ECONSTOR
Make Your Publications Visible.

A Service of
ZBW
Leibniz-Informationszentrum Wirtschaft
Leibniz Information Centre for Economics

Sagbansu, Lutfu

Article

Banking system in Kyrgyz Republic

IBSU Scientific Journal (IBSUSJ)

Provided in Cooperation with:
International Black Sea University, Tbilisi

Suggested Citation: Sagbansu, Lutfu (2006) : Banking system in Kyrgyz Republic, IBSU Scientific Journal (IBSUSJ), ISSN 1512-3731, International Black Sea University, Tbilisi, Vol. 1, Iss. 1, pp. 39-53

This Version is available at:
https://hdl.handle.net/10419/54609

Standard-Nutzungsbedingungen:

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

Terms of use:

Documents in EconStor may be saved and copied for your personal and scholarly purposes.

You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.

If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.

WWW.ECONSTOR.EU

Mitglied der Leibniz-Gemeinschaft

Banking System In Kyrgyz Republic

Lutfu SAGBANSUA*

Abstract

This paper examines the overall banking system and the basic banking system development factors such as internet banking and deposit insurance in the world and particularly in Kyrgyzstan. The analyses show that progress in banking reform, introduction of deposit insurance and internet banking concepts are essential for avoiding harmful problems, development stable and solvent banking system. These developments include the more effective regulation of the entry and exit of banks, removal of obstacles to the expansion of foreign-owned banks and the transfer of technology and banking skills that expand access to finance, particularly by small and medium-sized enterprises.

Keywords: Banking, deposit insurance, Kyrgyzstan.

INTRODUCTION

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

The reform of the banking system must constitute an important element of the marketizing reforms undertaken in the countries of the former Soviet Union. No program of macroeconomic stabilization (including the reduction of inflation) can be executed in the absence of well-developed central bank mechanisms for the conduct of monetary policy. Moreover, the realization of structural changes in the economy and programs for enterprise restructuring and privatization are strongly linked with changes in the operating principles of commercial banks. The first condition necessary for the initiation of reforms in the banking system is the adoption of changes in relevant legislation enabling the central bank and commercial banks to undertake activities corresponding to their new tasks and roles as defined by the principles of well-functioning market economies. Based on the experience of reforming countries up to this point in time, one can distinguish two distinct phases in the realization of banking sector reform. In the first, it is necessary to introduce a two-tiered banking system. The central bank is made responsible for the conduct of monetary policy aimed at the curbing of inflation and the stabilization of the currency. The commercial banks attain independence in their activities, and the old and new clients of those institutions are allowed freedom in their choice of a bank. At the same time, a liberal licensing policy is introduced regulating the opening of new banks. The problems arising in the second stage concern the credit portfolios of old and new commercial banks. Their gradual solution requires simultaneously changes in the credit policy of the banks

*PhD, International Ataturk Alatoo University, Department of Management, Bishkek, Kyrgyzstan, e-mail:lutsua@gmail.com

as well as the restructuring of the enterprises indebted to them. At this point, the strengthening of banking supervision by the central bank and the introduction into practice of international standards of risk appraisal and commercial banking activity become especially important.

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

Importance of banks for the economy, the risk of potential depositors' losses because of bank failures, and the necessity to lower the risk of "epidemic" force many countries to establish the systems ensuring financial security. These systems usually include the following components functioning together: prudential supervision and regulation, lender-of-last-resort function, and protection of deposits.

Establishing a Deposit Protection System (DPS) is a typical example illustrating protection of bank depositor interests and support of the banking system stability. In many countries, the theory and practice of deposit insurance proves that this mechanism facilitates stability of commercial banks, lowers the risk of sudden change for the worse of individual banks' financial situation as a result of panic among depositors, and helps to strengthen confidence in the banking and financial system in general.

International practice shows that introduction of a DPS should be preceded by fulfillment of some indispensable conditions - healthy and viable banking system is one of such conditions.

Banking sector of the Kyrgyz Republic underwent considerable change since the beginning of the transition to the market based economy. A number of important measures had been taken over the last decade to create market infrastructure and gradually move the banking system to the new stages of development.

LITERETURE REVIEW

According to Kazimierz Kloc (1994), in the nearest future changes will also be necessary in the banking legislation making it possible to institute the administration by commissioner of banks in particularly difficult situations, implement structural reforms including the mergers of banks, and increase requirements concerning the structures of credit portfolios.

Andrew Rodgers (2002) reviews developments in the New Zealand banking industry over the year ended December 2002. It discusses some of the structural developments in the banking system, in achieving this result the banks benefited from a relatively strong New Zealand economy, which supported asset growth and helped to maintain the quality of the banks' assets. The interconnections between New Zealand banks and their foreign parents could create difficulties with respect to managing the failure of a bank in this country. The Reserve Bank will therefore be continuing to ensure that the New Zealand

operations of banks are structured in ways that will deliver outcomes that promote the maintenance of a strong financial system.

Gabriela Mundaca and Qui Quifeng (2005) studied the model that analyzes the interrelationships between the interest rate, bailout, output growth and net return. It says that bank's performance needs to be monitor. There may be difficulties to observe the bank's performance, but certain mechanisms must be implemented in order to give the right incentives to the banks to reveal their true return. Rewarding high levels of effort and success may be important and when these two are revealed, a bailout will be just a necessity that does not necessarily will cause moral hazards problems.

Ali Argun Karacabey measured the efficiencies and productivity changes of Turkish commercial banks for last four years. Banks' reluctance or inability to fulfill their duties as financial agents hinders savings' transformation to real investment and this weakens economic development.

An examination of the role of solvency risk in the Danish small bank sample suggests that the higher risk banks exhibited a greater negative response to the proposed deposit insurance system. This result contrasts with studies of the U.S. system in which the general conclusion has been that deposit insurance benefits the more risky banks.

Alston (2000) provides an analytical narrative of the political and economic causes and consequences of institutional changes in the Argentine banking system. Most of attention devoted to the privatization of the provincial banks. Though there was more than a two year unanticipated lag between the law establishing an independent Central Bank and the wave of privatizations in 1995, this lag was a result of the enormous inflow of deposits into the system prompted by the successful reception of the convertibility plan. The deposit inflow allowed the provincial banks to remain afloat despite their continued loans to the public sector. Once a crisis hit, causing a deposit outflow, many of the provincial banks were doomed. Once the reforms were in place they caused deposits and credit to grow. This set in motion a virtuous cycle with continued evolutionary institutional deepening such that the Asian and Russian crises had little impact on the banking system.

Arthur J. Rolnick, Bruce D. Smith, and Warren E. Weber Suffolk's history suggests ways that Suffolk was able to maintain its extraordinary profits for so many years and also suggests that the note-clearing business may have been a natural monopoly. It had a monopoly in the interbank deposit and loan markets.

The reform and development of the Polish banking system has forced commercial banks to seek strategic foreign partners, which would be in the position to support banking transformation by sharing their know-how. The financial cooperation with international financial institutions and European Community bodies played an important role in the modernization of the Polish banking system and putting into operation of the reforms necessary for future membership in the European Union and in the Economic and Monetary Union.

BANKING SYSTEM IN KYRGYZ REPUBLIC

If we look through the banking system during Soviet Union, there were

only three large banks operated in Kyrgyzstan, such as Promstroybank, Agroprombank and Sberbank. They had limited number of activities which were regulated by the government. These banks had specialized in specific fields, for example, as for Agroprombank; it was specialized only on agricultural sector. There are a number of reasons for limited commercial lending. In the Soviet system of directed credits, credit was allocated by directive rather than based on risk analysis and repayment ability.

Since, independence, because of successful efforts implemented by the government through various reforms, privatization and favorable business environment, banks started to play significant role in Kyrgyz economy. The reform of the banking system in Kyrgyzstan began in June 1991 with the passage of the Law on the State Bank and the Law on Banks and Banking Activity. The most important result of these two pieces of legislation was the creation of a two-tiered system of banking institutions. At the same time the former republican branch of the State Bank of the USSR was transformed into the National Bank of Kyrgyzstan (NBK), which was at that time subject to parliamentary control.

The National Bank of the Kyrgyz Republic (NBKR) became independent from government and it had been given the right to license, supervise and regulate the activity of financial institutions in the country. Governing banking facilities and management of relations with foreign central banks are also included in its activities. The National Bank formulates monetary and foreign exchange policies. It is accountable to the Parliament and one of its main objectives is to ensure the stability of som, the national currency of the Kyrgyz Republic introduced in 1993. The two-tier banking sector functions in accordance with the National Bank Law and the Commercial Banking Law, which were both passed in 1992.

After the independence and because of appropriate environment for establishing banks, the banking system developed rapidly. In mid-1994 20 banks were functioning in Kyrgyzstan in the form of joint-stock companies (Russian abbreviation: AKB) or commercial banks (abbreviation: KB). These included the three largest state banks, which had been converted into joint-stock companies in which the enterprises financed by them up to that point became the shareholders. Thus, they simply represented a continuation of the former state banks, financing particular sectors and branches of the economy. Specifically, these banks are AK Kyrgyzagroprombank (Joint- Stock Commercial Kyrgyz Agricultural-Industrial Bank), AK Kyrgyzpromstroibank (Joint-Stock Commercial Kyrgyz Industrial-Construction Bank), and AKB Kyrgyzstan (which had previously financed chiefly light and manufacturing industry). These banks were responsible in mid-1994 for 85 percent of the value of all credits and loans distributed in the entire commercial banking sector. From the outset of their independent activity (at the end of 1991) they have been engaged in increasing the number of their branches. Thus, in the course of two years, Kyrgyzagroprombank increased the number of its branches from 45to 51, thus attaining the largest number of branches. Kyrgyzpromstroibank created seven new branches and by mid-1994 had 27, and AKB Kyrgyzstan increased the number of its branches from 19 to 25. The fourth largest bank is to be created on the foundation of former savings institutions (so- called "sbergkasy"). It has the largest number of branches (54) but by mid-1994 did not yet have a status

affirmed by the central bank and was not able to fulfill the function of a commercial bank. The problems of this bank are connected with the transfer of its funds to Russia in the final phase of the existence of the Soviet Union and difficulties with their recovery. At this time it held 85 percent of the savings of private individuals, which, however, constituted only 15 percent of the value of all deposits in the banking system (held by both individual persons and enterprises).

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

A Comprehensive Financial Sector Reform Program supported by a Financial Sector Adjustment Credit (FINSAC) was launched in June 1996. This focused on the liquidation of Agroprombank and Elbank, downsizing and restructuring through private capitalization of the remaining two state-owned banks - Promstroi and AKB Kyrgyzstan and creation of a policy and regulatory environment.

The Basle standards on capital adequacy were adopted in June 1995. From September 1999 the NBKR increased the minimum of authorized capital up to KGS 300 million (US$ 6 million) for the newly opened banks. Existing banks have to increase their paid in capital to KGS 50 million (US$ 1 million) by the end of July 2000, and further to KGS 100 million by the end of July 2001.

In mid-1995 Kyrgyzstan's parliament passed a Law on Foreign Currency Operations, which placed national and foreign banks on an equal footing on the Republic's financial market. The law also lifted restrictions on the level of hard currency operations and exports.

Most financial institutions have very limited representation outside the Chuy oblast and therefore many households do not have any access to financial services. The most widely spread banks include SSC with 48 offices throughout the country, Promstroibank and AKB Kyrgyzstan with 26 and 20 offices respectively.

Lending to the private sector is still limited, although there is some mainly short term lending for trade taking place. Commercial lending especially to the rural sector or urban poor is extremely limited. Most banks require 120-200 % collateral on loans and charge interest rates of 50-100 %.

Individual bank saving is still very limited. When the Soviet banking

system collapsed, savings were frozen and repayment of those assets has begun only recently. Lack of confidence in the banking system is widespread. Loss of value in deposits due to inflation and low interest rates (currently around 8 %/a in demand deposits) further discourage savings. Opening accounts is often a costly, cumbersome and time-consuming procedure.

The domestic banking system crisis, owing to the Russian financial crisis of 1998, has shown that our commercial banks were vulnerable and poorly protected from an impact of an external shock. Commercial banks had unreasonably large loan portfolios in foreign currency, and did not take into account the fact that the there could be adverse developments in the financial markets.

Banking sector reform

A new Charter of Accounts, based on International Accounting Standards (IAS), has been introduced, and is being made obligatory for all commercial banks. A set of financial laws have also been enacted, including the new Law on Banks and Banking Activities, the new Law on Pledge, the new Bankruptcy Legislation, and amendments to the Tax Code.

As a result of these significant improvements, a small core of well-managed private commercial banks has emerged. In the enterprise sector, private and newly privatized enterprises are being served by these new private banks, which are equipped with better credit policies and trained staff. In recent years, four banks participated as financial intermediaries for a line of credit financed by the EBRD, and also benefited from technical assistance to enhance their credit analysis skills

Despite the increasing health of the banking sector, the loan market remains very thin, with loans to enterprises accounting for less than 5.5 per cent of GDP. Due to its small capital base and limited institutional capabilities, the financial sector is still not effective in mobilizing domestic financial resources or in providing finance to the economy. Consequently, credit lines from international financial institutions continue to be a vital source of medium and long-term capital for SMEs.

Overall Financial Status of the Banking System

The balance sheet total of the banking system for nine months of 2004 increased by 30.9% and amounted to 14,897.6 million soms (increased by 3,516.9 million soms). During the same period of 2003 an increase in balance sheet total made up 42.2% (increased by 3,308.2 million soms). The structure had a significant share of funds placed in cash offices of banks and to the correspondent account with the NBKR 1,803.3 million soms or 12.1% of all assets (as of the beginning of the year 1,331.8 million soms or 11.7%). During the same period last year this share in the structure of assets was 11.7% or 1.331.8 million soms.

The amount of funds placed in correspondent accounts increased by 19.8% (or by 913.5 million soms), their share in total assets made up 37.1% (as of the beginning of the year 40.5%) accordingly.

From the beginning of the year the securities portfolio of commercial

banks decreased by 21.1% (243.4 million soms), and as of the reporting date totaled 912.1 million soms. The volume of securities purchased by banks under REPO agreements increased by 14.0 % or by 25.1 million soms, and as of the reporting date totaled 205.2 million soms. The total share for these categories of assets in the balance sheet total of the banking system made up 7.5%.

Deposit Base

Total volume of deposits of enterprises and the population attracted to the banking system increased during the reporting period by 32.6%, and amounted to 6,339.2 million soms (for the corresponding period last year an increase made up 14.6%).

As of October 1, 2004 deposits of the banking system had the following structure:

- Deposits of legal entities 4,429.2 million soms or 69.9% of total deposits (as of the beginning of the year 3,351.8 million soms or 70.1%);
- Deposits of individuals 1,910.0 million soms or 30.1% (as of the beginning of the year 1,429.3 million soms or 29.9%);

A significant growth of deposits of individuals was observed during the reporting period an increase by 33.6%, and deposits of legal entities increased by 31.2%.

Capital

The indicator of net total capital of the banking system applied to calculate economic ratios established by the NBKR, as of October 1, 2004 was 2,533.8 million soms, having increased during the reporting period by 343.8 million soms or 15.7% (as of the beginning of the year 2,190.0 million soms).

A similar trend is observed with regards to changes in total balance sheet capital, which increased during this period by 346.6 million soms (16.2% growth) and totaled 2,483.9 million soms. During a corresponding period last year the increase was 97.5 million soms (5.3%).

Problems in Kyrgyz banking system

The Kyrgyz Republic is at the beginning of banking reform, the eventual goal of which is a sound, competitive and market-oriented banking system. Today, the country badly needs domestic investment, but citizens do not trust local banks. Banking reform must include improvement of banking policy and the regulatory environment. Legislation also needs to be developed to facilitate these improvements. The goal of reform is to establish a competitive and efficient private banking system that is both sound and capable of providing a broader range of financial services to borrowers and investors.

At the beginning of 2002, the total capitalization of the banking sector was around US$ 33 million. Kyrgyz banks are far from functioning as financial intermediaries, as Kyrgyzstan is largely a cash society. With depositors having lost their money in failed banks, confidence in the banking system is low, and there is an apparent preference for keeping money "under the mattress" rather than in bank deposits. According to official statistics, 61 per cent of all the money in circulation is currently outside the banking system. The ratio of deposits to GDP is very low at

8 per cent.

There is one problem aspect, which requires attention both of the central bank, and commercial banks. Macroeconomic stabilization achieved in the recent years has lowered negative expectations of the population and investors concerning the rate of the national currency and inflation. As a consequence, since 1999, "dollarization" of credits, that is that part of a loan portfolio, which is most exposed to the currency risk, has decreased from 72 to 61 percent. Nevertheless, still, despite of the reduction, the rate of dollarization remains high. Therefore it is extremely important for the further reduction of the currency risk to keep low rates of inflation and to continue implementing measures aimed at enhancing confidence in the Som.

However, the majority of the population continues, speaking in plain words, to keep money under "mattresses". The system of non-cash payments and development of microfinance institutions requires improvement. The main task is to achieve growth of confidence in the banking system through joint efforts of the National Bank and the commercial banks. It is necessary that common people and investors bring money to the banks, that these unused as yet resources would work for development of the economy of our motherland. One of the essential steps along this direction is to work on drafting a bill "On Deposit Protection". In is based on the Concept of the Deposit Protection System drafted after a wide-spread discussion of comments and proposals of the public and the international financial organizations.

Investment Climate in Kyrgyzstan

Since, independence, the Kyrgyz government has shown a great commitment to democracy and market economy, steering the country on a clear path away from the trade protectionism of its neighbors and towards a free market with a WTO entry in 1998.

Kyrgyzstan's business attractions include:

1. Liberal trade regime. Realizing the interdependence of the economies of the world, Kyrgyzstan has taken the lead in a number of areas aimed at integrating its economy with the world. On the trade side, in 1998 Kyrgyzstan became a member of the World Trade Organization after an unprecedented quick processing of the application.
2. Liberal exchange control regulations. Kyrgyzstan offers unrestricted movement of capital and dividends. All payments abroad, including repatriation of capital and remittance of profits, are freely permitted. Kyrgyzstan's accession to Article 8 of the IMF's Articles of Association assures free transfer of funds and free interchangeability of currency.
3. Dynamic financial sector. The financial and banking sector is young but rapidly developing. In June 1991, an independent central bank, the National Bank of Kyrgyzstan, was established. The role of the National Bank corresponds to that of an independent central bank in the West with responsibility for monetary policy and banking supervision. Foreign investment in the financial sector is permitted in the form of subsidiaries

with ownership of up to 100%, and participation in existing banks.

4. Progressive economic policies, including investment incentives (effective July, 1997 there will no longer be tax holidays given to new joint-ventures however there are other benefits such as no VAT on machinery imports);
5. Well-educated work-force;
6. Centralized location for serving Central Asian markets;
7. Abundant natural resources;
8. Readily available debt financing for properly structured projects;
9. Positive attitudes towards foreign investors;
10. Freely convertible currency;
11. Well managed central bank;
12. Strong support from international financial institutions (IMF, World Bank, IFC, ADB, EBRD, Islamic Development Bank) and donors (USAID, Japan, Germany, Switzerland, Denmark);
13. Low wage level;
14. Free transfer of foreign currencies and profits;
15. Liberation of duty and taxes in free economic zones; and
16. Liberal and more democratic conditions for private business development

Internet Banking in Kyrgyzstan

The Internet is a huge information space in which partners and possible clients operate, banks make out transactions, and numerous financial streamlets merge in one powerful stream. The Internet - banking are services for users of Internet - banks, namely - translations of financial assets, purchase / sale of currency, carrying out inside and interbank operations, realization of municipal payments, and opening of deposits.

The Internet banking is more effective, rather than traditional bank operations by the way of resource management not only for clients, but also, undoubtedly, for the banks giving such services.

The basic advantages of using internet banking are the following:

1. Efficiency of attraction of new clients worldwide, practically not beginning from the territorial factor,
2. Significant decrease of expenses on the maintenance of branch network,
3. Rendering of essentially new services raising their competitiveness, increase in volumes of bank operations by decreasing in their cost price, and
4. The opportunity dynamically to react to the slightest fluctuations of the market and change of operating conditions and structures of bank.

One of the basic problems of the Internet in general, and the Internet - banking in particular, is the possible non-authorized access to another's information. In this connection there is a danger of a fake of the electronic signature which is the integral tool of realization of operations with the account through the Internet. Carrying out of on-line operations demands presence of powerful internal information system. Also immediate realization of the operations initiated by the client, and at substantial growth of speed of the

operations made by clients, required to one of the most significant positive moments of using system of the Internet - banking, it creates considerable difficulties, and not only technical character.

In the beginning of 21st century, realization of the business processes on the Internet and the information technologies have become one of the basic areas of business activity in Kyrgyzstan. This kind of services consists of creation of systems of electronic commerce, control systems of bank and financial operations, virtual corporate and inter-regional networks of information interchange, and also other applied systems.

As of July, 1, 2005 in the Kyrgyz Republic only 2 banks render services the Internet - banking on connection to system free-of-charge: Open Joint Stock Bank « Kazkommertsbank Kyrgyzstan » and Joint-Stock Company « Demir Kyrgyz International bank ». Two more banks: Open Joint Stock bank «Amanbank ", Open Joint Stock Bank « Bakai bank » implementing actions on preparation for full transition to the Internet - banking.

Transition of traditional banks to on-line technologies at rendering services to the population, such transition is already started in republic. Now a number of commercial banks offer service of « the electronic client », giving an opportunity of the removed access at management of the account.

Internet banking in Kyrgyzstan gives such possibilities as:

1. full control over your balances and account movements
2. execution of the banking transfers
3. currency conversion
4. print-outs of account statements
5. payments for utilities, internet services, Ala-TV, cellular communication, insurance, and other services
6. archive of payment orders and statements

It would be desirable to note prospects of development the Internet - banking in the Kyrgyz Republic. By 2010 in Kyrgyzstan, according to experts of National Bank of the Kyrgyz Republic, electronic services will give, obviously, all banks. Services of them to some extent starting from carrying out of bank operations and finishing municipal payments will use about third of population of republic. Their number will include all working, pensioners, students, and other categories of the population. For comparison: now services of commercial banks use about 50 thousand person, legal and physical persons that makes about 1 % from the 5-million population of republic.

To avoid danger of a fake of the electronic signature, in the Internet - banking it is necessary to apply more widely modern technologies of hardware-software protection which are constantly improved. To guarantee confidentiality and safety of means on the account, except for the password, use a database of prints of fingers, or limit the maximal losses of the client on the account. Apply smart cards, plastic cards with the built - in microcircuit and a contact platform, readers - devices of reading / record of the cards, connected to a computer of the user.

The electronic payments introduced in the world everywhere, already

today have was extended and in the Kyrgyz Republic. Now, it will be effective the presence of corresponding legislative base, use of positive aspects of experience of the advanced countries in sphere of the Internet - Banking, accordingly prepared highly professional personnel and minimizing of risk of loss of the finance. In Kyrgyzstan, one of the first among the countries CIS, 15th October 1999 Law KR « About electronic payments » is authorized, prepared by National bank of Kyrgyzstan many normative documents already operate, but the priority should be given to development of system of protection, both depositary base processes of crediting, and protection of interbank operations in the internet.

Deposit Insurance in Kyrgyzstan

In many countries, banks are the most important financial institutions mediating between the depositors and the borrowers, functioning as monetary policy transmission mediums, and providing settlement and savings services. Banks attract considerable volumes of funds in relation to their capital; therefore, even relatively small losses resulting from lending activities can make them unable to meet their obligations in time.

Bank solvency is sensitive to any adversity, as banks transform short-term deposits into longer-term and less liquid loans and investments, the quality of which can deteriorate and their value decline. This can result in non-repayment of loans by the borrowers, depreciation of investments and, in the final analysis, problems for the bank, including reduction in liquidity.

Serious problem of liquid asset shortage can also arise during bank runs, which are the response of the public to real or perceived belief about bank's liquidity reduction or other problems. For some banks, this can result in insolvency and failure.

A bank's failure can lead to the “contagion” of financial difficulties among the clients of the bank and its counterparts. While failure of banks does not occur as often as the failure of other economic entities, it can have an impact that is much more dangerous for the economy in general due to the nature of the banking system, which is subject to the risk of the “domino effect.” Failure of a large bank or several banks often entails a wave of bankruptcies in other banks and some clients of the bank closely related with it. As a rule, bank bankruptcies result in large-scale losses for the society with numerous and unpredictable economic and social implications.

Importance of banks for the economy, the risk of potential depositors' losses because of bank failures, and the necessity to lower the risk of “epidemic” force many countries to establish the systems ensuring financial security. These systems usually include the following components functioning together: prudential supervision and regulation, lender-of-last-resort function, and protection of deposits.

Establishing a Deposit Protection System (DPS) is a typical example illustrating protection of bank depositor interests and support of the banking system stability. In many countries, the theory and practice of deposit insurance proves that this mechanism facilitates stability of commercial banks, lowers the risk of sudden change for the worse of individual banks' financial situation as a

result of panic among depositors, and helps to strengthen confidence in the banking and financial system in general.

International practice shows that introduction of a DPS should be preceded by fulfillment of some indispensable conditions - healthy and viable banking system is one of such conditions.

Banking sector of the Kyrgyz Republic underwent considerable change since the beginning of the transition to the market based economy. A number of important measures had been taken over the last decade to create market infrastructure and gradually move the banking system to the new stages of development.

Transition period resulted in the establishment of a legal foundation, which provides a framework for market entry, formation of the foundation for banks' capital growth, promoting development of banking activities and increasing the share of profitable banks. Measures have also been taken to strengthen the banking system, including restructuring and liquidation of problem banks and their assets.

However, continuing economic difficulties, the impact of such external factors as financial crisis in the Russian Federation in 1998; dependence of the economy on certain large enterprises, and slow growth of the real sector affected the development of the financial sector of the country. As a result, several banks were declared insolvent, which led to the loss of citizens' deposits and considerable reduction of confidence in banks.

Notwithstanding the fact that the results of the last three years (2001, 2002, and 2003) demonstrated profitable operation of the banking system, growth in the deposit base, and improvement in the quality of credit portfolio of banks, public's confidence in banks is still low and this fact is hampering progressive development of the banking sector and its resource mobilization capacity.

The Law on Banks' Conservation, Liquidation and Bankruptcy recently enacted by Jogorku Kenesh (Parliament) of the Kyrgyz Republic, grants priority right for reimbursement in the amount of 25 thousand soms in case of the bank's bankruptcy to the depositors who are physical persons not related to the bank over other depositors. This provision of the Law strengthens protection of depositors. It should be emphasized, however, that the measure of protection provided by the Law is not completely transparent and is not sufficient in terms of increasing confidence of population and avoiding bank runs. The depositors are still dependent on the quality of the assets of the bank under liquidation, the value of the liquidation base, liquidation costs, which can be considerable, and possible delays caused by the procedural complexities associated with the submission and satisfaction of claims and long judicial proceedings. Thus, despite the improvements in the legal framework, this system is somewhat ambiguous and does not completely minimize possible financial and social instability (tension).

A DPS may promote stability of the national financial system if it is part of a properly organized system ensuring financial security. It will allow the participants of the system, the Government, and the National Bank of the Kyrgyz Republic (NBKR) to participate more efficiently in the processes taking place in the banking and financial sector of the economy. The optimal structure of the DPS must correctly reflect potential problems, which may arise in the process of its

development and implementation. Despite the fact that in general the establishment of a DPS is a positive development, there are some important issues, which will arise during its introduction, such as moral hazard, adverse selection and aspects of economic theory associated with asymmetrical information (when one party, - in this case, small depositors, - have no adequate access to relevant information to make an informed decision, or are not able to do so compared to bankers or better informed (large) depositors or investors). Such potential problems require deliberate approach when developing a protection system with minimum costs involved in its implementation and functioning.

Properly organized, the system ensuring financial security contributes to the stability of the financial system, and, vice versa, in case of poor organization, it may increase risks, especially those related to moral hazard, which may arise when protection provided to depositors, first, makes them careless about selecting the bank, and later about risk diversification by not moving their funds to safer banks. Furthermore, the owners and the management of banks participating in the DPS, knowing that bank runs are less likely, may take additional risks when investing their resources and lower the amount of capital and liquidity reserves which they have to have for unfavorable situations. Therefore, high dependence by banks on the DPS may result in the potentially increased burden for the state budget, which may be called upon to reimburse depositors' money, as was the case in many countries.

If the DPS is attractive for weak banks but is unattractive for the strong ones, it will generate adverse selection, which often takes place in those cases when participation in the DPS is strictly voluntary and the premium is not adjusted for the risk taken by the Protection Fund. In such situation, the strong banks will most likely refrain from joining the DPS or withdraw from it later if they are members. When the strong banks leave the DPS, the premium collected from the remaining members will increase in order to cover the costs of reimbursements to the depositors of failed banks. Such premium increases may compel the next level of strong banks to withdraw from the system, and so on, until the time when only the weak banks remain in the system. It will not be possible for such a system to remain solvent. In other words, improperly designed DPS can lead to deterioration of the situation in the banking system.

Development of the design for an effective Deposit Protection System for the Kyrgyz Republic is the main goal and objective of this Concept. In this regard, it is important to keep in mind that an efficient system of deposit protection can not function if not interrelated with other elements, such as adequate legal framework, financial infrastructure, efficient bank supervision and regulation, and a set of preventive measures and sanctions (enforcement measures), which are fully supported by the judicial system.

Key issues articulated by this Concept must serve as the basis when drafting the Law of the KR “On Protection of Deposits”. These issues aim to define the most optimum mode for the effective and efficient DPS that is acceptable to all the participants.

Conclusion

In conclusion we may state that creation of insurance mechanisms in countries helped resolve simultaneously several problems, the most important of which are the following:

- Depositors show more trust to bank system;
- Disorders related to bank bankruptcy are thus prevented and depositor's interests are protected;
- Extent of population social protection increases;
- Incentives are created to attract resources on deposit accounts ensuring by this the growth of investment resources;

Bank system gets stronger turning in one of the most important factors for normal functioning of economy. As can be seen from the experience of foreign countries, without implementing measures on bank supervision that include indisputable standards on bank capital and other mechanisms to strengthen market discipline, together with macroeconomic measures to reinforce monetary circulation (lower rates of money mass growth and stabilization of inflation), the system will not be efficient in achieving its targets. On the contrary, it will put additional burden on the state budget and bank system. That is why, the approach to introduction of insurance system must be of consistent character and supported by relevant sources of financing. It should be protected by measures against moral damage, macroeconomic measures on strengthening financial discipline and development relations in economy. The success of East European countries was directly supported by macroeconomic reforms namely by liberalization of interest rates on deposits and achieving real positive interest rate by applying indirect measures of monetary policy. Unlike these countries, many CIS republics are still in the process of developing or at the initial stage of introduction of insurance systems. It is natural, as they must find solution to aggregate problems (stabilization of cash money circulation, reforms in bank sector, development of foreign economic activity, stabilization of national currency and etc.). At the same time, one should take into consideration that with all its advantages translated through adequate protection of depositors' interests and stabilization of the bank sector the system of deposit insurance has a number of imperfections. It leads, by world experts' opinion, to weaker motivation of clients to choose the most reliable bank; it increases expenses of all banks, which they, probably, tend to add to the cost of their services. There appear evidences of irresponsibility and misuse of funds by a bank management. Designing of the system on deposit protection depends on the degree of economic development of a country. Nevertheless, foreign practice allows outlining fundamentals on system development with maximal possible output from their functioning and with consideration of local specific features. System to protect bank depositors must be supported by a special law adopted at the national level. The law must clearly formulate general postulates on relations between the system participants in regard of issues arising in connection with system functioning (organizational structure of the system, system sources of financing and forms of commercial banks participation and etc.)

Analysis of various deposit insurance systems and experience of many countries demonstrate that the DPS viability requires certain conditions to be met, including macroeconomic stability and the adequacy of the financial and legal infrastructure. The designers undertook situational analysis and self-assessment in order to identify the presence of the required preconditions and to assess current situation. Therefore, in addition to the need to meet the conditions listed below, an important condition for the DPS introduction will be the continuation of a coherent monetary and fiscal policy carried out by the NBKR and the Government of the Kyrgyz Republic aimed at maintenance of the macroeconomic stability.

As a final conclusion it could be note that Kyrgyz banking system will develop in a fast manner if all recommendations about the deposit insurance system and basic legislation will be prepared in an appropriate way.

References

1. Ali Argun Karacabey, "Analyzing the production changes of the Turkish Banking System".
2. Andrew Rodgers (2002) "Developments in the New Zealand banking industry» reviews developments in the New Zealand banking industry over the year ended December 2002.
3. Arthur J. Rolnick, Bruce D. Smith, and Warren E. Weber Suffolk, "The Suffolk Banking System", pp. 182558.
4. B. Gabriela Mundaca and Qui Quifeng (2005), "Bailout Policy in the Chinese Banking System".
5. Demirguc, A. and Detragiache, E. "Does Deposit Insurance Increase Banking System Stability".
6. Kazimierz Kloc (1994), "The Banking System in Kyrgyzstan", Warsaw, November 1994, Center for Social & Economic Research.
7. Lee J. Alston (2000), "Developments in Argentine banking system".
8. Central Bank of Danish, "Deposit Insurance and Market assessment of banking system stability: Evidence from Denmark".
9. The National Bank of Poland, (2001). "The Polish banking system in the nineties".
10. Financial Sector Assessment Program of the Kyrgyz Republic, November 2002, 1- 126. (Recommendation by the joint IMF and World Bank Mission)
11. Business Information Service for the Newly Independent States (BISNIS).The Kyrgyz Republic: Economic and Trade Overview.
12. IMF Working Paper 00/3, January 2000.

Electronic Sources

Commercial News Update 2004. www.bisnis.doc.gov
Demir Kyrgyz International Bank. www.demirbank.kg
International Association of Deposit Insurers. www.iadi.org
National Bank of Kyrgyz Republic. www.nbkr.kg