

# Kyrgyz Republic

**Ruth Goodwin-Groen**

## **Summary**

*The Kyrgyz Republic, with a population of 4.7 million, was established in 1991 following the break-up of the former Soviet Union. It is undergoing transition from central planning to a market economic system. The microfinance sector is still in its infancy, and the National Bank of the Kyrgyz Republic (NBKR, the central bank) has had relatively little involvement with it. However, NBKR has undertaken some "developmental" activities to support agriculture which have had implications for microfinance. The economy was hit badly by the Russian financial crisis toward the close of the 1990s, and this has severely stretched NBKR's resources.*

*The most important contribution that the central bank can make, both to microfinance and to the wider financial system, is to reduce inflation and ensure monetary stability. Regulation of the microfinance sector would be premature at this stage. There may be a case, however, for NBKR to undertake some limited "promotional" activities to support microfinance.*

---

## Kyrgyz Republic

### Currency Equivalent

Currency Unit – som (Som)

US\$1 = Som42 (at September 1999)

### Abbreviations

ADB	Asian Development Bank
FCSCU	Financial Company for the Support and Development of Credit Unions
FINCA	Foundation for International Community Assistance
GDP	gross domestic product
GNP	gross national product
KAFC	Kyrgyz Agricultural Finance Corporation
KAT	Kyrgyz Ayl Trust
MFI	microfinance institution
NBFI	nonbank financial institution
NBKR	National Bank of the Kyrgyz Republic
NGO	nongovernment organization
RCC	rural credit cooperative
SSC	Savings and Settlement Company
UNDP	United Nations Development Programme
USAID	United States Agency for International Development

### Note

In this report, “\$” refers to US dollars.

## Contents

## Kyrgyz Republic

<b>1</b>	<b>Introduction and Background</b>	<b>130</b>
1.1	Economic Performance	130
1.2	Human Development	131
<b>2</b>	<b>Development of Microfinance</b>	<b>132</b>
2.1	Microfinance in the Kyrgyz Republic	132
2.2	NGOs in Microfinance	133
2.3	Nonbank Financial Institutions in Microfinance	136
2.4	Banks in Microfinance	137
2.5	Demand for Microfinance	137
<b>3</b>	<b>Role of the Central Bank</b>	<b>138</b>
3.1	Mandate of the Central Bank	138
<b>4</b>	<b>Central Bank Involvement with Microfinance</b>	<b>139</b>
4.1	NBKR Activities in the Microfinance Sector	139
4.2	NBKR Perceptions of Microfinance	140
4.3	Potential Future Activities for the Central Bank	141
<b>5</b>	<b>Regulation and Supervision of Banks</b>	<b>142</b>
5.1	Overview of the Banking System	142
5.2	Minimum Capital Requirements	143
5.3	Interest Rate Regulation	143
5.4	Prudential Regulation and Supervision	143
<b>6</b>	<b>Regulation and Supervision of NGOs and Nonbank MFIs</b>	<b>144</b>
6.1	Central Bank Regulation of Nonbank Institutions Serving the Microfinance Market	144
6.2	Regulation and Supervision of Credit Unions	144
6.3	Regulation and Supervision of Credit-only Institutions	145
6.4	Regulation and Supervision of Savings-only Institutions	146
6.5	Regulation of NGOs	146
<b>7</b>	<b>Conclusions and Recommendations</b>	<b>147</b>
7.1	Conclusions	147
7.2	Recommendations	147
	<b>References</b>	<b>150</b>
	<b>Appendix</b>	<b>152</b>

## 1 Introduction and Background

### 1.1 Economic Performance

*Although Kyrgyz Republic is the most liberal of the central Asian economies, rapid transition and external shocks have brought disruptions*

The Kyrgyz Republic was established in 1991 during the break-up of the former Soviet Union, and its currency, the Som, introduced in May 1993. Kyrgyz is a recent entrant to the World Trade Organisation and was the earliest reformer among the new central Asian states. In terms of political and economic conditions, it is now considered to be the most liberal and open of all the central Asian republics (Meyer and Nagarajan 1999). However, the rapid transition has entailed severe economic dislocations; per capita gross domestic product (GDP) has fallen by over 50 percent since Independence and stood at \$480 in 1997.<sup>1</sup>

The severe adverse impact of the Russian crisis in 1998 has so far prevented the Kyrgyz Republic from reaping the benefits of economic liberalization. During 1997 and until August 1998, the Kyrgyz Republic had made significant progress in its economic recovery. According to the Asian Development Bank (ADB) Country Economic Review (ADB 1999a), real GDP grew in 1997 at a robust 9.9 percent, with decelerating inflation (down from 1,366 percent in 1993 to 14.7 percent in 1997), declining budget deficit, and improving current account balance. But in 1998, real GDP growth was only 1.8 percent and inflation was 18.3 percent (instead of the targeted 12 percent), and interest rates rose sharply. The Som fell from 17.38 to the dollar at the end of 1997 to 43.18 by 31 May 1999.

The soundness of the Kyrgyz banking system was also severely impaired by the Russian crisis. The largest commercial bank was declared bankrupt by the central bank, the National Bank of the Kyrgyz Republic (NBKR), in April 1999. This followed the failure of seven banks to meet all of NBKR's prudential requirements. The story has continued into 1999 with at least 15 percent of total banking assets under temporary or direct supervision of NBKR (ADB 1999a). Extreme tightening of credit by the banks led to a 75 percent drop in Som credits in the last quarter of 1998, which has also contributed to weakness in the enterprise sector.

However, even without the Russian crisis, the effects of liberalization have not been all positive. Privatization is a major part of the Kyrgyz economic reforms, and by mid-1997<sup>2</sup> the private sector share of GDP had increased from almost zero to 60 percent (among the highest in the Commonwealth of Independent States) (ADB 1999a). But Nellis (1999, ix) noted that "in some institutionally weak transition economies ownership change has so far not delivered on its promise," and that "in an institutional vacuum privatization can and has led to stagnation and decapitalization rather than to better financial results and increased efficiency." This has been part of the Kyrgyz experience as well.

*The banking system has also suffered disruption*

There has also been a greater relative dependence on the agriculture sector as a result of the transition (exacerbated by the Russian crisis). Approximately 82 percent of the population (about 3.8 million people) are now dependent on agriculture for their livelihood. Agriculture accounts for 42 percent of employment

1 If purchasing power parity numbers are used for gross national product (GNP) per capita, the Kyrgyz Republic's income rises to \$2,180 (World Bank 1999).

2 The privatisation of the large state-owned enterprises was halted in 1997 (ADB 1999a).

### Transition and Economic Crisis in the Kyrgyz Republic

- Established in 1991 at the breakup of the Soviet Union, and with its own currency only since 1993, the Kyrgyz Republic is in transition to a market-based economic system.
- Per capita income fell by some 50 percent to 1997 due to economic dislocation.
- Shrinkage of the industrial economy and state sector has forced greater reliance on agriculture and self-employment in the service sector.
- The incidence of poverty has increased drastically, from 35 percent in 1992 to around 60 percent in 1998.
- Financial institutions were saddled with heavy nonperforming loans, while inflation increased their difficulties.
- Financial crisis in Russia from 1998 damped the recovery then underway in Kyrgyz.

and its share in GDP increased from 35 percent in 1991 to 52 percent in 1997 (International Monetary Fund 1998, quoted in Meyer and Nagarajan 1999). But, according to the Area Study Centre (1995), only about 7 percent of the country's terrain is arable and of this, some 70 percent depends on irrigation. The transition has also resulted in a rapid increase in criminal activity — in particular, the cultivation of, and trade in, illegal drugs.

For 1999, the projected economic growth rate was 2.7 percent and the target inflation rate was single digit (ADB 1999a). But the inflationary pressure from the devaluation resulted in inflation estimates “on the street” of between 11 percent and 40 percent. “The Kyrgyz economy remains in a precarious state at least for 1999” (ADB 1999a, 16).

## 1.2 Human Development

The Kyrgyz Republic had a population of 4.6 million in 1997, and its average annual population growth rate was 1.4 percent in the period 1980 to 1997. It is classified in the “medium” category of human development by the United Nations Development Programme (UNDP) with a Human Development Index rating of 0.702, ranking it 97th among 174 countries listed (UNDP 1999c).

In 1999, over 60 percent of the population (more than 2.8 million people) are estimated to live under the poverty line of \$7 per month (UNDP 1999b). The proportion of households considered to be poor has steadily increased since Independence. From 35 percent in 1992, it rose to 40 percent in 1993, and to 49 percent in 1996 (World Bank 1997, cited in Meyer and Nagarajan 1999), and now to 60 percent. These percentages mask significant disparities between regions and between urban and rural populations. In general, the rural and southern regions are more affected by poverty than the urban and northern regions. UNDP (1999c) does not calculate the Human Poverty Index for Kyrgyz.

The Russian crisis further reduced the standard of living. There was late payment of wages and pensions and payment in kind, especially towards the end of 1998, as well as cutbacks in the delivery of social services and social assistance. As the economic slowdown continues, unemployment, estimated by the World Bank (1996) at 10.2 percent, is likely to increase and real income to decrease. This in turn

***Kyrgyz Republic is in the “medium” human development category, although fully 60 percent of the people are now under the national poverty line***

will cause poverty to rise. As is commonly the case, women and children suffer more than others in times of economic hardships. Female unemployment continued to increase in 1998, with its share in total unemployment climbing to almost 60 percent (ADB 1999a).

According to UNDP (1999b, 5), “the absence of a coherent and well-defined vision of the role of the state at both central and local levels and the institutional mechanism to implement the reform process remain the most significant obstacles to economic and social transformation.” This is hardly surprising given the “precarious” (ADB 1999a) and unprecedented economic situation faced by a government team with little experience managing a new economy and currency.<sup>3</sup>

## 2 Development of Microfinance

### 2.1 Microfinance in the Kyrgyz Republic

In transition economies such as Kyrgyzstan, with closures or cutbacks of state-owned enterprises and conversion of state collective farms into small private farms, there is a general upsurge in small enterprises and micro-enterprises in business, trade, production, and farming units operated by poor and very poor people. This, together with good literacy and education, good roads and reasonable access to rural areas, and a cooperative culture (particularly among the elderly), means there are positive drivers for microfinance (Wadhwa 1998b). However, these positive aspects are offset by low population density, mountainous terrain in some areas, lack of a credit and repayment culture, lack of entrepreneurship, an undeveloped legal and institutional framework, and few experienced nongovernment organizations (NGOs). All of this can make the development of microfinance institutions (MFIs) very challenging.

The financial sector has evolved from a monobanking system in the early 1990s to a complex system composed of state-owned and private commercial banks and nonbank financial institutions (NBFIs). The banking sector now comprises 24 commercial banks, but it is highly concentrated with the largest four accounting for about two thirds of all credit and deposits. These banks maintain a network of 140 branches across the country, a banking density still low by international standards (ADB 1999a), and some 70 percent of the population is thought to lack any reasonable access to financial services (Wadhwa 1998b).

According to the ADB Microfinance Development Strategy (ADB 2000, 1), microfinance can be defined as “the provision of a broad range of financial services such as deposits, loans, payment services, money transfers, and insurance to poor and low-income households, and their microenterprises.” In addition to banks, these financial services to the poor are provided in the Kyrgyz Republic by:

- (i) the Savings and Settlement Company (SSC) that collects savings;
- (ii) NBFIs that lend, such as the Kyrgyz Agricultural Finance Corporation (KAFC); funded under a World Bank project, this is the largest microfinance institution in the country);
- (iii) donor-funded nongovernment microcredit programs;

*Economic change has forced people into micro- and small business, but many factors operate against microfinance and private enterprise*

3 More detail about the Kyrgyz Republic's economic and human development can be found in the Asian Development Bank's (ADB) Country Economic Review for 1999 (ADB 1999a) and UNDP's Country Review for 1999 (UNDP 1999b).

- (iv) credit unions (assisted by ADB) that follow a typical credit union approach;
- (v) rural credit cooperatives (RCCs);
- (vi) subsidized micro farm credit through local government budgetary provisions; and
- (vii) informal finance.

The table summarizes key aspects of most major microfinance programs in the Kyrgyz Republic. It does not include the budgetary transfers to low income populations in rural areas that were estimated at about 45–50 percent of existing credits for 1996–1997 (ADB 1999a). Various lending institutions in Kyrgyzstan use the term “microcredit” to refer to loans ranging from under \$60<sup>4</sup> to over \$25,000. But this range is not agreed upon. Some argue that it should stop at \$1,000. For transparency, the table includes all programs with a primary loan product below \$25,000 when the exchange rate was between Som27 and 33 to \$1 (Eggert 1999). Also, in some of these programs the criteria for membership in the microfinance programs are based on a minimum landholding and/or membership in a farmers’ association (Wadhwa 1998a). Such programs would not reach the non-landed.

***A range of organizations, state and voluntary, foreign and domestic, provide micro-finance services***

## 2.2 NGOs in Microfinance

### Foundation for International Community Assistance

With 14,128 active clients (as of 31 July 1999), the Foundation for International Community Assistance (FINCA) has the largest clientele of any MFI in the Kyrgyz Republic. Funded by the United States Agency for International Development (USAID), it uses village banking methods where 10–30 members save together. They lend FINCA-supplied credit as well as their own savings to one another. With a portfolio outstanding of Som48.7 million (\$1.132 million), FINCA has an average loan size of approximately Som3,500 (around \$90). There are no public data on FINCA’s financial viability. However, with a nominal monthly interest rate of 5 percent, a 1 percent affiliation fee per loan on a four-month loan cycle, and a portfolio at risk of only 0.3 percent, it is probably more than covering direct operating costs.

***“Village banking” (as practiced by FINCA) and Grameen are among the models introduced by NGOs***

### Kyrgyz Ayl Trust

Kyrgyz Ayl Trust (KAT) is the sole Grameen Bank replication in the Kyrgyz Republic. It started in 1996 with a \$50,000 loan from the Grameen Trust, worth Som1 million at the time. As at 31 July 1999, KAT had grown to some 1200 borrowers, all low income women with no loans in arrears. KAT operates only in the south-western “peninsula” of the country, the home region of its founder. The nominal annual interest rate is 30 percent on loans of approximately Som1,000 (now only around \$25). The interest income, together with a small grant, covers all the operating costs, but not the cost of inflation in local currency or foreign exchange losses.<sup>5</sup>

Other NGOs listed in the table were visited but are not described in detail here. FINCA and KAT are good contrasting examples of an international and a local NGO which use different models and approaches but are both forward looking. These two MFIs are preparing for the day when they will be able to register as some form of NBF. Even though their interest rates seem high, informal moneylenders charge at least 30 percent interest per month (Wadhwa 1998a).

4 Given the drop in the Som–\$US exchange rate during 1998 and 1999 (ADB 1999a), it is more useful to use dollar numbers for loan sizes.

5 KAT is not included in the table.

## Major Microfinance Programs in the Kyrgyz Republic

Name of Program	Implementing Organisation	Donor	Loan Type	Targeted Sector(s)	Targeted Oblast(s)	Loan Amounts	Expected 1999 Disbursements
Osh Farm Credit Association (OFCA)	ACDI-VOCA and AFC	USDA, GTZ, USAID	Individual, group	Small rural farm enterprises, agribusinesses	Osh	\$450–3,000	\$360,000
Chui Farm Credit Association (CFCA)	ACDI-VOCA and Winrock International	USDA, USAID	Individual, group	Small rural farm enterprises, agribusinesses	Chui	\$600–1,650	\$210,000
Agro-Credit Djalal-Abad Association (ACDA)	ACDI-VOCA and Caritas	USDA, USAID, Swiss Development Agency	Individual, group	Small rural farm enterprises, agribusinesses	Djalal-Abad	\$600–4,500	\$420,000
Agriculture Credit	MCI and Farm Credit Organisations	USDA, UNICEF	Individual	Medium-sized farms, farm organisations, food processors	Issyk Kul, Naryn, Chui, Talas	\$700–25,000	\$1,000,000
Women's Micro Credit	Various local NGOs	USDA	Group	Rural women	Osh, Djalal-Abad, Issyk Kul, Talas	\$66–300	\$250,000
Small- and Medium-Sized Enterprise Credit	MCI	CAAEF	Individual	All sectors except agriculture	Chui, Osh, plan to open Djalal-Abad office	\$500–25,000	\$2,000,000
FINCA Kyrgyzstan	FINCA International	USAID	Individual, group	Women engaged in bazaar commerce and small business owners	Osh, Chui, Issyk Kul, Djalal-Abad, Naryn	\$65–1,000	\$5,600,000
Small Farmers Credit Outreach Program (SFCOP)	KAFC	World Bank	Cooperative to individual with collateral	Small rural farmers	All six oblasts in Kyrgyzstan	Up to \$600 per member	\$2,000,000
Farm Development Fund (FDF)	KAFC, UNDP, EU TACIS	World Bank IFAD	Group, based on savings	Rural poor farmers	All six oblasts in Kyrgyzstan	Up to \$150 per member	\$350,000
Farm Corporation Credit Program	KAFC	World Bank	Individual with collateral	Middle and large farm corporations	All six oblasts in Kyrgyzstan	\$600–150,000	—

Name of Program	Implementing Organisation	Donor	Loan Type	Targeted Sector(s)	Targeted Oblast(s)	Loan Amounts	Expected 1999 Disbursements
WPP Small Business Development Program	Helvetas Kyrgyzstan, Swiss Association for International Cooperation	Swiss Government	Individual, credit union	Small rural entrepreneurs	Issyk Kul, Naryn	\$300–10,000	—
Helvetas Agro Project	Helvetas Kyrgyzstan, Swiss Association for International Cooperation	Swiss government	Individual, group	Rural farmers	Naryn	—	—
KAIS	Helvetas Kyrgyzstan, Swiss Association for International Cooperation	EU TACIS	Individual	Small entrepreneurs	Chui	—	—
State Fund for Support of Small and Medium Businesses	State Fund for Support of Small and Medium Businesses	Meerim Foundation/Kyrgyz Republic	Individual	Small and medium businesses	All six oblasts in Kyrgyzstan	Up to \$15,000	\$360,000
Civil Fund for Microcredit	Asian Development Bureau	Meerim Foundation	Group	Small rural entrepreneurs	All six oblasts in Kyrgyzstan	—	—
Credit Unions	Financial Company for Support and Development of Credit Unions	Asian Development Bank	Credit union	Small rural entrepreneurs	All six oblasts in Kyrgyzstan	—	\$197,000

— = data not available or not calculated.

CAAEF = Central Asian-American Enterprise Fund, EU TACIS = European Union Technical Assistance for the Commonwealth of Independent States, GTZ = German government technical cooperation agency, IFAD = International Fund for Agricultural Development, MCI = Mercy Corps International, UNICEF = United Nations Children's Fund, USDA = United States Department of Agriculture. See also Abbreviations.

Source: Eggert 1999, 5–6.

## 2.3 Nonbank Financial Institutions in Microfinance

### Kyrgyz Agricultural Finance Corporation

K AFC was formed in 1996 as a government-owned NBFI to develop the rural finance system and to fill a perceived void created by the closure of Agroprombank. It is funded under the Rural Financial Project of the World Bank and is allowed to lend but not to accept deposits. As of December 1998, K AFC's total portfolio outstanding was Som113 million (\$3.9 million), up from Som31 million (\$1.07 million) in 1997. Thus, it has the largest microfinance portfolio in the Kyrgyz Republic (K AFC 1998).

*K AFC, a state institution, holds the largest microfinance portfolio*

As can be seen in the table, K AFC has two microcredit products. There is a solidarity group lending product for poor farmers and an agricultural credit cooperative lending product for small farmers. A third, an individual lending product for larger farmers has a lower limit of \$600 for loans and is probably beyond the scope of microfinance as defined here. K AFC believes that the smallest loans given to solidarity groups based on the group's savings are the most beneficial for low income clients. Because of the importance of savings services to their clients, K AFC is discussing options for how the agricultural credit cooperatives might transition towards a successful credit union model demonstrated under the ADB credit union project (the Rural Financial Institutions Project) or start saving with SSC (see discussion later in this section).

The interest K AFC charges on loans is 32 percent per annum, a rate "approved" by its board, chaired by the minister of finance. The corporation knows that this does not cover the cost of operations, loan loss, and cost of funds because it had a net loss of Som5.6 million in 1998. Indeed, if the effect of inflation is considered, this could be a negative real interest rate. The Ministry of Finance believes, however, that the best way to compensate producers for the lack of profitability in the agriculture sector is to subsidize credit, but expects to take a less interventionist role as K AFC develops.

### Savings and Settlement Company

SSC was established in July 1996 to replace the rural deposit mobilization and payment services provided by Elbank. It is wholly owned by NBKR, the central bank. It is allowed to accept deposits but not to lend, and has the largest network of any financial institution in the country with 48 branches that reach even the most remote areas. Its total deposit base in December 1998 was Som89.7 million (\$3 million), and it is thought that elderly people held most of these accounts. The minimum account balance was Som100 (\$2.30 in June 1999). (There is a more detailed discussion of SSC in Section 6.)

### Financial Company for the Support and Development of Credit Unions

*NBKR, the central bank, has extended support to credit unions as a means of rural financial outreach*

The Financial Company for the Support and Development of Credit Unions (FCSCU), wholly owned by NBKR, was established in April 1997 under the Rural Financial Institutions Project of ADB. As of 30 June 1999, 131 credit unions had been licensed with 4,986 members and loans outstanding of Som26.3 million (around \$610,000) on which the credit unions typically charge a nominal interest rate of 36 percent per annum. (With inflationary pressures this interest rate may rise.) Even though the project is currently making a loss, breakeven is projected in the third year of operations.

According to Mr Duishegulov of NBKR, the credit union project is the most successful financing program ever undertaken by the Government. There is 98 percent on-time payment of principal and 94 percent on-time payment of interest, which is the highest in the whole banking system.

## 2.4 Banks in Microfinance

Kyrgyz Promstroi Bank is a commercial bank, partially owned by the Government. It was recapitalized in the mid-90s so it could continue to service the rural sector from its 24 branches. However, its lending activities to microentrepreneurs and poor people in agriculture and agribusinesses remain negligible. Its total loan portfolio at the end of 1998 was Som104 million (\$3.5 million at December 1998 exchange rates) which was 34 percent of total assets. The nominal interest rate charged is approximately 80 percent per annum on Som loans. Of this portfolio, 5–10 percent was in loans of less than Som100,000 (\$3,500). That means the maximum Promstroi Bank had outstanding in small loans was around Som10 million (\$350,000). However, these were not loans to poor microentrepreneurs because Promstroi Bank requires its clients to be known to them, to have good collateral or a personal guarantor, and to be an existing business (no start-ups). This is a familiar pattern because the share of household loans in the loan portfolios of the rural branches of commercial banks was less than four percent in 1996 (ADB 1997, cited in Meyer and Nagarajan 1999). A senior officer of Promstroi Bank claims it does have “many small savings accounts”; all commercial banks have a minimum deposit amount of Som2,000.

Kyrgyz Republic bankers are little different from other bankers. They generally consider the poor to be risky, incapable of income generation or savings and of repaying loans. The National Microcredit Summit in 1998 heard that banks in the Kyrgyz Republic lack staff who are able to evaluate the profitability of agricultural and agribusiness enterprises and management able to assess the cost-effectiveness of credit delivery. Hence, their main focus remains the client’s collateral (UNDP 1998b).

## 2.5 Demand for Microfinance

The Government has noted the importance of developing micro-enterprises and delivery of microcredit to tackle poverty in the country (Wadhwa 1998b). With over 60 percent of the population now in poverty (approximately 2.8 million people), this is a significant challenge. There are indications, however, that substantial savings exist which are neither being deposited in banks nor circulated in the economy (ADB 1997). One reason for that may be (as already noted) that an estimated 70 percent of the population (approximately 3.22 million) are without any reasonable banking services. However, the National Microcredit Summit’s outreach target for 2005 of 1 million poor families (UNDP 1998b) seems to be an overestimate of the demand, given the population estimates and the definition of demand (discussed later).

The 1999 ADB Country Economic Review (ADB 1999a) estimated rural credit supply (based on 1997 numbers) to meet approximately one third of the potential needs. Von Pischke (1991) explains that this “credit need” approach is not helpful. “Debt capacity”<sup>6</sup> is a more meaningful concept than “demand,” especially when the latter is not considered in relation to the cost of credit or the capacity to repay. The debt capacity perspective emphasizes improvements in the operations of financial markets. It requires financial intermediaries that are financially viable because they understand the repayment capacity of clients and the risk involved. Any approach to meeting credit needs with subsidized funds from a financially unsustainable institution will not be addressing a client’s actual debt capacity.

Viewing the potential market in terms of “debt capacity” rather than “credit needs” or “demand” may be helpful for MFIs in the Kyrgyz Republic. Even now, as many as six different microcredit programs are competing against each other for

***Kyrgyz commercial banks have little or no exposure to microfinance and Kyrgyz bankers are not attuned to it***

***Some 70 percent of people lack any reasonable access to formal financial services***

6 For a detailed description of how to calculate debt capacity, and methods to increase a client’s debt capacity, see chapter 12 of Von Pischke (1991).

**Competition between providers may produce oversupply in some regions, but excess demand exists at the national level**

similar clients in the same region, with subsidized interest rates. This level of competition is expected to increase as MFIs expand and broaden their product base (Eggert 1999). This may pose problems both for the absorptive capacity of the market in the regions where the competition is intense, as well as for the growth of individual institutions to the scale necessary for sustainability. Though there may be emerging situations of oversupply at the regional level, this is not a national phenomenon. If we use the definition of client “debt capacity” for microfinance demand, it is possible to conclude that there is almost certainly a situation of overall excess demand for sustainable microfinance services.

**During the 1990s, the socialist monobanking system yielded to a two-tier system, with NBKR as the central bank**

## 3 Role of the Central Bank

### 3.1 Mandate of the Central Bank

In 1992, under a Group of Seven mandate, 23 central banks agreed to cooperate with the International Monetary Fund to provide intensive central banking technical assistance to the Baltic states and the Commonwealth of Independent States. One of the measures taken subsequently in the Kyrgyz Republic was the establishment of a two-tier banking system comprising NBKR (the central bank) and commercial banks. This was confirmed in legislation by the adoption of the Laws on the National Bank of the Kyrgyz Republic and on Banks and Banking Activities (Sundararajan et al. 1996).

According to the legislation, NBKR has two major responsibilities: (i) to implement a monetary policy that ensures a low inflation rate and stabilization of the national currency, and (ii) to undertake supervisory functions with respect to commercial banks’ activities, with the aim of protecting the interests of their depositors and creditors. The main instruments of the monetary policy pursued by the national bank are credit auctions, treasury bill auctions, and foreign exchange auctions, as well as continuing direct measures such as reserve requirements (Sundararajan et al. 1996).

Over the past two years, NBKR has adhered to the policy of curbing inflation and maintaining the stability of the Som. With increasing experience in conducting monetary policy and a growing number of monetary instruments at its disposal, this tight policy stance has had considerable success, even allowing for the extraordinary circumstances brought about by the Russian crisis (ADB 1999a). Inflation declined from 1,366<sup>7</sup> percent in 1993 to 14.7 percent in 1997 and even with the crisis it was kept to 18.3 percent in 1998 (ADB 1999a). This is significant in contributing to an enabling environment for microfinance.

**NBKR has a clear understanding of its twin tasks — stabilizing the financial sector and supervising the banks**

NBKR is an exception to UNDP’s finding that “the absence of a coherent and well-defined vision of the role of the State at both central and local levels and the institutional mechanism to implement the reform process” are the most significant obstacles to economic and social transformation in the Republic (1999b, 5). NBKR has a clear sense of its dual responsibilities to the stability of the financial sector and the supervision of the banking system. However, as noted earlier, to manage these responsibilities is an extremely challenging task for a young team with a new economy and currency facing a precarious and unprecedented economic situation (ADB 1999a).

NBKR may be likened to a hospital emergency room. The central bank is trying to save badly battered commercial banks whose demise would jeopardize the whole financial system. The key to action in such a situation (as all emergency room doctors know) is “triage” (choosing the priority “cases” for immediate treatment).

Where there are MFIs with significant international support and which pose little threat to the financial system, they will receive little attention under “emergency room” conditions.

## 4 Central Bank Involvement with Microfinance

### 4.1 NBKR Activities in the Microfinance Sector

#### Financial Company for the Support and Development of Credit Unions

FCSCU, wholly owned by the central bank, was established in April 1997 to develop and supervise the ADB credit union project. Its capital is Som10 million. As of 30 June 1999, 131 credit unions had been licensed against a projected 100. The number of members was 4,986, an average of 38 members per credit union. Total assets of the licensed credit unions are Som29.5 million (\$736,586), a growth of 324 percent over the year. Total loans outstanding have also increased markedly, by 315 percent to Som26.3 million (ADB 1999a).

FCSCU conducts training for each credit union, which includes management, general accounting, credit analysis, and other operational functions. The rapid establishment of a large number of credit unions is likely to have adverse implications, both for the capacity of FCSCU to provide training and for the quality of management and operations of credit unions. ADB (1999a) believes that continued and more substantial training for both FCSCU and credit unions is urgently needed in the areas of credit union management and supervision, asset and liability management, credit analysis and risk management, accounting and financial management, and loan pricing.

***The central bank acts out a strong “developmental” role with the financial institutions it owns and controls***

#### Savings and Settlement Company

SSC is a joint stock company, again wholly owned by the central bank, with the goal of “attraction of monetary resources from the population and the settlement and cash servicing of physical persons, as well as carrying out a complex of banking services for legal entities.” It is also licensed by NBKR to undertake foreign exchange operations and to operate in the interbank market (Savings and Settlement Company 1998).

#### Collateral Registration Office

NBKR currently has a pledge registration office for tracking collateral that has been pledged to guarantee loans. Information from this office can be directly accessed by MFIs and might be incorporated into the information provided by a microfinance credit bureau. The central bank is already in the process of developing a credit rating agency for commercial banks (Eggert 1999).

7 The World Bank (1996) noted that determination of inflation rates is difficult in transition economies because of rapid changes in those economies and the lack of appropriate methodologies to measure inflation accurately, especially in rural areas.

### Developmental Activities of NBKR in Relation to Microfinance

- Established and owns FCSCU, an entity charged with nurturing the credit union movement through training, supervision, and operational involvement.
- Established and owns SSC as a deposit-taking and financial services company.
- Conducts a “pledge registration office” providing information to lenders, including MFIs.
- Continues to administer agricultural credit subsidies.

***Kyrgyz Republic has clung to the orthodoxy of subsidized rural credit, although phase-out is scheduled by end-2000***

### Subsidized Credit to Agriculture

As already mentioned, more than 80 percent of the population depends on agriculture, a degree of dependency which has actually increased as a consequence of the contraction of other sectors. The Government has continued to provide subsidized credit to agriculture under the Emergency Financial Support Program through regional and district authorities. These allocations are in decline but are justified as a stopgap arrangement until an alternative institution replaces the Agroprombank. The loans have been made at nominal annual interest rates of between zero and 30 percent. Even though total outreach of these various budgetary allocations is reported to be very small, the Government has been reluctant to shift completely to the new paradigm of a market-oriented financial market out of fear of underserving rural areas (Meyer and Nagarajan 1999).

The orthodox approach to subsidized rural credit in Kyrgyz hampers the development of a commercially viable financial system in agriculture and so should be phased out in 2000 as scheduled (ADB 1999a). However, as with other policy measures which are a legacy of socialist economic planning, subsidies can only be phased out as part of a sequenced program of policy reform, and as external economic conditions permit (Nellis 1999).

## 4.2 NBKR Perceptions of Microfinance

One of the NBKR officials interviewed thought that microfinance meant loans to groups of poor people, a savings requirement, no collateral and “easy terms,” that is, a subsidized interest rate. The head of NBKR’s Legal Department thought that because there is no clear legislated definition, each person comes to it from his or her own perspective. The head of the Non-Bank Financial Institution Department had the clearest working definition of microfinance: small, short-term loans to those clients the commercial banks cannot serve.

***The savings side of the microfinance “coin” is hidden, and microcredit “summitry” may have helped obscure it***

While there was universal agreement that microcredit is good for the country and that the demand for microcredit is high, there was little discussion of savings, other than in the context of credit unions. This might be because only credit unions (and SSC) are authorized to collect savings or because publicity given to the 1998 National Microcredit Summit meeting in Bishkek had focused attention on credit to the exclusion of savings. The credit unions in particular were viewed with much hope. This was because it was thought people believed in the credit union principles, they were managed at the local level, and they were low cost. It was generally felt that this type of nonbank “credit community” where people save and lend together needed to grow. The main issue was to ensure the people knew how to manage them properly. The general assumption was that specialized NBFIs such as the credit unions, KAFC, and others already noted would provide loans for the microfinance market.

Even though there was agreement that MFIs should be financially self-sufficient, and even profitable in real terms, the main issue was when this should happen. There seemed some reluctance to move as quickly as might be necessary (given the time frame of funding for externally supported projects).

### 4.3 Potential Future Activities for the Central Bank

There is arguably a role for central banks in undertaking short-term activities that promote financial systems able to provide poor households with access to financial services on a sustainable basis. Such “promotional activities” (Chandavarkar 1996) are intended as a catalyst for private sector activity. They may include support for pilot projects using innovative approaches to microfinance, for research, collection, and publication of data, and for advocacy and training.

In addition to these examples of possible direct involvement in microfinance, several “promotional” ideas have been suggested to NBKR. One is that NBKR should develop a comprehensive national microcredit strategy through dialogue with clients, practitioners, facilitators, donors, and the Government (UNDP 1998b). However, recognizing that NBKR is forced to “triage” — that is, decide which financial issues it should tackle first — it hardly seems a priority to develop such a strategy within the next 12 to 18 months.

Another option is for NBKR to create a national information network about microcredit programs among different partners, to increase coordination and ensure that some of the poorer regions are as well served as others (UNDP 1998b). To this it might be replied that if practitioners think this is such a good idea, why are they not doing it themselves?<sup>8</sup> In many other countries it has been the MFIs themselves that have undertaken information gathering and dissemination about microfinance.

It has also been suggested NBKR should establish an effective legal environment for the licensing of NBFIs (ADB 1999b). NBKR has already established the NBFI supervision department, which is now finalizing a credit union law. It will also work on other NBFI legislation. Since the savings issue is a difficult one for NBFIs, this

*The central bank is aware of opportunities to “promote” microfinance*

#### Potential Areas for Promotion of Microfinance by NBKR

Activities commonly suggested for more established central banks include:

- pilot projects
- research
- data collection
- consultation with stakeholders and “leadership.”

Specific suggestions for NBKR include:

- developing a comprehensive national microcredit strategy
- creating a national information network on microfinance programs
- establishing an effective legal framework for licensing NBFIs which encompasses MFIs
- conducting supervision of these organisations.

These suggestions are all premature or impractical at this stage, due to resource constraints and the urgency of other needs.

8 Such a network has been suggested by the Meerim Foundation.

***Creating an appropriate legal environment is important, but it should not call for supervision and management beyond NBKR's capacities***

might be an opportunity for NBKR to work with MFI practitioners so that they understand the NBKR perspective. The main issue again is whether the supervision department will have enough staff to supervise any licensed institutions effectively. Similarly, it has been proposed that the central bank should take responsibility for supervising NGOs in microfinance (ADB 1999b). But if NBKR does not have the resources to manage licensed NBFIs, why would it have the capacity to manage many and smaller NGOs which would take even more resources?

Finally, it has been proposed that NBKR should undertake comprehensive training of local staff to replace consultants, with donors focusing on specific areas including training (ADB 1999a). But, again, we have a staff resources question for NBKR. An option that might be less resource intensive is for NBKR to collaborate with MFIs to develop reporting standards that would build up the rigor of the industry.

## **5 Regulation and Supervision of Banks**

### **5.1 Overview of the Banking System**

The banking sector was restructured during 1996 and 1997 with new laws and regulations strengthening the framework within which the commercial banks operate. Restructuring was needed because overdues in the banking system at the beginning of 1996 accounted for over 3.6 percent of GDP, and the volume of nonperforming loans exceeded 60 percent of the banking sector's lending portfolio. New enactments included a central bank law and a banking law (ADB 1999a).

The Kyrgyz banking sector is also hampered by other constraints. These include low levels of bank capitalization, inadequate risk management, inadequate loan loss provisioning, low deposit growth, and inadequate accounting systems. Bank staff at all operational levels are inadequately trained, and some practices (such as savings withdrawal fees) discourage the use of banks. Public confidence in the formal financial system is lacking because of the erosion of the real value of savings due to inflation, seizures of deposits for tax arrears, and the recent poor performance of banks. Banks do not have a customer service orientation, and clients lack an understanding of loans as a contract requiring repayment (a legacy of Soviet-era use of the banks as conduits for state subsidies) (ADB 1997).

In addition to this catalogue of weaknesses, the soundness of the Kyrgyz banking system was further impaired by the Russian crisis. The largest commercial bank was declared bankrupt by NBKR in April 1999. This followed the failure of seven banks to meet all of the central bank's prudential requirements. The story continued into 1999 with at least 15 percent of total banking assets under temporary or direct supervision of NBKR (ADB 1999a). The extreme tightening of liquidity by the banks led to a 75 percent drop in Som credits in the last quarter of 1998, contributing to weakness in the enterprise sector. There is increasing dollarisation of credit and deposits, and it is very difficult for the formal financial system to perform the fundamental role of mobilizing deposits and transforming these into loans, particularly in rural areas.

A recent study of the influence of law on formal economic activity in the Kyrgyz Republic noted that "Kyrgyzstan enterprises rely overwhelmingly on self-finance" and that this is "evidence of the influence of a poor legal environment" (Lee and Meagher 1999). The authors note that smaller enterprises are more seriously affected by this unfavorable legal environment than larger ones (and one may reasonably infer that micro-enterprises are even more seriously affected).

***Although it has new banking and central banking laws, the banking system continues to labor under many disabilities***

## 5.2 Minimum Capital Requirements

The banking system as a whole is a losing business in the Kyrgyz Republic, and individual institutions are weak. But if NBKR lets any bank fail, the public might lose confidence in the system as a whole. This would result in a run on the banks<sup>9</sup> and the financial system would fail. Because several banks are so small, it would take only the bankruptcy of two or three large clients of one bank to challenge the whole financial system. NBKR has already had to recapitalize two state-owned banks, Promstroi Bank and AKB Kyrgyzstan Bank, to enable them to continue to service the rural sectors (Lailieva 1998, cited in Meyer and Nagarajan 1999).

The root of the problem is that the banks had insufficient equity to weather the crises brought on by the Russian financial meltdown. The minimum capital requirements for banks used to be only Som24 million. When banks have substantial equity, they are much more able to absorb their losses. NBKR now requires capital of Som300 million for new banks. All existing banks have to reach capitalization of Som100 million by August 2001 and then grow to Som300 million.

*The extent of self-financing by enterprises shows the weakness of financial intermediation*

## 5.3 Interest Rate Regulation

There is no official NBKR regulation of bank interest rates in the Kyrgyz Republic, but there is very strong influence exerted by the Government to keep interest rates down for political reasons (see Section 6).

*The central bank does not fix interest rates*

## 5.4 Prudential Regulation and Supervision

To identify and mitigate risk in the banking system, the central bank has taken a number of supervision measures. These include:

- (i) classification of assets by risk, and requiring provisions for loan losses according to classifications;
- (ii) liquidity management; and
- (iii) a listing of loans to insiders and related persons (Sundararajan et al. 1996)

In addition, bank inspections address all components of the CAMEL<sup>10</sup> system. However, the main challenge of supervision, as identified by NBKR, is that it is able to check the banks only against the established “norms.” There are insufficient staff to do more. A senior commercial banker agreed that NBKR was concerned only about banks complying with and meeting their prudential norms to ensure the safety of the financial system. The 1998 annual report of Promstroi Bank states that it “attained considerable overfulfilment of the rates set up by the National Bank.” Bank supervisors would like to have the resources to pay special attention to accounting within banks, and to check on what happens between presentation of financial statements.

*Bank supervision procedures are in place but staff resources limit their effectiveness*

9 According to the law, a bank has to respond within 48 hours to requests for deposits in demand accounts. Thus, there is little time for banks to manoeuvre if there is a run.

10 Capital, asset quality, management, earnings, liquidity (set of criteria used for rating banks).

## 6 Regulation and Supervision of NGOs and Nonbank MFIs

### 6.1 Central Bank Regulation of Nonbank Institutions Serving the Microfinance Market

Currently, there are three different types of NBFIs regulated by NBKR. First, credit unions are currently regulated under a presidential decree, but laws and supervision norms have now been drafted to legalize them fully. NBKR has delegated the supervision role to FCSCU. Second are credit-only entities such as KAFC. KAFC is currently regulated and supervised as if it were a bank, because there are no specific NBFIs laws and supervision norms. However, the Kyrgyz Ayl Trust has requested a NBFIs license for undertaking microfinance as KAFC does. It is understood that the NBKR board agreed in principle to establish such a legal entity with supervision norms for the microfinance sector at some point in the future. Third are savings-only entities, for example, SSC, which is owned and supervised by NBKR.

International NGOs do not have to be registered if they operate under an international agreement, but local NGOs do have to be registered. In addition, there is discussion of laws on mortgage lenders and other types of specialized NBFIs.

#### Categories of NBFIs

- Credit unions: supervision delegated to FCSCU by the central bank.
- Credit-only entities: the central bank regulates KAFC like a bank in the absence of appropriate norms.
- Savings-only entities: SSC is regulated by the central bank.
- MFIs operated by NGOs: supportive legal framework is lacking.

***NBKR and practitioners agree a framework is needed, but there has not yet been time to review international experience as a guide to action***

Very preliminary ideas have been suggested, by the Office of the President, for broad legislation for microfinance under the civil code, but their status is not clear. It was also unclear whether discussion of any such legislation would be coordinated by NBKR. Certainly, there was a general feeling, shared by practitioners and NBKR, that a framework is needed for the supervision of NBFIs and NGOs undertaking microfinance, which will not stifle innovation or prevent services being provided at low cost. However, there has not been time to learn from the (often negative) international experience or to assess the costs and benefits of such regulation.

However, the main issue on regulation for NBKR is lack of staff. Even if appropriate regulations were in place, NBKR does not have the staff to undertake effective supervision. Its priority is to deal with major (and prior) problems in the financial sector (as discussed in Section 3.1).

### 6.2 Regulation and Supervision of Credit Unions

At present, the credit union system is established and regulated on the basis of a presidential decree and temporary rules and regulations. NBKR has delegated its supervisory role to FCSCU because it does not have the staff to supervise them itself. NBKR has just drafted new laws for the supervision of credit unions. These include good rigorous prudential norms to prevent high levels of risk, including caps on lending based on savings held and the percentage of the total capital, together with

liquidity requirements and strict loan loss reserve policies (NBKR 1999b).<sup>11</sup> The new laws do not include any collateral requirements for loans, nor do they include the Basle capital adequacy requirements (NBKR 1999a).

Some relevant regulatory issues that still need to be addressed by NBKR include:

- (i) **Definition of capital.** The savings of members that can be withdrawn are called capital and this is not consistent with international accounting standards.
- (ii) **Lack of capital adequacy requirement.** It has been argued that the minimum capital adequacy standard needs to be higher for MFIs than for banks (with the latter required to meet the Basle standard of 8 percent).
- (iii) **Need for high standards for credit union licensing.** Unless high financial management standards are required and enforced, the long-term stability of the credit union system will be in doubt. These might include:
  - (a) annual external audits;
  - (b) standard internal control procedures;
  - (c) maintenance of the real value of equity: for example, the current loan pricing policy of negative real interest rates means that in real terms the credit unions are being decapitalized (ADB 1999a).
- (iv) **Whether the general public will be allowed to save with the credit unions if they do not become members.** The credit unions in the Kyrgyz Republic appear to inspire greater trust in local communities than do other financial institutions. This is thought to reflect a degree of disillusionment with state institutions, including the banks, in the post-Soviet era. It may also indicate local-level endorsement of the ownership structure and management style of the credit unions. Against this background, the suggestion was made that perhaps the credit unions should be allowed to accept deposits from the public (that is, from nonmembers).

This suggestion assumes that modes of governance and accountability could be devised to safeguard the interests of all parties in such a situation. However, the suggestion appears to disregard the intrinsic nature of the credit union as an institution. This is that, where these institutions operate well, they do so because of the strength they derive from their membership bases and from the nature of the relationships fostered by an accountable membership structure. In the Kyrgyz circumstances, for credit unions to accept deposits from nonmembers could erode the relationship between them and their members, which would diminish the credit unions' capacity to provide appropriate services on a sustainable basis.

- (v) **The possibility of forming a credit union bank.** This was brought up in discussions by NBKR staff not directly associated with this study. Again, however, this seems to violate the basic credit union principles. The difficulty of grafting on activities which are contrary to the institutional character of credit unions seems a formidable obstacle.

*NBKR has drafted laws for supervision of credit unions, but significant regulatory issues remain*

*Capital adequacy and financial management are issues, also whether credit unions should accept nonmember deposits*

## 6.3 Regulation and Supervision of Credit-only Institutions

### Kyrgyz Agricultural Finance Corporation

KAFC was formed in 1996 as an NBFIs to develop the rural finance system after the closure of the Agroprombank. As of December 1998, it had assets of Som224 million and is the largest MFI in the Kyrgyz Republic (KAFC 1998). It is regulated by NBKR like a bank because there are no norms yet to determine the risk level for this type

<sup>11</sup> The reserve requirements are: 1 to 30 days late, 5 per cent of the balance of the principal outstanding; 31 to 90 days late, 50 percent; and more than 90 days, 100 percent reserve requirement. Write-off should occur after 120 days.

***Lending is restricted because the principal asset, land, still cannot be offered as collateral***

of institution. Even if there were specific norms that NBKR could follow, there is a lack of personnel to supervise NBFIs so there would be little effective supervision. Regulatory issues for KAFC involve the problems with the collateral law and management's wish to be licensed to accept deposits and eventually to become a universal bank with foreign exchange dealing and other functions.

The collateral law affects all banks in that they are not allowed to accept land collateral. They are allowed to accept houses, but this is problematic since the land on which they stand is not included. This law needs to be clarified if KAFC and commercial banks are going to be able to make larger loans, but it does not seem of primary importance for microfinance. KAFC thinks that its lending would be better if it had clients' savings and if it was also providing a deposit service to its clients. Furthermore, KAFC wants to be able to provide payments services to clients by becoming a universal bank. KAFC will also eventually be privatized.

## **6.4 Regulation and Supervision of Savings-only Institutions**

### **Savings and Settlement Company**

As noted earlier, SSC is a joint stock company owned by NBKR which carries out a variety of financial and banking services, as well as undertaking foreign exchange operations and operating in the interbank market (Savings and Settlement Company 1998). An external supervision department of the central bank currently supervises it.

The three regulatory issues facing SSC, in regard to the role of NBKR and microfinance, are deposit insurance, the interest rate regime, and regulation of the credit unions. There is currently no deposit insurance although a draft law is before the Parliament to create deposit insurance for savings under Som10,000. It is understood that financial institutions licensed to accept savings would have to pay a fee to the government insurance fund based on their deposit base. This regulation would protect low income savers.

On interest rates, SSC can pay its depositors only a maximum of 36 percent per annum. This is because its own assets are invested in government securities and other secure financial instruments that are not generating positive real interest rates. So if SSC is to maintain a spread, it cannot fulfill its mandate of attracting savers, especially low income savers. This depressed interest rate regime also affects the public's perception of the cost of SSC's services. SSC is considered to have high prices for its payment services in remote areas, although it charges what it costs. Unfortunately, there seems to be a focus only on the price rather than on the cost of the financial service or the trade-off if that service is subsidized.

SSC thinks that the credit unions could potentially damage the financial sector if they are allowed to operate and grow outside NBKR's usual prudential norms. It also believes that, unless the credit unions are held to rigorous financial management standards, in the long term there could be a serious collapse and loss of poor people's money.

## **6.5 Regulation of NGOs**

Currently, international NGOs operating in this sector under bilateral agreements with the Government of the Kyrgyz Republic do not need to be registered locally. But all are considering how to become local institutions. Local NGOs are often registered as trusts. UNDP's Gender and Development Unit is managing the hiring of a consultant on the legal framework for microcredit schemes on behalf of a group of NGOs. The consultant will review the existing regulatory framework, including all the laws, decrees, resolutions, orders, and regulations that affect both micro-lending and micro-

***SSC cannot lend and may only invest in low-yielding securities, so it cannot offer positive real interest rates to savers***

saving, and identify the positive and negative factors in the legal framework for microfinance schemes. The consultant will also identify legal possibilities for microfinance in the present legal environment and identify the need for a new legal framework for the successful development of a sustainable microfinance sector. This is particularly important for international and local NGOs whose donors think there needs to be a supportive legal framework for them to continue supporting this sector. There are several such donors.

NBKR recognizes that some of the regulatory issues it will need to address, when it eventually prepares its regulation and “normative documents” for nonbank MFIs, include the savings component of microfinance, reserve requirements, and the tax issues that would be dilemmas for such institutions. It has begun to research these issues informally.

***The regulatory framework for NGOs in microfinance is under review***

## 7 Conclusions and Recommendations

### 7.1 Conclusions

In conclusion, the most important priority for the National Bank of the Kyrgyz Republic (NBKR) for both the economy and the microfinance sector is to reduce inflation and ensure monetary stability. Without this, all other actions for the development of a sustainable microfinance sector will have minimal long-term effect. The young Kyrgyz economy was hit very badly by the Russian financial crisis just as it was beginning to benefit from economic reform in the post-Soviet era. As of early 2000, the independent Kyrgyz economy was only eight years old, its currency had been in existence for only six years, and the government economic policy team was working in perilous and uncharted territory. Given this context, NBKR has to focus on holding the economy steady and bringing it through this difficult period.

***Macroeconomic stability is the essential prerequisite***

The recommendations in this final section are based on interviews conducted with the leading institutions involved with microfinance in the Kyrgyz Republic and the extensive international literature on regulation for the microfinance sector. As per the terms of reference of this study, the recommendations focus only on the role of the central bank, in this case NBKR, in the development of sustainable microfinance. They do not provide a comprehensive set of recommendations for the development of the microfinance sector.

They are divided into three basic areas. Recommendations 1 and 2 address the economic aspects of NBKR’s activities as they affect the working poor who currently have limited access to formal financial services. Recommendations 3 to 6 address NBKR’s role as the bank supervision agency insofar as it relates to financial services for microentrepreneurs. Finally, Recommendation 7 addresses options for NBKR to provide leadership in the development of sustainable microfinance in the Kyrgyz Republic.

### 7.2 Recommendations

#### **(1) NBKR should continue to focus on reducing inflation and ensuring monetary stability.**

The most important role for NBKR in the development of sustainable microfinance in the Kyrgyz Republic is to continue its focus on reducing inflation and ensuring monetary stability. Severe economic dislocation from the transition reforms and, subsequently, from the Russian crisis has made NBKR’s primary task of ensuring financial stability even more important.

***Subsidized rural credit must cease***

**(2) The central bank should continue to phase out subsidized credit to the agriculture sector.**

As part of its financial sector liberalization, the central bank should continue to reduce its “developmental” activities, including subsidized credit. Developmental activities undertaken to affect the allocation of resources directly, which also include directed credit programs and financial support for banks, are justifiable, if at all, only at the very early stages of central banking.

***Eradicate misunderstanding about interest rates***

**(3) NBKR should clarify interest rate policy.**

NBKR should collaborate with the Ministry of Finance to make it very clear to financial institutions that interest rates are not an issue for government directives. Interest rates are a central element of the contractual relationship between the financial institution and its client. They are set to ensure both the competitiveness and the financial viability of the financial institution. Such a clarification would benefit all those involved in pricing credit including the Kyrgyz Agricultural Finance Corporation (KAFC), the banks, NGOs, and other institutions.

**(4) The central bank should maintain a financial sector environment in which poor people are able to save safely.**

NBKR should continue the current practice of allowing only licensed and regulated financial institutions to collect demand deposits from the general public. (This does not include credit unions because members’ savings are not demand deposits.) Poor people are entitled to have confidence in institutions that offer deposit services. It would be imprudent to give deposit-taking licenses to institutions that do not meet high financial management and performance standards. Like it or not, licenses for deposit-taking services generally carry an implicit government guarantee and NBKR has to be prepared to stand behind the institutions it licenses. It is also recommended that the Financial Company for the Support and Development of Credit Unions (FCSCU) set and enforce high financial management standards as part of the licensing criteria for credit unions. Credit unions are licensed to accept poor people’s savings, provided they are members. If the credit unions do not have the capability to meet appropriate financial management standards, they should either not be licensed or should receive training to enable them to improve. Unless this is urgently undertaken, the safety of poor people’s savings will not be ensured.

**(5) NBKR should collaborate with NBFIs and NGOs in researching options for regulation of microfinance institutions.**

Since NBKR has little experience in the microfinance arena, it recognizes that comparative research is necessary before laws on the nonbank microfinance institutions (NBFIs) are drafted. There would be better laws and better acceptance of those laws if persons with experience in microfinance in the Kyrgyz Republic were also involved. Therefore, it is recommended that the central bank collaborate in such research with concerned NBFIs and nongovernment organizations (NGOs) involved in microfinance. The Kyrgyz Republic’s microfinance sector is still embryonic; as yet, no NGOs are fully commercially viable. However, involvement in such research may lead some of the major NGOs currently providing microfinance to understand the importance of commercial viability. For example, Kyrgyz Ayl Trust (KAT) has already applied for a finance company license and the Foundation for International Community Assistance (FINCA) is planning to undertake research in this area soon. The United Nations Development Programme (UNDP) is reviewing current regulations affecting microfinance, both lending and saving. It would be appropriate for NBKR to take the initiative to involve at least those institutions.

As noted previously, in the current economic climate there are greater priorities for NBKR than new laws for the microfinance subsector. However, if collaboration with NBFIs and NGOs were initiated by the central bank to research the options,

**Box 1: MFI Regulatory Issues for Research**

Some MFI regulatory issues for research include:

- Should the model of separate institutions to provide loans (for example, KAFC) and mobilize deposits (for example, the Savings and Settlement Company or SSC) in rural areas be continued?
- Should there be minimum capital requirements for these new NBFIs and, if so, at what level?
- What performance standards or “prudential norms” should be set for microfinance NBFIs?
- Which body should supervise such institutions and what recourse would it have if there were noncompliance with performance standards?
- What tax status should the new NBFIs have?

this could reduce the number of key personnel needed to focus on this subject. Box 1 contains some suggestions.

**(6) NBKR should avoid becoming involved in regulating microfinance NGOs.**

It is recommended that NBKR does not become involved in regulating NGOs providing microcredit services. It is not a priority for the sustainable development of microfinance, and experience in Latin America has shown it cannot be done well. At the moment the central bank has more urgent priorities to address than regulating microfinance. However, it is possible that at some stage in the future it would become part of its mandate. Before that happens, there would need to be serious investment in building the capacity of staff of the central bank to undertake this role.

***NBKR has more urgent priorities at present than regulating MFIs***

**(7) The central bank should consider undertaking promotional activities that would catalyze the microfinance sector.**

There is arguably a role for central banks in undertaking short-term activities to promote financial systems able to provide poor households with access to sustainable savings and credit services. These so-called “promotional activities” are intended to be a catalyst for private sector activity. They may include support for pilot projects using innovative approaches to microfinance, as well as research, collection and publication of data, advocacy, and training. Two such activities are recommended.

**(i) Developing a forum for rigorous financial reporting.**

NBKR has said that the credit union project is one of its most successful, especially with respect to its portfolio quality and outreach. However, the performance of the credit unions cannot be compared with that of other microfinance programs or with banks. Therefore, it is recommended that the central bank develop a forum in which the performance of MFIs in the country can be compared. This would require developing and agreeing a set of rigorous performance indicators covering portfolio quality, efficiency, profitability, and outreach. The next step could be to establish a publication or website reporting these numbers on a quarterly basis. Such a forum could also improve the level of understanding of microfinance among government agencies.

**(ii) Collaborating to disseminate information about, and to promote innovation in, profitable microfinance.**

There is a lack of understanding in both government and the financial sector about the potential of microfinance to be a profitable business. It is recommended that NBKR collaborate with the microfinance sector to disseminate information about profitable MFIs and products. This should include case studies of lending and savings institutions and products, as well as related areas such as insurance and leasing. Examples could be drawn from within the Kyrgyz Republic, and from other economies whose characteristics and problems are relevant to those of Kyrgyzstan.

**Government and financial sector institutions need more information about microfinance**

Such efforts could serve to encourage innovation in this sector as Kyrgyz banks and NBFIs begin to understand how to address this market. Specific issues faced by the Kyrgyz microfinance sector, including how to price products in an inflationary environment, and how to cover all the costs of microfinance in a transitional economy, would be of particular interest.

## References

- ADB. 1997. *Proposed Loan-Rural Financial Institution Project (Kyrgyz Republic)*. R132-97: Loan No. 1529-KGZ, 31 July. Manila: Asian Development Bank.
- ADB. 1998. *Microfinance: An Interim Action Plan*. Manila: Asian Development Bank.
- ADB. 1999a. *Country Economic Review: The Kyrgyz Republic*. CER: KGZ 99008, June. Manila: Asian Development Bank.
- ADB. 1999b. *Rural Financial Institutions Project*. KGZ: Loan No. 1529: Aide Memoire of the Project Review Mission, 3–7 September. Manila: Asian Development Bank.
- ADB. 1999c. *Kyrgyz Republic: Microfinance Strategy: In-Country Consultations*, 2–5 March. Manila: Asian Development Bank.
- ADB. 2000. *Finance for the Poor: Microfinance Development Strategy*. Manila: Asian Development Bank.
- Area Study Centre. 1995. *Central Asia: The Commonwealth of Independent States*. Peshawar: University of Peshawar.
- Asia Pacific Rural Finance*. 1998. Micro Financial Systems Development in Transitional Economies of Asia. July–September.
- CGAP. 1996. *Regulation and Supervision of Micro-Finance Institutions: Stabilizing a New Financial Market*. Focus Note 4. Washington DC: Consultative Group to Assist the Poorest.
- Chandavarkar, Anand. 1996. *Central Banking in Developing Countries*. London: Macmillan.
- Eggert, Don. 1999. Assessment of Needs and Solutions for a Microfinance Credit Reporting Network in Kyrgyzstan. Draft report for United Nations Development Programme. Bishkek.
- European Bank for Reconstruction and Development. 1997. Strategy for Kyrgyzstan. Update. European Bank for Reconstruction and Development, London.
- FINCA. 1999. FINCA Kyrgyzstan Factsheet. Foundation for International Community Assistance, Bishkek.
- International Bank for Reconstruction and Development. 1998. Kyrgyz Republic — Country Assistance Strategy. International Bank for Reconstruction and Development, Washington, DC.
- International Monetary Fund. 1998. *Kyrgyz Republic: Recent Economic Development*. Staff Country Report no. 98/8. Washington, DC: International Monetary Fund.
- Kyrgyz Agricultural Finance Corporation (KAFC). 1998. Auditors' Report and Financial Statements as at 31 December 1998 and 1997. Kyrgyz Agricultural Finance Corporation, Bishkek.
- Kyrgyz Promstroi Bank. 1998. *Annual Report*. Bishkek: Kyrgyz Promstroi Bank.
- Lailieva, Maya D. 1998. *Kyrgyz Republic's Financial Stabilization: The Banking Crisis*. Economic Development Institute. Washington, DC: World Bank. May.
- Lee, Young and Patrick Meagher. 1999. *Misgovernment or Misperception? Law and Finance in Central Asia*. Discussion Paper. The IRIS Center. College Park, Maryland: University of Maryland.

- 
- Meyer, Richard L. and Geetha Nagarajan. 2000. *Rural Financial Markets in Asia: Paradigms, Policies, and Performance*. London: Oxford University Press.
- NBKR. 1997a. Rules of Regulation of Activities of Banks in the Kyrgyz Republic: Resolution of the Board (as of 8 July). National Bank of the Kyrgyz Republic, Bishkek.
- NBKR. 1997b. Temporary Rules of Regulating Activities of Credit Unions in the Kyrgyz Republic: Resolution of the Board (as of 16 September). National Bank of the Kyrgyz Republic, Bishkek.
- NBKR. 1999a. Amendments to the Temporary Rules of Regulating Activities of Credit Unions in the Kyrgyz Republic: Resolution of the Board (as of 18 February). National Bank of the Kyrgyz Republic, Bishkek.
- NBKR. 1999b. Regulation on Creation of the Reserve for Coverage of Potential Credit, Leasing Losses and Damages in the Credit Unions: Resolution of the Board. National Bank of the Kyrgyz Republic, Bishkek.
- NBKR. 1999c. Temporary Instruction on Work with Deposits in Credit Unions: Resolution of the Board. National Bank of the Kyrgyz Republic, Bishkek.
- Nellis, John. 1999. *Privatization in Transition Economies?* Discussion Paper No. 38, International Finance Corporation. Washington, DC: World Bank.
- Savings and Settlement Company. 1998. *Annual Report*. Bishkek: Savings and Settlement Company.
- Sundararajan, V., Arne B. Petersen, and Gabriel Sensenbrenner. 1996. Central Bank Reform in the Transition Economies. Background papers for the Joint Coordinating Meeting of the Baltic, CIS, and Cooperating Central Banks and International Organizations, International Monetary Fund, Basle, May.
- UNDP. 1998a. *Investing in People: The United Nations Development Programme in Kyrgyzstan*. Bishkek: United Nations Development Programme.
- UNDP. 1998b. National Microcredit Summit. United Nations Development Programme, Bishkek.
- UNDP. 1999a. Proposal Terms of Reference — Local Short-Term Consultant on Legal (Regulatory) Framework for Micro Credit Schemes. United Nations Development Programme, Gender in Development Bureau, Bishkek.
- UNDP. 1999b. *UNDP Country Review for Kyrgyzstan: Mission Report 17 May–4 June*. Bishkek: United Nations Development Programme.
- UNDP. 1999c. *Human Development Report 1999*. New York: Oxford University Press.
- Von Pischke, J. D. 1991. *Finance at the Frontier: Debt Capacity and the Role of Credit in the Private Economy*. Washington DC: Economic Development Institute, World Bank.
- Wadhwa, S.C. 1998a. Important Measures for Institutional Sustainability of Micro Credit Programmes in Kyrgyzstan. Background paper for National Microcredit Summit, United Nations Development Programme, Bishkek.
- Wadhwa, S.C. 1998b. Micro Credit Development in Kyrgyzstan: Current Trends, Challenges and Future Opportunities. Background paper for National Microcredit Summit, United Nations Development Programme, Bishkek.
- World Bank. 1996. Report and Recommendation of the President of the International Development Association to the Executive Directors on a Proposed Financial Sector Adjustment Credit to the Kyrgyz Republic. Report No. P-6891-KG. World Bank, Washington, DC.
- World Bank. 1997. *Kyrgyz Republic: Country Overview*. Washington, DC: World Bank.
- World Bank. 1998. *Kyrgyz Republic: Strategy for Rural Growth and Poverty Alleviation*. Discussion Paper No. 394. Europe and Central Asia Department. Washington, DC: World Bank.
- World Bank. 1999. *World Development Indicators 1999*. Washington, DC: World Bank.

## Appendix: Persons Consulted

Abdraimov, Mr. Taalai	Deputy Director, Financial Company for the Support and Development of Credit Unions
Abdraimov, Mr.	Head of the Non-Banking Sector, National Bank of Kyrgyz Republic
Achylova, Dr. Prof. Rahat	Chief Executive, Kyrgyz Ayl Trust (Grameen Replication)
Akmatbekov, Mr. Ruslan	Head of the Banking Supervision Department, National Bank of Kyrgyz Republic
Atabayeva, Ms. Narina	Head of the Department of Economy and Agriculture Finance, Ministry of Finance
Bit-Avraham, Ms. Elena	Head of the Legal Department, National Bank of Kyrgyz Republic
Brainich, Mr. Eric	Country Director for Kyrgyzstan, Mercy Corps International (Group Lending)
Cooling, Ms. Kimberly	Executive Director, Foundation for International Community Assistance (Village Banking)
Duishegulov, Mr. Marlis	Director, Directorate on Investments and Technical Assistance Coordination, National Bank of Kyrgyz Republic
Fueg, Ms. Karin	Programme Director, Helvetas Kyrgyzstan, Swiss Association for International Cooperation
Hubner, Mr. Wojciech	Chief Technical Adviser, Small Business Development Centres, United Nations Development Programme
Kameneva, Ms. Olga	Deputy Chairman, Kyrgyz Promstroi Bank
Karabasheva, Ms. Gulsara	Team Leader, Helvetas Kyrgyzstan, Swiss Association for International Cooperation
Kyptchakbaeva, Ms. Ainura	General Director, Savings and Settlement Company
Meikle, Mr. Jason S.	Operations Manager, Foundation for International Community Assistance (Village Banking)
Misnikov, Mr. Yuri	Deputy Resident Representative, United Nations Development Programme
Musisi, Ms. Christine	Chief Technical Advisor, Gender and Development Bureau, United Nations Development Programme
Ni, Ms. Svetlana	Expert Economic Policy Department, Office of the President of the Kyrgyz Republic
Shamkanov, Mr. Orunbek	Operations Officer (responsible for KAFC), Kyrgyz Resident Mission of the World Bank
Shamkeyev, Mr. Baktybek	Manager of Development Department, Kyrgyz Agricultural Finance Corporation
Tagylykova, Ms. Lyldyz	Head of Credit Department, Kyrgyz Agricultural Finance Corporation
Whittle, Mr. John	Senior Project Economist, Asian Development Bank Liaison Office in the Kyrgyz Republic