NBKR, 18 operating commercial banks and 143 branch offices, two branches of foreign banks, the Central Treasury of the Ministry of Finance, the Kyrgyz Agricultural Financial Corporation (KAFC) and OshInvest.

153. The payment system consists of a gross interbank settlement system and a clearing system. Both are based on paper payment documents, but with settlement information for the clearing system calculated using electronically submitted files of payment details. Purchase/sale of foreign exchange and securities are carried out through NBKR operated trading systems and settled in the gross system. Interbank borrowing is arranged directly between commercial banks, generally with settlement through the gross system.

154. The gross settlement system settles financial market transactions, as well as large and urgent interbank payments. The settlement is immediate upon receipt for each separate payment in NBKR correspondent accounts, if the balance is sufficient to make the payment. This system handles an average of 80 payments per day, representing 4 percent of interbank payments and 67 percent of the value.

155. An affiliate of the NBKR, the NACH (the National Automated Clearing House), operates a multilateral net clearing system. Payment documents are accumulated during a single daily clearing cycle and a net position calculated and settled in the gross payment system. This system clears approximately 1500 payments daily, representing 96 percent of the number of all interbank payments and 33 percent of the total amount of transactions. Card payment services are in their infancy. One bank is servicing Union-card and making it



available only to its own customers and another is servicing Alai-card licensed by Golden Crown (Russia).

### **C. Main Findings**

156. The main findings are as follows:

#### **Legal foundation (CP I)**

157. There are overlaps and in a few cases contradictory definitions of relevant terms in existing regulations and guidelines. The number of documents governing payments should be reduced and streamlined to eliminate the potential for confusion resulting from such discrepancies. Priority should be given on preparing the legal framework for the planned introduction of electronic payments.

#### **Understanding and management of risks (CPs II–III)**

158. No material shortcomings were identified.

#### **Settlement (CPs IV–VI)**

159. Because the payment services are still paper based, commercial banks can delay payment to the beneficiary for one day for payments cleared and settled through the gross system and for one day for intra-regional payments, three days for payments from regions to bank branches in Bishkek and five days for payments between bank branches outside Bishkek, pending the arrival of the paper documents. The NBKR intends to shorten the availability schedule for customer credit in the context of NACH conversion to electronic clearing later this year.

160. There are occasions when payments are not cleared and settled on the day submitted because of insufficient funds in the account, even though the bank may have collateral to support a loan executed before the end of the day. The NBKR should review procedures for providing liquidity to the payment system.

#### **Security and operational reliability, and contingency arrangements (CP VII)**

161. There are no documented plans or facilities for business continuity at an alternate site, should a serious disaster make the primary facilities supporting NBKR accounting and gross settlement system or the clearing service of NACH inoperable for an extended period of time. A similar deficiency is said to exist in most, if not all, commercial banks. Bank supervisory authorities should survey banks about the status of credible and tested business continuity plans.

**iciency and practicality of the system (CP VIII)**

The main problem for bank customers is the time it takes for the beneficiary's account to be credited because of the reliance on paper payments. In addition, affordable, convenient and secure non-cash means for consumers to receive funds and make payments are not available. This deters the mobilization of savings in the banking system.

**Criteria for participation (CP IX)**

are no No material shortcomings were identified.

**Criteria for observance of the payment system (CP X)**

163. The process used for publication of proposed new service initiatives and regulatory changes should be formalized to provide all interested parties, not just commercial banks and other governmental entities, an opportunity to comment on such proposals. An analysis of comments should also be included in the documentation presented to the NBKR Board for channel action on proposals. The NBKR should also formalize the role and responsibilities of relevant departments participating in the provision of payment services and their supervision to ensure that all critical functions are assigned to a responsible department and the necessary financial resources made available to carry out the assigned tasks.

**Criteria for observance of all Bank Responsibilities in applying the CPs**

164. Responsibility B states that the central bank should ensure that the systems it operates comply with the core principles. The main areas of concern have been identified above in the comments on the core principles.

165. Responsibility C states that the central bank should oversee observance of the core principles in systems it does not operate and should have the ability to carry out this oversight. With respect to NACH, two deficiencies exist: (1) the absence of documented and facilities for effective business continuity in case the primary site becomes inoperable for an extended period of time; and (2) the absence of regular on-site inspections over NBKR bank supervisors to verify that operational and required audit and security controls plans are documented and are being observed in ongoing operations. This second point will require training of on-site inspectors to allow them to better carry out on-site payment system reviews of payment system participants. This becomes critically important in the context of the conversion of payments services from paper to electronic forms.

**Criteria for observance of all Bank Responsibilities' responses**

166. The authorities were in broad agreement with the assessment and recommended course of action.

167. courses

Table 6. Recommended Actions to Improve Observance of CPSS Core Principles and Central Bank's Responsibilities in Applying the CPs

Reference principle	Recommended action
Legal foundation	
CP I – The system should have a well-founded legal basis under all relevant jurisdictions.	Reduce and streamline the number of documents governing the regulation of payments.  Complete the legal framework for introduction of electronic payments.
Settlement	
CP IV - The system should provide prompt final settlement on the day of value, preferably during the day and at a minimum at the end of the day.	Change funds availability guidelines for commercial bank crediting of bank customers in connection with implementation of electronic payment clearing in NACH.
Security and operational reliability, and contingency arrangements	
CP V – The multilateral netting should be capable of ensuring the timely completion of daily settlements.	The NBKR should review its arrangements for providing banks with liquidity.
CP VII – The system should ensure a high degree of security and operational reliability and should have contingency arrangements for timely completion of daily processing.  Responsibility B – The central bank should ensure that the systems it operates comply with the core principles.  Responsibility C – The central bank should oversee observance with the core principles by systems it does not operate and it should have the ability to carry out this oversight.	Plan for and implement credible business continuity plans for payment system and accounting functions.  Ensure that NACH does the same.  Plan for and implement programs and procedures for the banking supervision function to carry out its essential role in the oversight of NACH and commercial bank payment system operations.  Survey commercial banks to determine the state of their business continuity readiness.
Efficiency and practicality of the system	
CP VIII – The system should provide a means of making payments, which is practical for its users and efficient for the economy.	Finalize strategy and implementation plans for the introduction of electronic affordable, convenient recurring payment services.

## VII. TRANSPARENCY OF MONETARY AND FINANCIAL POLICIES

### A. The IMF's Code of Good Practices on Transparency of Monetary Policy

168. This is an assessment of the NBKR's observance of the MFP Transparency Code with regard to its responsibilities as agency responsible for monetary policy in the Kyrgyz Republic. It was prepared as part of the joint IMF/World Bank FSAP missions to the Kyrgyz

Republic that took place in May and in August–September 2002. the assessment is based on review of relevant legislative and other documents and interviews with the authorities.

169. Monetary policy in the Kyrgyz Republic is the responsibility of the NBKR, and is governed by the National Bank Law. The main goal of monetary policy is to attain and maintain price stability.

170. The mission found that overall and in most respects, the transparency of the NBKR's monetary policy is very good. The NBKR makes great efforts to inform the public about its primary objective, maintaining price stability, and its basic monetary policy framework. It also conducts its operations in an open and transparent manner. It makes a concerted and largely successful effort to communicate with the public, as evidenced by its extensive publications, high-quality annual report, and excellent website. The NBKR issues detailed and relatively transparent financial statements are audited by a major international auditing firms. In the detailed assessment of the extent to which good practices are observed in the Kyrgyz Republic, virtually all of the practices are rated either "observed" or "broadly observed."

171. However, further improvements are recommended. The main steps the NBKR should take to improve its observance of the Transparency Code include (1) regularly publishing information on the NBKR's activities with regard to monetary policy, including more systematic explanations of the reasons for policy actions; (2) explaining the principles underlying its involvement with the economy, including in particular its ownership and management of financial institutions, and its plans for divestiture; and (3) disclosing more fully its relationships with the government.

#### **Clarity of roles, responsibilities, and objectives of central banks for monetary policy**

172. The roles, responsibilities and objectives of the NBKR for monetary policy are clearly established in the National Bank Law, and conveyed to the public through public documents and the NBKR website. The institutional relationship between monetary and fiscal operations are also defined in that legislation. Transparency could be strengthened by providing an explanation of the principles underlying the involvement of the NBKR in the rest of the economy.

#### **Open process for formulating and reporting monetary policy decisions**

173. Most good practices are observed by the Kyrgyz authorities. The main policymaking body, including its composition, structure, and functions are laid out in the National Bank Law and publications. However, more emphasis should be placed on providing systematic and timely explanations of changes in the setting of monetary policy instruments.

**Public availability of information on monetary policy**

174. All good practices are observed by the Kyrgyz authorities. Particularly commendable are the high quality Annual Report, the informative website, an information office open to the public, and a weekly television program.

**Accountability and assurance of integrity by the central bank**

175. Virtually all good practices regarding transparency of monetary policy are observed. With regard to the latter, transparency might be strengthened by providing more structured and systematic information about internal governance procedures of the NBKR.

**Authorities' responses**

176. Authorities and staff were able to agree on most aspects of the IMF's Transparency code for monetary policy. Slight differences in opinion may have persisted in a few areas such as the extent to which NBKR sufficiently explained changes in policy, and interactions between it and the MOF.

Table 7. Recommended Actions to Improve Observance of IMF's MFP Transparency Code—Monetary Policy

Reference Practice	Recommended Action
I. Clarity of Roles, Responsibilities and Objectives of Central Banks for Monetary Policy	1) Provide an explanation of the principles underlying the NBKR's involvement with the economy, including in particular its ownership and management of financial institutions. 2) Disclose more fully interactions between the NBKR and the Ministry of Finance.
II. Open Process for Formulating and Reporting Monetary Policy Decisions	1) Provide more systematic explanations of the reasons for policy actions. 2) Publicly announce the scheduled meetings of the Board at which monetary policy is to be discussed.
IV. Accountability and Assurances of Integrity by the Central Bank	Provide more systematic information on internal governance procedures of the NBKR.

**B. The IMF's Code of Good Practices on Transparency of Banking Supervision**

177. Banking supervision in the Kyrgyz Republic is conducted by the NBKR. The Law on the National Bank of the Kyrgyz Republic of July 1997 underpins the supervisory responsibilities and objectives for the NBKR.

178. The assessment of the transparency of NBKR practices regarding supervision of the banking sector was based on the IMF's Code of Good Practices on Transparency in Monetary and Financial Policies. The assessment was based on a review of the legal framework, a self-assessment questionnaire prepared by the staff of the NBKR, and discussions with NBKR officials.

179. The NBKR observes most good transparency practices regarding banking supervision. The main steps the NBKR should take to improve its observance of the *Transparency Code* include: (1) establishment of public consultation procedures with a clearly defined time framework for proposed substantial technical changes to the structure of banking regulations; and (2) reporting of internal governance procedures to the public on a regular basis in NBKR's publications.

### **Main findings**

#### ***Clarity of roles, responsibilities, and objectives of the banking supervisory agency***

180. The responsibilities of the banking supervisory agency (NBKR) are well defined in the law. The NBKR is in the process of improving transparency of the policies on risk management and antimonopoly regulation of the payments service market.

#### ***Open process for formulating and reporting of banking supervisory policies***

181. The conduct of financial policies is transparent. The Annual Report provides a broad summary of the activities of the NBKR and the status of the banking industry. The NBKR can further enhance transparency by devising public consultation procedures with clearly defined time framework to foster full understanding of supervisory requirements and an open dialogue with the industry.

#### ***Public availability of information on banking supervision***

182. The NBKR issues a comprehensive Annual Report, which gives an overview of its supervisory activities in the banking sector. It also presents an overview of legislative work pertaining to the banking industry. The Annual Report is published in the Kyrgyz, Russian, and English languages, and is also available on the NBKR website.

#### ***Accountability and assurances of integrity by the banking supervisory agency***

183. The management of the NBKR is available to explain the objectives and policies of the NBKR. Internal governance procedures necessary to ensure the integrity of operations, including internal audit arrangements, are in place. The activities of NBKR's Internal Audit Department and its internal governance procedures are disclosed to the personnel of the NBKR and to the public through TV broadcasts. Transparency would be further enhanced by reporting developments in internal governance procedures in regular NBKR's publications.

**Recommended actions**

Table 8. Recommended Actions to Improve Observance of IMF's MFP  
Transparency Code Practices—Banking Supervision

Reference Practice	Recommended Action
VI. Open Process For Formulating And Reporting Of Financial Policies	The development of a clearly defined time framework for public consultation procedures should be pursued for proposed substantial technical changes to the structure of banking regulations.
VIII. Accountability and Assurances of Integrity by Financial Agencies	Internal governance procedures should be reported to the public on a continuous basis in NBKR's publications.

**Authorities' response**

184. Authorities were in agreement with the assessment of the transparency code in banking supervision, and voiced no disagreement with the recommended course of action.

**C. Transparency of Payment System Oversight**

185. In the Kyrgyz Republic, the NBKR has responsibility for the oversight of the payment system. The National Bank Law underpins the responsibilities and objectives of the NBKR with respect to oversight of the payment system.

186. The assessment of the transparency of the NBKR regarding oversight of the payment system was based on the IMF's Code of Good Practices on Transparency in Monetary and Financial Policies (Transparency Code). The assessment was based on a self-assessment by the NBKR, responses from the NBKR to questionnaires, a review of legislation, and discussions with the NBKR staff and market participants during the May and August/September 2002 missions.

**Main findings—Summary**

187. The NBKR observes most good transparency practices regarding supervision and oversight of the payment system. The main steps the NBKR should take to improve its observance of the Transparency Code in payment system oversight include: (1) more clearly define the role of the NBKR bank supervision in the oversight of the NACH operations, and (2) establish more formalized process of seeking public comments on proposed changes in policies.

***Clarity of roles, responsibilities and objectives of financial agencies***

188. The code, in general, is observed with respect to the clarity of roles, responsibilities and objectives of financial agencies in the area of payment systems oversight. Three matters will require NBKR's attention (see Table 10).

***Open process for formulating and reporting of financial policies***

189. Formalize further the process of seeking public comments on proposed changes in policy operating procedures, regulation or legal agreements affecting payments.

***Public availability of information on financial policies***

190. More attention should be given to keeping the public informed about reform initiatives, their expected benefits and their implications for the major users of the services as well as on expected implementation timeframes.

***Accountability and assurances of integrity by financial agencies***

191. The role of the internal audit department in the review of payment system operation consistent with CPSIPS should be formalized and publicly disclosed.

**Authorities response**

192. There were no significant areas of disagreement between the authorities and staff with respect to the IMF's Transparency Code for Payment Systems Oversight.

Table 9. Recommended Actions to Improve Observance of IMF's MFP Transparency Code Practices—Payment Systems Oversight

Reference practice	Recommended action
V. Clarity of roles, responsibilities and objectives of payment system oversight agencies	1) Prepare and fund effective business continuity plans at the NBKR and NACH. 2) Organize an educational effort to highlight needed security safeguards and the role of internal and external auditors and on-site bank inspection to prepare for the introduction of electronic payments. 3) Clarify the role of NBKR banking supervision in the oversight of NACH operations and perform regular on site inspections.
VI. Open process for formulating and reporting of payment system oversight policies	Formalize the process of seeking public comments on proposed changes in policy, operating procedures, regulation or legal agreements affecting payments, to broaden the scope for public comment before final action is taken by the NBKR.
VII. Public availability of information on payment system oversight policies	1) Focus more attention on reform initiatives, their expected benefits and their implications for the major users of the services as well as on expected implementation timeframes. 2) Eliminate overlaps and contradictory definitions



	of relevant terms in existing regulations and guidelines.
VIII. Accountability and assurance of integrity by payment system oversight agencies	Formalize and publicly disclose the role of the internal audit department in the review of payment system operation.