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Report No: 65993-KG

PROJECT APPRAISAL DOCUMENT

ON A

PROPOSED CREDIT

IN THE AMOUNT OF SDR 4.7 MILLION
(US$7.15 MILLION EQUIVALENT)

AND A

PROPOSED GRANT

IN THE AMOUNT OF SDR 3.9 MILLION
(US$5.85 MILLION EQUIVALENT)

TO THE

KYRGYZ REPUBLIC

FOR THE

FINANCIAL SECTOR DEVELOPMENT PROJECT

February 1, 2012

CURRENCY EQUIVALENTS

(Exchange Rate Effective February 1, 2012)

Currency Unit	=	Kyrgyz Som (KGS)
US$1	=	KGS 46.78
US$1	=	SDR 0.65

FISCAL YEAR
January 1 – December 31

ABBREVIATIONS AND ACRONYMS

ATM	Automated Teller Machine	ISP	Internet Service Provider
APAP	Agricultural Productivity Assistance Project	JCSS	Joint Country Support Strategy
AUB	Asia Universal Bank	KAFC	Kyrgyz Agriculture Finance Company
CAMELS	Capital, Asset quality, Management, Earnings, Liquidity and Sensitivity	KGS	Kyrgyz Som (Local currency)
CAS	Country Assistance Strategy	KPO	Kyrgyz Post Office
CLMU	Credit Line Management Unit	LOC	Line of Credit
DA	Designated Account	MFO	Micro Finance Organization
DLI	Disbursement-linked indicator	MoF	Ministry of Finance
EBRD	European Bank for Reconstruction and Development	MSME	Micro, Small, and Medium Enterprises
ECA	Europe and central Asia	MTC	Ministry of Transport and Communications
EFT POS	Electronic Funds Transfer at Point of Sale	MTO	Money Transfer Operator
EMF	Environmental Management Framework	NBFI	Non-Bank Financial Institution
EMP	Environmental Management Plan	NBKR	National Bank of the Kyrgyz Republic
FCSDCU	Finance Company for the Support and Development of Credit Unions	NPL	Non-Performing Loans
FSAP	Financial Sector Assessment Program	PBSMP	Payments and Banking System Modernization Project
GDP	Gross Domestic Product	PCU	Project Coordination Unit
GIZ	German Agency for International Cooperation	PDO	Project Development Objective
GSM	Global System for Mobile Communications	PIN	Personal Identification Number
ICT	Information and Communications Technology	PIU	Project Implementation Unit
ID	Identity Document	POM	Project Operations Manual
IDA	International Development Association	ROA	Return on Assets

IFC	International Finance Corporation	ROE	Return on Equity
IFI	International Financial Institution	SECO	Swiss State Secretariat for Economic Affairs
IFR	Interim Un-audited Financial Reports	SIL	Specific Investment Loan
IFRS	International Financial Reporting Standards	SME	Small and Medium Enterprises
IMF	International Monetary Fund	SOE	Statement of Expenses
IS	Implementation Support	SPMF	State Property Management Fund
ISA	International Standards of Audit	TORs	Terms of Reference
ISN	Interim Strategy Note	WB	World Bank

Vice President:	Philippe Le Houerou
Country Director:	Saroj Kumar Jha (after 1/31/2012 Motoo Konishi (until 1/31/2012)
Sector Director:	Gerardo Corrochano
Sector Manager:	Sophie Sirtaine
Country Sector Coordinator:	Emanuel Salinas
Task Team Leader:	Brett E. Coleman

PAD DATA SHEET

Kyrgyz Republic

FINANCIAL SECTOR DEVELOPMENT PROJECT

PROJECT APPRAISAL DOCUMENT

EUROPE AND CENTRAL ASIA

ECSPF

Basic Information			
Date:	01-Feb-2012	Sectors:	SME Finance (40%), Banking (40%), Microfinance (20%)
Country Director:	Saroj Kumar Jha	Themes:	Micro, Small and Medium Enterprise support (60%), State-owned enterprise restructuring and privatization (20%), Regulation and competition policy (20%)
Sector Manager/Director:	Sophie Sirtaine/Gerardo M. Corrochano		
Project ID:	P125689	EA Category:	F - Financial Intermediary Assessment
Lending Instrument:	Specific Investment Loan		
Team Leader(s):	Brett E. Coleman		
Joint IFC: No			

Borrower: Ministry of Finance			
Responsible Agency: National Bank of the Kyrgyz Republic			
Contact:	Ms.Zina Asankojoeva	Title:	Chairwoman
Telephone No.:	996312669010	Email:	zasankojoeva@nbkr.kg
Responsible Agency: Kyrgyz Post Office			
Contact:	Mr.Jusup Turgunbaev	Title:	Director General
Telephone No.:	996312613607	Email:	jusup@posta.kg
Responsible Agency: Aiyl Bank			
Contact:	Mr.Toktobek Akmatov	Title:	Chairman
Telephone No.:	996312665133	Email:	akmatov@ab.kg
Responsible Agency: Collateral Registry			
Contact:	Ms. Valentina Redchenko	Title:	Director
Telephone No.:	996312610103	Email:	mjzalog@gmail.com

Project Implementation Period:	Start Date: 01-May-2012	End Date: 30-Jun-2017

Expected Effectiveness Date:	15-Apr-2012
Expected Closing Date:	30-Jun-2017

Project Financing Data(US$M)

[ ]	Loan	[X]	Grant	[ ]	Other
[X]	Credit	[ ]	Guarantee		

For Loans/Credits/Others

Total Project Cost (US$M):	13.00
Total Bank Financing (US$M):	13.00

Financing Source	Amount(US$M)
BORROWER/RECIPIENT	0.00
International Development Association (IDA)	13.00
Total	13.00

Expected Disbursements (in USD Million)

Fiscal Year	2012	2013	2014	2015	2016	2017
Annual	1.00	3.00	4.00	3.00	2.00	0.00
Cumulative	1.00	4.00	8.00	11.00	13.00	13.00

Project Development Objective(s)

Project Development Objectives are to: (i) enhance financial sector stability, and (ii) increase access to financial services.

Components

Component Name	Cost (USD Millions)
Strengthening the legal, regulatory, and supervisory framework for banks, MFOs, and credit unions	1.50
Enhancing financial services via KPOs network	5.55
Supporting Aiyl Bank for deposit mobilization and privatization	4.15
Modernizing the moveable collateral and debt resolution regime	1.00
Project coordination and monitoring	0.80

Compliance

Policy

Does the project depart from the CAS in content or in other significant respects?	Yes [ ]	No [X]
Does the project require any exceptions from Bank policies?	Yes [ ]	No [X]

Have these been approved by Bank management?	Yes [ ]	No [X]
Is approval for any policy exception sought from the Board?	Yes [ ]	No [X]
Does the project meet the Regional criteria for readiness for implementation?	Yes [X]	No [ ]

Safeguard Policies Triggered by the Project	**Yes**	**No**
Environmental Assessment OP/BP 4.01	**X**	
Natural Habitats OP/BP 4.04		**X**
Forests OP/BP 4.36		**X**
Pest Management OP 4.09		**X**
Physical Cultural Resources OP/BP 4.11		**X**
Indigenous Peoples OP/BP 4.10		**X**
Involuntary Resettlement OP/BP 4.12		**X**
Safety of Dams OP/BP 4.37		**X**
Projects on International Waterways OP/BP 7.50		**X**
Projects in Disputed Areas OP/BP 7.60		**X**

Conditions and Legal Covenants:

Financing Agreement Reference	Description of Condition/Covenant	Date Due
V.5.01.(a)	At least one Subsidiary Agreement has been executed on behalf of the Recipient and one of the Project Implementing Entities.	By effectiveness
V.5.01.(b)	The Project Steering Committee has been established with representation from the Ministry of Finance, the CLMU, the Ministry of Transport and Communication, the State Property Management Fund, the Ministry of Justice, and each of the Project Implementing Entities in a manner and with the composition and terms of reference satisfactory to the Association.	By effectiveness
V.5.01.(c)	The Project Coordination Unit has been established by KPO in a manner and with the composition and terms of reference satisfactory to the Association.	By effectiveness
V.5.01.(d)	The Project Operational Manual has been completed by KPO in a manner satisfactory to the Association.	By effectiveness
V.5.02.(a)	For the Subsidiary Agreement that has been executed, that Subsidiary Agreement has been executed by the Recipient and the Project Implementing Entity in such a form as to be	By effectiveness

	legally binding upon the Recipient and the Project Implementing Entity in accordance with its terms.	
Schedule IV, B.1 (a) – (g)	No withdrawal shall be made: (a) for payments made prior to the date of this Agreement, except that withdrawals up to an aggregate amount not to exceed thirty thousand Special Drawing Rights (SDR 30,000) equivalent may be made for payments made prior to this date but on or after December 20, 2011, for Eligible Expenditures under Categories (5) and (7); and (b) for payments under Category (6) with respect to each tranche as set forth in the table in paragraph B.2.(a) of this section, for which a withdrawal request has been submitted, unless the Recipient has submitted satisfactory evidence to the Association that Sub-financing totaling an amount of the submitted withdrawal request has been appraised and approved under terms and conditions set forth in this Agreement and the Project Operational Manual. (c) for expenditures under Category 1 until the Recipient and NBKR have entered into a Subsidiary Agreement, acceptable to the Association, and that Subsidiary Agreement has been executed by the Recipient and NBKR in such a form as to be legally binding in accordance with its terms; (d) for expenditures under Categories 2, 5, and 7 until the Recipient and KPO have entered into a Subsidiary Agreement, acceptable to the Association, and that Subsidiary Agreement has been executed by the Recipient and KPO in such a form as to be legally binding in accordance with its terms; (e) for expenditures under Category 3 until the Recipient and KPO and the Recipient and Aiyl Bank have entered into Subsidiary Agreements, acceptable to the Association, and those Subsidiary Agreements have been executed by the Recipient and KPO and the Recipient and Aiyl Bank in such a form as to be legally binding in accordance with their terms; (f) for expenditures under Category 4 until the Recipient and KPO and the Recipient and the Central Collateral Registration Office have entered into Subsidiary Agreements, acceptable to the Association, and those Subsidiary Agreements have been executed by the	Before withdrawals

	Recipient and KPO and the Recipient and the Central Collateral Registration Office in such a form as to be legally binding in accordance with their terms; and (g) for expenditures under Category 6 until the Recipient and Aiyl Bank have entered into a Subsidiary Agreement, acceptable to the Association, and that Subsidiary Agreement has been executed by the Recipient and Aiyl Bank in such a form as to be legally binding in accordance with its terms.	
Schedule IV, B.2 (a)	Withdrawals shall be made in eight (8) tranches, each of SDR 260,000, either separately or concurrently, and in amounts not exceeding the total of the ceilings per each respective DLI provided in the table below, subject to submission to the Association of evidence satisfactory to the Association that the following DLIs have been achieved: 1. Adoption of an updated privatization plan for Aiyl Bank. 2. Announcement of tender to hire privatization transaction advisor. 3. Signature of contract with privatization transaction advisor. 4. Assembly of a data room of relevant information and documentation on Aiyl Bank enabling potential buyers to assess all critical aspects of the bank's operations. 5. Announcement of tender for Aiyl Bank. 6. Announcement of tender results for Aiyl Bank. 7. Increase in mobilized individuals' deposits by 50 percent from the level at December 31, 2011. 8. Increase in mobilized individuals' deposits by 100 percent from the level at December 31, 2011.	Before withdrawals

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Team Composition

Bank Staff

Name	Title	Specialization	Unit
Brett E. Coleman	Sr Financial Sector Spec.	Team Lead	ECSF2
Adam Shayne	Lead Counsel	Legal	LEGEM
Irina Goncharova	Procurement Specialist	Procurement	ECSO2
Isabelle Huynh	Sr Operations Officer	ICT/Post Office	TWICT

Galina Alagardova	Financial Management Specialist	Financial Management	ECSO3
Bujana Perolli	Financial Analyst	Financial Sector	ECSF2
Raha Shahidsaless	Private Sector Development Spec.	Private Sector Development	CICBR
Uzma Khalil	Financial Sector Specialist	Financial Sector	ECSF2
Damodaran Krishnamurti	Sr Financial Sector Spec.	Financial Sector	FFSAB
Joseph Formoso	Sr Finance Officer	Disbursement	CTRLA

Non Bank Staff

Name	Title	Office Phone	City
Amy Evans	Environment Safeguard Specialist		Washington
Hans Boon	Consultant		
Andrew Mason	Consultant		
Monnie Biety	Consultant		
Nurlanbek Tynaev	Consultant		

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Locations

Country	First Administrative Division	Location	Planned	Actual	Comments

Kyrgyz Republic

Financial Sector Development Project

TABLE OF CONTENTS

Annexes

The Kyrgyz Republic

Financial Sector Development Project

I. STRATEGIC CONTEXT

A. Country Context

1. **The Kyrgyz Republic's economic performance deteriorated significantly during the 2008-09 global crisis, but a recession was avoided due to a large fiscal stimulus.** As external demand, remittances, and capital inflows dropped, the authorities responded by relaxing fiscal and monetary policies. Economic growth dropped from 7.6 percent to 2.9 percent in 2009, but a recession was averted.

2. **The Kyrgyz Republic, however, suffered a deep political crisis in 2010, which caused an economic downturn.** In the three year period to April 2010, the president concentrated power in his administrative apparatus, weakened the national assembly, and circumvented ministries. In April 2010, anti-government demonstrations led to the overthrow of the government and the formation of an interim administration. In June 2010, violent clashes took place over three days, particularly in the cities of Jalalabad and Osh. It was officially reported that over 300 persons were killed, over 2500 were injured, and nearly 400,000 were temporarily displaced. The disturbances also damaged infrastructure and destroyed private and public property. Economic activity was disrupted, investment fell, trade was adversely affected, and the financial sector was severely stressed. The economy contracted by 1.4 percent and inflation rose to about 20 percent in 2010.

3. **In the wake of the 2010 events, the authorities have moved to re-establish political and economic stability.** The provisional government drafted a new constitution, which was approved in a referendum in June 2010. Under the new constitution, a parliamentary system was created, elections were held in October 2010, and a new coalition government took office in December 2010. Presidential elections were held on October 30, 2011, and won by the Kyrgyz Prime Minister Almazbek Atambayev.

4. **The international community has helped the Kyrgyz authorities mitigate the effects of the crisis.** Following the conflict in 2010, the multilateral development partners prepared a Joint Economic Assessment that provided the basis for a donor conference in July 2010 that pledged US$1.1 billion in financial support. As a result, the budgets for 2010 and 2011 were adequately financed by donors. In June 2011, the IMF board approved a three-year program under the Extended Credit Facility in the amount of US$106 million.

5. **Following the economic downturn in 2010, the Kyrgyz economy is showing signs of recovery.** With increased political stability and a favorable external environment, the economy grew 8.7 percent year-on-year in the first nine months of 2011, and is expected to

grow 7 percent year-on-year by end-2011. Inflation has eased due to a decline in international food prices, resumption of domestic agricultural production, and monetary tightening – from above 20 percent in July 2011 to 9.5 percent in October 2011, and is projected at about 7.5 percent at end-2011. External trade has grown, tourism has recovered, and the current account has improved. Increased political stability has contributed to the economic recovery.

B. Sectoral and Institutional Context

6. **The Kyrgyz financial sector is dominated by the banking sector and complemented by a growing and vibrant microfinance sector.** As of September 2011, the financial system includes 22 banks, 432 microfinance organizations (MFOs), and 198 credit unions; the Kyrgyz Post Office (KPO) also offers a limited range of financial services. Banks account for 80 percent of total assets, and non-bank financial institutions (NBFIs) account for about 14 percent of the financial sector's assets.[1] Of the 22 banks, three are state-owned,[2] including Aiyl Bank, which focuses on lending to agriculture and is limited in its ability to take deposits.

Financial Sector Stability

7. **Despite serious vulnerabilities, the Kyrgyz financial sector remained stable throughout the 2008-2009 global financial crisis.** The banking sector had built up vulnerabilities prior to the 2008-2009 crisis, especially in terms of: (i) high credit risk resulting from rapid credit growth and a high share of foreign currency loans to unhedged borrowers, (ii) heavy reliance on wholesale funding (especially from Kazakhstani banks), and (iii) a concentrated banking sector. However, the banking sector withstood the effects of the financial crisis relatively well, with capital adequacy and liquidity remaining adequate throughout 2009. The National Bank of the Kyrgyz Republic (NBKR), which supervises banks, MFOs, and credit unions,[3] coordinated with the government to mount an effective crisis management response (e.g., launching a deposit insurance system, setting up a facility for emergency liquidity support for banks, and requiring banks to prepare anti-crisis contingency plans), while the relative isolation of the Kyrgyz Republic from the global crisis contagion channels also minimized the impact.

8. **However, the political upheavals of 2010 led to significant financial sector instability.** The political crisis caused a large and immediate deposit outflow. Total deposits fell by 30 percent between March and April 2010, mostly due to large withdrawals from nonresident accounts. The deposit decline was mainly concentrated in Asia Universal Bank (AUB), the largest bank with 53 percent of deposits and 33 percent of assets at end-2009.[4] In addition, non-performing loans (NPLs) increased rapidly after March 2010, reaching 17 percent of total loans at end-October 2010 (from 8 percent in 2009). Capitalization also declined, with the capital adequacy ratio reaching 22 percent in October 2010 (compared to 34

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[1] NBFIs include MFOs and credit unions. Insurance companies, pension funds, and investment funds account for 6 percent of total financial sector assets.
[2] The other state-owned banks are RSK bank and Zalkar Bank.
[3] Other segments of the financial sector, i.e., insurance, pensions, and the securities market, are supervised by the State Service for Regulation and Supervision of the Financial Market of the Kyrgyz Republic.
[4] AUB's portfolio was affected by connected and insider lending.

percent at end-2009). Although some banks remained profitable and weathered the crisis well, overall banks incurred substantial losses in the first ten months of 2010 (in the amount of KGS 4.5 billion), with a negative return on equity (ROE) of 50 percent and a negative return on assets (ROA) of 9 percent. The liquidity ratio (liquid assets as a percentage of liabilities maturing within 30 days) also declined to 65 percent in October 2010 (from 87 percent at end-2009).[5]

9. **The NBKR took immediate measures to restore financial stability, although the interventions stretched its capacity severely.** Following the large deposit outflow, the NBKR took seven banks (accounting for 45 percent of the system's assets) under temporary administration, including AUB.[6] Following a complicated legal process, AUB was nationalized and declared bankrupt at the end of 2010. It was split into a "good bank", named Zalkar Bank, and a "bad bank", AUB, in February 2011.[7] In the absence of a sound bank resolution legal framework, the intervention of AUB engulfed the authorities in a complicated legal process, which was aggravated by AUB's involvement in questionable transactions related to the previous political regime. The authorities are in the process of privatizing Zalkar bank, and AUB will be liquidated. Four other banks remain under conservatorship; the NBKR cannot take action to resolve these banks because of pending court cases from their shareholders.

10. **Due to the NBKR's interventions, as well as improved stability in the political and economic climate, banking sector indicators have begun to improve.** At end-October 2011, NPLs levels declined to 11.2 percent and capitalization increased to 29.6 percent. Banks' profitability improved with the ROE at 17.4 percent and the ROA at 2.9 percent, and banks reported KGS 1.6 billion in profits. The liquidity ratio also improved to 72.7 percent at end-October 2011.

11. **Despite these improvements, the challenges faced by the NBKR in resolving problem banks highlighted deficiencies in the bank resolution legal framework.** The bank resolution framework is fragmented, and there are gaps, overlaps and inconsistencies across several laws, such as the Law on Conservation, Liquidation and Bankruptcy of Banks, the Law on Banks and Banking Activities, the Law on the National Bank of the Kyrgyz Republic, and the Law on Bankruptcy (Insolvency). These problems make the laws difficult to interpret or apply, leading to court decisions that have undermined the NBKR's ability to take prompt actions to deal with the banks placed under official administration.

12. **The banking crisis also highlighted weaknesses in the supervisory framework for the banking sector.** There are weaknesses in onsite and offsite supervision, stress testing, and contingency planning and crisis management. Although the NBKR has been working towards

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[5] The financial soundness indicators showed improvement starting in December 2010, when the data included only the good bank (Zalkar Bank) and excluded AUB.

[6] The NBKR also imposed direct supervision in ten banks, and issued instructions to senior officials of three additional banks.

[7] Most of the loan book, liquid and fixed assets, deposits, and losses from AUB's swap agreements with microfinance institutions were transferred to Zalkar Bank. Assets and liabilities of related parties, nonresident liabilities, and deposits from the State Property Bureau (pending criminal cases related to these deposits) remained in AUB.

strengthening the prompt remedial actions framework, it does not have in place an effective framework that it can use to ensure that effective remedies are initiated at the earliest stage of bank problems. In addition, the supervisory staff do not have adequate legal protection from prosecution for actions taken in performance of their duties, and thus have been hesitant to take supervisory actions. There are weaknesses in onsite supervision, in the CAMELS[8] methodology and processes, the quality control framework for on-site examinations, and the bank supervision manual. The experience from the recent stress in the banking sector has also confirmed the need to strengthen the off-site reporting framework[9] as there are weaknesses in the reporting formats and the analysis of information. In addition, the single factor stress tests undertaken by the NBKR do not capture vulnerabilities adequately – stress tests on more parameters would enhance NBKR's capacity to monitor vulnerabilities. The NBKR also lacks a formal framework for crisis preparedness and crisis management, and a special supervisory framework designed for 'systemic' or 'large' banks.

13. **The supervisory framework is also affected by an outdated information and communications technology (ICT) framework.** NBKR's bank supervision department is at present using limited ICT to support its operations. The ICT framework needs to improve so that it can support off-site and on-site supervision, including building a better off-site data base, early warning system, stress tests, dynamic modeling, and macro-prudential supervision.

14. **There are also deficiencies in the regulatory framework for the banking sector.** For example, the regulation on credit risk management does not explicitly require banks to adopt uniform asset classification within the bank or across banks, which can lead to an understatement of NPLs. The liquidity risk management guidelines do not require separate management of risks for domestic currency and foreign currency.[10] The NBKR lacks prudential guidelines for banks to address the indirect risks inherent in foreign currency loans to unhedged clients, such as fixing prudential limits on such exposures or periodical internal monitoring of unhedged foreign currency exposures. In addition, there are no regulations on electronic banking, business continuity planning, outsourcing, new products and related risks, Basel II, Basel III, consolidated supervision, and risk-based supervision.

15. **The crisis also highlighted weaknesses in the NBKR's human resource management.** The NBKR's supervision department suffers from a high level of attrition and corresponding low average level of experience of its current staff. Despite their admirable performance during the 2010 banking crisis, capacity was stretched beyond the department's limits, suggesting that improvements are needed in NBKR's HR policies including, among others, aspects relating to recruitment, staff mobility, training and higher education, compensation, career progress, and staff retention.

[8] Capital, Assets, Management, Liquidity, Earnings, Sensitivity.

[9] Amongst others, the off-site framework should include details of: (i) unhedged foreign currency exposures of bank customers; (ii) asset-liability mismatches in greater detail; and (iii) duration of interest rate sensitive assets and liabilities to support more intensive stress testing.

[10] The guidelines must also require adoption of board approved policies, prescribe norms for assigning various items of assets and liabilities to the relevant maturity bands, and fixing of appropriate management limits for maturity mismatches.

Access to Financial Services

16. **Financial intermediation in the Kyrgyz Republic is limited, and became more limited due to the global economic crisis and the 2010 political events.** The Kyrgyz Republic ranks low in credit and deposit penetration compared to other countries in the region. Credit to the private sector as a share of GDP amounted to 13 percent in 2010 and deposits as a share of GDP amounted to 16 percent in 2010. Access to finance became more limited in 2009-10 due to the global economic crisis and the 2010 political events. The global crisis undermined market confidence and caused banks to become risk averse and reduce lending. The sharp increase in NPLs following the 2010 events also impacted bank lending. In 2010, credit grew by 4.8 percent despite a decline in mid-year following the political crisis, and grew by 16 percent in the first ten months of 2011.[11]

17. **The supply of financial products to micro, small, and medium enterprises (MSMEs) is particularly limited due to legal constraints, as well as weak capacity in the banking sector.** There is no factoring (i.e. the purchase of commercial accounts receivable to provide short term finance to small suppliers) due partially to the legal framework's prohibition on transferring ownership of a debt by way of assignment. Legal and institutional weaknesses in the registration and execution of moveable collateral limit its use to secure loans. There is also little leasing for equipment financing, as it is taxed disadvantageously compared to borrowing a loan. Without access to long-term finance, companies face significant problems in financing investments for expansion or acquiring modern technologies. This is a significant obstacle to private sector growth, expansion of exports, competing in international markets, and employment generation.

18. **While MFOs and credit unions are filling some of the gaps in access to finance for smaller borrowers, the poor, and the agricultural and rural areas, most remain small and face high operational and funding costs, capacity constraints, and legal, regulatory, and institutional constraints that inhibit their expansion.** MFOs and credit unions provided 22 percent of all credit provided by the financial sector as of end-2010**.** MFOs have high funding costs because they are largely dependent on international credit lines and on local banks for conducting swaps to convert foreign currency funding to local currency funding. Credit unions lack the governance and operational skills to become more efficient and lower costs. They are largely dependent on the Finance Company for the Support and Development of Credit Unions (FCSDCU) for financing.

19. **Deposit services are virtually non-existent in rural areas.** Deposit services provide a significant benefit to households, reducing transaction costs, improving money management, and contributing to wealth creation. Most rural inhabitants do not have access to deposit services. There is only one branch per 150,000 rural inhabitants. Banks are the primary deposit-taking institutions, but most do not have rural branches, and Aiyl Bank, the one bank focused on rural clients and with a rural branch network, has a license that limits its deposits to a maximum of 50 percent of its capital, which limits its deposit services. Of the 198 credit

[11] Bank credit increased on average by 55 percent per year in 2004-2007, although it slowed down to a 23 percent in 2008, and declined by 1.8 percent in 2009 due to the economic crisis, which led to increased risk aversion in banks and reduced demand by clients.

unions, only 11 are licensed to take deposits;[12] and only one MFO is licensed to take deposits, having received its license only in 2011.

20. **While the causes of the constraints on access to finance are numerous,[13] reforms and investments in certain key areas will likely have the most significant impact.** Several factors contribute to limited access to financial services in the Kyrgyz Republic such as limited competition in the banking sector, lack of adequate financial information on firms due to weak accounting standards and practices, weaknesses in the credit bureau, weak risk management and credit assessment skills in financial institutions, low public confidence in banks, legal and regulatory obstacles, and others.[14] However, reforms in the following key areas will likely have the most impact: (i) reforming and investing in KPO to expand its financial services through its large network of branch offices; (ii) privatizing Aiyl Bank and expanding its deposit services; and (iii) modernizing the moveable collateral and debt resolution regimes. A detailed overview of each of these institutions and the key challenges they face is presented in Annex 6.

(i) Reforming the KPO. KPO is a state-owned entity under the Ministry of Transport and Communications (MTC) with the potential to play a significant role in expanding access to basic financial services with a country wide network of 923 post offices, 684 of them located in rural areas. KPO's current range of financial services is mostly limited to domestic cash-based payments and paper-based processing of payments. These services include: (i) cash distribution of state pension and social welfare payments; (ii) cash collection for public utilities, telecommunications companies, taxes, police fines, and school fees; and (iii) domestic and international postal money orders. Recently, KPO has introduced financial services based on agency agreements with banks, Money Transfer Operations (MTOs), MFOs, and insurers. These services include disbursing migrant remittances, collecting loan installments and accepting deposits, and accepting payments of insurance premiums.[15] However, KPO lacks most of the required financial management capabilities, business processes, and instruments to expand the delivery of basic financial services. Its financial management capability does not stretch beyond traditional bookkeeping that records paper-based inputs and follows government tax accounting standards. It also lacks an adequate ICT infrastructure to allow it to expand basic financial services.

(ii) Expanding deposits in Aiyl Bank, and ensuring that it is ready for privatization. Aiyl Bank is a state-owned bank with a rural branch network. In May 2008, the Kyrgyz Parliament approved the sale of 67 percent of Aiyl Bank's equity,[16] but the 2008 crisis

[12] The largest of these, accounting for 75 percent of credit union deposits, is in the process of converting to an MFO and giving up its deposit-taking license.
[13] Access to Financial Services Policy Note, World Bank, June 2010.
[14] Some of these constraints are being addressed by other donor interventions, e.g., the IFC (credit bureau and risk management) and corporate financial reporting (World Bank and FIRST TA). The World Bank, EBRD, IFC, and ADB are providing credit lines for agricultural and SME finance. Development of the mortgage market has been supported, with significant results, by the World Bank. Moreover, the FCSDCU is being privatized, and international strategic investors are considering investments and support to it.
[15] KPO does not extend credit on its own account and does not plan to do so in the near or medium term.
[16] Subsequent to this approval, an Action Plan to privatize the bank was prepared under the Payment and Banking System Modernization (PBSM) Project, financed by the World Bank.

halted the momentum to privatize the bank. In addition, the political crisis of 2010, which prompted a banking crisis, focused the authorities' attention in other areas. However, with renewed stability, the government has reconfirmed its commitment to privatize Aiyl Bank if market conditions are conducive. Privatizing Aiyl Bank with a strong strategic investor(s) with international experience in rural and agricultural finance will help ensure that Aiyl Bank continues to grow as a market-oriented provider of rural financial services, strengthens its governance, improves its operations, strengthens the capacity of its staff and management, reduces costs, promotes competition in the financial sector, attracts additional financial resources to the country, and develops new products and services to meet the demands of its clients. Aiyl Bank has so far been fully dependent on donor funding for financing. It has projected liquidity needs at US$8 million in 2012 and 2013, based on planned annual increases of about 20 percent in its lending portfolio. The recent decision to allow it to collect deposits should improve its ability to obtain more funding and satisfy more demands for loans. Although Aiyl Bank has a strong track record in lending, having built up considerable capacity in this area since it was established in 1996, it has limited capacity to mobilize deposits to finance its lending and will require technical assistance to build this capacity. In the meantime, it also needs liquidity to finance its loan portfolio.

(iii) Modernizing the moveable collateral and debt resolution regimes. Movable collateral registration in the Kyrgyz Republic is paper-based and mandatory for loans as small as KGS 25,000, which is prohibitively costly since there are pledge offices only in seven oblasts in the country. For borrowers located in remote areas, the costs of making trips to one of these seven offices make using collateral expensive, which in turn restricts their access to bank and non-bank lending. Thus, the collateral registration system needs to be upgraded to allow for online registration, as well as online searches, which would significantly lower costs and increase access to the collateral registry. There are also shortcomings in the legal and regulatory framework for a well-functioning collateral registration and execution regime. The use of alternative dispute resolution systems for debt resolution is also limited. Out-of-court enforcement is allowed in principle, but is almost never possible because any argument brought to court by the debtor stops the creditor's enforcement, even if the parties have agreed to out-of-court enforcement in their security agreement. Also, by the time the creditor can enforce, assets often disappear or have significantly lost value. Moreover, there is not enough capacity to serve regions outside of Bishkek - most arbitrators are in Bishkek, making arbitration inaccessible in most other parts of the country. In addition, there is often a significant loss of value when the debtor becomes insolvent due to weaknesses in the insolvency system.[17]

21. **The World Bank is well suited to deploy the required expertise and guidance for this project.** The Bank has had extensive experience with previous and current lending projects, technical assistance, and analytical work to support financial sector reforms in the Kyrgyz Republic. These include: (i) the payment and banking system modernization lending project (ongoing); (ii) the 2002 FSAP, the 2006 FSAP Update, and the FSAP Follow Up TA

[17]Insolvency procedures often lead to liquidation and take a long time. Methods such as the use of arbitration in insolvency proceedings that would expedite procedures are not available.

projects (in 2003, 2007, and 2009); (iii) a feasibility study of the potential of the Kyrgyz Post Office in expanding access to financial services (May 2008); (iv) a vulnerability assessment of the banking sector (June 2010); (v) an Access to Financial Services policy note (June 2010); and (vi) an Insolvency and Creditor Rights Report on the Observance of Standards and Codes (2009).

22. **The Bank has extensive experience with similar projects throughout the region.** The Bank has been involved in many projects in the Europe and Central Asia (ECA) region aimed to: (i) improve the legal framework, supervision and regulation in the financial sector, and (ii) increase access to finance including working on the privatization of state-owned banks, reform of post offices, and reform of secured lending and debt resolution regimes. For example, the Azerbaijan Financial Services Development Project supported the transformation of the Azeri Post to increase access to financial services, the Kosovo Business Environment TA project supports the modernization of the collateral registry, and numerous interventions have supported reforms to the legal, regulatory, and supervisory framework in the financial sector.

C. Higher Level Objectives to which the Project Contributes

23. **The proposed Project contributes to the higher level objectives of enhancing financial sector stability and increasing access to finance.** These higher level objectives are supported by the Interim Strategy Note (ISN)[18]. The ISN is built on three key pillars: (i) improving governance, effective public administration, and reducing corruption; (ii) economic stabilization to support recovery, reconstruction and sustained growth; and (iii) social stabilization, through social services, community infrastructure, and employment, with emphasis on the south. The proposed project supports all three objectives. It supports improving governance through reforms in the legal, regulatory, and supervisory framework for the financial sector, which aims to strengthen the independence, responsiveness, and capacity of the banking supervision function and modernize its supporting ICT system. Reforms in KPO will improve governance and reduce scope for corruption, e.g., through improved cash handling and movements to electronic payments in areas like pension distribution and utility payments. The project supports economic stabilization through reforms that aim to ensure financial sector stability and access to finance, so that a healthier financial sector can effectively intermediate funds to the economy, and thus support private sector development, increased investment, and economic growth. The project also supports social stability by promoting a more stable financial system, which will better protect depositors' savings. Increasing access to a variety of financial services, especially deposit services, for the poor, vulnerable, and other underserved populations, will help them manage shocks (e.g., food prices, illness, unemployment), especially in rural areas and remote regions of the country, and will enhance employment opportunities.

24. **The proposed project will support the country's priorities.** The coalition government that came into power in December 2010 developed a one-year Plan of Actions for 2011, retaining security and governance reforms at the core of its agenda, with financial and private sector development a key area of reform. The draft Country Medium Term

[18] The ISN covers the period of August 2011 to June 2013 and succeeds the previous CAS of 2007- 2010.

Development Strategy for 2012-2014 also includes financial sector reforms as a key area, including reforms in bank resolution and prompt remedial action frameworks, deposit insurance system, and bank supervision. The proposed project supports the government's Banking Sector Development Strategy of 2009 – 2011, and will support the Banking Sector Development Strategy for 2012-2015.

II. PROJECT DEVELOPMENT OBJECTIVES (PDO) AND RESULTS INDICATORS

A. PDO

25. **The Project Development Objectives are to:** (i) enhance financial sector stability, and (ii) increase access to financial services.

B. Project Beneficiaries

26. **The direct project beneficiaries are the NBKR, KPO, Aiyl Bank, and the moveable collateral registry.** Ultimately, clients of banks, MFOs, and credit unions will benefit from the project as it is expected to increase the safety of the institutions and their outreach. With its focus on expanding access to financial services in rural areas, the project will be beneficial to a large segment of the underserved population. Given the explicit targeting of women as good clients by many MFOs and credit unions, it is expected that women will particularly benefit from this project.

C. PDO Level Results Indicators

27. **The PDO Level Results Indicators are:**

- Legal, regulatory, and supervisory framework for banks, MFOs, and credit unions following international good practice to enhance stability is developed, adopted, and implemented.
- Increased number of financial transactions through KPO.
- Increased deposits/GDP.
- Increase in individual deposits in Aiyl Bank.
- Increased number of moveable collateral registrations.

III. PROJECT DESCRIPTION

A. Project Components

28. **The project consists of the following four components in the areas of (a) supporting financial sector stability and (b) expanding access to financial services.[19]**

[19] Component 5 of the Project is on project coordination and monitoring.

Financial Sector Stability

29. **Component 1: Strengthening the legal, regulatory, and supervisory framework for banks, MFOs, and credit unions (US$2.5 million, out of which US$1 million from SECO is expected[20]).** Component 1 will support measures to improve the legal, regulatory, and supervisory framework for the banking sector and increase the NBKR's capacity to monitor and address vulnerabilities. While the focus will be on the banking sector, to enhance the sector's stability, Component 1 will also support similar measures for MFOs and credit unions as needed. The project will be flexible in addressing the areas below or related areas as they are identified during the course of the project. Indicative areas that the component will support are:

(i) ***Strengthening the legal framework.*** The project will assist in the review and revision, among others, of laws relevant to the regulation and supervision of banks, MFOs, and credit unions, as well as cooperation and coordination with international financial sector regulators and supervisors. This work will be conducted in close coordination with the IMF, which has also been providing assistance to review and revise the legal framework for the banking sector and will provide assistance on anti-money laundering and combating the financing of terrorism.[21]

(ii) ***Improving the regulatory framework.*** The project will strengthen regulations on risk management; develop new regulations on key areas such as electronic banking, business continuity planning, outsourcing, new products and related risks, Basel II, Basel III, consolidated supervision, and risk-focused supervision; and introduce or revise internal guidelines on all relevant areas. Roundtables and seminars for key stakeholders (e.g., banks) will be conducted on these topics, as well as training for the NBKR staff.

(iii) ***Strengthening the supervisory framework.*** The project will help improve the supervisory methods, processes and capacity in specific areas of off-site and on-site supervision, including risk-based supervision, consolidated supervision, stress testing, and contingency planning and crisis management, and promote application of advanced ICT to support supervisory effectiveness.

(iv) ***Improving HR policies.*** The project will assist the NBKR to review and revise its HR policies to improve supervisory staff efficiency, including aspects relating to recruitment, staff mobility, training and higher education, compensation, career progression and staff retention.

(v) ***Improving the ICT infrastructure.*** The project will support strengthening the ICT infrastructure for off-site and on-site supervision, which is crucial for improving the effectiveness of the supervision of the banking sector, MFOs, and credit unions. The

[20] SECO will make its final determination after reviewing this PAD.

[21] NBKR, with TA from the IMF, has been preparing a Banking Code to consolidate and revise the major banking laws. Following this work, which is due to be completed by April 30, 2012, with submission of the new Banking Code to parliament, secondary legislation and regulations will be required, and during the course of the project, further amendments to the Banking Code may be considered as issues are identified.

ICT system currently in use in the NBKR's supervision departments was installed some ten years ago and serves only the off-site supervision unit. Although the system is supported technically by the NBKR's ICT Department, there is no support for business use of the system and thus, in recent years its functionality has lagged behind the evolving activities of its users, particularly in providing enhanced analysis and reporting capability. Likewise the system does not support the collection of all data elements that are needed to carry out effective supervision. The project will support the development of a modern, customized, and integrated package which will replace the existing system, and will also provide support to all areas of the banking supervision department, including off-site supervision, on-site supervision, and licensing. The project will include procurement of new hardware servers dedicated to running the system, as well as related services and training of NBKR supervision staff. These procurements will be compatible with the implementation of the NBKR's information systems development strategy, under which a comprehensive data warehouse will be developed to collect and hold all external data from all sources including commercial banks and NBFIs. This will improve the consistency of data across the NBKR. The NBKR staff's capacity to use technology will also be strengthened. This activity will be closely coordinated with TA in other ICT aspects from the Swiss National Bank.[22]

Access to Financial Services

30. **Component 2: Expanding financial services via KPO's network (US$5.55 million).** This component will transform KPO's existing operation[23] into a cost-effective distribution channel for basic financial services to increase access by poor and rural communities. Corporate governance, managerial capability, and market orientation are currently at a very limited stage of development. The project will support a first phase of operational and financial enhancements (see Annex 6, Addendum). The project is funding the building blocks for this transformation, focusing predominantly on postal financial services, but including all of KPO's activities to some extent.[24] The project supports three main subcomponents that require close coordination: (i) strengthening of financial management; (ii) business process modernization; and (iii) expansion of financial services. All three subcomponents will include considerable training of KPO staff to ensure the necessary capacity building. More specifically:

[22] Since 2006, SNB has provided TA to NBKR in financial market operations. NBKR is planning a single electronic trading system for various financial transactions as well as an integrated system for securities safekeeping to build and link these components with the payment system. SNB advised the NBKR about possible specifications for these systems, procurement, and selection of system suppliers. The support takes place within the framework of cooperation between the two countries in the Swiss voting group in the Bretton Woods institutions and is coordinated with the SDC Cooperation Office in Bishkek. In August 2011, NBKR chose a system provider, and the relevant contract negotiations are almost completed. NBKR has asked SNB for further assistance, particularly with regard to implementation of the system, including detailed planning of specifications of the new trading system and the introduction of the new system and training the employees concerned.

[23] Annex 6 provides a brief profile of the current operation of KPO.

[24] Financial services represent about 70 percent of total revenues in 2011. The project does not aim at improving mail services per se, but general enhancement of support functions such as financial management and accounting, human resources management, and marketing will benefit both lines of business.

(i) ***Strengthening of Financial Management.*** This subcomponent will strengthen the financial management capacity of KPO as part of its on-going corporate reform, resulting in improved corporate governance and improved compliance with financial sector regulations. The subcomponent has three modules: (a) strengthening core financial management systems; (b) supporting the preparation of IFRS financial statements and external audits; and (c) amending the legal and regulatory framework for KPO to provide financial services and be in compliance with financial sector regulations.

(ii) ***Business Process Modernization.*** This subcomponent will support the reengineering of a paper-based business process for bulk flows of small value financial transactions. It will introduce and implement a state-of-the-art ICT architecture for the distribution of financial services, resulting in significant improvement in quality, timeliness, reliability, cost-efficiency, and profitability of the delivery of financial services. It will link up to 360 of KPO's 923 post offices to a central hub to expand services across the post office network. This subcomponent includes the following modules: (a) design of the ICT architecture and detailed ICT technical specifications; (b) installation of ICT components; and (c) other activities such as the preparation of a manual with corporate standards and guidelines for the design of the retail space of the post offices, a help desk for post offices, and implementation of a pilot in secure and efficient cash logistics with small secure compact cars.

(iii) ***Expansion of financial services.*** This subcomponent will support a progressive expansion of the range and scope of financial services delivered via KPO. Recently, KPO has introduced financial services based on agency agreements with banks, MTOs, and MFOs. However, further expansion of agency agreements will be pursued. The subcomponent will support: (a) capacity building for financial services management, including the set up of a business unit responsible for marketing management and business development; and (b) piloting of new, improved or expanded financial services supported with market research, advertising, and impact assessment. Potential pilot financial services include: deposit account products, migrant remittances, domestic payment services for bill collection and payroll services, microcredit related transactions such as loan disbursement and collection of periodic installments under agency agreements with MFOs, collection of insurance premiums, and others.

31. **Component 3: Supporting Aiyl Bank for privatization and deposit mobilization (US$4.15 million).** This component will support Aiyl Bank by providing: (i) technical assistance to mobilize deposits; (ii) technical assistance to finalize an action plan for privatization; (iii) technical assistance to implement the action plan for privatization; and (iv) a credit line to respond to liquidity needs while deposits are building and privatization is being prepared and carried out. More specifically, the project will support Aiyl Bank as follows:

(i) **Deposit mobilization.** The project will provide technical assistance on various aspects of deposit mobilization, including marketing, product development, liquidity management, risk management, and review of ICT systems.

(ii) **Finalization of an action plan for privatization.** An action plan for the privatization of Aiyl Bank was prepared under a FIRST TA grant in 2009. This action plan will be updated and include a new timeline for Aiyl Bank's privatization. The action plan will include the pre-privatization phase, tender preparation, pre-launch investor outreach, and tender implementation.

(iii) **Implementation of the action plan for privatization.** The project will support hiring a privatization transaction advisor to assist the Kyrgyz authorities to carry out Aiyl Bank's privatization.

(iv) **Credit line for liquidity needs.** The credit line (in the amount of US$3.2 million) will be used to finance projects that fall within the agricultural portion of Aiyl Bank's lending policy, subject to the negative list cited in the environmental management framework.[25] Aiyl Bank's clients will receive sub-loans/leases in accordance with agreed eligibility criteria. To be eligible, a borrower must be at least 75 percent privately owned. The average working capital loan size is expected to be around US$5,000, while the average investment loan is expected to be in the range of US$25,000 equivalent, with a maximum of US$50,000 per loan under this credit line. The financial and commercial viability of the sub-projects and beneficiaries under this facility will be assessed by Aiyl Bank, including the cash flow coverage ratio of potential borrowers to ensure their capacity to repay. It is estimated that around 500 farmers will have access to sub-loans under this program. Aiyl Bank will lend at market interest rates, which are around 22 percent as of September 2011. While the credit line will finance Aiyl Bank's liquidity needs for agricultural lending, it will also be designed to support momentum to privatize the bank and to build capacity to mobilize deposits. Hence, the credit line will be disbursed in eight equal tranches based on Aiyl Bank's withdrawal applications, as well as meeting the following disbursement-linked indicators (DLIs) for privatization and deposit mobilization. For each DLI that is achieved, Aiyl Bank will be eligible to receive one tranche of US$400,000.

1) Adopt an updated privatization action plan;
2) Announce tender to hire privatization transaction advisory;
3) Sign contract with privatization transaction advisory;
4) Assemble data room;
5) Announce tender;
6) Announce tender results;
7) Increase mobilized individuals' deposits by 50 percent from the level at December 31, 2011;
8) Increase mobilized individuals' deposits by 100 percent from the level at December 31, 2011.

[25] This credit line has been coordinated with the IFC, which is not currently providing any credit lines to Aiyl Bank and has no plans to do so in the near future. The IFC is providing support to other financial institutions in the Kyrgyz Republic, including Bai Tushum (an MFO), Demir Bank, Kyrgyz Investment and Credit Bank (KICB), FINCA (an MFO), and Unicredit Bank.

32. **Component 4: Modernizing the moveable collateral and debt resolution regimes (US$1 million).** This component will strengthen the regime for moveable collateral registration and execution through: (i) improvements in the legal and regulatory framework for secured lending and debt resolution; (ii) modernization of the collateral registry; and (iii) capacity building of stakeholders.

(i) ***Improvements in the legal and regulatory framework for secured lending.*** The project will support improvements to the legal and regulatory framework for secured lending and debt resolution. It will support improvements in the legal framework in the areas of creating a security interest, registering a security interest, priorities, obligations towards collateral, enforcement, and debt resolution, including through insolvency of the debtor, and the use of alternative dispute resolution mechanisms, such as arbitration both inside and outside insolvency. The project will also support the development of necessary regulations for the proper functioning of the collateral registry.

(ii) ***Modernization of the collateral registry.*** The project will support the modernization of the registry by developing an online system of registration for collateral that is sustainable, easy to access, reliable, and secure. It will include preparing the registry's specifications and conducting a competitive bidding process for installation of a new registry. This involves the procurement of hardware and software and related services for the proper functioning of the registry, as well as staffing, housing, and equipping the registry. The collateral registry may also be linked to other asset-based registries,[26] as electronically linking the registries can make it possible for users to submit their registrations into one data center, and to conduct their searches through one point of entry.

(iii) ***Capacity building***. The project will increase awareness and provide training to public stakeholders on compliance with the new laws and regulations, on the use of the online system, and on asset-based lending techniques. Training will be provided to the staff of the registry, judges, arbitrators, and bailiffs on compliance with new laws and regulations, and to private stakeholders on the use of the new online registration system, asset-based lending techniques, and debt resolution mechanisms. This activity will be complemented by and coordinated with IFC training to private sector participants (e.g., banks and MFOs).

33. **Component 5: Project coordination and monitoring (US$0.8 million).** This component will finance the project management function, as well as periodic monitoring and evaluation. Given the number of implementing agencies (NBKR, KPO, Aiyl Bank, and collateral registry), a Project Coordination Unit (PCU) will be established in KPO. KPO is selected for this function as its component will be the largest and encompass the largest procurement packages. The NBKR has a well functioning project implementation unit (PIU) from the Payment and Banking System Modernization (PBSM) project, and this PIU will be responsible for implementing the NBKR component. Similarly, an existing credit line

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[26] There are several asset-based registries that are not linked to each other, such as for vehicles, vessels and ships, and agricultural machinery.

management unit (CLMU) in the Ministry of Finance (MoF) will be responsible for implementing the credit line for Aiyl Bank. The PCU will provide support to the collateral registry and will coordinate with the PIUs in NBKR and MoF, as well as Aiyl Bank management, for project implementation and management, preparation of bidding documents, implementation of selection procedures, preparation of contracts in line with World Bank rules, payments processing, disbursement monitoring, preparation of financial reports, and other project management functions.

B. Project Financing

Lending Instrument

34. **The project will be financed by a Specific Investment Loan (SIL) in the amount of US$13 million equivalent.** The SIL will be financed by a combination of IDA credit and IDA grant on standard IDA terms to the Kyrgyz Republic. SECO is considering providing an additional US$1 million for TA to the NBKR.[27] The implementing agencies are the NBKR, Aiyl Bank, KPO, and the collateral registry. By letter no. 16-2-2/11789 of December 09, 2011, MoF has indicated its intention to provide grant funding to NBKR in respect of the IDA-financed portion for Component 1. Retroactive financing of up to US$50,000 will be provided, beginning December 20, 2011, to hire PCU consultants and purchase computers for the PCU to enable project effectiveness.

Project Cost and Financing

Project Components	Project Cost (US$ million)	IDA Financing (US$ million)	SECO (US$ million)	% IDA Financing
Component 1: Strengthening the legal, regulatory, and supervisory framework for banks, MFOs, and credit unions	2.5	1.5	1.0	60
Component 2: Expanding financial services via KPO's network	5.55	5.55		100
Component 3: Supporting Aiyl Bank for deposit mobilization and privatization	4.15	4.15		100
Component 4: Modernizing the moveable collateral and debt resolution regimes	1	1		100
Component 5: Project coordination and monitoring	0.8	0.8		100
Total Financing Required	14	13	1.0	93

[27] Following the World Bank's appraisal mission, and based on the project appraisal document, SECO will make a final determination if it will co-finance the project.

C. Lessons Learned and Reflected in the Project Design

35. **The proposed project design incorporates lessons learned from previous initiatives in the Kyrgyz Republic, and similar operations throughout the region.**

36. **A sound legal, regulatory, and supervisory foundation, along with the necessary tools to implement this framework, is essential to ensure financial sector stability.** The vulnerability assessment of the Kyrgyz banking system undertaken during late 2009 and early 2010 revealed several weaknesses in the sphere of bank regulation and supervision, which aggravated the severity of the banking crisis in mid 2010. The technical assistance provided to the NBKR soon after the crisis to address issues of immediate relevance indicated that a more comprehensive engagement with the NBKR is required to improve the effectiveness of banking supervision. To achieve the best outcome, the project has been designed to address the key elements in a comprehensive manner by taking into account the findings of the vulnerability assessment. The project will focus on the legal and regulatory framework, the supervisory methodology and processes, and the application of technology options to improve supervisory effectiveness. These components will collectively improve banks' operating discipline, improve supervisory effectiveness; and enable the bank supervision function to use ICT to generate early warning signals and respond in a consistent and timely manner.

37. **The project design also incorporates lessons learned regarding the importance of coordinating closely with other donors.** The IMF, Swiss National Bank, and GIZ are also providing technical assistance to the NBKR. The IMF has assigned a banking supervision resident advisor to assist the NBKR with strengthening bank supervision and regulation, and is also providing TA on the legal framework. GIZ is supporting training on some elements of Basel II supervision. The project will engage in close coordination with the IMF and other donors to ensure complementarity of efforts.

38. **The project also incorporates lessons learned from complex projects with significant ICT procurement and TA provision, particularly with counterparts with low capacity.** Experience with such projects in other countries has shown the importance of: (i) conducting an in-depth analysis of the counterpart's institutional capacity to design appropriate TA to support and match the ICT component; (ii) providing substantial support in the areas of procurement and financial management for the PCU located in KPO, and insuring that it has direct access to the counterparts' management in the other implementing agencies of the project; (iii) having a high-level steering committee that can operate outside the normal bureaucratic procedures to respond quickly and flexibly to project issues that arise; and (iv) proposing simple ICT solutions with installation done by the supplier in a turn-key fashion, with knowledge transfer and training to staff. All of these lessons have been incorporated in the project, with particular focus on KPO and its ICT procurement.

39. **The project has incorporated lessons learned in other projects about using postal systems as an instrument for providing access to financial services in underserved areas.** The Financial Sector Development Project for Azerbaijan (2005-2010), which was broadly dedicated to the transformation of AzerPost into a large payment platform, has provided valuable lessons. The lessons learned include:

- ***A thorough initial institutional assessment of the capacity and operating framework of the post office is needed to design an adequate program.*** A detailed feasibility study of KPO was prepared in 2008. An updated assessment was conducted during project preparation, highlighting corporate and financial management weaknesses and the limited capacity of the KPO. The assessment highlighted key areas needed for strengthening KPO's financial management practices, modernizing its business processes, and expanding financial services.

- ***A multi-pillar approach reaps sustainable results in post office reform.*** The project will establish a legal and governance framework for KPO to increase access to finance. In parallel, it will implement fundamental changes in the entire organization and its operations: restructuring the financial services business, fully automating the network, and launching strategic and business planning. For KPO, the project has designed three interrelated components of strengthening the financial management practices, modernizing its business processes, and expanding financial services.

- ***The efforts should be coordinated and resolved at a high level in a Steering Committee consisting of the key stakeholders, operating outside bureaucratic procedures***. A high-level steering committee will be created to coordinate issues related to the KPO project component and the parallel process of corporatization.

- ***Substantial capacity building for KPO staff***. Training and capacity building are included in all three subcomponents. For each subcomponent, a semi-resident consultant will identify training needs, design a tailored training program for the key staff, and ensure training implementation either through direct support (organizing the training themselves), hiring local training firms, or supporting staff to be trained abroad. For financial management capacity building, for example, about 15 qualified accountants will be hired to help prepare the 2010 through 2012 accounts, and bring KPO to a stage where its financial accounts can be externally audited in 2012. This support aims at knowledge transfer and ability for KPO to manage fully its financial management function by 2013.

- ***Support in the government and a champion in the post office are instrumental for success.*** The project enjoys significant support at the highest levels of the government, MTC, NBKR, and KPO.

40. **International experience has shown that the role of state-owned banks should be limited to addressing market failures without reducing the authorities' incentives to correct those market failures.** State-owned banks, particularly those in less developed or transition economies with a development mandate, tend to perform more poorly than private banks on a number of measures. They frequently suffer from weak governance, weak management, unclear or contradictory mandates, and dependence on government and donor credit lines. Weak governance and management often make such banks subject to undue political influence in operational decisions, resulting in loans to connected borrowers rather than to profitable businesses, distorting local financial markets. Aiyl Bank was appropriately created to address a market failure following the collapse of the rural financing system in the

early 1990s. Because of the risks of state ownership, it was agreed with the World Bank when KAFC (the precursor to Aiyl Bank) was created in 1996 that it would be privatized after achieving scale to address the initial market failure. Aiyl Bank has performed better than other state-owned banks, thanks to a relatively strong management and board, officials in the government that support its commercial principles, and periodic interventions by donors. Nonetheless, it has still relied almost exclusively on donor and government credit lines, and it still comes under periodic pressure from government officials to lend at below-market interest rates to particular sectors or regions, jeopardizing its viability.

41. **The project will benefit from international experience in implementing moveable collateral and debt resolution reforms. Some of these lessons include:**

- ***An integrated approach to reform is key to its success.*** Improving the regulatory framework alone without modernizing the collateral registry will not be sufficient to lead to significant impact. Ensuring the existence of a modern, online moveable collateral registry that is reliable, accessible and easy to use will provide creditors confidence that their interest over their moveable collateral is protected. It will also allow subsequent creditors to find out, with ease, whether a particular moveable asset is encumbered or not.

- ***Capacity-building is a key success factor for any moveable collateral and debt resolution reform.*** Even with the existence of a good legal framework, and a modern collateral registry, if creditors do not know how to evaluate and monitor moveable assets, if debtors are not aware of their obligations to care for the assets, and parties do not know how to use alternative methods of debt resolution to improve recovery, creditors will continue to rely on traditional banking practices and refuse to take new types of assets as collateral. Therefore, a good capacity-building program is an integral part of any moveable collateral and debt resolution reform. The project will therefore include capacity-building and, for more comprehensive training for creditors and businesses, the project will coordinate with the IFC's Access to Finance team.

- ***A reliable enforcement and debt resolution mechanism is crucial for the success of a moveable collateral reform.*** Despite the strength of all the other parts of a moveable collateral framework, if enforcement and debt resolution mechanisms are not efficient and reliable, creditors will face greater risk of losing their interests upon a debtor's default, and will translate this increased risk into their pricing. It is important for the moveable collateral law to maintain a balance between the debtor's rights to due process, and the ability of the creditor to enforce its interest efficiently upon a debtor's default. In addition, the soundness of the overall insolvency system, and the rights of secured creditors in the case of the insolvency of the debtor, should also be evaluated to ensure consistency with the moveable collateral law. Finally, alternative mechanisms of debt resolution, such as the use of arbitration both in and outside of insolvency should be considered. The project will identify various ways in which the law can be strengthened in this regard.

- ***Keeping track of the success of the reform through a proper data collection process pre and post reform is important as it helps identify whether ongoing reforms are sufficient or not.*** In order to evaluate the success of the reform, it is important to collect data pre and post reform. The comparison of the data will assist the government in understanding whether the reform carried out requires further improvements or whether it has been successful in reaching its goals. In addition, the data collected will allow the authorities to learn more about the current banking practices. Recommendations will then be tailored to meet the specific needs of the financial and business sectors.

- ***For the reform to be successful, it must have the buy-in of not just the government but the private sector as well.*** In order to ensure that the system reflects the concerns and needs of the relevant stakeholders, the project will include consultations with the private sector, including banks, MFIs, credit unions, businesses, and their associations, to ensure that the new system reflects their needs.

IV. IMPLEMENTATION

A. Institutional and Implementation Arrangements

42. **Implementing agencies will be the NBKR, KPO, Aiyl Bank (along with the CLMU in the MoF), and the collateral registry.** Given the number of implementing agencies, a Project Coordination Unit (PCU) will be established in KPO. KPO is selected for this function as its component will be the largest and will encompass the largest procurement packages. The NBKR has a well functioning PIU from the PBSM Project, and this PIU will be responsible for implementing the NBKR component. Similarly, the existing CLMU in MOF will be responsible for implementing the credit line for Aiyl Bank. The PCU will manage the KPO component, the collateral registry component, and the Aiyl Bank component (other than the credit line), and will coordinate with the PIUs in the NBKR and MOF. A high-level Project Steering Committee with representation from all counterparts and/or their ministries will be established to oversee project implementation. The PBSM Project has worked with the PIU within the NBKR, which has demonstrated good project management, administration, financial recordkeeping, procurement, and contracting. Specific roles and responsibilities are detailed below:

- *Project Steering Committee.* The Project Steering Committee will be comprised of representatives of key stakeholders including the MoF, the MTC, the State Property Management Fund (SPMF),[28] the Ministry of Justice, and representatives from the implementing agencies. The scope of work will include: (i) strategic guidance for overall project implementation; (ii) development and approval of annual plans for project activities, project budget, and procurement plan; (iii) coordination and consensus building on key policy issues related to implementation; and (iv) monitoring of broad issues related to implementation of reforms.

[28] The SPMF is the owner of state entities in the Kyrgyz Republic and manages their privatization.

- *Project Implementation Units.* The PCU at KPO will manage the KPO component and support the collateral registry component and the Aiyl Bank component (other than the credit line), and will ensure overall project coordination. The PIU at the NBKR will be responsible for the NBKR component, and the CLMU in the MoF will manage the credit line to Aiyl Bank. The PCU will coordinate with the PIUs in the NBKR and the MoF.

- *Implementing Agencies.* The agencies will be responsible for defining the tasks under each component and preparing technical TORs for contracting needs. The TORs will be reviewed for quality by the responsible PIUs or the PCU, which will proceed with competitive contracting and selection ranking procedures, using a panel of appointed experts and appropriate tender/selection committees.

B. Results Monitoring and Evaluation

43. **Monitoring and evaluation (M&E) of outcomes and results during implementation will follow standard World Bank practice.** Annex 1 presents the Results Framework. The PCU assisted by external TA, will consolidate the data and reports provided by the PIUs for quarterly review by the Project Steering Committee on the preparation and implementation of the project, in conjunction with World Bank supervision missions. Discussions during supervision missions related to institutional capacity building, financial viability, technical reviews and site visits will also provide effective means of monitoring progress. In addition to the results indicators shown in Annex 1, additional indicators will be monitored by the PCU and the World Bank. For example, a number of financial soundness indicators in Aiyl Bank (e.g., capital adequacy ratio, liquidity ratio, profitability ratios) will be monitored to ensure that it remains in compliance with World Bank requirements for eligibility of financial intermediation loans.

C. Sustainability

44. **The government and implementing agencies are committed to the proposed project activities, and substantial capacity building has been incorporated in the project to ensure sustainability.** The project has included capacity building in every component, including capacity building for NBKR, KPO, Aiyl Bank, the collateral registry, stakeholders with an interest in secured lending and debt resolution, the PCU, and the PIUs. Capacity building will include trainings, workshops, and technology transfer to the implementing agencies. The improved legal, regulatory, and supervisory environment will also enhance the probability of long term stability and growth of the banking and NBFI sectors.

45. **The KPO component will tackle a first phase of transformation, which will require a follow-up phase to ensure sustainability and an irreversible turn-around of KPO into an efficient platform of financial service delivery.** This phased approach was suggested in the initial feasibility study (see Annex 6). The assumption is that the second phase of transformation will be more easily financed and rolled out if the first phase is successfully implemented, with effective corporatization and tangible enhancements in the corporate governance, managerial capabilities, market orientation and financial sustainability of KPO. This result-based approach will provide better grounds for long term sustainability.

V. KEY RISKS AND MITIGATION MEASURES

A. Risk Ratings Summary Table

Risks	Rating
Stakeholder Risk	Moderate
Implementing Agency Risk	
- Capacity	High
- Governance	Moderate
Project Risk	
- Design	Moderate
- Social and Environmental	Low
- Program and Donor	Moderate
- Delivery Monitoring and Sustainability	Moderate
Overall Implementation Risk	**Moderate**

B. Overall Risk Rating Explanation

46. **The overall risk for the project is moderate.** As indicated in more detail in the Operational Risk Assessment Framework (ORAF) in Annex 4, the following are the main risks and mitigation measures:

- **Inadequate institutional capacity.** One of the main risks for the project is the implementing agencies' limited institutional capacity. The project will include substantial technical and administrative capacity building for the implementing agencies. For example, for KPO, the project envisages increasing capacity in KPO in financial management, internal controls, internal audit, and external audit, and delivering financial services in compliance with financial sector regulations. The project will also include TA for financial management and procurement, since issues in these areas can delay disbursements during implementation.

- **Further political instability**. The political situation remains volatile. Presidential elections were held on October 30, 2011 and won by the Kyrgyz Prime Minister Almazbek Atambayev. The presidential inauguration took place on December 1, 2011. Political stability and governance are likely to be strained by competition among members of the interim government. A fractured legislature and the need to accommodate different interest groups may delay the formation of a viable government. Political instability could delay decision making and therefore affect project implementation.

- **Further social instability.** Government control in the South is weak. A risk of a renewed outbreak of violence remains in the South or even in Bishkek. A major security failure would affect project implementation. It could also lead to border closures with neighboring Kazakhstan and Uzbekistan.

- **Further financial sector instability.** Further political and social instability would likely cause financial sector instability. This would halt reforms as the focus shifts to immediate crisis responses. In addition, further instability could cause banks and MFIs to fail, thus reducing access to finance despite the project activities. If the Eurozone crisis is not adequately resolved, some limited spillover to the Kyrgyz financial sector and/or economy could occur. In such an environment, the project team will continue policy dialogue on the advantages of reforms, will provide TA to progress reforms, and will reinforce reforms through development policy operations (DPOs). Moreover, the project has been designed flexibly to respond to needs as they evolve.

- **Changes in government officials.** The new government to be formed in January 2012 may result in changes of high level government officials, and thus resulting in policy changes or delays. For KPO, there may be delays in implementation and commitment towards its corporatization and license as a NBFI institution. However, this risk is partially mitigated by the fact that political stakeholders have intended to increase KPO's role in expanding basic financial services for several years. For Aiyl Bank, there may be delays or even a reversal in government policy regarding privatization, as different factions may have different views on the political value of Aiyl Bank as a state-owned bank. Moreover, despite earlier interest expressed by Rabobank, Agha Khan Agency for Microfinance, Soros Foundation, EBRD, and IFC, market conditions could make it difficult to find strategic investors interested in purchasing the bank.

VI. APPRAISAL SUMMARY

A. Economic and Financial Analyses

47. **Due to the nature of this project, traditional economic and financial analyses do not apply to all components.** However, seen from a qualitative perspective, the project will have significant positive benefits for the implementing agencies, clients, the government, and for overall economic development.

- **Benefits for implementing agencies.** The TA, institutional capacity building, and ICT investments in the supervisory framework for the financial sector will result in improved effectiveness of the NBKR supervision, improved work processes, and lower costs to supervise the system. The significantly strengthened ICT platform for the financial sector will result in enhanced reliability, coverage, consistency, and timeliness of information on financial sector developments. International experience shows that this leads to a better assessment of financial institution risks and more effective actions to address them by the supervisor. TA and ICT investments will improve KPO's financial performance, efficiency, and profits. TA, capacity building, and ICT investments will also increase the effectiveness of the collateral registry and lower its operating costs. The TA will enable Aiyl Bank to increase its deposit base, and thus have a more stable funding source, and the credit line will enable Aiyl Bank to increase its lending while it mobilizes deposits.

- **Benefits for clients.** The legal, regulatory, and supervisory reforms for the financial sector will result in a safe and stable financial sector, in which depositors' savings are better protected. Clients will also have increased access to financial services, reduced transaction costs, increased returns on savings and income, increased ability to manage and cope with financial risks, and improved financial products. Reforms in the moveable collateral and debt resolution regimes[29] will lead to: (i) improved access to secured credit by permitting businesses to use more of their assets as collateral to gain access to loans; (ii) improved terms of credit, including larger amounts, longer terms, and lower interest rates; (iii) improved access to unsecured credit by permitting lenders (including banks, microfinance institutions, and non-bank credit sellers) to use their portfolios of unsecured loans as collateral for secured loans, which can then refinance their extension of further loans; and (iv) improved rates of recovery for creditors in case of debtor default. Improving access to credit for businesses will increase their ability to expand their operations, finance innovations, improve profitability, and increase hiring, thereby improving employment. Expanded deposit services by Aiyl Bank and KPO will provide a much needed new service to remote households that have no access to deposit services. Privatization of Aiyl Bank will reduce political pressure on commercial decisions and attract new capital and technical know-how from a strategic investor, improving efficiency, service and product quality, and profitability.

- **Benefits for financial institutions.** A strengthened moveable collateral regime contributes to financial institutions' ability to: (i) diversify assets and spread risks more efficiently by taking moveable assets as collateral; (ii) tap the MSME market that may not own immoveable assets, and thus increase profits; and (iii) have highly liquid assets, especially short-term assets such as accounts receivable, which are easier to sell in an environment that protect the rights of creditors adequately.[30] Privatization of Aiyl Bank will enhance competition and a level playing field.

- **Benefits for the government.** Effective regulation and supervision of the financial sector will enhance financial sector stability and reduce the likelihood of any future government bailout. The envisaged reform in KPO will improve KPOs' efficiency and financial performance, and will reduce the need for financial assistance from the government.

[29] For example, in Vietnam, a moveable collateral system instituted in January 2007 enhanced creditors' and debtors' rights by: increasing the scope of assets that can be used as collateral, making registration of security interests easier, protecting secured creditors and establishing a clear priority scheme in case of default, and facilitating enforcement mechanisms. As a result, there was an increase in the number of registrations in the National Registry of Secured Transactions from 43,000 in 2005 (when the project started) to 120,000 by the end of 2008. Some 3,200 searches on existing security interests were also done in 2008.

[30] Liquidating immoveable assets, such as real estate or land is often time-consuming and difficult. Banks may find it hard to sell an immoveable asset that has been taken as collateral, and that has been seized as a result of a debtor's default. However, some moveable assets (such as accounts receivable) are highly liquid, and, therefore, usually more desired by banks in modern moveable collateral systems that protect the rights of creditors adequately.

- **Benefits for economic development.** The legal, regulatory, and supervisory reforms in the financial sector will contribute to financial sector stability, and therefore to the Kyrgyz Republic's sustainable economic growth. Expanding financial services via KPO's network will improve access to financial services for the underserved mainly in the rural areas. A modern moveable collateral and debt resolution system contributes to increased levels of credit,[31] and lower cost of credit.[32] Increased access to financial services will deepen the financial sector, fostering economic growth, reducing poverty and contributing to macroeconomic stability.

48. **For the collateral registry, the economic analysis shows large benefits, but a financial analysis cannot be conducted before policy choices are made.** The expected investment cost in the first two years of reforming the pledge registry, legal framework, and related capacity building is US$800,000, while the maintenance costs of the online system are US$60,000 per year thereafter. The table below shows these costs and estimated lending volumes attributable to these improvements based on the impact model developed by the secured transactions unit in the World Bank.[33] The table also shows the estimated economic benefits, assuming a modest average return of 10 percent on each dollar loaned. Based on this analysis, the net present value over five years, at a discount rate of 10 percent, is US$1.618 million. A financial analysis for the pledge registry cannot be conducted, however, as the financial projections depend on policy decisions regarding the fee structure and outsourcing.[34] However, the economic analysis clearly shows large benefits, while the financial analysis would merely determine how those benefits are distributed depending on policy decisions taken for the new registry.

	Year 1	Year 2	Year 3	Year 4	Year 5
Increased lending	US$3,960,957	US$5,149,244	US$6,694,017	US$8,032,821	US$9,639,385
Costs	US$400,000	US$400,000	US$60,000	US$60,000	US$60,000
Benefits, assuming 10% return on investments	US$396,096	US$514,924	US$669,402	US$803,282	US$963,939
Net present value, assuming discount rate of 10%	US$1.618 million				

49. **For the KPO, the financial analysis undertaken in the FIRST feasibility study in 2007, indicating a net present value of US$12 million over five years, has been updated with more modest assumptions reflecting the delays and post-crisis environment**. The implementation of the KPO component is expected to contribute to a relatively rapid increase

[31] In countries where creditors can rely on clear priority rules in case of default, credit to GDP averages 60 percent, compared to 30 percent of average for countries without a clear creditor protection system.
[32] In industrial countries, borrowers with collateral get nine times more cash, repayment periods of up to 11 times longer, and interest rates up to 50 percent lower than borrowers without collateral.
[33] This model assumes 30 percent annual growth in lending volume for three years. To extend the analysis to five years, the analysis presented here conservatively assumes that growth falls to 20 percent in years 4 and 5.
[34] In some countries, the government chooses to make registration free and covers the costs through the budget; in other countries, the government runs the registry on a fee-for-service basis; and in other countries, the registry is outsourced to a private operator that runs it for profit.

in revenues mainly stemming from (i) delivery of remittances, (ii) collection of bills and (iii) agency banking services for licensed banks, MFOs, and insurers.

- On the revenue side, the analysis assumes:
  - 25 percent of households would more intensively but not necessarily exclusively use the post offices as a channel for payments, as paying at the post office will be more convenient than making recurrent payments at many different locations;
  - approximately 10 percent of households make 10-15 payments per year to or from an account of a bank, MFO, or insurer, for loan installments, savings, or premium payments;
  - a market share of 5 percent is gained in the delivery of migrant remittances, in particular in the smaller remittances towards rural communities.

- On the expenditure side, the analysis assumes:
  - staff cost will increase by 5 percent per year as a result of adjusting remuneration to market levels;
  - communications expenditures increase to US$20 per day per connected post office;
  - an average of US$7000 per post office for advertising and promotions campaigns, staff training, and redesign and upgrading the interior of post offices;
  - increased expenditures for vehicle leases and transport of cash.

50. **Based on these assumptions, overall revenue flow is projected to grow by 62 percent in the next five years, while expenditures grow by 56 percent**. The operations income (before depreciation and tax) of KPO would remain positive in the range of 5-8 percent of gross revenues and allow KPO to further improve its assets and resources to operate in a competitive market. Dependency on revenues originated by the state (e.g., pension distribution) would decrease to less than 40 percent, while postal mail revenues evolve from non-core (15 percent) to marginal (less than 10 percent of total revenues). The table below shows the results of the analysis.

Revenues (in US$ amount)	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**
Pension + social welfare payments	7,500,000	7,500,000	7,350,000	7,125,000	6,975,000	6,750,000
Utility bill collection	1,500,000	1,875,000	2,250,000	2,750,000	3,500,000	4,500,000
Other (recurrent) bills		25,000	750,000	1,000,000	1,250,000	1,500,000
Agency bank services		12,500	100,000	200,000	250,000	300,000
Remittance delivery		300,000	1,000,000	1,400,000	1,900,000	2,500,000
Postal (mail/parcel) services	1,500,000	1,500,000	1,500,000	1,500,000	1,500,000	1,500,000
Total revenues	**10,500,000**	**11,212,500**	**12,950,000**	**13,975,000**	**15,375,000**	**17,050,000**
Expenses (in US$ amount)						
Staff	8,000,000	8,400,000	8,820,000	9,261,000	9,724,050	10,210,253
General (utilities, transport)	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
Communications	500,000	700,000	1,500,000	1,500,000	1,500,000	2,000,000

Marketing and advertising			100,000	300,000	300,000	500,000
Training				100,000	150,000	200,000
Maintenance	200,000	800,000	1,000,000	1,000,000	1,000,000	1,000,000
Other				200,000	200,000	200,000
Total expenses	**9,700,000**	**10,900,000**	**12,420,000**	**13,361,000**	**13,874,050**	**15,110,253**
Net operations result	**$800,000**	**$312,500**	**$530,000**	**$614,000**	**$1,500,950**	**$1,939,747**

B. Technical

51. **The technical design of the project has been examined by the World Bank staff during project appraisal and is considered to be sound and in line with international standards.** The design is also grounded in analytical work undertaken prior to project design.[35]

- **The component on strengthening the legal, regulatory, and supervisory framework for the financial sector has been designed to address relevant issues in a comprehensive manner** – improving the regulatory and legal framework; improving the effectiveness of supervisory methods and processes; imparting a forward-looking element and timeliness to supervision through the stress testing and early warning systems; and enabling timely intervention by the supervisor.

- **The proposed ICT architecture is in line with international practices for data management of central banks,** which are based on centralized system architectures that support higher operational efficiency, strengthened risk management and enhanced opportunities for stronger internal controls. The project addresses weaknesses in the ICT system for the supervisory framework of the financial sector. These weaknesses have been identified during the project preparation process.

- **The technical solutions proposed for the KPO component are based on proven technology**. The technical architecture includes an integrated multi-functional front office terminal equipped for standard financial transactions, standard postal applications, and functionality to operate as a standard retail cash register for sales of other services or products. The terminal configuration includes peripheral technology and secure cash lockers. The connectivity of the post offices to one central hub in Bishkek is technically feasible on the basis of the existing Global System for Mobile Communications (GSM) telecom networks. The project will identify the best technological options, assessing what are the existing connectivity options for each given post office, and decide which option is preferable based on a cost/benefit analysis. The country has some backbone infrastructure (optic fiber) and a substantial portion of the country is covered by wireless technologies. The project is not covering recurring cost of connectivity, but may cover some last mile fixed infrastructure (e.g., connect a post office to the backbone through copper or fiber, or purchase some wireless equipment, such as Wimax antennas and repeaters).

[35] Vulnerability Assessment of the Financial Sector Policy Note, and Access to Financial Service Policy Note.

- **The collateral registry design is consistent with international best practice and the needs and capacity of the country.** The technical design proposed for the registry has been developed and tested in other jurisdictions. The architecture of the registry calls for only one database in which information is captured and retained, and from which information may be retrieved. The technical design includes the creation of an online collateral registry, which users of the registry's services can access through the internet. To ensure easy access for users in regions where internet service providers do not exist, it may be necessary to provide intake points for users to present paper documents. These intake points may be provided either by the government or the private sector. Regular users of the registry will establish payment accounts with the registry that may be either pre-paid or post-paid accounts, where payments are made on periodic statements for services rendered during the period. Regarding ICT, there is a need for domain, email and firewall servers, the operating system, database, and firewall software. The product used for the operating system and database could be either open source, Microsoft, or Oracle running on Unix. While customized software could be developed, the preferred method is taking an off-the-shelf software and modifying it to meet the system's needs.

C. Financial Management

52. **A financial management (FM) assessment has been conducted to determine whether the FM arrangements for the project meet the World Bank's minimum requirements.** The FM arrangements at the CLMU and the NBKR PIU, including flow of funds, auditing, accounting, reporting, budgeting and staffing, are assessed to be adequate and acceptable to the Bank.

53. **The PCU to be established in KPO will be responsible for the FM arrangements, including the flow of funds, budgeting, accounting, reporting, and auditing for the KPO component, the collateral registry component, and the Aiyl Bank component (except for the credit line).** The PCU, NBKR and CLMU will open separate designated accounts (DAs) at the commercial banks if they wish to use the DA method of disbursement. In addition, the PCU in the KPO will be responsible for the consolidation and submission of the project's annual budgets, quarterly Interim un-audited Financial Reports (IFRs), and annual financial statements to the World Bank. A time-bound action plan (Annex 3) aimed at building the financial management capacity at the PCU in KPO has been elaborated and agreed with the client. The overall project Financial Management arrangements are not in full compliance with the Bank's requirements under OP 10.02.

54. **The PCU will recruit a full time disbursement specialist and a financial manager to manage the project-related financial management and disbursement work under the components managed by KPO, and the consolidation of the project's financial information.** The PCU will procure and install a standard accounting system software widely used in the Kyrgyz Republic and other Central Asian countries to support project accounting and reporting. The system shall have the functionality of automatic generation of reports for the government as well as statements of expenses (SOEs) and IFRs required for reporting to the Borrower and the World Bank. The system shall have adequate security safeguards for reliable reporting and data integrity. All FM staff will receive focused training when the

project launches and hands-on training during implementation. The FM Manual, which is part of the project operational manual, will describe budgeting, audit arrangements, internal control and accounting policies, and procedures to be followed for the project.

55. **Disbursements from the IDA credit account will follow the transaction-based method, i.e., traditional Bank procedures**. These will include advances to the designated account, direct payments, special commitments, and reimbursement (with full documentation and against SOEs). For payments above the minimum application size, as specified in the Disbursement Letter, implementing agencies may submit withdrawal applications to the Bank for payments to suppliers and consultants directly from the Loan Account.

56. It has been agreed that under the proposed project, the project and entities' audits will be conducted by independent private auditors acceptable to the World Bank, on terms of reference (TOR) acceptable to the World Bank, and according to International Standards on Auditing (ISA) issued by the International Auditing and Assurance Standards Board of the International Federation of Accountants (IFAC). The annual audited project and entities' financial statements together with the management letter will be provided to the World Bank within six months of the end of each fiscal year and also at the closing of the project.

D. Procurement

57. **Procurement for the proposed project will be carried out in accordance with the World Bank's Guidelines.** Specifically, procurement will be carried out in accordance with: (i) Procurement of Goods, Works and Non-Consulting Services under IBRD Loans and IDA Credits & Grants by World Bank Borrowers (January 2011); (ii) Guidelines: Selection and Employment of Consultants under IBRD Loans and IDA Credits & Grants by World Bank Borrowers (January 2011); and (iii) the provisions stipulated in the Financing Agreement.

58. **The PIU in the NBKR will manage the NBKR component, and the PCU will manage the KPO component, the collateral registry component, the Aiyl Bank component (excluding the credit line), and ensure overall coordination**. The NBKR will be responsible for procurement under Component 1 through its PIU, which is now responsible for all procurement for the NBKR. The head of the PIU has received training in international procurement from the World Bank seminars and will work closely with the NBKR ICT, legal, and other departments in managing the procurement cycle for this component. The procurement performance under the PBSM Project has been satisfactory. The NBKR has made noticeable progress in conducting procurement activities under all the components of the PBSM Project. Procurement for the other components (excluding the credit line) will be the responsibility of the PCU in KPO. The procurement capacity assessment revealed that while the KPO has staff in place for its own procurement following national procurement procedures, they do not have prior experience with Bank (or other International Financial Institution (IFI)) financed procurement.

59. **The overall procurement risk for the project is high**. Based on experience from past and ongoing projects in the Kyrgyz Republic, the procurement risks are due to low capacity in KPO, little competition in procurement due to the high cost of doing business in the region, and limited development in the local manufacturing industry.

60. **To mitigate these risks, a procurement specialist who is familiar with the World Bank procurement procedures will be hired in the PCU.** The World Bank's procurement staff from the country office will provide advice and assistance on a regular basis. The procurement packages and plans will be carefully developed to attract international participation in the bidding process, and procurement notices will be advertised widely. Further procurement training will be provided during project implementation, as needed, to PCU, PIUs, and members of tender committees. The World Bank will ensure close supervision and monitoring of the procurement function under the project, particularly from the country office. The initial procurement plan covering the entire project period has been developed. Details on procurement arrangements are presented in Annex 3.

E. Social (including safeguards)

61. **The proposed project activities contribute to positive social impacts.** These include: (i) a broadened and deepened financial sector that fosters economic growth, reduces poverty and contributes to macroeconomic stability; (ii) a well supervised financial sector that encourages and preserves depositors' savings; and (iii) increased access to financial services for the poor, especially in rural and remote areas. The identified positive impacts of the project from increased access to financial services in rural areas include: (a) increased food security and household income for the smallholder farmers, due to higher agricultural productivity; (b) improved nutritional status of the farmers due to increased agricultural production; (c) increased savings mobilization and increased productivity on farms; and (d) increased opportunities for engagement in other income-generating activities or small scale businesses by smallholder farmers due to increased food security for the households.

F. Environment (including safeguards)

62. **The project is assigned with the World Bank environmental category Financial Intermediary (FI), as the exact sub-projects to be funded under the credit line are not identified prior to implementation**. However, only sub-projects that present moderate environmental risks that can be readily mitigated during implementation will be eligible for funding. The planned new credit line for farmers and agribusinesses is intended to support productivity increases in agriculture.

63. **There are potential positive and negative environmental impacts that may result from the implementation of the project.** The identified positive impacts of the project include improved soil fertility due to fodder crop sowing (enrichment by nitrogen) and use of phosphorus-potassium fertilizers. The potential negative environmental impacts that may result from implementation of the project include: (a) increased pollution of ground and surface waters due to soil erosion and use of fertilizers and pesticides; (b) threats to human health and wildlife due to improper handling of treated seeds, fertilizers and pesticides; (c) increased siltation of water bodies due to soil erosion; (d) introduction of genetic monoculture through seed purchased with credit line financing; and (e) construction waste. These potential negative impacts will be mitigated through the environmental screening and sub-project environmental management plans (EMPs) under the Environmental Management Framework (EMF). The project will not finance acquisition of land, genetically modified organisms (GMOs), pesticides, or World Bank Category A sub-projects under the credit line.

64. **The CLMU under the Ministry of Finance will support implementation of the credit line and undertake the safeguards functions for the project.** Aiyl Bank will serve as the financial intermediary and implement the credit line. The CLMU has prepared an EMF for the project, based on their previous experience with the similar World Bank-financed Agricultural Productivity Assistance Project (APAP) and previous Agri-Business and Marketing Project (ABMP). Because of the similarity in the credit line objectives and the EMF for APAP and the current proposed project, consultations on the EMF for APAP, conducted in March 2011, are considered adequate for the proposed project's EMF. The CLMU's experience in supporting implementation of the project in keeping with the EMF is considered very strong, based on its role with previous similar World Bank projects. The CLMU's capacity will be strengthened by recruitment of the local environmental specialist for this project. Aiyl Bank also has good experience with similar environmental procedures through serving as a participating financial institution for on-lending under both the APAP and ABMP. Aiyl Bank loan officers at headquarters and all branch offices will receive training on the EMF procedures, and will be able to draw on support from the CLMU environmental specialist in case of need.

G. Safeguard Policies

65. This project triggers the environmental assessment safeguard policy and access to information policy.

Safeguard Policies Triggered by the Project	Yes	No
Environmental Assessment OP/BP 4.01	X	
Natural Habitats OP/BP 4.04		X
Pest Management OP 4.09		X
Indigenous People OP/BP 4.10		X
Physical Cultural Resources OP/BP 4.11		X
Involuntary Resettlement OP/BP 4.12		X
Forests OP/BP 4.36		X
Safety of Dams OP/BP 4.37		X
Projects on International Waterways OP/BP 7.50		X
Projects in Disputed Areas OP/BP 7.60		X
Access to Information	X	

Annex 1: Results Framework and Monitoring

Country: Kyrgyz Republic

Project Name: KG Financial Sector Development Project

Results Framework

Project Development Objectives

PDO Statement

Project Development Objectives are to: (i) enhance financial sector stability, and (ii) increase access to financial services.

PDO Level Results Indicators*	Core	Unit of Measure	Baseline	Cumulative Target Values**					Frequency	Data Source/ Methodology	Responsibility for Data Collection
				YR 1	YR 2	YR3	YR 4	YR5			
Indicator One: Legal, regulatory, and supervisory framework following international good practice to enhance stability is developed, adopted, and implemented[36]	☐	Number	0	3	6	9	12	15	6 months	NBKR	NBKR
Indicator Two: Number of transactions through KPO related to financial services	☐	Number (millions)	10[37]	11	11	13	15	17	Quarterly	KPO and NBKR	KPO
Indicator Three: Deposits/GDP	☐	%	15%	15%	16%	17%	18%	20%	6 months	NBKR	NBKR
Indicator Four: Increase in individual deposits in Aiyl Bank	☐	%	Dec 31, 2011 individual deposits	50	100	200	250	300	6 months		Aiyl Bank
Indicator Five: Number of new annual registrations in the moveable collateral registry, using moveable	☐	% increase	Number of new registrations in 2011 36,000	2%	2%	5%	10%	20%	Yearly	Collateral Registry	Collateral Registry

[36] Paragraph 2 in Annex 2 lists areas to be covered under new or revised laws and regulations. This will, at the minimum, include: (i) implementation of risk based supervision and key aspects of Basel II and Basel III; (ii) review and revision of supervisory processes, bank supervision manual, and quality control framework for on-site bank examinations; (iii) strengthening the package of off-site returns and early warning systems; and (iv) introduction of formal contingency planning and crisis management frameworks.

[37] Unaudited estimate. The baseline and targets are subject to revision once accurate data are available. The indicator excludes government payments (e.g., pensions and social benefits).

PDO Level Results Indicators*	Core	Unit of Measure	Baseline	Cumulative Target Values**					Frequency	Data Source/ Methodology	Responsibility for Data Collection
				YR 1	YR 2	YR3	YR 4	YR5			
assets as collateral											
INTERMEDIATE RESULTS											
Intermediate Result (Component One): Strengthening the legal, regulatory, and supervisory framework for the financial sector											
Intermediate Result indicator One: Adoption of modern supervision methods	☐	Text	Supervisory framework lacking modern supervision methods	Implementation of improved off-site reporting and analyses	Adoption of new bank supervision manual	Adoption of risk focused supervision	Adoption of consolidated supervision	Implementation of Pillar 2 and 3 of Basel II	6 months	NBKR	NBKR
Intermediate Result indicator Two: Effective supervision, measured in terms of number banks under special supervisory action for over 1 year	☐	Number	6	4	0	0	0	0	6 months	NBKR	NBKR
Intermediate Result indicator Three: Upgraded ICT system	☐	Text	No	Needs assessment completed, technical specifications developed, procurement launched for of ICT hardware & software.	Procurement of new hardware and software completed, new hardware and software installed.	New hardware and software fully operational. All supervisory and regulatory staff trained and working on computerized systems	Fewer than 5 incidents of supervisory setback for want of ICT support.	No incident of supervisory setback for want of ICT support.	6 months	NBKR	NBKR
Intermediate Result indicator Four: Contingency planning and crisis management framework	☐	Text	No	Formal framework developed	Formal framework in place	Simulation conducted to test the adequacy of the framework & improvement made	Simulations do not reveal any serious shortcoming	No systemic crisis that was not adequately addressed in time	6 months	NBKR	NBKR
Intermediate Result indicator Five: Improved staff capacity, measured in terms of number of years of	☐	Number	2	2.5	3	3.5	4	4.5	6 months	NBKR	NBKR

PDO Level Results Indicators*	Core	Unit of Measure	Baseline	Cumulative Target Values**					Frequency	Data Source/ Methodology	Responsibility for Data Collection
				YR 1	YR 2	YR3	YR 4	YR5			
staff experience in supervision departments											
Intermediate Result (Component Two): Expanding financial services via KPO's network											
Intermediate Result Indicator One: Number of ICT-equipped Post Offices (with installed, operational front office cash terminals) connected to the central hub	☐	Number	0	0	50	150	250	360	Quarterly	KPO	KPO
Intermediate Result Indicator Two: Revenues from non-government[38] transactions as a share of total KPO revenues from financial services	☐	%	15%	15%	16%	17%	18%	20%	Quarterly	KPO Financial MIS reports	KPO
Intermediate Result Indicator Three: Improved quality, reliability and cost-efficiency of small value payments operations, measured in terms of same day Straight Through Processing (STP) as a share of total transactions to and from bank accounts	☐	%	0%	0%	>5%	>10%	>20%	>30%	Quarterly	KPO's Financial Management	KPO
Intermediate Result Indicator Four: Enhanced transparent financial performance	☐	Text	No	No	Audit of 2012 IFRS accounts of published and management letter issued	Audit of IFRS/ Accounts of SE or Opening Balances sheet JSC[39]	Annual audited statements	Annual audited statements	Annually	External auditor's report	KPO

[38] Government payments to persons, such as pensions and social security, are a quasi-monopoly assigned by the State to subsidize the postal mail losses. This purpose of this indicator is that KPO needs to reduce its dependency on such revenue and transform its business based on market needs and opportunities.
[39] JSC = Joint Stock Company

PDO Level Results Indicators*	Core	Unit of Measure	Baseline	Cumulative Target Values**					Frequency	Data Source/ Methodology	Responsibility for Data Collection
				YR 1	YR 2	YR3	YR 4	YR5			
Intermediate Result Indicator Five: Introduction of performance measurement, in terms of accounting reports with separated profitability and risk analysis for financial services and postal services	☐	Text	0	0	0	Monthly financial reports	Monthly financial reports	Monthly financial reports	Quarterly	KPO's Financial Management	KPO
Intermediate Result Indicator Six: Number of cashiers, tellers, postmasters and other operational staff completed NBKR training to operate financial services at KPO	☐	Number	0	10	240	400	600	1200	Annually	KPO reports	KPO
Intermediate Result Indicator Seven: Enhanced competitive outreach for last mile delivery of remittances, measured in terms of market share of KPO in total remittances	☐	%	0%	0%	0.5%	0.7%	1%	2%	Quarterly	NBKR	KPO
Intermediate Result (Component Three): <u>Support to Aiyl Bank for Privatization and Deposit Mobilization</u>											
Intermediate Result indicator One: Tender announced for privatization of Aiyl Bank	☐	Text	No	No	No	Yes	Yes	Yes	6 months	Aiyl Bank	Aiyl Bank
Intermediate Result (Component Four): <u>Modernizing the Moveable collateral and Debt Resolution Regimes</u>											
Intermediate Result indicator One: Amended legal framework for moveable collateral and debt resolution regimes	☐	Text	No	No	Yes	Yes	Yes	Yes	Yearly		Ministry of Justice/National Bank/Working Group
Intermediate Result indicator Two: Issued regulations for the well-functioning of the collateral registry	☐	Text	No	No	No	Yes	Yes	Yes	Yearly		Ministry of Justice/National Bank/Working Group
Intermediate Result indicator Three: Online	☐	Text	No online system	No	No	Yes	Yes	Yes	Yearly		Ministry of Justice/Working

PDO Level Results Indicators*	Core	Unit of Measure	Baseline	Cumulative Target Values**					Frequency	Data Source/ Methodology	Responsibility for Data Collection
				YR 1	YR 2	YR3	YR 4	YR5			
system for registering collateral is operational											Group
Intermediate Result Indicator Four: Number of dissemination and capacity-building and training events held	☐	Number	0	0	1	3	5	6			Ministry of Justice/National Bank/Working Group
Intermediate Result indicator Five: Increase in lending based on new registration of security interests in the registry, using moveable assets as collateral	☐	% increase	To be measured at end- 2011	2%	2%	2%	10%	20%		Collateral Registry	Collateral Registry
Intermediate Results indicator Six: Increase in the debt recovery rate for creditors	☐	Text	To be measured at end-2011	No increase	No increase	No increase	No increase	30 cents on the dollar of 4% of insolvent companies			
Volume of Bank funding: Line of Credit- MSME	☒	US$	0						6 months	PCU	
Volume of Bank funding: Institutional Development-MSME	☒	US$	0						6 months	PCU	
Volume of Bank funding: Enabling Environment-MSME	☒	US$	0						6 months	PCU	
Number of active loan accounts - MSME	☒	Number	To be measured at end-2011						6 months	Aiyl bank	
Outstanding MSME loan portfolio	☒	US$	To be measured at end-2011						6 months	Aiyl bank	
Percentage of active loans to women - MSME	☒	%	To be measured at end-2011						6 months	Aiyl bank	
Number of active individual savings accounts	☒	Number	To be measured at end-2011						6 months	Aiyl bank	

PDO Level Results Indicators*	Core	Unit of Measure	Baseline	Cumulative Target Values**					Frequency	Data Source/ Methodology	Responsibility for Data Collection
				YR 1	YR 2	YR3	YR 4	YR5			
Percentage of active individual savings accounts held by women	☒	%	To be measured at end-2011						6 months	Aiyl bank	
Portfolio at Risk – MSME (%)	☒	%	To be measured at end-2011						6 months	Aiyl bank	
Return on Assets (%)	☒	%	To be measured at end-2011						6 months	Aiyl bank	
Return on Equity (%)	☒	%	To be measured at end-2011						6 months	Aiyl bank	

Results Framework

Project Development Objective Indicators

Indicator Name	Description (indicator definition etc.)
Legal, regulatory, and supervisory framework following international good practice to enhance stability is developed, adopted, and implemented	Areas covered by new or revised laws or regulations
Number of transactions through KPO related to financial services	No description provided.
Deposits/GDP	No description provided.
Increase in individual deposits in Aiyl Bank	No description provided.
Number of new annual registrations in the moveable collateral registry, using moveable assets as collateral	No description provided.

Intermediate Results Indicators

Indicator Name	Description (indicator definition etc.)
Improved staff capacity, measured in terms of number of years of staff experience in supervision departments	No description provided.
Number of ICT-equipped Post Offices (with installed, operational front office cash terminals) connected to the central hub	No description provided.
Adoption of modern supervision methods	No description provided.
Effective supervision, measured in terms of number of banks under special supervisory action for over 1 year	No description provided.
Upgraded ICT system	No description provided.
Contingency planning and crisis management framework	No description provided.
Revenues from non-government transactions as a share of total KPO revenues from financial services	No description provided.
Improved quality, reliability and cost-efficiency of small value payments operations, measured in terms of same day Straight Through Processing as a share of total transactions to&from bank accounts	No description provided.
Enhanced transparent financial performance	Publication of audited IFRS accounts
Introduction of performance measurement, in terms of accounting reports with separated profitability and risk analysis for financial services and postal services	No description provided.
Number of cashiers, tellers, postmasters and other operational staff completed NBKR training to operate financial services at KPO	No description provided.

Enhanced competitive outreach for last mile delivery of remittances, measured in terms of market share of KPO in total remittances	No description provided.
Increase in lending based on new registration of security interests in the registry,using moveable assets as collateral	No description provided.
Tender announced for privatization of Aiyl Bank	No description provided.
Amended legal framework for moveable collateral and debt resolution regimes	No description provided.
Issued regulations for the well-functioning of the collateral registry	No description provided.
Online system for registering collateral is operational	No description provided.
Number of dissemination and capacity-building and training events held	No description provided.
Increase in number of new annual registrations in the registry, using only moveable assets as collateral	No description provided.
Increase in lending based on new registration of security interests in the registry, using only moveable assets as collateral	No description provided.
Increase in the debt recovery rate for creditors	No description provided.
Volume of Bank Support: Lines of Credit - SME	A line of credit is "SME finance" if the supporting subloans have an average outstanding balance > microfinance cut-off noted below, but no more than $300,000. A line of credit is classified "microfinance" if supporting subloans: a) Have an average outstanding balance (gross loan portfolio ÷ number of active borrowers) < 300% of the latest per capita GNI, OR b) Less than $1,000. EITHER circumstance triggers classification as microfinance. Lines of credit and other funding for retail SME sub-loans by Participating Financial Institutions or Community-Managed Loan Funds. Report the cumulative amounts disbursed as of most recent date available. If a split by micro and SME is not available or possible, please use 50% for each as proxy.
Volume of Bank Support: Institutional Development - SME	Institutional development financing relates to capacity building at institutions including technical assistance, training, fixed assets etc. Report the cumulative amounts disbursed as of most recent date available. If a split by micro and SME is not available or possible, please use 50% for each as proxy.
Volume of Bank Support: Enabling Environment - SME	Support at wholesale level for Microfinance as opposed to specific institutions for financial infrastructure (such as training programs, industry networks, credit registries) and direct policy support (such as reform of laws/regulations). Report the cumulative amounts disbursed as of most recent date available. If split by micro and SME is not available or possible, please use 50% for each as proxy.
No of active loan accounts -SME	Provide the total number of active SME loans for all institutions supported by the Bank. Do not report the cumulative number of loans over the life of the project. Report on the entire SME portfolio of the PFI/CMLF, not just the Bank-financed portion. If number of loan accounts is not available, use number of borrowers as a proxy. The optional "breakdown" tab can be used to report by institution.
Percentage of project-supported institutions that are reporting on this indicator	No description provided.

Outstanding SME Loan Portfolio	Provide the outstanding (i.e., not yet repaid or written off) amount of the SME loan portfolio for each PFI or CMLF promoter receiving Bank support. Report the entire portfolio of the institution as of a reasonably recent date, not just the Bank-financed portion.
Percentage of project-supported institutions that are reporting on this indicator	No description provided.
% active loans to women - Microfinance	Report on the percentage of total loan accounts noted above that were made to women.
Percentage of project-supported institutions that are reporting on this indicator	No description provided.
Number of active micro-savings accounts	Micro-savings means savings products whose average outstanding balance (total deposit amounts ÷ number of open accounts) is ≤ 150 percent of the latest GNI per capita. Report on the total number of Micro-savings accounts of the institutions, not just the Bank-financed portion. The optional tab can be used to report by institution.
Percentage of project-supported institutions that are reporting on this indicator	No description provided.
% active micro-savings accounts held by women	Report on the percentage of the total micro-savings accounts noted above that are held by women. Applies to projects that support micro-savings and deposits.
Percentage of project-supported institutions that are reporting on this indicator	No description provided.
Portfolio at Risk - SME	Portfolio at Risk = Outstanding (or not yet repaid) balance of all loans where payment is late by > 90 days / Gross outstanding loan portfolio. Report the Portfolio at Risk (PAR) for the PFI's entire SME portfolio. Do not report on the PAR for just the Bank-funded portion. Loans that have been rescheduled or renegotiated should also be included in the numerator of the PAR. Weight each institution's PAR by its outstanding SME portfolio to calculate the average PAR for the project. The optional "breakdown" tab can be used to report by institution.
Percentage of project-supported institutions that are reporting on this indicator	No description provided.
Return on Assets/Equity	Return on Assets (Equity) = Annual After Tax Profits / Average Assets (Equity) over the Period Return on Assets (Equity) reflects that organization's ability to deploy its assets (equity) profitably. This indicator is used for commercial institutions that do not receive subsidies. The optional "breakdown" tab can be used to report by institution.
Percentage of project-supported institutions that are reporting on this indicator	No description provided.

***Please indicate whether the indicator is a Core Sector Indicator (see further http://coreindicators)**
****Target values should be entered for the years data will be available, not necessarily annually**

Annex 2: Detailed Project Description

1. The project consists of four components that aim to: (a) support financial sector stability; and (b) expand access to financial services. [40]

Financial Sector Stability

Component 1: Strengthening the legal, regulatory, and supervisory framework for banks, MFOs, and credit unions (US$2.5 million, out of which US$1 million to be provided by SECO)

2. Component 1 supports measures to improve the legal, regulatory, and supervisory framework for banks and increase NBKR capacity to monitor and address vulnerabilities. While the focus will be on the banking sector, to enhance the sector's stability, Component 1 will also support similar measures for MFOs and credit unions as needed. These measures will ensure that the Kyrgyz framework is compliant with the international best practices. The project will be flexible in addressing the areas below, or related areas as they are identified during the course of the project.

- **(i) Legal framework:** The project will assist in the review and revision of laws relevant to bank regulation and supervision; and cooperation and coordination among financial sector regulators and supervisors. This work will be conducted in close coordination with the IMF, which is advising on the development of a Banking Code at the time this project is being prepared. It is expected, however, that the Banking Code itself will need to be reviewed after some period of implementation to assess the need for further amendments. The project will have the flexibility to conduct this review if necessary.

- **(ii) Regulatory framework**: Some banking regulations need to be strengthened to be comprehensive and in line with international best practices. The introduction of new regulations is also needed in the following areas: electronic banking, business continuity planning, outsourcing, new products and related risks, Basel II, Basel III, consolidated supervision, and risk based supervision. Regulations that are work in progress will also be reviewed, including on: funding risk, reputation risk, strategic risk, and internal guidelines for issuing bank licenses to interested NBFIs**.** Existing regulations will also be reviewed and revised on the basis of domestic and global developments and standards, during the course of the project. Internal guidelines will also be introduced or revised, where relevant, on functional areas where the regulations will be issued or revised.

- **(iii) Off-site supervision**: The experience gained during the recent stress in the banking system confirmed the need to strengthen the off-site reporting framework and the processes adopted by the off-site unit to improve its effectiveness. This will include, among other things, reviewing and revising the package of supervisory reporting, including reporting formats; strengthening the early warning system; improving the analyses of off-site reporting information; designing new management reports to the

[40] Component 5 of the project is on project coordination and monitoring.

NBKR's senior management and board; and establishing new processes to act upon these reports as necessary.

(iv) **On-site supervision**: The project will also strengthen the on-site examination framework and the processes adopted by the on-site unit to improve its effectiveness. The areas that need improvement include introduction of processes and methodologies for inspection of new and emerging areas of bank operations (like derivatives, electronic banking, and cross-border banking); introduction of a quality control framework for on-site examinations; preparation of a revised bank supervision manual; and a review and revision of CAMELS[41] inspection methodology and processes.

(v) **Risk-based supervision**: The NBKR is currently practicing compliance-based supervision. It initiated work to adopt a risk-oriented approach in 2009 but it did not complete it due to the developments in 2010. With the advances in banking products, their operational systems, and the operating environment, it will be appropriate to adopt risk-based supervision, and develop a risk estimation methodology. In the move to adopting risk-based supervision, the tasks will include development of a risk assessment, estimation and rating methodology for all relevant risks; and development of a supervisory framework that will escalate the level of supervisory focus as appropriate to the level of risk or supervisory concern.

(vi) **Stress test methodology:** While the NBKR currently undertakes sensitivity and single factor stress tests on a limited scale, the project will help enhance its capacity to undertake stress tests on more parameters, dynamic stress tests, and scenario analyses. The NBKR will also migrate to macro stress tests and promote bottom-up stress tests for all critical parameters. The project will also assist NBKR to introduce a system whereby the outcomes of the periodic stress testing of banks' financial positions feed into an early warning system.

(vii) **Contingency planning and crisis management:** Building on the NBKR's experience in handling the recent crisis and the challenges faced, the project will assist the NBKR to put in place a formal contingency planning and crisis management framework that will equip it to prepare itself and the financial system to manage stress situations. The project will also include simulation exercises to assess the adequacy of and improve the effectiveness of the crisis management framework.

(viii) **HR policies:** In view of the high level of attrition and the low average level of experience of NBKR staff, the project will assist the NBKR to review and revise its HR policies including, among others, aspects relating to recruitment, staff mobility, training and higher education, compensation, career progress and staff retention. The project will also assist to design appropriate packages for ongoing training, in-house experience sharing, and mentoring.

(ix) **ICT support:** The activities above will be underpinned by the upgrading of the ICT infrastructure, which currently supports only off-site banking supervision. This

[41] Capital, Assets, Management, Earnings, Liquidity, Sensitivity.

infrastructure has not been upgraded since its installation in the early 2000s, and has also not been locally supported for the last few years so that, while it originally provided a satisfactory level of information support, it has not kept pace with developments in the off-site banking supervision unit's functions and activities. In addition, the hardware on which it runs is rather slow and at times unreliable. The ICT infrastructure upgrade will be carried out in the context, and as an integral part, of a planned major overhaul of the NBKR's entire ICT capabilities, which is described in the *Strategy of the National Bank of the Kyrgyz Republic information system development for the period 2011-2015*. This strategy was recently approved by the NBKR's Board for implementation starting in early 2012. One of the first elements in the strategy is planned to be the implementation of a corporate 'data warehouse', which will be used to collect and hold all external data from all sources including commercial banks and NBFIs. In parallel with this, the existing off-site supervision software package (FINA) will be replaced by a more modern system with more extensive functionality to support the evolving activities of the banking supervision department, including off-site supervision, on-site supervision, and licensing. The project will contribute US$1.5 million to cover:

- Procurement of new hardware servers and related ICT infrastructure to operate new banking supervision software, that will include adequate redundancies and disaster recovery capabilities;
- Development of a software package that will:
    - Support data storage and retrieval for all regulated entities, both on-site and off-site, with adequate data security and access protocols;
    - Facilitate collection, validation and standard analyses of a broad range of data, both financial and non-financial, pertaining to the regulated entities with minimal human intervention;
    - Support effective supervision through enhanced analyses of data and information received from regulated entities, the curators in the off-site supervision, the on-site supervisors, the functionaries attending to various authorizations, and other sources; including through stress testing, generating early warning signals and supporting macro-prudential supervision;
    - Support generation of efficient management information reports for individual banks, group of banks and the banking system as a whole that will facilitate decision making and policy making;
    - Provide flexibility in the software package to enable supervisory staff to perform new analyses and generate modified reports as may be required, without requiring intervention from ICT technical staff,;
- Facilitate integration of the new hardware and software package into the NBKR's ICT infrastructure as required;
- Training of staff across all banking supervision units, including the methodology department, to use the new system effectively.

In parallel with these ICT developments, the tasks under this component will include review and revision of supervisory practices and processes to make them amenable to better application of ICT. These improvements will achieve an improved supervisory database to facilitate the capture of both financial and non-financial information pertaining to banks, and make the ICT system capable of supporting stress testing, generating early warning signals and supporting macro-prudential supervision. The NBKR staff capacity to use technology will also be strengthened to improve effectiveness.

Access to Financial Services

3. **The proposed project will expand access to a variety of financial services through a number of components as follows:** (i) expanding financial services via KPO's network; (ii) supporting privatization of, and deposit mobilization in Aiyl Bank, linked to credit line disbursements to ensure short-run liquidity; and (iii) supporting legal, regulatory, and institutional reforms, and an ICT upgrade to modernize the system for moveable collateral.

<u>Component 2: Expanding financial services via KPO's network (US$5.55 million)</u>

4. **The project will transform KPO's existing operation[42] into a cost-effective and market-driven distribution channel for basic financial services in order to increase access by poor and rural communities**. The project design features an output-based, turn-key delivery implementation approach for the three main subcomponents that require close coordination: (i) strengthening of financial management; (ii) business process modernization; and (iii) expansion of financial services. This approach addresses capacity building of the three core management functions to operate the delivery of financial services: financial management, operations, and marketing.

(i) Strengthening of Financial Management (US$1.06 million)

5. **This subcomponent will strengthen the financial management capacity of KPO as part of its on-going corporate reform, resulting in improved corporate governance and improved compliance with financial sector regulations.** KPO lacks most of the required financial management capabilities, skills and instruments to expand the delivery of basic financial services. Its financial management capability does not stretch beyond traditional bookkeeping that records paper-based inputs and follows government tax accounting standards. The subcomponent has three modules: (a) strengthening core financial management systems, so that KPO has a comprehensive modern corporate financial management practices; (b) supporting external audits; and (c) amending the legal and regulatory framework for KPO to provide financial services.

(a) Strengthening core financial management systems

6. **This module supports the following activities:**

[42] The addendum in Annex 6 provides a brief profile of the current operation of KPO.

- Upgrade the **<u>general ledger system</u>** including :
    - Design of an adjusted detailed chart of accounts with applicable costing types and classes and cost centers;
    - Review, specification, and selection of software for an upgraded general ledger system, including automated online data entry of post office teller transactions at up to 360 computerized positions (for accounting, reporting, and tax reporting);
    - Review, design, and prepare manuals for the authorization and verification of offline and online data entry into the accounting system;
    - Design of a cost allocation methodology and internal transfer pricing system, preparation of manuals, conduct of training, and guidance in implementation.

- Strengthen the **<u>planning, budgeting, and control function</u>**. This includes:
    - Design and development of a budgeting system that is applied at headquarters, at the regional (oblast) level, and at the individual postal office level;
    - Prepare necessary instructions and manuals;
    - Design the implementation plan;
    - Organize budgeting function in headquarters;
    - Organize (re)training of accounting staff and design new manuals and instructions;
    - Design a budget vs. reality reporting system (per business line and regional center) that takes place on a regular (preferably monthly) basis and which highlights all significant variances from the targets and objectives.
- Introduce a **<u>performance measurement system</u>.** Based on the above mentioned strengthening of planning, budgeting and control, this includes building reporting that reflects real cost and profitability per product type and/or client group and show how these vary across the postal network;[43]
- Setup and implement a **<u>centralized treasury</u>** for liquidity and cash management, including reporting, control, cash flow projections, and related cash logistics management;
- Design and implement a **<u>centralized risk management function</u>** covering settlement, liquidity, currency exchange, debtor, supplier, technological, and operational and other risks;

[43] On the basis of the progress in implementing these activities, it is expected that there will be increased transparency on the net cost of the postal universal service obligation and the method of financing it.

- Design and implement an **<u>asset management function</u>**, including a centralized record of assets, such as buildings, vehicles, equipment, and inventory;

- Establish a **<u>centralized procurement function</u>**;

- Design and implement a centralized **<u>human resource management</u>** and **<u>payroll accounting system</u>** for the more than 4,000 staff;

- Design and implement an **<u>enterprise resource planning system</u>** to support an integrated approach to the above functions and linked to the configuration to operate the financial services;

- Strengthen the **<u>internal audit</u>** function;

- Set up and introduce a **<u>register</u>** or archive of all **<u>corporate documentation</u>**;

- Design and introduce manuals, policies, guidelines, and standards documenting the above functions;

- Provide hands-on training and coaching in the new systems.

(b) External audits

7. Based on the strengthened financial management and the alignment of financial accounts on IFRS, this module will fund the preparation of the first external audits, for fiscal years 2012 and 2013.

(c) Amending the legal and regulatory framework for KPO

8. This module includes support for the application of KPO for a NBFI license, and support for the corporatization process of KPO.

- Support the application of KPO for a NBFI license, in particular to:
  - Prepare a policy note for the government as a basis to transfer regulation and supervision of KPO's financial services from MTC to NBKR;
  - Assist in the preparation of KPO's application for an NBFI license; and
  - Design a plan to ensure KPO's compliance with NBKR's regulatory framework, in particular through the implementation of the activities in strengthening financial management.

- Support to the corporatization process of KPO. The on-going corporatization process will continue to be led by the Task Force appointed by the government pursuant to its decrees, including published action plans. Project support to the process will be flexible, limited, and stem from results or progress achieved.

(ii) Business Process Modernization (US$3.79 million)

9. **This subcomponent will support the reengineering of a mainly manual and paper-based business process for bulk flows of small-value financial transactions.** It will introduce and implement a state-of-the-art ICT architecture for the distribution of financial services, resulting in significant improvement in quality, timeliness, reliability, cost-efficiency, and profitability of the delivery of financial services. It will link post offices to a central hub to expand services across the post office network. This subcomponent includes the following modules: (a) design of the ICT architecture and detailed ICT technical specifications; (b) installation of ICT components; and (c) other activities such as the preparation of a manual with corporate standards and guidelines for the design of the retail space of the post offices, setting up a help desk for post offices, and implementation of a regional pilot in secure and efficient cash logistics with small secure compact cars.

(a) Design of ICT architecture and detailed ICT technical specifications

10. **This module will support the design of an integrated, interoperable and comprehensive ICT architecture for KPO, favoring a progressive and cost effective approach.** It will be closely coordinated with and rely on inputs from the two other subcomponents. This module will propose options for back-up solutions to secure activities and archives.

(b) ***Installation of ICT components*** for key elements for up to 360 of KPO's 923 post offices, of which approximately 220 will be in rural areas[44], mainly focusing on:

- Integrated desk top **front office computerization**, which will be comprised of a serviced terminal configuration with narrow-casted touch screens; inside the terminal configuration there will be a PC and two or three small but different printers; the terminal will also feature an optical character reading or bar code scanner, an identity document (ID) scanner, signature pad, EFT- POS terminal, scales, and cash box;

- **Standard software** for a broad range of applications at the retail front end (for transactions related to financial services and postal services), interoperable with the Enterprise Resource Planning software applications resulting from subcomponent 1, and interoperable and open for integration of other applications regarding remittances, lottery, transport tickets, e-government, and e-commerce;

- **Operator training**, taking into account the existing level of computer literacy with many of the rural postal staff;

[44] These 360 post offices are in the process of being selected based on a defined set of criteria, mainly related to the level of activities and revenue generated, the potential development of the area (through the identification of other public and private services in the vicinity), as well as the state of the building (and its ownership by KPO). The modernization of the rest of the post offices will be subject to financial sustainability, and will need to be funded under another source or with additional financing under a subsequent phase.

- **Connectivity** solutions, which will be mainly based on the third generation (3G) networks of the Global System for Mobile Communications, to be negotiated with mobile telecom operators;

- **Security,** including safe boxes that are time-locked and PIN-code secured (with one per office as main cash storage), video monitoring, and alarm systems;

- Installation of a **central hub** to which the front office terminals in post offices are connected. This central hub will be connected to:

    - the back office systems at banks for transaction processing and client account keeping; with NBKR and the banks KPO will need to agree the detailed specifications of connecting directly to each of the banks' back offices or via the Interbank Automated Payment Centre;

    - MTOs, MFOs for transaction processing and their client account keeping;

    - the relevant back office systems at KPO for its financial management;

    - a call center at KPO's head office;

    - KPO's postal back office functions; and

    - Other third parties, such as:

        - the National Social Security Institution for disbursement of pension and social welfare payments;

        - telecom operators, public utilities, housing corporations, etc., for data transmission related to collection of bills;

        - publishers for recording newspaper subscriptions and fee collection;

        - insurance companies for sales and collection of insurance premium;

        - lottery agencies for sales of tickets and disbursement of (small) prizes;

        - schools and public agencies for collection of certain taxes and fees.

11. **The envisaged ICT architecture of KPO will have full compatibility and interoperability with back office systems of financial institutions with which KPO has concluded an agency agreement.** While implementation of the above activities would significantly improve KPO's business process capabilities, the envisaged ICT architecture of KPO will not include full-fledged back office functionality for own payment systems, savings administration, etc.

(c) Other activities

12. **The following activities will also be undertaken under this subcomponent:**

- Preparation of a manual with corporate standards and guidelines for the design of the retail space of the post offices used by KPO for the preparation of the post offices to be equipped;[45]

- Set up of a help desk for post offices; and

- Implementation of a regional pilot in secure and efficient cash logistics with small, secure compact cars. These vehicles will be equipped with a time-locked personal identification number (PIN), secured cash boxes, and Global Positioning System (GPS) navigation tools that are linked via the Global System for Mobile (GSM) communications via KPO's hub to KPO's cash logistics center for planning, tracing and tracking the vehicle's daily routes based on Geographic Information System maps and coordinates.

(iii) Expansion of financial services (US$0.7 million)

13. **This subcomponent will support a progressive expansion of the range and scope of financial services delivered via KPO.** KPO's current range of financial services is mostly limited to domestic cash-based payments and paper-based processing of payments. The services include: (i) cash distribution of state pension and social welfare payments; (ii) cash collection for public utilities, telecommunications companies, taxes, police fines, and school fees; and (iii) domestic and international postal money orders. Recently, KPO has progressed with the introduction of financial services based on agency agreements with banks, MTOs, and MFOs.

14. **This subcomponent includes the following two modules**: (a) capacity building for financial services management, including the buildup of a business unit responsible for marketing management and business development; and (b) piloting of new, improved or expansion of financial services supported with market research, advertising, and impact assessment.

(a) Capacity building for financial services management

15. **This module will include:**

- Restructuring the head office of Kyrgyz Post, to create the **business unit for financial services**, including marketing management functions with responsibilities and tasks clearly separated from the postal operations;

- Strengthening of financial services management capacities;

- Building capacity in **marketing management** of basic mass-market financial services, including market and public opinion research, "know-your-client" tools, competitor analysis, market planning, business planning, financial targeting, relationship management, operations oversight, quality assurance, and risk management;

[45] For example, the manual will define office colors, configuration and size of the desks, curtains, uniforms, etc. The project, however, will not finance any work on the offices.

- Supporting the new unit in its initial tasks, such as an updated analysis of the market, updated diagnosis of the financial performance of KPO, identification and review of current relationships, identification of potential new partners, preparation of a **three-year business plan** as input for improved financial management and business operations modernization, and an update of the action plan prepared under the 2008 Feasibility Study.

16. In more detail, the following activities will be undertaken to strengthen KPO's capacity to manage financial services:

- Analyze the current organization and identify functions and officers involved in financial services management and development;

- Design the organizational structure of the head office, including a Central Department for Business Management of Financial Services;

- Define job profiles of key staff;

- Define functional relationships and reporting lines between the Business Management unit and the post offices, district post office centers, and regional centers;

- Define the functional relationship and reporting lines between financial service management and financial management;

- Update and analyze the potential for delivery of ICT-based financial services through the Kyrgyz post offices, including potential volumes and profit, by district, oblast, Bishkek city, and nationwide;

- Set up relationship management between Kyrgyz Post and its current key institutional clients, assist in planning for potential new clients, and define the sales process, contract approval, and after-sales process;

- Define key products and project growth scenarios;

- Prepare product descriptions, terms and conditions, distribution policy, promotions, advertising, and pricing strategies;

- Organize business planning processes;

- Develop a business plan with projections for the next three years including market analysis based on research;

- Identify training needs in marketing, product knowledge, and customer service;

- Organize training for the different types and levels of staff involved in financial services.

(b) Piloting of financial services

17. **The project will assist KPO to prepare, implement, and evaluate pilot programs to improve existing financial services and to add new ones.** Potential pilots include the following:

- Domestic payments services ("pay@post" or universal bill payments), as a service to medium sized and large corporations and institutions (e.g., telecoms, municipalities, hospitals, schools) for efficient collection of the recurrent receivables from the public via standard format bills and invoices; the bills payments would all be credited to the bank account of the corporate client and KPO could act as a collecting agent, as well as printer and distributor of the bills;

- Payroll services for corporations for cash disbursement of wages by postal staff; this would be based on agreements between KPO and the employer and the bank of the employer;

- Card-based payment instruments such as prepaid cards, debit cards, or branded as, e.g., a Post ID Card;

- Payments solutions for non-cash instruments for ordering direct via e-commerce or internet;

- Last-mile migrant remittances delivery, including delivery at the post office or at the door of the recipient;

- Deposit account products including such products as savings cards, savings certificates or retail savings bonds (in small denominations), and these could be postal branded products and provided as an agency operation based on an agreement with one or more selected banks or the State Treasury;

- Children's savings or school savings;

- Mobile money, in collaboration with a mobile telecom network operator and a bank, whereby KPO acts as the cash agent;

- Insurance (premium collection, sales of basic insurance products), as postal branded or agency operation with one or more selected insurance companies;

- Microcredit related transactions such as loan disbursement and collection of periodic installments, under agency agreements with MFOs;

- Leasing space in post offices to MFOs so they can offer advice to potential clients in the preparation of their applications

18. **Each pilot is expected to focus on a different pilot area (e.g., a selected district), mainly in rural regions, with 10-15 post offices involved in the pilot.** Pilots will be implemented through special pilot task forces, involving staff from the head office, the regional and district centers, and the selected post offices. Based on evaluation of the completed pilot, a

plan for rolling out the services will be prepared in the following two months and implemented in the subsequent 12 months.

Component 3: Support to Aiyl Bank for Privatization and Deposit Mobilization (US$4.15 million)

19. Aiyl Bank was originally created as the Kyrgyz Agriculture Finance Company (KAFC) with World Bank support in December 1996. The earliest project documents envisaged a government-owned KAFC as a temporary, stop-gap measure to address the collapse of the agricultural finance system in the early years of post-Soviet transition. It was expected that KAFC would transform into a private commercial bank through a merger, buy-out, or outright sale. This transformation was supported by IMF conditionality in the mid-2000s, and steps were undertaken to carry out this transformation and privatize the bank. On December 27, 2006, the NBKR approved a resolution to transform KAFC into OJSC Aiyl Bank, a rural bank solely owned by the government, but with restrictions of practically all banking transactions, except for crediting of agricultural producers and their settlement-cash servicing. During 2008-2010, Aiyl Bank's license was expanded to allow it to: (i) accept deposits up to 25 percent of its capital (later increased to 50 percent), (ii) open and maintain the accounts of individuals and legal entities, (iii) independently establish and perform calculation on correspondent accounts (iv) make loans in foreign currency and to 30 per cent of the credit portfolio for non-agricultural activities, (v) conduct leasing, and (vi) provide guarantees.

20. Aiyl Bank's mission is to increase the efficiency and profitability of the rural sector in the Kyrgyz Republic and improve living conditions of the village population by providing financial services. The bank's objectives are to: (i) provide high quality financial services to agricultural and rural sectors in an efficient and cost-effective manner; (ii) support the development and raise efficiency of production and incomes of the private agricultural and rural sectors of the country; (iii) meet the client target groups' demand for credit resources; (iv) provide high quality management of the credit portfolio ensuring appropriate pricing, minimization of lending risks, diversification of the portfolio, and sustainability of the lending operations through timely repayment of the loans by the borrowers. Aiyl Bank devotes 70 percent of its lending to agriculture (including agribusiness) and 30 percent to non-agricultural businesses.

21. The Kyrgyz Parliament approved the sale of 67 percent of Aiyl Bank's equity on May 22, 2008. Subsequent to this approval, an Action Plan to privatize the bank was prepared under the PBSM Project, financed by the World Bank. The global financial crisis that began in September 2008, however, halted the momentum to privatize the bank as the economic downturn in the Kyrgyz Republic, as well as increased caution on the part of potential strategic investors, reduced interest in privatizing the bank. The Kyrgyz political crisis of 2010, which prompted a banking crisis, further focused the authorities' attention elsewhere in the financial sector. However, with renewed stability and commitment to reducing the government's involvement in commercial activities, the Kyrgyz authorities have again requested assistance to privatize Aiyl Bank. The new government has confirmed its commitment to the privatization of Aiyl Bank, if market conditions are conducive, by including it on its list of state-owned enterprises to be privatized by 2014.

22. Aiyl Bank, and the financial sector as a whole, will benefit from its privatization. Privatizing Aiyl Bank with a strong strategic investor(s) with international experience in rural and agricultural finance will help ensure that Aiyl Bank continues to grow as a market-oriented provider of rural financial services, strengthens its governance, improves its operations, strengthens the capacity of its staff and management, reduces costs, promotes competition in the financial sector, attracts additional financial resources to the country, and develops new products and services to meet the demands of its clients. Over the years, several potential investors have expressed interest in becoming strategic investors, including Rabobank, Agha Khan Agency for Microfinance, Soros Foundation, the European Bank for Reconstruction and Development (EBRD), and the International Finance Corporation (IFC).

23. Aiyl Bank has so far been fully dependent on donor funding for financing, although the recent decision to allow it to collect deposits should improve its ability to obtain more funding and satisfy more demands for loans. Its license currently restricts it to accept deposits up to only 50 percent of its capital, although it applied for a full deposit-taking license in July 2011. Deposit mobilization by Aiyl Bank will not only make Aiyl Bank less dependent on donor credit lines, but will also provide a highly needed financial service to its clients. The Kyrgyz Republic has one of the lowest deposit rates in ECA, with the share of deposits to GDP of 15 percent at end-August 2011, and only 115 adults out of 1000 with a deposit account (the latter is the second lowest in ECA after Tajikistan). A key reason for the low deposit penetration is the virtual absence of any licensed deposit facilities in rural areas. Although Aiyl Bank has a strong track record in lending, having built up considerable capacity in this area since it was established in 1996, it has limited capacity to mobilize deposits to finance its lending and will require TA to build this capacity. In the meantime, both while it awaits a full license and as it builds its capacity, it will require liquidity in the form of credit lines to finance its loan portfolio.

24. The project will include a credit line for Aiyl Bank that will be linked to technical assistance to support privatization and deposit mobilization. Aiyl Bank has projected liquidity needs at US$8 million in 2012 and 2013, based on planned annual increases of about 20 percent in it lending portfolio. The project's credit line to Aiyl Bank will only partially fulfill its additional liquidity need and will be linked to technical assistance on privatization and deposit mobilization, intended to wean it from the need for non-commercial credit lines from donors, including the World Bank. The credit line will be used to finance projects that fall within the agricultural portion of Aiyl Bank's lending policy, subject to the negative list cited in the environmental management framework. The credit line beneficiaries will receive sub-loans/leases in accordance with agreed eligibility criteria. To be eligible, a borrower must be at least 75 percent privately owned. The average working capital loan size is expected to be around US$5,000, while the average investment loan is expected to be in the range of US$25,000 equivalent, with a maximum of US$50,000 per loan under this credit line. The financial and commercial viability of the sub-projects and beneficiaries under this facility will be assessed by Aiyl Bank. It is estimated that around 500 farmers will have access to sub-loans under this program.

25. Therefore, the project will provide support to Aiyl Bank in four areas as outlined below:

(i) **Deposit mobilization (US$0.2 million).** The project will provide TA on various aspects of deposit mobilization, including marketing, product development, liquidity management, risk management, ICT systems, etc.

(ii) **Finalization of an Action Plan for privatization (US$0.05 million).** An action plan for the privatization of Aiyl Bank was prepared under a FIRST TA grant in 2009. This action plan will be updated and include a new timeline for Aiyl Bank's privatization. The action plan will include the pre-privatization phase, tender preparation/pre-launch investor outreach, and tender implementation.

(iii) **Implementation of the Action Plan for privatization (US$0.7 million).** The project will support hiring a privatization transaction advisor to assist the Kyrgyz authorities to carry out Aiyl Bank's privatization.

(iv) **Credit line to respond to liquidity needs while deposits are building and privatization is being prepared and carried out (US$3.2 million).** While the credit line will finance Aiyl Bank's liquidity needs, it will also be designed to support momentum to privatize the bank and to build capacity to mobilize deposits. Hence, the credit line will be disbursed in eight equal tranches based on Aiyl Bank's withdrawal applications as well as meeting the following disbursement-linked indicators (DLIs) for privatization and deposit mobilization. For each DLI that is achieved, Aiyl Bank will be eligible to receive one tranche of US$400,000.

Privatization benchmarks:

- Adopt an updated privatization Action Plan;
- Announce tender to hire privatization transaction advisory;
- Sign contract with privatization transaction advisor;
- Assemble data room;
- Announce tender;
- Announce tender results;

Savings mobilization benchmarks:

- Increase mobilized individuals' deposits by 50 percent from the level at December 31, 2011;
- Increase mobilized individuals' deposits by 100 percent from the level at December 31, 2011.

Addendum 2.1 to this Annex presents the terms and conditions of the credit line to Aiyl Bank.

<u>Component 4: Modernizing the Moveable collateral and Debt Resolution Regimes (US$1 million)</u>

26. **The moveable collateral registration, creation, execution process, as well as the debt resolution regime in the Kyrgyz Republic needs to improve to increase borrowers' access to finance.** Most banks are highly selective in the collateral that they will accept, limiting this to prime real estate in Bishkek and lending primarily to large borrowers in Bishkek. This is due to the fact that, within the current framework, using moveable assets as collateral is highly risky.

As a result, most of the financial needs of the poor, as well as of MSMEs, located in rural areas and smaller urban areas are underserved. Moveable collateral (e.g., vehicles, equipment, livestock) in the Kyrgyz Republic is accepted to a limited degree. The collateral creation, registration[46] and execution process is costly and lengthy, and there are no efficient methods of resolving bad debts. There is often a significant loss of value when the debtor becomes insolvent due to weaknesses in the insolvency system. The current requirement to register pledge for loans as small as KGS 25,000 is prohibitively costly for small loans since there are pledge offices only in seven oblasts. For borrowers located in remote areas, the costs of making trips to one of these seven offices make using collateral prohibitively expensive, which in turn restricts their access to bank and non-bank lending. Thus, the Collateral Registry's systems should be upgraded to allow for online registration, as well as online searches, which would significantly lower costs and increase access to the Collateral Registry. There are also shortcomings in the legal and regulatory framework for a well-functioning collateral creation, registration and execution regime**.** Out-of-court enforcement is allowed in principle, but is almost never possible in practice because any argument raised by the debtor to challenge enforcement by the creditor in court, can put a stop to the creditor's out-of-court enforcement, even if the parties have agreed to such enforcement mechanism in their security agreement at the time of the creation of the agreement.

(i) Legal and Regulatory Framework (US$0.35 million)

27. This project will support improvements to the legal and regulatory framework for secured lending and debt resolution. It will support improvements in the legal framework in the areas of creating a security interest, registering a security interest, priorities, enforcement, and debt resolution both in and outside of insolvency. It is preferable that registration be made optional, with a clarification in the law that registration is not necessary for the purposes of the validity of a collateral agreement, but is necessary to make the security interest enforceable against third parties.[47]

28. The project will assist in the development of a legal framework that would allow the registration of all encumbrances over moveable assets, not just pledges. The current registration system does not include the registration of interests and rights over a moveable asset other than pledges that create encumbrances on a moveable asset, such as transfers or retentions of title, taxes, leases, judgments, or assignments. Thus, it is difficult for lenders to know, for example, whether a piece of equipment being offered as collateral is leased, and therefore encumbered by another interest. Covering the registration of all encumbrances on moveable assets for the purposes of protecting that interest vis-à-vis third parties will allow lenders to assess whether an asset is clear of limitations, and decide whether they would accept it as collateral or not. Therefore, all encumbrances on moveable assets (not just pledges) will be covered by the registry in the collateral registry, and parties will (with some limited exceptions clearly stipulated in the law) be provided priority from the moment of registration.

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[46] The Central Pledge Registry (hereinafter "Pledge Registry") registers pledges in moveable collateral, while the State Registry registers immoveable collateral. This Project will address only the former.

[47] For example, if Creditor A registers it security interest over a particular collateral, and Creditor B does not register its security interest over the same collateral, then Creditor A will have priority over Creditor B if the borrower defaults, regardless which creditor made its loan first. If both creditors register their security interest over the same collateral, then the creditor who registers first will have priority over the creditor who registers second.

29. A working group will be formed to drive legal and regulatory improvements and to consult with key stakeholders. The project will also support the development of regulations for the proper functioning of the registry including, but not limited to, in the following areas:

- Time and location of operation of the registry;
- The manner in which the head of the registry discharges his duties and obligations;
- Requirements to complete a registration, including amendment, cancellation, and extension;
- Requirements to complete a search request;
- Search methodology;
- Format of confirmation of registrations and search results reports;
- Establishment of regular user accounts for access control and fee payment;
- Methods and processes for payment of fees;
- Fees for registry services.

(ii) On-line Registry (US$0.4 million)

30. The project will support the modernization of the registry by developing an online system of registration for encumbrances over moveable assets that is sustainable, easy to access, reliable, and secure. It will include preparing the registry's specifications and conducting a competitive bidding process for a turnkey installation of a new registry that involves the procurement of legal, operational and ICT experts, hardware, software, training, and related services for the proper functioning of the registry. Specific activities will include the following:

- Preparing detailed user requirements for the software and application software required to support the technical design of the registry;
- Preparing tender documents for the software and hardware;
- Procuring:
    - o the application software and hardware to ensure that all relevant agencies have the necessary ICT infrastructure (software and hardware) in place for the systems to be able to communicate and exchange information
    - o Internet Service Provider (ISP) services
    - o servers
    - o office equipment for the registry operations staff
- Developing operating budget estimates for the functioning of each registry;
- Testing and deploying new technology systems.

31. The project will develop a collateral registry that could be linked to other asset-based registries. There are several asset-based registries which are not linked to each other. Assets such as for vehicles, shares and stocks, vessels and ships, agricultural machinery and security interests on these assets are registered in a number of asset-based registries. For example, when accepting a car as collateral, the security interest has to be registered both in the collateral registry and with the police. This creates redundancy and an increase in transaction costs. Electronically linking the collateral registry with other asset-based registries will make it possible for users to submit their registrations into one data centre, and to conduct their searches through one point of entry. Once the registries are linked, the central point of entry will then transmit the information to each relevant registry. The design of the registry will be such that creating such linkages to other registries will be possible and easy in the future.

32. **The collateral registry will be financially autonomous.** The moveable collateral registry is not currently financially autonomous. Under the current system, any amount collected from fees that exceed what is required to sustain the registry is transferred to the state budget. Also, registry staff are considered civil servants, so their salaries are set by the government, rather than by competitive market forces. As a result, the registry is not able to attract qualified staff at competitive market salaries. The registry should become a financially self-sustaining entity, with a separate account where all fees collected (less taxes) are deposited, and where the money could be used to upgrade and maintain the registry.

(iii) Capacity Building (US$0.25 million)

33. **The project will provide training and awareness-building to public stakeholders** (including the staff of the registry, judges, and bailiffs) on compliance with new laws and regulations, and to private stakeholders (e.g., creditors, businesses, and arbitrators) on the use of the new system including on the use of the registry, asset-based lending techniques, and debt resolution mechanisms. These activities will include peer-to-peer learning events for banks and businesses on developing the moveable asset-based lending market in the Kyrgyz Republic. It will also include targeted study tours for selected groups, in order to familiarize them with the use of a modern system of moveable collateral and collateral registries.

Component 5: Project Coordination and Monitoring (US$0.8 million)

34. **This component will finance the project management function, as well as periodic monitoring and evaluation**. Given the number of implementing agencies (NBKR, KPO, Aiyl Bank, Collateral Registry), a Project Coordination Unit will be established in KPO. KPO is selected for this function as its component will be the largest and encompass the largest procurement packages. The NBKR has a well functioning PIU from the PBSM Project, and this PIU will be responsible for implementing the NBKR component. Similarly, an existing PIU in MoF will be responsible for implementing the credit line for Aiyl Bank. The PCU will provide support to the Collateral Registry and will coordinate with the PIUs in NBKR and MOF, as well as Aiyl Bank management, for project implementation and management, preparation of bidding documents, implementation of selection procedures, preparation of contracts in line with World Bank rules, payments processing, disbursement monitoring, preparation of financial reports, etc.

Addendum 2.1. Terms and Conditions of Credit Line to Aiyl Bank

1. The terms and conditions of the credit line will be largely the same as under other World Bank projects, and Aiyl Bank will be expected to provide co-financing in the amount of 20 percent of the sub-loan. The credit line beneficiaries will receive sub-loans or leases in accordance with agreed eligibility criteria. Detailed eligibility criteria and lending procedures will be described in lending guidelines, which will be part of the Project Operational Manual (POM). The financial viability and commercial viability of the sub-projects and beneficiaries under this facility will be assessed by Aiyl Bank. Aiyl Bank will be responsible for identifying prospective sub-borrowers, determining the type of sub-project to be financed and assessing conformity of the proposed activities with the eligibility criteria and that of the sub-loan/lease beneficiaries as described in the legal documents. Each sub-project will undergo an environmental assessment in line with the requirements of the Environmental Management Framework (EMF).

2. Key terms and conditions of the Subsidiary Loans:

(i) The Subsidiary Loans and Sub-financing will be provided on terms and conditions set forth in the POM and EMF;

(ii) The funds will be available in US Dollars and/or KG Som, based on the demand of the Sub-borrowers;

(iii) The interest rates to Aiyl Bank will be set based on the following formula:

a. On the Som portion, the interest rate will be variable (floating), based on the reference rate, which shall be equal to the average between the annual inflation rate projected by NBKR for the current year and the actual inflation rate of the preceding year. The reference rate shall be reviewed jointly with the Association, the Ministry of Finance and Aiyl Bank and revised semi-annually as necessary. An initial fixed margin of up to 1 percent will be added by the Ministry of Finance to the basic reference rate to compensate for the administration costs, and a fixed margin of up to 1 percent will be added for risk coverage.

b. On the US Dollar portion, the interest rate will be variable (floating), based on the reference rate which shall equal the 6-month LIBOR rate for Dollars. The reference rate shall be reviewed jointly with the Association, the Ministry of Finance and Aiyl Bank and revised semi-annually. A minimum margin of 1 percent will be added at all times to the basic reference rate by the Ministry of Finance to compensate for the costs associated with administration of the Credit and Subsidiary Loans, and risk coverage.

(iv) The principal amount of the Subsidiary Loan shall be repaid by Aiyl Bank over a period of fifteen (15) years, inclusive of a grace period not exceeding 3 (three) years, in accordance with a detailed amortization schedule that will be furnished to Aiyl

Bank by the Ministry of Finance before the expiration of the grace period indicated above.

3. Key terms and conditions of the sub-financings:

(i) The sub-financings will be denominated in KG Som or US Dollars, based on the demand from the sub-borrower, in accordance with the provisions of the POM;

(ii) The term and grace period of the sub-financings will depend on the type of investment financed, the repayment capacity of the sub-borrower, and other banking considerations.

(iii) The interest rates charged on the sub-financings will be consistent with prevailing market interest rates for comparable loans.

4. For the purposes of introducing the eligibility criteria and terms and conditions for the credit line, a subsidiary loan agreement (SLA) to be signed between the Ministry of Finance and Aiyl Bank will be developed. These documents shall need to be acceptable to IDA.

5. The Credit Line Management Unit (CLMU) in the Ministry of Finance, which is responsible for implementation of other World Bank credit lines, will also be responsible for implementation of the new credit line.

Annex 3: Implementation Arrangements

Financial Management

Country Issues

1. **The country public financial management (PFM) systems will be used only under the Component 1 of the project - *Strengthening the legal, regulatory, and supervisory framework for the financial sector,* which will be implemented by the NBKR**. Given that the country's PFM systems of accounting, financial reporting and audit are still considered to be weak, the country fiduciary risk is assessed to be substantial. As a result, to mitigate this risk, Bank-financed projects continue to rely on stand-alone financial management systems (which install accounting systems that are parallel to those used in the respective implementing agencies) for project implementation. Capacity among accounting professionals in the country is low, professionally qualified accountants are scarce, and knowledge of internationally recognized accounting and auditing standards, such as International Financial Reporting Standards (IFRS), International Public Sector Accounting Standards (IPSAS), and International Standards on Audit (ISA) among public and private sector accountants is limited. Most PIUs use cash-basis accounting, which is allowed under IPSAS; and in many cases, sufficient for accurate project accounting. Internal audit functions exist in a small but growing number of institutions, including line ministries; and external audit is practiced by individuals and a few audit firms.

2. **External audits of government agencies is conducted by the Chamber of Accounts.** Due to the agency's relatively low capacity, the Bank does not yet place any reliance on audits conducted by the Chamber of Accounts. However, the World Bank has provided support to strengthen the capacity of this supreme audit institution and it is anticipated that it will eventually rely more on audits conducted by the Chamber of Accounts, once its capacity has been adequately developed. Audit of Bank financed projects in the country has been performed by private sector firms that meet the Bank's eligibility criteria.

3. **Corruption is still acknowledged as a major issue in the public sector.** In addition to the risk mitigation measures summarized in the table below, the project will emphasize full disclosure, transparency, and strengthened complaint handling mechanisms for procurement activities. The country risk is assessed as substantial before mitigation measures and to be moderate after mitigation measures.

4. **Audits of Bank-financed projects in the country have been performed by private sector firms that meet the Bank's eligibility criteria**. In 2011, the Bank conducted a review of local audit firms to determine their capacity to audit Bank-financed projects, and only three firms were qualified for entity audits such as would be required under the project.

Implementing agencies

5. **There will be three implementing agencies involved in the financial management function under the proposed project**. The internal PIU established within the NBKR will be responsible for financial management arrangements of *Component 1 (Strengthening the legal, regulatory, and supervisory framework for the financial sector),* including budgeting,

accounting, funds flow and financial reporting. The NBKR has experience in implementing the Bank-financed projects and currently is responsible for implementation of the PBSMP. FM arrangements at the NBKR's internal PIU (including accounting, reporting, planning, and budgeting and staffing) have been assessed and are considered satisfactory to the Bank. The CLMU within the MoF will be responsible for the financial management of Component 3 (iv) (*Credit line for liquidity needs to Ayil Bank)* including budgeting, accounting, funds flow and financial reporting. The current CLMU has extensive experience in implementation of the Bank-financed projects and currently is responsible for fiduciary arrangements under four ongoing projects. An FM assessment was carried out to determine the FM implementation risk and the FM arrangements at CLMU, including accounting, reporting, planning, and budgeting, and staffing, and are considered satisfactory to the Bank. The PCU to be established within the KPO will be responsible for the financial management arrangements including the flow of funds, budgeting, accounting, reporting, and auditing under the remaining project components. In addition, the PCU within the KPO will also be responsible for the consolidation and submission of the project's annual budgets, quarterly IFRs, and annual financial statements to the World Bank.

Strengths and weaknesses

6. **The Financial Management system has weaknesses and strengths.** The main weaknesses are: (i) KPO lacks prior experience in the Bank-financed projects; (ii) there is no existing FM Manual that clearly describes financial reporting, accounting and internal control policies and procedures, budgeting and planning mechanisms to be followed by implementing agencies; (iii) the PCU within KPO is not yet established, and subsequently there is no FM staff and accounting and financial reporting capacity at the KPO. The strengths include: (i) there are similar FM arrangements under existing projects implemented by the CLMU and NBKR's PIU are found to be satisfactory; (ii) there are no significant issues in audits of active projects implemented by the CLMU and the NBKR's PIU; and (iii) there are experienced FM staff at CLMU and the NBKR's PIU.

7. The following Action Plan has been agreed to be implemented to ensure existence of satisfactory financial management arrangements that meet Bank requirements:

Actions for capacity building	Responsible	Completion Date
1. Procure and install automated accounting system that will be utilized by the PCU at KPO for project accounting, budgeting and reporting. The accounting system shall have functionality of automatic generation of reports for the GoK, as well as SOEs and IFRs for the project, and with inbuilt controls to ensure data security, integrity and reliability.	KPO	By effectiveness
2. Organize training on the WB FM and disbursement policies and procedures for the PCU FM staff.	KPO and the World Bank	By June 30, 2012
3. Develop the FM chapter of the Project Operational Manual (POM) to reflect the project related internal control, budgeting,	External Consultant	By effectiveness

external auditing, financial reporting and accounting policies and procedures		
4. Recruit the FM staff (financial manager and the disbursement specialist) with relevant experience for the PCU within KPO.	KPO	By effectiveness

8. **The overall residual FM risk of the project is substantial**.

Budgeting and planning

9. **Under the project, the PCU within KPO will be responsible for the preparation of the annual budget under KPO implemented components and consolidating annual project budgets based on procurement plans, and separate budgets received from the NBKR and CLMU**. The CLMU and the NBKR have, in general, acceptable budgeting and planning capacity under the ongoing projects. The annual budgets at the implementing agencies will be prepared in detail, which is necessary for monitoring the existing projects and will be based on the final procurement plan approved by the World Bank. The project budget will form the basis for allocating funds to project activities and requesting counterpart funds from the government, where appropriate. The consolidated budgets will be prepared according to the IFR format (disbursement categories, components and activities, account codes, and broken down by quarter).

Accounting and maintaining of accounting records

10. **The project accounting will be maintained on the cash basis.** For reporting purposes, cash basis and the World Bank guidelines for investment projects will be used under the project. The Financial Management Chapter of the POM will be elaborated to properly reflect accounting policies and procedures applicable to the project. For the purpose of the maintenance the project accounting the PCU with the KPO and CLMU will utilize 1-C accounting system and the NBKR will utilize the automated in-house accounting system for their respective components of the project. Those systems will be specially designed to meet the Bank-financed projects requirements, including ability to generate IFRs, withdrawal applications, SOEs, annual financial statements, etc. The systems shall have the safeguards against the input of inaccurate data using appropriate security profiles. In addition, regular back up of the accounting data shall be made by the accounting staff. Consolidated project financial reports as required by the World Bank and GoK, including IFRs, budgets and Annual Financial Statements will be prepared in Excel spreadsheets by the PCU within KPO. The proposed PCU within KPO will hire qualified FM staff responsible for: (i) overall FM arrangements under the KPO implemented Components of the project, including maintenance of accounting records, preparation of SOEs and withdrawal applications, financial reporting, budgeting and planning, etc; and (ii) consolidation of IFRs and annual financial statements and coordination of the project audit process.

11. **The CLMU and NBKR have prior experience with maintaining the independent accounting system under existing projects and will use current staff for the FM of the project**. The current FM personnel at the CLMU and NBKR PIU will be responsible for the project accounting, reporting and disbursements. All implementing agencies will use the cash basis IPSAS for reporting purposes.

Internal controls

12. **For the purposes of the current project, sound internal control system will be maintained in all implementing entities**. The internal control systems at the NBKR and CLMU are acceptable to the Bank and were assessed to be capable of providing timely information and reporting under the ongoing projects. Similar internal control systems will be maintained for the purpose of the proposed project. The proposed KPO PCU will be staffed with an experienced financial manager and disbursement specialists to provide for the proper segregation of duties. Expenditures incurred by the KPO will be authorized by the PCU director and verified for the eligibility and accuracy by the financial manager.

13. **Project related specific internal control activities applicable for each implementing agency will be described in the Financial Management chapter of the POM** including: procedures over cash transactions including maximum allowed daily cash operations, expenditure authorization, invoices approval and payments processing procedures; data backup arrangements; reconciliation procedures of project records with Client Connection, safeguards of assets, including cash. This section of the POM will also reflect the policies and procedures applicable for conflict of interest and related party transactions (real and apparent) and provide safeguards to protect the organization from associated risks. The bank account reconciliation will be prepared by the disbursement specialist and reviewed and approved by the financial manager of each respective implementing agency.

Financial reporting

14. Project management-oriented IFRs will be prepared under the project. Each implementing agency will produce separate financial reports for that part of the project that is implemented by that respective agency and submit them to the PCU for consolidation. The PCU within KPO will produce a full set of the project consolidated IFRs every three months throughout the life of the project to minimize the financial reporting risk. The format of IFRs has been agreed during the assessment, and includes: (a) Project Sources and Uses of Funds, (b) Uses of Funds by Implementing Entities, (c) Designated Account Statements, and (d) SOE Withdrawal Schedule. Separate IFRs will be produced by the accounting software installed at each implementing agency, consolidated with use of the Excel application and will be submitted to the World Bank within 45 days of the end of each quarter.

External audit

15. **The auditor's reports on the financial statements of existing projects implemented by the CLMU and NBKR for FY 2010 have been received on time (by June 30, 2011).** The auditors have issued unqualified (clean) opinions on the CLMU and NBKR executed projects financial statements with no major issues raised in the Management Letters. According to the Kyrgyz legislation, KPO's annual financial statements are not subject to the statutory audit.

16. **For each operation supported by a World Bank credit, the World Bank requires the borrower to maintain financial management arrangements that are acceptable to the World Bank** and that, as part of the overall arrangements that the borrower has in place for

implementing the operation, provide assurance that the proceeds of the credit are used for the purposes for which the loan was granted.

17. **Under the proposed project, (i) the project audit is required and will be paid from the Credit funds.** Project audit conducting will be coordinated by the PCU within KPO; and (ii) entities (i.e. KPO and Aiyl Bank) audit is required and will be paid from the Credit funds. Each Agency (i.e. Aiyl Bank and KPO) will be responsible for conducting its entity audit. Both projects and entity audits will be conducted by independent private auditors acceptable to the World Bank, on terms of reference (TOR) acceptable to the World Bank; and according to the International Standards on Auditing (ISA) issued by the International Auditing and Assurance Standards Board of the International Federation of Accountants (IFAC). The TORs will include activities involving: (a) audits of financial statements, (b) assessments of the accounting system, and (c) a review of the internal control mechanisms. The annual audited project and entities' financial statements together with the management letter will be provided to the World Bank within six months of the end of each fiscal year and also at the closing of the project.

18. **The following table lists the audit reports to be prepared by the project implementation agencies and their due date for submission to the World Bank:**

Audit Report	Due Date
Continuing entities' financial statements	Within 6 months of the end of each fiscal year and also at the close of the project
Project Financial Statements (PFS) The PFS include Project Balance Sheet, Sources and Uses of Funds, Uses of Funds by Implementing Entities, SOE Withdrawal Schedule, Designated Account Statement, Notes to the financial statements, and Reconciliation Statement.	Within 6 months of the end of each fiscal year and also at the closing of the project

19. **The audited financial statements will be publicly disclosed in a manner acceptable to the World Bank** and, following the World Bank's formal receipt of these statements from the borrower, the World Bank makes them available to the public in accordance with The World Bank Policy on Access to Information.

Flow of funds and disbursement arrangements

20. **The following Disbursement Methods may be used under the Financing**: (i) reimbursement; (ii) direct payment; (iii) advance; and (iv) special commitment. Details on the ceiling of the designated accounts (DAs) will be provided in the Disbursement Letter. Withdrawal applications for the replenishments of the DA will be sent to the World Bank at least on a quarterly basis.

21. **The following table specifies the categories of Eligible Expenditures that may be financed out of the proceeds of the Financing ("Category"), the allocations of the amounts of the Credit and of the Grant to each Category, and the percentage of expenditures to be financed for Eligible Expenditures in each Category:**

Category	Amount of the Credit Allocated (expressed in SDR)	Amount of the Grant Allocated (expressed in SDR)	Percentage of Expenditures to be Financed (inclusive of Taxes)
(1) Goods, non-consulting services, consultants' services, and Training under Part 1 of the Project		980,000	100%
(2) Goods, non-consulting services, consultants' services and Training under Part 2 of the Project	2,620,000	1,130,000	100%
(3) Goods, non-consulting services, consultants' services and Training under Part 3(i) – (iii) of the Project		620,000	100%
(4) Goods, non-consulting services, consultants' services and Training under Part 4 of the Project		650,000	100%
(5) Goods, non-consulting services, consultants' services and Training under Part 5 of the Project		390,000	100%
(6) Sub-projects under Part 3(iv) of the Project	2,080,000		80%
(7) Incremental Operating Costs under Part 5 of the Project		130,000	100%
TOTAL AMOUNT	4,700,000	3,900,000	

22. For the purposes of this Schedule:

(a) "Incremental Operating Costs" shall mean the expenses incurred by the Recipient, the PCU, or the CLMU for the incremental expenses on account of Project implementation, management, monitoring, including utilities, supplies, communications, maintenance costs, advertising expenses, Social Charges, bank charges, travel and per diems for employees of the PCU or the CLMU, salaries and statutory contributions of support staff, but not including salaries of officials or employees of the Recipient's civil service, as well as any contributions by these officials or employees to any social fund;

(b) "Social charges" means any payments, premiums or contributions for health benefits, unemployment benefits, disability insurance, workers' compensation benefits, retirement (pension or social security) benefits, and life insurance, which constitute payment for the drawdown of future benefits to the staff concerned; and

(c) "Training" shall mean the expenses incurred by the Recipient, the PCU, or the CLMU in connection with study tours, training courses, seminars, workshops and other training-related activities under the Project including travel costs and per diem for participants, trainers and trainees, trainers' fees, rental of training facilities, preparation and reproduction of training materials and other activities incidental to the preparation and implementation of training activities.

23. **Supporting documentation will be provided against payments to contracts for goods exceeding** US$100,000, US$200,000 for contracts with consulting firms and US$50,000 for individual consultant services contracts. Disbursements below these thresholds will be made according to certified SOEs. Full documentation in support of SOEs would be retained by each implementing agency for at least two years after the World Bank has received the audit report for the fiscal year in which the last withdrawal from the Credit Account was made. This information will be made available for review during supervision by World Bank staff and for annual audits which will be required to specifically comment on the propriety of SOE disbursements and the quality of the associated record-keeping.

Procurement

Procurement Capacity and Risk Assessment

24. **The PIU at NBKR will manage the NBKR component, and a PCU will be created in KPO to manage the KPO component, the collateral registry component, the Aiyl Bank component (excluding the credit line), and ensure overall coordination**. NBKR will be responsible for procurement under Component 1 "Strengthening the legal, regulatory, and supervisory framework for the financial sector" through its PIU, which is now responsible for all procurement for NBKR. The head of the PIU has received training in conducting international procurement in Bank-organized seminars and will work closely with the NBKR ICT, legal and other departments in managing the procurement cycle for the component. Procurement for the rest of the project, component 2 "Expanding financial services via KPO's network", component 3 "Supporting Aiyl Bank for Privatization and Deposit Mobilization" (excluding the Credit Line), component 4 "Modernizing the moveable collateral and debt resolution regime", and component 5 "Project Coordination and Monitoring" will be the responsibility of the PCU to be established in KPO.

25. **A procurement capacity assessment has been carried out at the NBKR, KPO, the CMLU under MoF, and Aiyl Bank.** Procurement capacity in the NBKR is in place as the PIU is responsible for the implementation of the ongoing PBSM Project. As for KPO, it revealed that while KPO has staff in place for its own procurement following national procurement procedures, neither of them has prior experience with Bank (or other IFI) financed procurement. In view of this, the main procurement risk would be potential delays due to low capacity of KPO. Another risk would be low level of competition in procurement due to the high cost of doing business in the region and the lower development of the local manufacturing industry. To mitigate these risks, a procurement consultant (who is familiar with the Bank procurement procedures) will be hired for PCU to be established in KPO. The Bank's procurement staff from the country office will provide advice and assistance on a regular basis. The procurement packages and plans will be carefully developed with a review to attract international participation in the bidding process, and procurement notices will be advertised widely.

26. **The CLMU under MoF will be responsible for implementation of sub-component (iv) (the credit line) under component 3.** Aiyl Bank will be responsible for ensuring that the sub-borrowers comply with the agreed procurement rules and procedures for sub-loans. The procurement capacity of Aiyl Bank is considered acceptable for supervision of the procurement under the commercial practices. Existing commercial practice requires that beneficiaries obtain several competitive bids before making a decision. In some cases they present those bids as part of the sub-loan application process. The general rule is to procure the least cost goods, works and services consistent with minimum quality requirements.

27. **The risk assessment rating for the entire project was done through Procurement Risk Assessment and Management System (P-RAMS).** Identified risks and proposed mitigation measures are described in the ORAF (Annex 4). The procurement risk is rated as **high.**

Applicable Guidelines

28. **Procurement for the proposed project will be carried out in accordance with the World Bank's Guidelines:** Procurement of Goods, Works and Non-Consulting Services under IBRD Loans and IDA Credits & Grants by World Bank Borrowers (January 2011) and Guidelines: Selection and Employment of Consultants under IBRD Loans and IDA Credits & Grants by World Bank Borrowers (January 2011); and the provisions stipulated in the Financing Agreement.

Procurement Plan and General Procurement Notice

29. **A draft procurement plan has been developed covering procurement activities for the entire project period (except for the credit line under sub-component (iv) of component 3).** The initial procurement plan has been agreed at negotiations (and is attached in Addendum 3.1 to this Annex). Thereafter, the plan will be updated from time to time or at least once per year and each update will be subject to the Bank's prior review. The initial procurement plan together with the subsequent updates will be published on the Bank's external web site in line with the requirements of Bank Guidelines. Due to the demand-driven nature of the credit line under sub-component (iv) of component 3, it is not possible to estimate the procurement

requirements for the sub-projects. Therefore, it is not possible for the sub-borrowers to develop a procurement plan, which would provide the basis for the procurement methods. Each sub-borrower will provide a list of items to be procured using the sub-loan proceeds.

30. **A General Procurement Notice (GPN) covering the project procurement activities, except the credit line under sub-component (b) of component 3, will be prepared and published at the negotiations.** More details on the procurement arrangements will be provided in the procurement section of Project Operational Manual.

Procurement of Goods

31. **ICT Systems and goods to be procured under the project will include**: ICT infrastructure for banking supervision; ICT software including installation and training for financial management system in KPO; ICT postal retail technology implementation system; compact cash transport cars; and software and hardware including training for modernization of the moveable collateral and debt resolution regime. ICB will be followed for most procurement packages. For a few small packages below US$100,000, shopping procedures will be followed.

Consultant Services

32. **Consultant services required under the project will include:** international TA for financial management capacity building in KPO including corporate reforms; financial services management (including marketing, pilot implementation, and training), and audit of 2012 and 2013 accounts in KPO; transaction advisor (firm) to assist the authorities to privatize Aiyl Bank. Individual consultants will be hired for: ICT business requirements and design under KPO; legal and regulatory framework for collateral agency; technical assistance for deposit mobilization and update privatization action plan of Aiyl Bank; individual consultants for PCU and CLMU.

Training and Operational Cost

33. **The project will finance some training activities (including personnel training, engagement of consumers and potential clients) and incremental operational costs for KPO and CLMU** as follows: office supplies, office rent, utilities and communications, travel and subsistence, and vehicle fuel and maintenance costs. Operational costs to be financed by the project will be procured using the implementing agency's administrative procedures, which were reviewed and found acceptable to the Bank. The implementing agencies will develop a detailed training plan and prepare annual operational budget for the Bank team's review and clearance.

Commercial Practices[48]

34. **In case of sub-loans with cost estimate less that US$500,000, which will be financed out of the credit line under sub-component (b) of component 3, the sub-borrowers may follow commercial practices that have been determined acceptable by the Bank.** Credit Line Guidelines will describe the basic guiding principles and acceptable procedures applicable to this sub-component. The Guidelines shall define the main responsibilities of Aiyl Bank such

[48] In accordance with paragraph 3.13 of the Procurement Guidelines and paragraph 3.13 of the Consultant Guidelines.

as: (a) assessing the capacity of the beneficiaries to carry out procurement efficiently; (b) approving acceptable plans for the procurement of goods, works and non-consulting services, and the selection of consultants as may be applicable; (c) agreeing to supervision and oversight arrangements under each sub-loan for the procurement to be carried out by the beneficiaries so as to ensure compliance with the agreed private sector methods and commercial practices under the sub-loans; and (d) maintaining all relevant records for the Bank's post review and audits when requested. Aiyl Bank should satisfy itself with the reasonableness of the price of contracts awarded by the beneficiaries in the particular market, if necessary through the hiring of an independent entity or auditors.

35. **The Subsidiary Loan Agreement to be signed between the MoF and Aiyl Bank will refer to the Bank's Anti-Corruption Guidelines as well as the Procurement Guidelines.** Aiyl Bank will check the contracts submitted by sub-borrowers so that the contracted firms are not on the World Bank list of debarred or suspended firms.[49] Contracts placed by sub-borrowers with their subsidiary or affiliated companies will not be eligible for financing. The procurement of second-hand goods shall not be eligible for financing.

36. **Advance Procurement.** To facilitate implementation of the project, all new procurement activities will be advanced as feasible in line with the agreed procurement plan.

37. **Retroactive financing.** There will be a provision for retroactive financing up to an aggregate amount not to exceed US$50,000 equivalent. This will cover eligible expenditures procured in accordance with World Bank guidelines and implemented in accordance with other relevant operational policies for executing project activities incurred prior to effectiveness. Retroactive financing will finance the relevant project expenditures incurred and payments made on or after December 20, 2011.

Procurement Supervision and Ex-post Review

38. **Routine procurement reviews and supervision will be provided by the procurement specialist based in the country office.** In addition, two supervision missions are expected to take place per year during which ex-post reviews will be conducted for the contracts that are not subject to Bank prior review on a sample basis (e.g., 20 percent in terms of number of contracts). One ex-post review report will be prepared per fiscal year, including findings of physical inspections for not less than 10 percent of the contracts awarded during the review period.

Additional Provisions for National Competitive Bidding

39. The standard NCB provisions for the Kyrgyz Republic, as included in the Financing Agreement, will be applied to all the NCB contracts in the country.

Procurement Thresholds

40. The thresholds for procurement methods and Bank prior review are indicated in the table below.

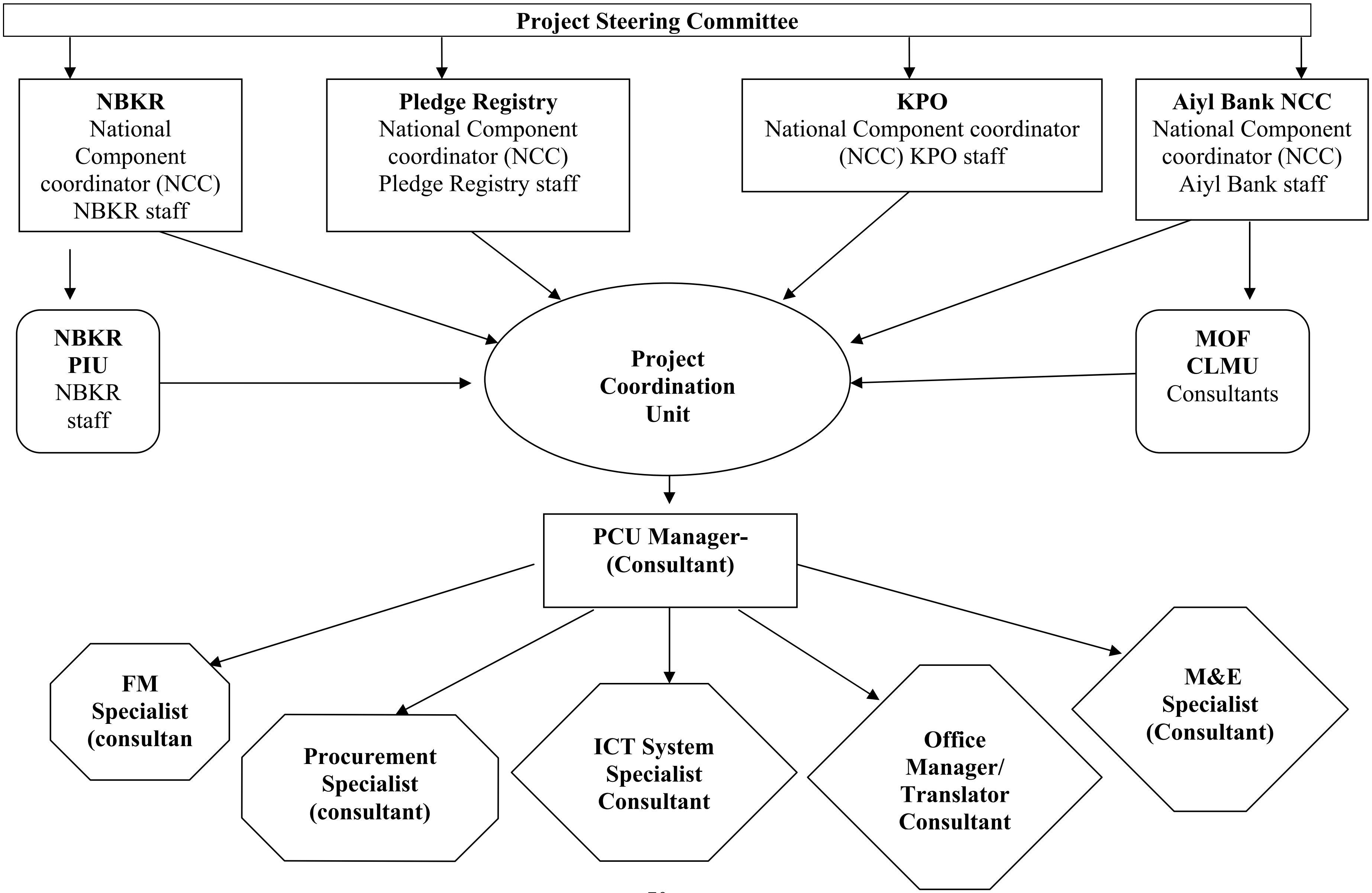
[49] List of debarred and suspended firms is available on the external website of the World Bank and the client connection website.

Expenditure Category	*Contract Value (US$)*	*Procurement Method*	*Bank Prior Review*
Goods	*>200,000*	*ICB*	*All ICB contracts*
	<=200,000	*NCB*	*The first two NCB contracts*
	<=100,000	*Shopping*	*The 1st Shopping contract*
	NA	*DC*	*All DC contracts*
Sub-loans	*<= 500,000*	*Commercial Practice*	*The 1st two contracts*
Consultant Services	*>300,000*	*QCBS, QBS, FBS, LCS*	*All contracts above US$100,000 for firms plus the 1st CQS contract regardless of value; and all contracts above US$50,000 for individuals; and all SSS contracts.*
	<= 300,000	*CQS*	
	NA	*SSS*	
	NA	*IC*	

Notes: *ICB – International Competitive Bidding*
NCB – National Competitive Bidding
DC – Direct Contracting
QCBS – Quality and Cost Based Selection
QBS – Quality Based Selection
FBS – Fixed Budget Selection
LCS – Least Cost Selection
CQS – Selection Based on Consultants' Qualification
SSS – Single (or Sole) Source Selection
IC – Individual Consultant selection procedure
NA – Not Applicable

41. The organizational chart on the next page shows the structure of the project implementation arrangements.

Chart 1. Project Implementation Arrangements – Organizational Chart



Addendum 3.1

Kyrgyz Republic
Financial Sector Development Project

PROCUREMENT PLAN - GOODS AND WORKS for Jan 2012 - Jun 2017
(Date of PP: January 26, 2012; Update No. initial; Date of WB NOL: negotiated version)

Item №	Contract Ref. №	Contract Description	Plan vs Actual	Procu. Method	WB Review (Prior/ Post)	Date of Draft BD to WB	WB No-objection to BD	Date of Invitation to Bids	Date of Bid Opening	Bid Evaluation Report	WB No-objection to Contract Award	Date of Contract Signing	Date of Contract Completion	Remarks
GOODS														
Component 1: Strengthening the legal, supervisory, and regulatory framework for the financial sector (US$ 1.5 Mln)														
1		ICT infrastructure for banking supervision	**Plan**	ICB	Prior	12/7/2012	12/21/2012	1/4/2013	3/5/2013	4/4/2013	4/18/2013	**5/9/2013**	5/9/2014	
Component 2: Expanding financial services via KPO's network (US$ 5.55 Million)														
2		ERP Software including Installation and Training (modules GLS, MIS, CM, RM)	**Plan**	ICB	Prior	12/15/2012	12/29/2012	1/12/2013	3/13/2013	4/12/2013	4/19/2013	**5/10/2013**	11/6/2013	
3		IT Postal Retail Technology implementation (400 location, central server, SW HW Training and Installation inc. Security, Helpdesk, Connectivity)	**Plan**	ICB	Prior	12/15/2012	12/29/2012	1/12/2013	3/13/2013	4/12/2013	4/19/2013	**5/10/2013**	5/9/2016	
4		Compact Cash Transport Cars	**Plan**	ICB	Prior	5/15/2013	5/29/2013	6/12/2013	8/11/2013	9/10/2013	9/24/2013	**10/15/2013**	4/13/2014	
Component 3: Supporting Aiyl Bank for Privatization and Deposit Mobilization (US$ 4.15 Million)														
No goods envisaged														
Component 4: Modernizing the secured transactions regime (US$ 1 Million)														
5		Procurement of software and hardware including training for modernizing the secured transactions regime	**Plan**	ICB	Prior	9/15/2012	9/29/2012	10/13/2012	12/12/2012	1/11/2013	1/25/2013	**2/15/2013**	8/14/2013	
Component 5: Project Coordination and Monitoring (US$ 0.8 Million)														
6		Computers for PCU	**Plan**	SH	Prior	2/15/2012	2/29/2012	3/14/2012	3/28/2012	4/27/2012	5/11/2012	**6/1/2012**	7/1/2012	
7		Furniture for PCU	**Plan**	SH	Post	n/a	n/a	3/28/2012	4/11/2012	5/11/2012	n/a	**6/1/2012**	7/31/2012	
8		Car for PCU	**Plan**	SH	Post	n/a	n/a	3/28/2012	4/11/2012	5/11/2012	n/a	**6/1/2012**	7/31/2012	
9		Accounting software for PCU	**Plan**	SH	Post	n/a	n/a	3/28/2012	4/11/2012	5/11/2012	n/a	**6/1/2012**	7/31/2012	

Kyrgyz Republic
Financial Sector Development Project

PROCUREMENT PLAN - CONSULTANTS - JAN 2012-JUN 2017

(Date of PP: January 26, 2012; Update No. initial; Date of WB NOL: negotiated version)

Item №	Contract Ref.	Contract Description	Plan vs Actual	Select. Method	WB Review (Prior/ Post)	Request for Exp. Of Interest	Draft RFP (incl. TOR, Short List)	WB No-objection to RFP (full package)	RFP Issued	Date of Proposal Submission	Tech. Evaluation Report (TER)	WB No-objection to TER	Combined Tech & Fin Eval. Report	Draft Final Contract	WB No-objection to Draft Contract	Date of Contract Signing	Date of Contract Completion	Remarks
Component 1: Strengthening the legal, supervisory, and regulatory framework for the financial sector (US$ 1.5 Mln)																		
no QCBS envisaged																		
Component 2: Expanding financial services via KPO's network (US$ 5.55 Million)																		
1		Financial management capacity building including corporate reforms	**Planned**	QCBS	Prior	3/5/2012	4/4/2012	4/18/2012	5/2/2012	5/30/2012	6/19/2012	7/3/2012	7/24/2012	8/13/2012	8/25/2012	**9/1/2012**	9/21/2014	
2		Financial Services Management (inc. Marketing, Pilot implementation, Training)	**Planned**	QCBS	Prior	3/5/2012	4/4/2012	4/18/2012	5/2/2012	5/30/2012	6/19/2012	7/3/2012	7/24/2012	8/13/2012	8/25/2012	**9/1/2012**	2/23/2016	
3		KPO Audit accounts 2012+2013	**Planned**	LCS	Prior	9/5/2012	10/5/2012	10/19/2012	11/2/2012	11/30/2012	12/20/2012	1/3/2013	1/24/2013	2/13/2013	2/27/2013	**3/6/2013**	9/2/2014	
Component 3: Supporting Aiyl Bank for Privatization and Deposit Mobilization (US$ 4.15 Million)																		
4		Transaction advisor to assist the authorities to privatize Aiyl Bank	**Planned**	QCBS	Prior	9/1/2012	10/1/2012	10/15/2012	10/29/2012	11/26/2012	12/16/2012	12/30/2012	1/20/2013	2/9/2013	2/23/2013	**3/2/2013**	3/2/2014	
Component 4: Modernizing the secured transactions regime (US$ 1 Million)																		
no QCBS envisaged																		
Component 5: Project Coordination and Monitoring (US$ 0.8 Million)																		
5		Project Audit	**Planned**	LCS	Prior	9/5/2012	10/5/2012	10/19/2012	11/2/2012	11/30/2012	12/20/2012	1/3/2013	1/24/2013	2/13/2013	2/27/2013	**3/6/2013**	4/14/2017	

Kyrgyz Republic
Financial Sector Development Project

PROCUREMENT PLAN - CONSULTANTS (CQS or Individual Consultants) - JAN 2012-JUN 2017
(Date of PP: January 26, 2012; Update No. **initial;** Date of WB NOL: negotiated version)

Item №	Contract Ref.	Contract Description	Plan vs Actual	Firm or Ind.	Select. Method	WB Review (Prior/ Post)	Draft TOR	WB No-objection to TOR	Request for Exp. Of Interest	Evaluation report for Short list & RFP	WB No-objection to RFP/ Short list	RFP Issued (for CQS)	Proposal Submission	Draft Final Contract	WB No-objection to Draft Contract	Date of Contract Signing	Date of Contract Completion	Remarks
Component 1: Strengthening the legal, supervisory, and regulatory framework for the financial sector (US$ 1.5 Mln)																		
1		IT requirements and design	Planned/ План	Ind	IC	Prior	7/2/2012	7/16/2012	7/30/2012	8/27/2012	9/3/2012	n/a	n/a	9/10/2012	9/17/2012	**10/1/2012**	12/25/2013	
Component 2: Expanding financial services via KPO's network (US$ 5.55 Million)																		
2		IT Business requirements and design	Planned/ План	Ind	IC	Prior	5/2/2012	5/16/2012	5/30/2012	6/27/2012	7/4/2012	n/a	n/a	7/11/2012	7/18/2012	**8/1/2012**	10/25/2013	
Component 3: Supporting Aiyl Bank for Privatization and Deposit Mobilization (US$ 4.15 Million)																		
3		TA (consulting services) for deposit mobilization	Planned/ План	Ind	IC	Prior	4/30/2012	5/14/2012	5/28/2012	6/25/2012	7/2/2012	n/a	n/a	7/9/2012	7/16/2012	**7/30/2012**	7/30/2013	
4		TA (consulting services) to update privatization action plan	Planned/ План	Ind	IC	Prior	4/30/2012	5/14/2012	5/28/2012	6/25/2012	7/2/2012	n/a	n/a	7/9/2012	7/16/2012	**7/30/2012**	9/28/2012	
Component 4: Modernizing the secured transactions regime (US$ 1 Million)																		
5		Legal and Regulatory Framework for secured transactions	Planned/ План	Ind	IC	Prior	4/30/2012	5/30/2012	6/13/2012	6/27/2012	7/4/2012	n/a	n/a	7/11/2012	7/18/2012	**8/1/2012**	12/25/2013	
6		Legal and Regulatory framework for debt resolution	Planned/ План	Ind	IC	Prior	4/30/2012	5/30/2012	6/13/2012	6/27/2012	7/4/2012	n/a	n/a	7/11/2012	7/18/2012	**8/1/2012**	12/25/2013	
7		Capacity Building consultant	Planned/ План	Ind	IC	Prior	6/1/2013	7/1/2013	7/15/2013	7/29/2013	8/5/2013	n/a	n/a	8/12/2013	8/19/2013	**9/2/2013**	1/26/2015	
Component 5: Project Coordination and Monitoring (US$ 0.8 Million)																		
8		Individual consultants for PCU and CMLU	Planned/ План	Ind	IC	Prior /Post	12/30/2011	1/6/2012	1/6/2012	1/20/2012	1/27/2012	n/a	n/a	2/3/2012	2/7/2012	**3/1/2012**	3/1/2013	

Annex 4: Operational Risk Assessment Framework (ORAF)

Kyrgyz Republic: Financial Sector Development Project

Stage: Negotiations

<table>
<tr><th colspan="8">Project Stakeholder Risks</th></tr>
<tr><td>Stakeholder Risk</td><td>Rating</td><td colspan="6">Moderate</td></tr>
<tr><td rowspan="2">Description:

(i) the government may resist reforms to increase the independence of the NBKR;
(ii) the NBKR may resist reforms to its regulations and supervision methods;
(iii) some banks or MFOs may resist some regulatory or supervisory reforms;
(iv) the government may resist reforms in Aiyl Bank, including privatization;
(v) the government or Ministry of Transport and Communications may resist reforms in KPO.</td><td colspan="7">Risk Management:

The team will: (i) continue policy dialogue on the advantages of reforms, (ii) refer as needed to earlier commitments, (iii) link the project, TA, and other support to progress in reforms, and (iv) reinforce reforms through DPOs.

The project team will ensure the recruitment of international experts to assist in the development of regulatory and supervisory frameworks in line with international good practices to ensure continuing support from the NBKR and market participants.</td></tr>
<tr><td>Resp:</td><td>Bank</td><td>Stage:</td><td>Implementation</td><td>Due Date:</td><td>Status:</td><td>In progress</td></tr>
<tr><th colspan="8">Implementing Agency (IA) Risks (including Fiduciary Risks)</th></tr>
<tr><td>Capacity</td><td>Rating</td><td colspan="6">High</td></tr>
<tr><td>Description:
The risk is that KPO's unfamiliarity with World Bank financial management procedures and procurement guidelines may result in occurrence of ineligible expenditures and improper financial reports and delay disbursements during implementation. As the location of the PCU, KPO may be perceived has being weak in dealing with other counterparts, particularly NKBR, leading to tensions in project coordination.</td><td colspan="7">Risk Management:
Responsible staff in KPO will receive training in financial management and procurement issues. The Financial Management Chapter of the Project Operations Manual will be elaborated that will properly document project related internal control, accounting, financial reporting procedures, etc. The WB required financial report will be produced automatically. A PCU located in KPO will manage the KPO component, collateral registry component, and Aiyl Bank component (other than the credit line) and be bolstered with consultants in financial management, procurement, ICT, monitoring, and office management. Retroactive financing will be used to hire the PCU consultants before effectiveness. KPO will also be supported by an experienced PIU in MTC. PIUs in the NBKR and the MOF will support the NBKR and Aiyl Bank credit line, respectively. A project steering committee will oversee the project and have necessary convening power to deal with potential tensions.</td></tr>
</table>

	Resp: Bank **Stage:** Implementation **Due Date:** **Status:** Not yet due
Governance	**Rating** Moderate
Description: The risk is that the implementing agencies' bureaucratic procedures will delay timely decisions for the project's activities.	**Risk Management:** Policy dialogue will continue, and training in procurement and financial management issues will be conducted. A project coordination unit (PCU) will be established in KPO and reinforced with consultants with expertise in financial management, procurement, and project monitoring and reporting.
	Resp: Bank **Stage:** Implementation **Due Date:** **Status:** Not yet due
Project Risks	
Design	**Rating** Moderate
Description: (i) The broad and complex scope may lead to implementation delays, as the project will involve multiple implementing agencies (e.g., NBKR, Aiyl Bank, KPO, collateral registry) and require significant project management and supervision; (ii) the complexity of the KPO reform in particular will be large and complex, and KPO's inexperience as an implementing agency and could result in delays and require extra supervision; (iii) populist tendencies in the current government may undermine efforts to reform and privatize Aiyl Bank, and to increase the independence and powers of NBKR; (iv) Despite earlier interest expressed by Rabobank, Agha Khan Agency for Microfinance, Soros Foundation, EBRD, and IFC, market conditions could make it difficult to find strategic investors interested in purchasing the bank.	**Risk Management:** Project design will include substantial technical and administrative capacity building for the implementing agencies. The team will (i) continue policy dialogue on the advantages of reforms, (ii) refer as needed to earlier commitments, (iii) link the project, TA, and other support to progress in reforms, and (iv) reinforce reforms through DPOs. The project team will incorporate lessons learned from other financial sector projects in the Kyrgyz Republic and will build on the experience of the implementing agencies. It will also incorporate lessons learned from the post office reform project in Azerbaijan. Adequate supervision resources will be necessary, and the team will ensure frequent assessments of project progress and will build flexibility to adjust components as circumstances evolve. A PCU will be established in KPO and reinforced with consultants with expertise in financial management, procurement, and project monitoring and reporting. A privatization advisor will be hired under the project to assist in privatization, including marketing, to find strategic investors.
	Resp: Bank **Stage:** Preparation **Due Date:** **Status:** In progress
Social and Environmental	**Rating** Low
Description:	**Risk Management:**

There are no social risks. There are limited environmental risks if Aiyl Bank's borrowers getting loans from the World Bank credit line do not comply with the World Bank's environmental requirements.	An environmental management framework has been prepared, approved, and disclosed. An environmental specialist will be hired to ensure subprojects' eligibility with the World Bank environmental requirements.							
	Resp:	Bank	**Stage:**		**Due Date:**		**Status:**	In progress
Program and Donor	**Rating**	Moderate						
Description:	**Risk Management:**							
The project activities do not depend on the completion of any other project. There is a risk of limited collaboration with donors, including the IMF, SECO, and GIZ. There is also a risk of delays in securing SECO cofinancing.	The World Bank will work to ensure close coordination with other donors, including the IMF, SECO, and GIZ.							
	Resp:	Bank	**Stage:**	Implementation	**Due Date:**		**Status:**	In progress
Delivery Monitoring and Sustainability	**Rating**	Moderate						
Description:	**Risk Management:**							
The risk is that progress may not be sustainable after project completion due to lack of technical capacity or adequate budget devoted to operation and maintenance of ICT systems.	The project will include substantial technical capacity building for implementing agencies to ensure sustainability of activities.							
	Resp:	Bank	**Stage:**	Implementation	**Due Date:**		**Status:**	Not yet due

Preparation Risk Rating:	Moderate	**Implementation Risk Rating:**	Moderate

Comments:

(i) The broad and complex scope may lead to implementation delays, as the Project will involve multiple implementing agencies (e.g., NBKR, Aiyl Bank, KPO, pledge registry) and require significant project management and supervision;
(ii) the complexity of the KPO reform in particular will be large and complex, and KPO's inexperience as an implementing agency and could result in delays and require extra supervision;
(iii) populist tendencies in the current Government may undermine efforts to reform and privatize Aiyl Bank, and to increase the independence and powers of NBKR;
(iv) despite earlier interest expressed by Rabobank, Agha Khan Agency for Microfinance, Soros Foundation, EBRD, and IFC, market conditions could make it difficult to find strategic investors interested in purchasing the bank.

Annex 5: Implementation Support Plan

The strategy for Implementation Support (IS) describes how the World Bank and other development partners will support the implementation of the risk mitigation measures and provide the technical advice necessary to facilitate achieving the PDO. The Implementation Support Plan also identifies the minimum requirements to meet the Bank's fiduciary obligations. It has been developed based on the nature of the project and its risk profile. It will aim to make IS efficient and flexible and will focus on the risk mitigation measures identified in the ORAF. Formal supervision and field visits will be carried out semi-annually and focus on:

- **Strong coordination between the World Bank, the implementing agencies, the PCU, the PIUs, and partners.** The World Bank project team will bring a comprehensive set of instruments and expertise to advise on project objectives and activities. It will work closely with the implementing agencies, the PCU, and the PIUs to ensure project success. The World Bank team will also coordinate closely with SECO on the legal, regulatory, and supervision activities for the NBKR, as well as with GIZ and the IMF.

- **Flexible approach.** The project will take a flexible approach to ensure that it meets client needs as circumstances evolve. The World Bank will continue a close policy dialogue with the implementing agencies and the government.

- **Financial management.** As part of its project supervision missions, the World Bank will conduct risk-based financial management supervision, initially after every six months and later at appropriate intervals based on assessed risk. A World Bank financial management specialist will interact with the client on an on-going basis. Areas for particular review will include the financing of ICT-related activities as a more risky area as well as checking that payments are done strictly in accordance with contract provisions. During project implementation, the World Bank will supervise the project's financial management arrangements in the following ways: (a) review the project's quarterly interim financial reports, the annual audited financial statements, the auditor's report, and remedial actions recommended in the auditor's management letters; and (b) during the World Bank's onsite supervision missions, review project accounting and internal control systems, budgeting and financial planning arrangements, and disbursement management and financial flows, as applicable.

- **Procurement.** As part of its project supervision missions, the World Bank will undertake procurement supervision, including post reviews. A dedicated procurement specialist will work with clients on a daily basis to ensure clients understand the Bank's procurement guidelines early during project implementation. Implementation support missions will be geared towards: (a) providing training to relevant staff of implementing agencies; (b) reviewing procurement documents; (c) providing detailed guidance on the Bank's Procurement Guidelines; and (d) monitoring procurement progress against the detailed Procurement Plan.

The main focus of the IS is summarized in the table below:

Time	Focus	Skills Needed	Resource Estimate (staff weeks)	Partner Role
First twelve months	Financial management training and supervision	FM specialist	6	
	Procurement training and review	Procurement specialist	6	
	Legal and regulatory acts, NBKR supervisory processes (TORs, recruitment of consultants, and supervision of consultants)	TTL, bank supervision expert, procurement specialist	4	SECO's participation in supervision missions
	ICT infrastructure for bank and nonbank supervision (TOR, recruitment, supervision)	TTL, procurement specialist	4	
	Financial management capacity building for KPO (TORs, recruitment, supervision of consultants)	TTL, postal reform expert, procurement specialist	4	
	Financial services management for KPO, including marketing, pilot implementation, training (TORs, recruitment, supervision of consultants)	TTL, postal reform expert, procurement specialist	3	
	Audit accounts for KPO for 2012 and 2013	TTL	1	
	ICT business requirements and design for KPO (TOR, recruitment of consultants, supervision)	TTL, postal reform expert, procurement specialist	2	
	ERP software including installation and training for KPO (TOR, recruitment of consultant, supervision)	TTL, postal reform expert, procurement specialist	2	
	ICT postal retail technology implementation (TOR, recruitment of consultant, supervision)	TTL, postal reform expert, procurement specialist	3	

	Compact cash transport cars for KPO (TOR, recruitment of consultant, supervision)	TTL, postal reform expert, procurement specialist	1	
	TA for deposit mobilization for Aiyl Bank (TOR, recruitment of consultants, supervision)	TTL, procurement specialist	2	
	TA to update privatization action plan for Aiyl Bank (TOR, recruitment of consultants, supervision)	TTL, procurement specialist	2	
	Transaction advisor to to privatize Aiyl Bank (TOR, recruitment, supervision of consultants)	TTL, procurement specialist	2	
	Legal and regulatory framework for moveable collateral and debt resolution (TOR, recruitment, supervision of consultants)	TTL, moveable collateral and debt resolution specialist, procurement specialist	3	
	Procurement of software and hardware, including training for the online registry (TOR, recruitment, supervision of consultants)	TTL, moveable collateral specialist, procurement specialist	3	
	Capacity building to stakeholders on new laws and regulations for moveable collateral and debt resolution and on the online registry (TOR, recruitment, supervision of consultants)	TTL, secured transactions and debt resolution specialist, procurement specialist	3	
	Project coordination and monitoring	TTL, procurement specialist, FM specialist	3	
13-48 months	Financial management supervision	FM specialist	8	

	Legal and regulatory acts, NBKR supervisory processes (supervision)	TTL, bank supervision expert, procurement specialist	12	SECO's participation in supervision missions
	ICT infrastructure for banking supervision (supervision)	TTL, procurement specialist	4	
	Financial management capacity building for KPO (supervision)	TTL, postal reform expert, procurement specialist	4	
	Financial services management for KPO, including marketing, pilot implementation, training (supervision)	TTL, postal reform expert, procurement specialist	12	
	Audit accounts for KPO for 2012 and 2013 (supervision)	TTL	2	
	ERP software including installation and training for KPO (supervision)	TTL, postal reform expert, procurement specialist	2	
	ICT postal retail technology implementation (supervision)	TTL, postal reform expert, procurement specialist	12	
	Compact cash transport cars for KPO (supervision)	TTL, postal reform expert, procurement specialist	1	
	TA for deposit mobilization for Aiyl Bank (supervision)	TTL, procurement specialist	3	
	Transaction advisor to to privatize Aiyl Bank (supervision)	TTL, procurement specialist	4	
	Legal and regulatory framework for moveable collateral and debt resolution (supervision)	TTL, moveable collateral and debt resolution specialist, procurement specialist	3	
	Procurement of software and hardware,	TTL, moveable collateral	2	

	including training for the online registry (supervision)	specialist, procurement specialist		
	Capacity building to stakeholders on new laws and regulations for moveable collateral and debt resolution,and on the online registry (supervision)	TTL, moveable collateral and debt resolution specialist, procurement specialist	6	
	Project coordination and monitoring	TTL, procurement specialist, FM specialist	6	

II. Partners

Name	Institution/Country	Role
SECO	Switzerland	Supervision of legal, regulatory, and supervisory framework for banks, MFOs, and credit unions
IMF		Coordination on legal framework for banks
GIZ	Germany	Coordination on regulatory and supervisory framework for banks, MFOs, and credit unions

Annex 6: Impact of the Political Turmoil on Financial Stability and Access to Finance in the Kyrgyz Republic

1. **Despite serious vulnerability, the Kyrgyz financial sector remained stable throughout the 2008-2009 global financial crisis.** The sector built up vulnerabilities prior to the 2008-2009 crisis, especially in terms of: (i) high credit risk resulting from rapid credit growth and a high share of foreign currency loans to unhedged borrowers, (ii) heavy reliance on wholesale funding (especially from Kazakhstani banks), and (iii) a concentrated banking sector. However, the banking sector withstood the effects of the financial crisis relatively well: capital adequacy and liquidity remained adequate throughout 2009, although NPLs grew from 5 percent at end-2008 to about 8 percent at end-2009. This resilience resulted from the authorities' crisis management response and the relative isolation of the Kyrgyz Republic from the global crisis contagion channels. Over the course of 2008-10, the authorities implemented various crisis contingency measures.[50]

2. **However, the political upheavals of 2010 led to significant financial sector instability.** The political crisis caused a large and immediate deposit outflow. Total deposits fell by 30 percent between March and April 2010, mostly due to large withdrawals from nonresident accounts. The deposit decline was mainly concentrated in AUB. AUB was the largest bank at that time with 53 percent of deposits and was most affected as its assets portfolio showed significant weaknesses. AUB's portfolio was affected by connected and insider lending, and a sizable portion of the bank's liquid assets were placed with asset management companies, which may not be recoverable. NPLs increased rapidly after March 2010, reaching 17 percent of total loans at end-October 2010 (from 8 percent in 2009). Capitalization also declined reaching 22 percent in October 2010 (compared to 34 percent at end-2009). Although some banks remained profitable and weathered the crisis well, overall banks incurred substantial losses in the first ten months of 2010 (in the amount of KGS 4.5 billion), with a negative ROE of 50 percent and a negative ROA of 9 percent. The liquidity ratio (liquid assets as a percentage of liabilities maturing within 30 days) also declined to 65 percent in October 2010 (from 87 percent at end-2009).[51]

[50] E.g., (i) the authorities launched a deposit insurance system in August 2008 that became effective in November 2009; (ii) the National Bank of the Kyrgyz Republic (NBKR) required banks to prepare anti-crisis contingency plans starting in October 2008, and banks increased liquidity, tightened lending standards, and increased provisioning; (iii) the government and NBKR issued a joint resolution in December 2008 on Measures for the Rehabilitation of Banks of Systemic Importance that identified the roles of NBKR and the Ministry of Finance (MoF) and allowed for capital injections into systemic banks through the budget; (iv) NBKR set up emergency liquidity support for banks by establishing the Specialized Banks Refinancing Fund in January 2009; (v) NBKR required banks to perform stress tests; (vi) NBKR increased the number of its targeted bank inspections and required all banks to send a weekly report on their liabilities and expected outflows; and (vii) NBKR lowered the discount rate from 14.4 percent in January 2009 to 1.6 percent in November 2009 to facilitate lending.

[51] The financial soundness indicators showed improvement starting in December 2010, when the data included only the good bank (Zalkar Bank).

Table 1: Financial Soundness Indicators

	Dec-09	Jun-10	Oct-10	Dec-10	Mar-11	Jun-11	Oct-11
Capital adequacy							
Net total capital/risk-weighted assets	34%	25%	22%	31%	30%	28%	30%
Liquidity							
Liquidity ratio	87%	76%	64%	73%	77%	73%	73%
Asset quality							
Nonperforming loans/total loans	8%	14%	17%	16%	14%	12%	11%
Loan-loss provisioning/gross loans	5%	7%	12%	11%	8%	7%	7%
Loan-loss provisioning/nonperforming loans	58%	53%	68%	68%	60%	60%	60%
Profitability							
Return on equity	14%	-58%	-50%	7%	16%	18%	17%
Return on assets	2%	-11%	-9%	1%	3%	3%	3%
Loans and deposits							
Loans/deposits	76%	104%	95%	95%	95%	95%	97%
Loans/assets	37%	49%	47%	45%	45%	46%	46%
Foreign currency exposure							
Share of foreign currency deposits in total deposits	68%	53%	55%	57%	57%	58%	54%
Share of foreign currency loans in total loans	62%	58%	56%	56%	54%	52%	53%

Source: NBKR

3. **The NBKR took immediate measures to restore financial stability, although the interventions stretched its capacity severely.** Following the large deposit outflow, the NBKR took seven banks (accounting for 45 percent of the system's assets) under temporary administration, imposed direct supervision (a less restrictive form of temporary administration) in ten banks, and issued instructions to senior officials of three additional banks.[52] After closer scrutiny, the temporary administration was removed in some banks, leaving five banks under temporary administration. AUB, one of the five banks under temporary administration, was later placed under conservatorship when the financial position was seen to be severely eroded due to flight of deposits, poor asset quality, and crystallization of a few contingent claims. The deficiencies in AUB's balance sheet, combined with legal complications and political compulsions, led to the withdrawal of AUB's license. Following a complicated legal process, AUB was nationalized and declared bankrupt at the end of 2010, and was split into a "good bank", named Zalkar Bank, and a "bad bank", AUB, in February 2011.[53] In the absence of a sound bank resolution legal framework, the intervention of AUB engulfed the authorities in a complicated legal process, which was aggravated by AUB's involvement in questionable transactions related to the previous political regime. The authorities are in the process of

[52] The NBKR also imposed direct supervision in ten banks, and issued instructions to senior officials of three additional banks.

[53] Most of the loan book, liquid and fixed assets, deposits, and losses from AUB's swap agreements with micro-finance institutions were transferred to Zalkar Bank. Assets and liabilities of related parties, nonresident liabilities, and deposits from the State Property Bureau (pending criminal cases related to these deposits) remained in AUB.

privatizing Zalkar bank, and AUB will be liquidated. Four other banks remain under conservatorship, and NBKR cannot take action to resolve these banks because there are pending court cases from their shareholders.

4. **Due to NBKR's interventions, as well as improved stability in the political and economic climate, banking sector indicators have also begun to improve.** At end- October 2011, NPLs levels declined to 11.2 percent and capitalization increased to 29.6 percent. Banks' profitability improved with the ROE at 17.4 percent and the ROA of 2.9 percent, and banks reported KGS 1.6 billion in profits. The liquidity ratio also improved to 72.7 percent at end-October 2011.

5. **Despite these improvements, the challenges faced by the NBKR in resolving problem banks highlighted deficiencies in the bank resolution legal framework.** The bank resolution framework is fragmented, and there are gaps, overlaps and inconsistencies across several laws, such as the Law on Conservation, Liquidation and Bankruptcy of Banks, the Law on Banks and Banking Activities, and the Law on the National Bank of the Kyrgyz Republic, the Law on Bankruptcy (Insolvency). These problems make the laws difficult to interpret or apply, leading to court decisions that have undermined the NBKR's ability to take prompt actions to deal with the banks placed under official administration.

6. **The banking crisis also highlighted weaknesses in the supervisory framework for the banking sector.** There are weaknesses in onsite and offsite supervision, stress testing, and contingency planning and crisis management. Although the NBKR has been working towards strengthening the prompt remedial actions framework, it does not have in place an effective framework that it can use to ensure that effective remedies are initiated at the earliest stage of bank problems. In addition, the supervisory staff do not have adequate legal protection from prosecution for actions taken in performance of their duties, and thus have been hesitant to take supervisory actions. There are weaknesses in onsite supervision, in the CAMELS[54] methodology and processes, the control framework for on-site examinations, and the bank supervision manual. The experience from the recent stress in the banking sector has also confirmed the need to strengthen the off-site reporting framework[55] as there are weaknesses in the reporting formats and the analysis of information. In addition, the single factor stress tests undertaken by the NBKR do not capture vulnerabilities adequately – stress tests on more parameters would enhance the NBKR's capacity to monitor vulnerabilities. The NBKR also lacks a formal framework for crisis preparedness and crisis management, and a special supervisory framework designed for 'systemic' or 'large' banks.

7. **The supervisory framework is also affected by an outdated information and communications technology (ICT) framework.** The NBKR's bank supervision department is at present using limited ICT to support its operations, which poses a number of challenges. The software package (FINA) is used only by the off-site supervision unit, it has not been upgraded since its installation in the early 2000s, there is no local support (necessary to keep it in line with changing requirements), and the performance of the hardware is unsatisfactory. These problems

[54] Capital, Assets, Management, Liquidity, Earnings, Sensitivity.

[55] Amongst others, the off-site framework should include details of : (i) unhedged foreign currency exposures of bank customers; (ii) asset-liability mismatches in greater detail; and (iii) duration of interest rate sensitive assets and liabilities to support more intensive stress testing.

are recognized by the NBKR management, which has recently approved a far-reaching corporate information systems strategy under which all information systems and technologies will be updated across the board over a five-year period starting in 2012. Under the strategy NBKR's collection of external data (which includes supervision-relevant data collected from banks and NBFIs) will be rationalized in a 'data warehouse' project. At the same time the existing FINA software will be replaced by a more modern system with more extensive functionality to support the evolving activities of the banking supervision department, including the on-site supervision and licensing units. This supervision module has the highest priority in the IS/ICT upgrade strategy.

8. **There are also deficiencies in the regulatory framework for the banking sector.** For example, the regulation on credit risk management does not explicitly require banks to adopt uniform asset classification within the bank or across banks, which can lead to an understatement of NPLs. The liquidity risk management guidelines do not manage separately the risks for domestic currency and foreign currency.[56] The NBKR lacks prudential guidelines for banks to address the indirect risks inherent in foreign currency loans to unhedged clients, such as fixing prudential limits on such exposures or periodical internal monitoring of unhedged foreign currency exposures. In addition, there are no regulations on electronic banking, business continuity planning, outsourcing, new products and related risks, Basel II, Basel III, consolidated supervision and risk focused supervision.

9. **The crisis also highlighted weaknesses in the NBKR's human resource management.** The NBKR's supervision department suffers from a high level of attrition and corresponding low average level of experience of its current staff. Despite their admirable performance during the 2010 banking crisis, capacity was stretched beyond the department's limits, suggesting that improvements are needed in the NBKR's HR policies including, among others, aspects relating to recruitment, staff mobility, training and higher education, compensation, career progress, and staff retention.

Access to Financial Services

10. **The banking sector in the Kyrgyz Republic expanded rapidly in recent years, but the global economic crisis of 2008-2009 and the 2010 political events led to a slowdown in growth.** Bank credit increased on average by 55 percent per year in 2004-2007, although it slowed down to a 23 percent in 2008, and declined by 1.8 percent in 2009 due to the economic crisis, which led to increased risk aversion in banks and reduced demand by clients. In 2010 and 2011, credit remained largely stagnant with a modest 4.8 percent growth in 2010, despite a decline in mid-year following the political crisis, and a 16 percent growth in the first ten months of 2011.

11. **Bank deposits also increased on average by 40 percent per year in 2004-2008, slowing down to 18 percent in 2009.** In 2010, deposits declined by 17 percent, after more than 30 percent of total deposits were withdrawn in April 2010. Deposit growth resumed in 2011 with an 11 percent growth in the first ten months of 2011.

[56] The guidelines must also require adoption of board approved policies, prescribe norms for assigning various items of assets and liabilities to the relevant maturity bands, fixing of appropriate management limits for maturity mismatches, etc.

12. **Financial intermediation in the Kyrgyz Republic remains limited, and became more limited due to the global economic crisis and the 2010 political events.** The Kyrgyz Republic ranks low in credit and deposit penetration compared to other countries in the region. Credit to the private sector as a share of GDP amounted to 13 percent and deposits as a share of GDP amounted to 16 percent in 2010. Access to finance became more limited in 2009-10 due to the global economic crisis and the 2010 political events. The global crisis undermined market confidence and caused banks to become risk averse and reduce lending. The sharp increase in NPLs following the 2010 events also impacted bank lending, as all banks suspended lending in the South, while bank lending was also affected in the North following border closures with Uzbekistan and Kazakhstan. AUB was forced to suspend operations, and banks under temporary administration had limited operations. A spike in NPLs in the microfinance sector due to their exposure in the South also caused microfinance organizations (MFOs) to reduce lending. About 37 percent of the total portfolios of the four largest MFOs was allocated in the affected southern regions, resulting in significant losses. MFOs' liquidity in local currency also tightened significantly due to the suspension of AUB operations, which was MFOs' primary source of local currency swaps.

13. **The supply of financial products to micro, small, and medium enterprises (MSMEs) is particularly limited due to legal constraints, as well as weak capacity in the banking sector.** There is no factoring (i.e. the purchase of commercial accounts receivable to provide short term finance to small suppliers) due at least partially to the legal framework's prohibition on transferring ownership of a debt by way of assignment. There is also very little leasing for equipment financing, as it is taxed disadvantageously compared to borrowing a loan. Without access to long-term finance, companies face significant problems in financing investments for expansion or acquiring modern technologies. This is a significant obstacle to private sector growth, expansion of exports, competing in international markets, and employment generation.

14. **While MFOs and credit unions are filling some of the gaps in access to finance for smaller borrowers, the poor, and the agricultural and rural areas, most remain small and face high operational and funding costs, as well as legal, regulatory, and institutional constraints that inhibit their expansion.** MFOs and credit unions provided 22 percent of all credit provided by the financial sector as of end-2010. MFOs have high funding costs because they are largely dependent on international credit lines and on local banks for conducting swaps to convert foreign currency funding to local currency funding. Only one MFO is licensed to take deposits, and it received this license in 2011. Credit unions lack the governance and operational skills to become more efficient and lower costs. They are largely dependent on FCSDCU for financing.

15. **Bank lending remains limited especially to the agricultural and rural areas.** The mountainous geography of the country makes it unprofitable to service isolated areas using traditional banking methods. The limited number of bank branches in rural areas means banks do not get to know rural and agricultural clients as easily as urban clients. Agricultural loans are recognized as risky because many farmers are poor, crop prices can be volatile from season to season and year to year, crop yields can also vary significantly from year to year, and yields of different farmers in the same area are correlated (so a large loan portfolio in a given area can be wiped out in a bad year). These problems are exacerbated by banks' lack of sector-specific knowledge and ability to appraise agricultural loans, as well as their lack of appropriate financial and risk management products. Moreover, in the Kyrgyz Republic, provisions of the Law on

Pledge and the Law on Administration of Land of Agricultural Purpose limit the usefulness of agricultural land as collateral.[57] Other disincentives to lend for agriculture include the unequal taxation of leasing, which limits leasing of agricultural equipment, and the requirement to register pledge for loans as small as KGS 25,000, which is costly in terms of travel time and expenses since there are pledge offices only in seven oblasts.

16. **Deposit services are virtually non-existent in rural areas.** Deposit services provide a significant benefit to households, reducing transaction costs, improving money management, and contributing to wealth creation. Most rural inhabitants do not have access to deposit services. Banks are the primary deposit-taking institutions, but most do not have rural branches, and Aiyl Bank, the one bank focused on rural clients and with a rural branch network, has a license that limits its deposits to a maximum of 50 percent of its capital, greatly limiting its deposit services. Of the 199 credit unions, only 11 are licensed to take deposits; and only one MFO is licensed to take deposits, having received its license in 2011.

17. **The Kyrgyz Republic receives large inflows of remittances from migrant workers, but only a minority of it is channeled through the formal financial sector.** In 2010, there was a large inflow of US$1.4 billion in remittances, accounting for 30 percent of GDP, which places the Kyrgyz Republic in the top 10 remittances receiving countries in the world. Most bank branches in Bishkek provide services for multiple money transfer operators, but the majority of recipients are rural and must travel long distances to collect their money. The sender of the remittances in the Russian Federation typically pays in Russian rubles, which in general is converted into U.S. dollars and made available either in U.S. dollars or Kyrgyz soms. The real cost of sending and receiving money from Russia to rural Kyrgyz Republic is therefore high and not always transparent.

18. **While the causes of the constraints on access to finance are numerous[58], reforms and investments in certain key areas will likely have the most significant impact.** Several factors contribute to limited access to financial services in the Kyrgyz Republic such as limited competition in the banking sector, lack of adequate financial information on firms due to weak accounting standards and practices, weaknesses in the credit bureau, weak risk management and credit assessment skills in financial institutions, low public confidence in banks, legal and regulatory obstacles, the mountainous geography of the country, and others.[59] However, reforms in the following key areas will likely have the most impact: (i) reforming and investing in the KPO to expand its financial services through its large network of branch offices; (ii) privatizing Aiyl Bank and expanding its deposit services; and (iii) modernizing the moveable collateral

[57] For example, under the Law on Pledge (Art. 66), (i) the claim for foreclosure against agricultural land may be refused if the debt is considered "very insignificant" and the amount of the pledgee's claims is, therefore, "incommensurate with the market value of pledged lands"; and (ii) in case of "valid reasons" for default, such as "bad harvest, natural disasters, flood, hail, and other extreme weather conditions" a court may (at the pledgor's request) postpone the sale of the land for up to a year. Furthermore, the Law on Administration of Land of Agricultural Purpose adds other limitations: (i) agriculture land shares used as collateral and seized by the lender may be sold only to other shareholders in the same plot of land (Art. 25); and (ii) agriculture land used as collateral and seized by the lender may be sold only to other rural inhabitants (Art. 17 and 26).

[58] Access to Financial Services Policy Note, World Bank, June 2010.

[59] Some of these constraints are being addressed by other donor interventions, e.g., the IFC (credit bureau and risk management) and corporate financial reporting (World Bank and FIRST TA). Moreover, the World Bank, EBRD, and ADB are providing credit lines for agricultural and SME finance.

regime. A detailed overview of each of these institutions and the key challenges they face is presented below:

KPO Financial Services

19. **KPO is the postal operator and a state enterprise regulated by the Ministry of Transport and Communications.** Since the late 1990s, the government has tried to improve KPO's operations with the aim of expanding access to financial services, particularly in rural areas and to poor communities.

20. **KPO's current range of financial services is mostly limited to domestic cash-based payments and paper-based processing of payments.** The services include: (i) cash distribution of state pension and social welfare payments; (ii) cash collection for public utilities, telecommunications companies, taxes, police fines, and school fees; and (iii) domestic and international postal money orders. Recently, KPO has progressed with the introduction of financial services based on agency agreements with banks, MTOs, MFOs, and insurers, such as disbursing migrant remittances, collecting loan installments and accepting deposits, and accepting payments of insurance premiums. The financial services include about 18 million transactions per year (an average of 75 transactions per day per office). This volume is nearly six times the volume reported by the NBKR for the transactions via ATMs, electronic funds transfer at point of sale (EFT-POS) terminals, and the interbank settlements and clearing system. The KPO network currently serves monthly more than one million adults for payments and other basic financial services at a cost of less than one percent of the value of the transaction.[60] The postal network is therefore a low cost distribution channel as compared to bank branches, ATMs or agents.

21. **More than 85 percent of KPO revenues are generated from financial services**. KPO offers a range of traditional postal services, but mail services represented only 14 percent of total revenues in 2011. Moreover, they are heavily loss making.[61] KPO's gross revenues will reach a projected US$10.4 million in 2011, and financial services generated US$9 million, with US$7.5 million from fees for delivering pensions (87 percent of state pension payments are made by KPO), and about US$1.5 million for fees from utility payments, migrant remittances, and bank agency services.

22. **The FIRST feasibility study conducted in 2007/2008 and follow up work have identified KPO's high potential as a low-cost distribution channel for providing or expanding access to basic financial services.** With a country wide network of 923 post offices, and especially through 684 post offices in rural areas, KPO has the potential to play a significant role in expanding access to basic financial services. There are 250 bank branches as of October 21, 2011, in the Kyrgyz Republic (an average of one branch per 22,500 inhabitants). In rural areas, access to financial services is even lower where there is less than one branch per 150,000 inhabitants. More than 90 percent of the Kyrgyz adult population cannot access the financial

[60] The transaction fees are paid by the institution that distributes or collects, not by the individual. This adds to transparency and simplicity for the small users and differs from banks and self-service payment terminals where the individual pays fees ranging from 0.75 percent to 5 percent.

[61] KPO's figures suggest that the postal mail business function has lost its market relevance and is currently being sustained by the state and through cross subsidizing mainly with revenues from state pension delivery.

sector's most basic service, i.e. cashless payments instruments, which can often be an entry point for accessing other financial services, such as savings, deposits, and insurance. Therefore, with a wide network of one post office per 6,000 inhabitants, KPO can contribute to expanding access to basic financial services, especially in rural areas. KPO's recent progress in expanding access to financial services could significantly advance through more agency agreements with banks and MFOs for financial services, taking advantage of its low cost distribution channel, to reach segments that the banks and even MFOs currently cannot reach. The potential financial services include: deposit products, migrant remittances, domestic payment services for bill collection and payroll services, microcredit related transactions such as loan disbursement and collection of periodic installments, collection of insurance premiums, and others.

23. **Based on the recommendations of the feasibility study highlighting KPO's weaknesses, the government has embarked upon a process of corporatizing KPO, although with limited progress to date.** Some progress towards corporatization has been made such as: (i) cadastral registration of part of KPO's real estate properties, (ii) market-based valuation by independent surveyors, and (iii) drafting a new postal sector law, company charter, and by-laws. However, given the limited institutional capacity of KPO, progress has been slow. The government has a renewed commitment for KPO's corporatization and the SPMF and MTC have confirmed that the preparations for the legal and related administrative aspects of corporatization are part of the government's privatization program for 2011-2014, which has been submitted to Parliament.

24. **KPO will need significant assistance to build up the basic elements of financial management required for KPO to operate within the formal financial sector**. KPO's financial management will need to ensure that the licensed financial institutions with which it has agency agreements can satisfy NBKR requirements for the delivery of their services and to limit their risk exposure when adding a large, additional distribution channel. The NBKR supports institutional reforms of KPO that would enable it to expand basic financial services and will consider expanding KPO's NBFI license, which currently covers KPO's foreign currency exchange office. To expand its license, KPO will need to strengthen its risk management, including cash and liquidity management. Moreover, the current postal legal framework, which allocates some regulatory powers for financial services to MTC, will need to be modified.

25. **One of the main weaknesses of the KPO is lack of a cost-efficient information and communications technology (ICT) infrastructure.** KPO lacks the technical management and financial resources needed for the buildup of a cost-efficient ICT framework that is interoperable with the banks' payments systems, as well as other back office ICT of banks, MFOs, MTOs, and insurers that is needed for the provision of reliable small-scale financial services. KPO has progressed in introducing ICT to support the payments processes by linking basic second-hand PC configurations in nearly 90 of its urban post offices. However, it has not been able to progress significantly in connecting rural post offices with ICT. Therefore, KPO needs substantial support in the design, implementation, and operation of integrated multi-functional front-office terminals equipped for both standard financial services transactions and for standard postal applications. They should have functionality to operate as a standard retail cash register for sales of other services and products and should include peripheral technology such as bar code scanner, EFT-POS card pad, or other biometric recognition and authentication technology.

Aiyl Bank

26. **Aiyl Bank was created as the Kyrgyz Agriculture Finance Company (KAFC) with World Bank support in December 1996.** The KAFC was envisaged as a temporary, stop-gap measure to address the collapse of the agricultural finance system in the early years of post-Soviet transition. It was expected that KAFC would transform into a private commercial bank through a merger, buy-out, or outright sale. This transformation was supported by IMF conditionality in the mid-2000s, and steps were undertaken to carry out this transformation and privatize the bank. In 2006, the NBKR approved a resolution to transform KAFC into OJSC Aiyl Bank, a rural bank solely owned by the government, but without a deposit-taking license. In 2009, Aiyl Bank's license was expanded to allow it to: (i) accept deposits up to 25 percent of its capital (later increased to 50 percent), (ii) join the deposit insurance system, (iii) make loans in foreign currency, (iv) conduct leasing, and (v) lend up to 30 percent of its credit portfolio for non-agricultural activities.

27. **The Kyrgyz government has confirmed its commitment to the privatization of Aiyl Bank, if market conditions are conducive**. In May 2008, the Kyrgyz Parliament approved the sale of 67 percent of Aiyl Bank's equity**.** Subsequent to this approval, an Action Plan to privatize the bank was prepared under the PBSM Project, financed by the World Bank. The global financial crisis that began in September 2008, however, halted the momentum to privatize the bank as the economic downturn in the Kyrgyz Republic, as well as increased caution on the part of potential strategic investors, reduced interest in privatizing the bank. The Kyrgyz political crisis of 2010, which prompted a banking crisis, further focused the authorities' attention elsewhere in the financial sector. However, with renewed stability and commitment to reducing the government's involvement in commercial activities, the Kyrgyz authorities have again requested assistance to privatize Aiyl Bank. The new government has confirmed its commitment to the privatization of Aiyl Bank, if market conditions are conducive, by including it on its list of state-owned enterprises to be privatized by 2014.

28. **Aiyl Bank has so far been fully dependent on donor funding for financing, although the recent decision to allow it to collect deposits should improve its ability to obtain more funding and satisfy more demands for loans.** Its license currently restricts it to accept deposits up to only 50 percent of its capital, although it applied for a full deposit-taking license in early 2011. Deposit mobilization by Aiyl Bank will not only make Aiyl Bank less dependent on donor credit lines, but will also provide a badly needed financial service to its clients. The Kyrgyz Republic has one of the lowest deposit rates in ECA. A key reason for the low deposit penetration is the absence of licensed deposit facilities in rural areas. Even after obtaining a full deposit-taking license, Aiyl Bank will have limited capacity to mobilize deposits to finance its lending and will require technical assistance to build this capacity. In the meantime, both while it awaits a full license and as it builds its capacity, it will require liquidity in the form of credit lines to finance its loan portfolio.

Moveable collateral and Debt Resolution Regime

29. **Weaknesses in the moveable collateral and debt resolution regime in the Kyrgyz Republic constitute an obstacle to increasing access to finance.** Moveable assets are rarely accepted as collateral in the Kyrgyz Republic. If they are accepted as collateral, financial institutions usually require other types of protections, such as security interests over immoveable

assets or personal/third party guarantees.[62] Individuals and SMEs may not own immoveable assets (such as real estate) that can be used as collateral by banks, and may not be in a position to provide the guarantees required by financial institutions (e.g. if they are self-employed). However, they may own moveable assets (such as inventory, equipment, accounts receivable, machinery, etc.), that can be accepted as collateral in an environment where creditors feel confident that their rights are protected. Out-of-court enforcement is allowed in principle, but is almost never possible because any argument raised by the debtor in court can stop a creditor's enforcement, even if parties have agreed to out-of-court enforcement in their agreement. In the case of the insolvency of the debtor, the rights of secured creditors are not adequately protected due to shortcomings in the overall insolvency framework that lead to loss of value of the debtor's assets. The use of alternative dispute resolution systems (such as arbitration) for debt resolution is limited. In addition, alternative methods of debt resolution such as arbitration face shortcomings (for example, the decision of an arbitrator could be reviewed and overturned by a court, and the decisions of arbitrators are not enforceable without first resorting to courts). Improving the moveable collateral and debt resolution framework could make a significant contribution to improving access to credit for individuals and SMEs in the Kyrgyz Republic.

30. **The moveable collateral registration system is paper-based and mandatory, while there are a limited number of pledge registration offices in the country.** The Central Collateral Registry registers pledges in moveable collateral, while the State Registry registers immoveable collateral. There are currently only seven permanent collateral registry offices and two temporary offices in the country, located at the oblast level. Since 2009, the law has required that collateral for all loans greater than KGS 25,000 be registered and that the registration process be made at a pledge or real estate registration office.[63] While these registries work reasonably well in oblast centers where their offices are located, registering collateral by borrowers in more remote locations can be prohibitively costly, which in turn restricts their access to bank and non-bank lending.[64] The reason for making registration mandatory was that banks were not registering their security interests on moveable property (although in their own interest to do so) because the registration process is too costly and burdensome. Thus, the mandatory nature of collateral registration has placed a significant burden especially in rural areas and thus, has added to the cost of lending, and reduced the number of loans. A modern online collateral registration system would significantly reduce the burden and costs associated with registering security interests on moveable property, as users would be able to submit registrations and search security interests from any computer with internet connection.

31. **There are shortcomings in the legal and regulatory framework for a well-functioning collateral registration and execution regime.** In order to respond to a rising number of foreclosures, policymakers are planning to make amendments to collateral related laws that would make it more difficult for creditors to enforce their interests over collateral. These changes could negatively affect the availability and cost of credit, as banks would feel less confident in their ability to enforce their rights upon a debtor's default. Improvements in the legal framework are needed in the areas of creating a security interest, registering the security

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[62] Lack of a secondary market for assets and the inability of banks to sell them is one of the principle obstacles to taking moveable assets as collateral.
[63] There is a current proposal by the banking sector to increase this limit to KGS 100,000-150,000.
[64] Banks provide examples of debtors spending KGS 800 for transportation to reach a registration center, when the budget of a household is only KGS 4,000 for the month.

interest, priorities, and enforcement mechanisms. For example, collateral registration is currently mandatory, and it should preferably be made optional with a clarification in the law that registration is not necessary for the purposes of the validity of a collateral agreement, but is necessary to make the security interest enforceable against third parties.[65] The registration of all encumbrances over moveable assets should also be required, not only of pledges, as it is currently difficult for banks to know whether an equipment being offered as collateral is, for example, leased because transactions such as transfers/retentions of title, taxes, leases, judgments, assignments, etc., are not registered in the collateral registry.

[65] For example, if Creditor A registers it security interest over a particular collateral, and Credit B does not register its security interest over the same collateral, then Creditor A will have priority over Creditor B if the borrower defaults, regardless which creditor made its loan first. If both creditors register their security interest over the same collateral, then the creditor who registers first will have priority over the creditor who registers second.

Addendum 6.1

Background information on the Kyrgyz Post Office

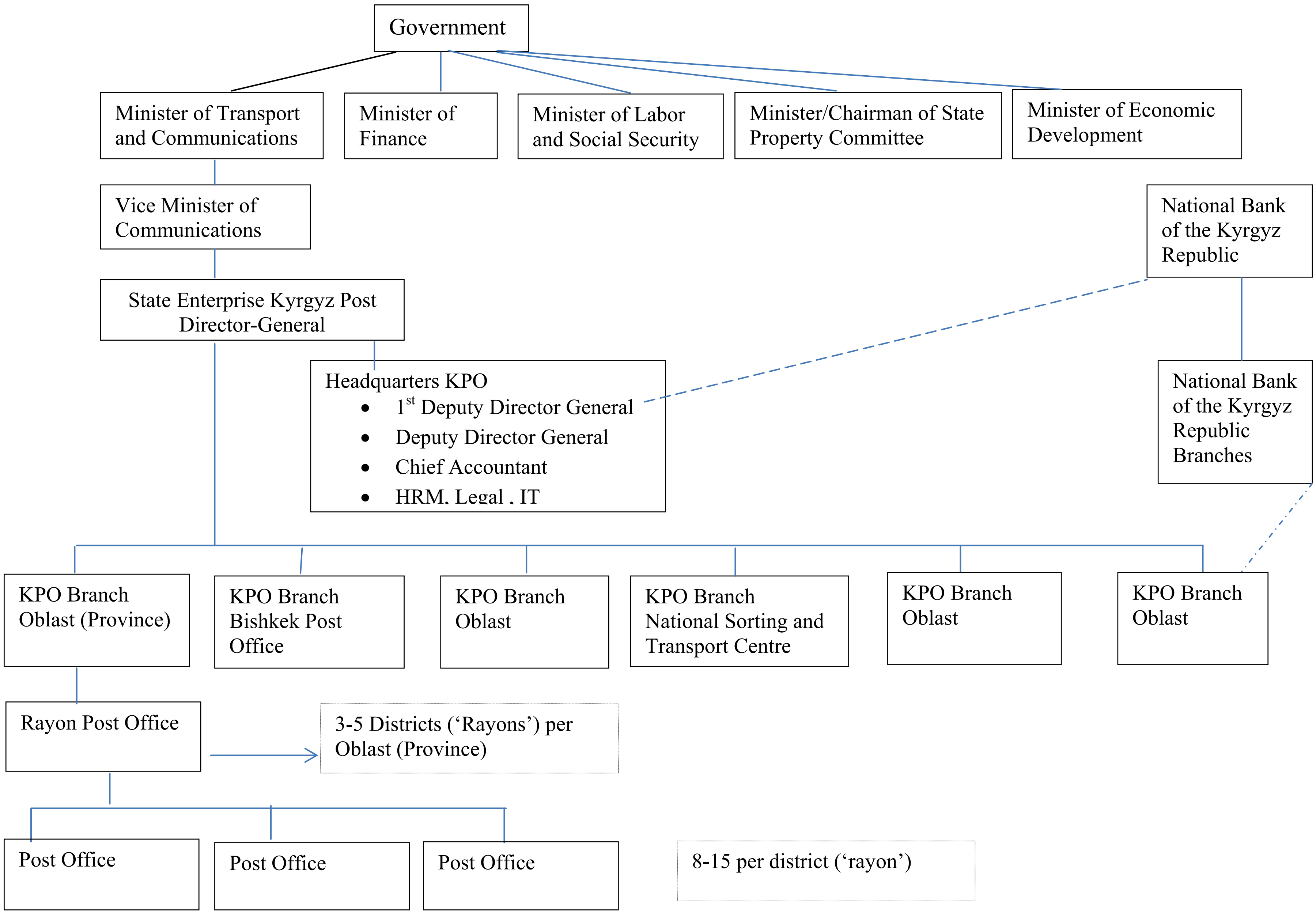
Introduction

1. **"Kyrgyz Pochtasi" (KPO)[66] is the historical postal operator.** It was created as an independent public operator in 1994 after the separation from Kyrgyz Telecom, and subsequently transformed into a state enterprise in 2003. KPO is overseen by the Ministry of Transport and Communications. The MTC is the policy maker and plays also the role of the owner and regulator of KPO.

2. **KPO is a large organization that employs over 4,000 staff and operates through a network of 923 post offices, 684 of them located in rural areas.** This represents about one post office for 6,000 inhabitants, a ratio that is three times higher than that of the bank branches country wide. In rural areas, however, there are about 20 times more postal branches than bank branches. As detailed below, KPO operates basic postal and financial services. Its operational performance is reportedly below standards as KPO has suffered from an absence of strategic orientation and under-investments. Since the late 90's however, the government has tried to address the issue of transforming KPO in a more efficient organization to improve its commercial viability, while playing a more strategic role in increasing access to finance in the Kyrgyz Republic. In 2008, the government added KPO in its privatization program, and in 2009 established a commission to prepare KPO's privatization. In parallel, in 2008 a detailed feasibility study was prepared with FIRST TA funding for improving postal financial services in order to increase access to finance in the Kyrgyz Republic in a sustainable manner.

[66] Formal and statutory name of KPO is : "Kyrgyz Pochtasy" State Enterprise under the Ministry of Transport and Communication of the Kyrgyz Republic

Chart 2: Organizational chart of KPO



Box 1: Governance structure and principles of KPO's operations

- KPO is a state enterprise under the Ministry of Transport and Communications (MTC).
- Under current legislation and regulations, the Ministry fulfills the functions of owner of the state enterprise, policy maker of the sector, regulator of the sector (through an internal agency) and supervisor of day-to-day management (via the Vice Minister and office).
- KPO is headed by a Director-General (DG). The DG is appointed by the Minister.
- The Ministry, through its Vice Minister, heads periodic sessions at the Executive Council ("Soviet") of KPO; the Ministry invites the DG KPO to the Ministry's Council ("Collegium"), a body headed by the Minister to meet and discuss all transport and communication issues with heads of departments and heads of state enterprises under the Ministry.
- The DG of KPO is supported in its function by a 1st Deputy DG, a Deputy DG Operations, a Chief Accountant, and several staff departments, e.g. for HRM, Legal, ICT, and International. All key senior staff is appointed by the DG after approval of MTC.
- KPO and its DG communicate only via MTC with other Ministries or other government agencies, unless it refers to routine administrative matters.
- KPO does not directly report to the MoF, except for tax issues. The annual budget and the accounts of KPO are part of the national budget and accounts of the Kyrgyz Republic and as such reported by MTC to the MoF and after government decision submitted to Parliament.
- KPO maintains a direct operational relation with the National Social Security Fund for distribution of pensions and social welfare.
- KPO maintains a direct relationship with NBKR only for operations within the scope of licenses issued (currently foreign currency exchange); no statistical reporting for payments or cash is maintained. Agency services are reported by the partnering bank, microfinance operator or the money transfer operator.
- KPO is subdivided in territorial branches and one functional branch (transport and mail sorting). The branches operate within a budget and Profit& Loss account (not IFRS standard).
- The directors of these branches are appointed by DG KPO after approval of MTC (and consultation with local authorities) – the directors have integrated responsibility for all operations and business development in their branch, and report directly to the DG.
- The directors of the branches meet periodically with the DG.
- The branch directors appoint their subordinate staff such as district directors, postmasters and postal staff. The branch directors meet periodically with the district directors and provide them daily instructions.
- The chief accountant of the branch has a functional reporting line to the chief accountant at headquarters, and accountants of the district post offices report to the chief accountant of the branch. Other functional reporting lines refer to transport routes and operations.
- All reporting follows government standards, quarterly, within six weeks – two months after elapse of the quarter. External audit is limited to the National Audit or Control Chamber, once per year. For pension payments, *ad-hoc* inspections may be undertaken by the National Fund.
- KPO via the Ministry provides inputs for the National Statistics Agency on its operations and key financial data, and to the Universal Postal Union.

Financial performance

3. **KPO's gross revenues will reach a projected US$10.5 million in 2011**, a 10 percent increase compared to 2010. The revenue structure is prominently dominated by postal financial services: 71.6 percent of total revenues in 2011 come from pension distribution, 14 percent from payments and remittances, and 14.4 percent from postal services. On the cost structure, a large component of the expenses is related to staff, estimated at US$8.5 m in 2011. The operations income before tax and depreciation is estimated at 5 percent. The company has no records of market-based valuation of its real estate property (approx. 100,000 sq. offices) and other assets, however gross revenues appear to be considerably less than the asset value. The reported Net Earnings (after tax and depreciation) are retained within the company and can be used for capital expenditure and business development.

Working conditions and human resources

4. **KPO employs over 4,000 staff in operations, i.e. for counter operations and mail and pensions delivery.** In general the conditions of these operations are poor, with limited to non existing computerization but impoverished working conditions in post offices (no heating in winter, no air-conditioning in summer, no toilet/washroom facilities, and no security). In general, the backlog in maintenance of the post offices exceeds 20 years. The transport vehicle fleet of KPO features similar characteristics. A large part of the fleet of 147 vehicles has been manufactured in the former Soviet Union and overall average age is 15 years. More than one third of the vehicles are not operational and most other cars require frequent repairs. Criteria related to technical safety and pollution seem non-existent. There is no policy to sell off vehicles and replace them by modern ones, that have much lower operational and maintenance cost. In addition, KPO has three railroad postal wagons, which have been out of use for more than five years. The level of computerization of post offices is very low but has been improved through aid from Korea Post with more than 300 (used) PC configurations. Most frequently, computers are present in the back offices of district and regional offices. However the abacus still serves in many places.

5. **The gross monthly salary for a full-time contract is about US$100 in 2011**, a significant increase compared to 2008 when it was in the range US$50-58, well below the poverty line of US$2 per day income**.** Most of the staff in this group are women, and many of them in the age group above 40. Turnover has substantially reduced with recent salary increases. There are practically no agreed performance related incentives. Training on the job is very limited and a perspective of career development remains absent. Less than 500 staff of KPO enjoys a monthly salary of US$400 and more. Some of those in critical management positions find extra income sources through additional employment elsewhere and from the postal operations through 'leakages and hemorrhages' as proper management functions including accountability, MIS, controlling, audit, centralized cash management, internal corporate communication etc. remain absent.

Mail services

6. **KPO has a *de jure* broad monopoly on basic mail services but evolves in a *de facto* liberalized postal sector.** Through its country wide network of nearly 1,000 post offices, KPO offers a narrow range of traditional postal services such as the acceptance, processing and delivery of ordinary domestic and international mail, newspaper delivery, as well as some express mail, registered mail, and parcels. Until 1991, the reported mail volumes exceeded 380 million items per year. The transformation from planned production to autonomous demand for these public postal services has resulted in a collapse till 1995 to very low figures and has continued to decline slightly during the past 15 years. The records show 23 million items in 2009, which is less than 4.3 items per capita per year (to compare with 12 items per capita per year in Kazakhstan for instance). These figures include newspapers and magazines. Strictly speaking, mail (letters, parcels) are less than one item per capita per year. Most mail is sent by State agencies and if one further analyses the mail flow, one finds an autonomous demand of less than 700 mail items sent per day by individuals and the private sector, or 0.03 item per capita per year.[67]

7. **The historic postal mail operations are characterized by low productivity and are presumably heavily loss making.** Postal tariffs are low, a standard rate of US$0.08 for a letter, although many letters are sent as registered mail at a rate of US$0.11. Newspapers and magazines are delivered at a reduced rate. Total revenues from the postal (mail/parcel) business reached approx. US$1.5 million in 2011 and this is far from sufficient to sustain a dense network with more than 4,000 staff and engaged in a six days per week "universal service obligation" to serve the entire nation with mail delivery. Productivity ratios are low, with a few (less than five) mail items delivered per day per employee, next to about 35 newspapers. The workload from other services/operations is mainly related to financial transactions, an average of 20 per day, and hence idle time of operations staff is estimated at a level of >60 percent.

8. **The postal mail services are a non-core business that represented 14.4 percent of total revenues of KPO in 2011.** The figures also suggest that the postal mail business function has lost its market relevance and is currently being sustained by the State serving a part of its mass communications, and through cross subsidizing with revenues from state pension delivery. A small part of the revenues are generated through mail and parcels from abroad, the net incoming flow was 36 ton in 2008, which generated US$120,000 revenues and US$260,000 in 2010. Although the Kyrgyz Republic is a land-locked and relatively isolated country, these figures indicate that the Post's role as a facilitator of trade and cargo for households and MSMEs is virtually non-existent. The express/courier/cargo market is mainly served by international and private operators and the informal sector that takes care of delivery of mail, messages and parcels by the hands of friends and acquaintances. Philately sales are a typical cash cow revenue stream in many developing countries in the range of US$0.5 to one million per year helping to finance the cost of the network. However, this situation does not exist in the Kyrgyz Republic, where the production and sales of stamps, including philately, is in the hands of another state enterprise "Markasi" under the MTC, which sells to KPO stamps needed for postage payment. Quality of service standards is not objectively measured. Marketing, promotion and sales or key account management functions are absent. New product development, for example, direct mail, advertising mail, hybrid mail, and value added mail services is quasi-nonexistent.

[67] Data are taken from KPO, UPU, WB, and NBKR most recent bulletins and reports.

Financial services

9. **The main asset of KPO lies in its network of post offices even if its condition is far from perfect.** The postal network is the most extensive low-threshold network reaching out to the underserved poor people especially in the rural areas of the Kyrgyz Republic. Financial sector development in the Kyrgyz Republic features progress with an increased level of intermediation and substantial strengthening in regulation and supervision. However, access to financial services remains low, as exemplified by the high level of cash usage (17.5 percent of GDP). Less than 10 percent of the adult population has a personal account, and there is a small network of less than 250 bank branches (an average of one point of access per 30,000 inhabitants). Access to financial services is even lower in rural areas, where there is less than one branch per 150,000 inhabitants. More than 90 percent of the Kyrgyz adult population cannot access the financial sector's most basic service, i.e. cashless payments instruments, which are pivotal to access other financial services, such as savings, deposits and (micro) insurance. With one post office per 6,000 inhabitants, KPO can contribute bridging the gap in rural financial access.

10. **KPO is a prominent provider of payments services.** About 18 million transactions per year are processed by KPO, which is about six times the volume reported by the NBKR for all transactions via ATMs, EFT-POS terminals and the interbank settlements and clearing system nationwide. In terms of value however, the role of the postal network is about two percent, as it concerns mainly small-value payments, while the banks process commercial and large-value payments. The 368 ATMs and 1,786 EFT POS terminals –only located in urban and tourist areas- processed slightly more than 1,163,234 transactions in the first three months of 2011, for the 237,124 cards issued as of end-June 2011. This indicates that efficient and secure cashless payments instruments are not widely used yet.

11. ***Utilities*****:** The cash operations generate the main revenue stream of KPO (approx. 75 percent of total revenues). These cash based payments streams comprise collection of public utility and other public service payments (telephone, police, etc.) through the counters of KPO. They also increasingly represent the main cash payment streams in the city of Bishkek. More than 50 percent of the utility payments in Bishkek are paid through the postal network, where the post offices are mostly computerized. In rural areas about 30 percent of the utility payments are paid through the post offices. This is an average and the actual performance ranges widely, from just above zero percent in a district to nearly 100 percent.

12. ***Pensions*****:** The number of pensioners across the country is about 0.5 million. Ninety percent of state pension payments are done by KPO. The annual regular growth is about 10-15 percent based on the decisions by the Kyrgyz government to increase state pensions. The average monthly pension was approximately US$40 in 2009 and increased to nearly US$60 in 2011. Pensioners are dependent on income from additional activities, family support and migrant remittances. The delivery of the pensions at the door can be considered the main activity of the postmen and the main income source of KPO (63.7 percent of gross revenues). On average more pension payments are delivered than mail items.

13. ***Remittances*****:** As last mile delivery service, the international (migrant) remittances represent a high potential for KPO. The market of incoming migrant remittances reached to more than US$1.1 billion in 2010, a 30 percent growth. The market share of KPO in the formal market amounts to less than 0.1 percent of the total remittances market. This suggests another large untapped potential for KPO given the fact that most of the remittances are meant for rural poor families, who currently face high cost and risk in collecting money from urban bank branches. Several international MTOs have repeatedly expressed their interest in cooperation with KPO. In 2011, new contracts have been concluded with e.g. Russlavbank (Kontakt), Leader, Zolota Korona, Blizko (Svyaz Bank), Western Union, MoneyGram, and negotiations with other MTOs are in progress. Implementation of the remittances delivery has started and gradually expands through more post offices.

14. ***Agency services for banks and MFOs*****:** Started with the predecessor of Ayil Bank for loan collections and repayments, this has been continued. Developments stagnated in 2009/2010, but have been recently revived after renegotiating the terms and conditions of the services. Bai Tushum is a leading MFO in the Kyrgyz Republic, which concluded an agency contract with KPO to support loan installment collection in rural areas.

15. ***Mobile banking*****:** In 2009, KPO tried to initiate a "Mobile Money" pilot project in a rural district with 31 offices intended in cooperation with one of the leading mobile telecom operators. This proved to be a premature and ill-timed initiative. The mobile telecom operators have progressed and seem to advance in their technical capability to operate mobile money applications; KPO could provide the network for the cash transactions and as a sales point for airtime.

Incorporation and privatization

16. In May 2008 the government, based on an initiative of MTC, submitted a resolution to incorporate KPO and to prepare it for partnership with the private sector. The resolution was approved by the Parliament, and pursuant to the decree several state entities (e.g. the State Property Committee, the Postal Regulatory Commission) took preparatory steps related to the incorporation process. A large part of the postal buildings has been valuated by an external local surveyor specialized in real estate valuation. The overall process of preparation, transition and incorporation is to be practically undertaken by the general management of KPO. Various steps are reported to be in a stage of preparation, such as cadastral registration of real estate properties, drafting a new postal sector law, drafting a company charter and by-laws but in view of the intrinsic institutional capability of KPO, milestones and deadlines in this process continue to remain fairly undetermined. The need of a vigorous corporate turnaround is increasingly seen by stakeholders and both the options of corporate restructuring and management through performance-based outsourcing to the private sector seem to be taken into consideration. Outside Bishkek, there is one access point (bank branch, MFO office) per 150,000 inhabitants or per 3,000 square kilometers (see Table 2). The main transaction activity (in volume) of the bank branches is cash disbursement of migrant remittances with an average of 42 per day per branch. Beyond the RTGS, the (retail) cashless payment system is at an early and fragmented stage. As of September 2011, there was KGS 1 billion cash in circulation. The M1/GDP ratio increased from 17.5 percent in 2007 to 20 percent in 2011.

Table 2: Basic Financial Access Data			
Use of financial services		Access to financial services	
Payment cards issued per 1,000 adults	94	Bank branches per 1000 km^2 In rural areas per 1,000 km^2	1.21 0.32
Payment card transactions per account per year	15	Post offices per 1000 km^2 In rural areas per 1,000 km^2	4,61 4,01
Migrant remittances p.a. per 1,000 adults	1,158	Number of bank branches per 100,000 adults In rural areas	6.2 4.0
Migrant remittances; average amount per tx	US$479	Number of post offices per 100,000 adults In rural areas	37 51
Number of depositor accounts with banks per 1,000 adults	181.43	Number of ATMs per 1,000 km^2 In rural areas	1.46 0
Avg. deposited amount per account - In local currency - In foreign currency	 US$265 US$331	Number of ATMs per 100,000 adults In rural areas	7.45 0
Avg. amount cash in hand per adult - In local currency	 US$328	Number of EFT-POS terminals per 1,000 km^2 In rural areas	27.35 0
Volume of payment txs per adult p.a. - Via banks - Via post offices	 0.8 6.8	Number of EFT-POS terminals per 100,000 adults In rural areas	20.6 0
Data: NKBR , April 1 [Payments] and May 31 [Deposits] , 2011 ; IMF FAS, 2010; World Bank Country Data 2009, UPU postal data 2009, BIS CPSS, N.A.			

Annex 7: Compliance with Bank Policy on Financial Intermediary Lending (OP 8.30)

1. The project design is compliant with World Bank Operational Policy on financial intermediary lending as contained in OP 8.30. The Project was cleared by the Finance and Private Sector Vice-Presidency on January 4, 2012.

Macroeconomic policies and sectoral conditions

2. Following the downturn in 2010, the Kyrgyz economy is showing signs of recovery. With increased political stability and a favorable external environment, the economy grew by 6.5 percent year-on-year in the first seven months of 2011, and is expected to grow by seven percent year-on-year by end-2011. Inflation has also started to ease after a peak of 22.6 percent in April 2011, due to a decline in international food prices, resumption of domestic agricultural production, and monetary tightening.

3. Section I B describes the vulnerabilities and weaknesses in the financial sector in detail. Of note, the project will strengthen the legal, regulatory and supervisory framework for banks, MFOs, and credit unions, and component 1 envisions several activities in this regard.

Financial Intermediary Selection and eligibility criteria

4. The World Bank Operational Policy 8.30 requires an assurance that all participating financial intermediaries (PFIs) in a World Bank financed line of credit (LOC) are viable financial institutions determined by: (a) adequate profitability, capital, and portfolio quality as confirmed by audited financial statements acceptable to the World Bank; (b) acceptable level of loan collections; (c) appropriate capacity, including staffing, for carrying out subproject appraisal (including environmental assessment) and for supervising subproject implementation; (d) capacity to mobilize domestic resources; (e) adequate managerial autonomy and commercially oriented governance; and (f) appropriate prudential policies, administrative structure, and business procedures.

5. Aiyl Bank has been selected as a PFI for the proposed LOC, and the LOC is linked to a specified action plan aimed at the privatization of the bank and to targets for increasing deposits in Aiyl Bank. The World Bank performed its financial due diligence of Aiyl Bank during project preparation in accordance with the established criteria set by OP 8.30 and confirmed its selection as the PFI. It is also noted that Aiyl Bank has satisfactorily participated as a PFI under previous World Bank LOC operations. Following is a summary of Aiyl Bank's compliance with OP 8.30 eligibility criteria. Unless otherwise stated, the financial analysis in this review is based on Aiyl Bank's IFRS statements audited by the bank's external auditor, KPMG.

Capital Adequacy, Portfolio Quality and Profitability

Aiyl Bank Selected Financial Soundness Indicators (in %)

	Aiyl Bank				Banking Sector Average
	2008	**2009**	**2010**	**Jun-11**	**Jun-11**
Capital to total assets	37.4	39.2	38.2	33.8	**-**
Capital to risk weighted assets	40.3	40.8	40.9	35.6	**28.0**
Non performing loans to gross loans	0.9	1.3	0.9	0.6	**12.0**
Provisions to gross loans	3.8	4.0	4.5	3.8	**7.0**
Provisions to NPLs	427.0	310.0	499.0	628.0	**60.0**
Liquid assets to short term liabilities	148.5	105.9	107.3	82.0	**72.0**
ROAA	1.5	1.8	4.9	4.2	**3.0**
ROAE	4.1	4.7	12.7	11.8	**18.0**

Adequate Capital

6. Aiyl Bank was adequately capitalized as of end June 2011, with a capital to total assets ratio of 33.8 percent. The bank's capital to risk weighted assets ratio of 35.6 percent as of end June 2011 remains well above the National Bank of the Kyrgyz Republic's (NBKR's) minimum requirement of 12 percent and banking sector average of 28 percent.

Portfolio Quality

7. Aiyl Bank's loan portfolio performed very well over the past years including during the 2010 crisis when compared with the banking sector average. The nonperforming loans (NPLs) remain below two percent and declined further during 2011 to 0.6 percent. The current provisioning coverage for NPLs appears to be high, as discussed below, and provides sufficient coverage for substandard as well as renegotiated loans.

Aiyl Bank – Analysis of NPLs, Renegotiated loans and Provision (in %)

	2008	2009	2010	Jun 2011
NPLs to gross loans	0.9	1.3	0.9	0.6
Substandard loans to gross loans	1.2	1.0	0.3	0.2
Renegotiated loans to gross loans	N/A	1.1	1.3	N/A
NPLs plus substandard loans plus renegotiated loans to gross loans	2.1	3.4	2.6	0.8
Provision to gross loans	3.8	4.0	4.5	3.8
Provisions to NPLs plus substandard and renegotiated loans	186	116	173	459

Note: NPLs are loans past due by more than 90 days, substandard loans are loans 30-89 days past due
N/A information not available

Profitability

8. Aiyl Bank has positive profitability that has improved considerably during 2010 with a Return on Average Assets (ROAA) of 4.9 percent and 4.2 percent at end 2010 and June 2011 respectively. The earnings are volatile primarily due to significant variation in the bank's cost of funding as the main source of funding, i.e., funds received from the Ministry of Finance and donors, are linked to inflation that has varied significantly during the past couple of years.

Risk management, credit appraisal and supervision

9. The bank's existing procedures and capacity for risk management and credit appraisal are adequate for its current size and scope of operations. The bank's credit appraisal methodology is simplified taking into account the small size of the loans (on average US$1,700) made primarily to small businesses and farmers in the rural areas. The bank has a separate credit administration department that is responsible for periodic monitoring of the credit portfolio. As Aiyl Bank plans to expand its business, the bank can learn from international best practice and further strengthen its capacity in the areas of credit risk assessment, risk management and internal controls. These are expected to be addressed by knowledge transfer from the strategic buyer after privatization.

Capacity to mobilize domestic resources

10. Aiyl Bank's main source of funding is long-term subordinated loans received from the Ministry of Finance under different international projects on concessional terms. As of end June 2011, this funding accounted for 50 percent of the bank's liabilities. As noted earlier the cost of these funds varies significantly on a yearly basis in line with inflation.

11. The bank received a limited deposit taking license in 2009 and currently it can accept deposits up to 50 percent of its regulatory capital. As of end June 2011, total deposits accounted for 12.1 percent of its liabilities and 23 percent of regulatory capital.[68] The bank participates in the mandatory deposit insurance system of the Kyrgyz Republic.

12. As the bank may receive a full deposit taking license in the near term it would benefit by strengthening its capacity in deposit mobilization. It is noted that under the project TA would be provided on various aspects of deposit mobilization including marketing and product development. Also, it is expected that a full deposit taking license as well as privatization of the bank would help reduce its reliance on government and donor funding.

Managerial Autonomy and Governance

13. Aiyl Bank is 100 percent owned by the government through the State Property Committee. The bank's Board of Directors and Chairman are appointed by the government. Aiyl Bank's organizational structure and staffing are appropriate for fulfilling its function as a state-owned financial institution with a specialized development mandate to provide financing in the agricultural sector particularly in the rural areas. The bank's primary funding source is the Ministry of Finance through different credit lines, including from the World Bank, to finance its loan portfolio. The interest rates on loans in the agricultural sector are at the lower end of the market (for example during 2011 the interest rate on Aiyl Bank's agricultural loans is 18 percent compared to the average market interest rate of 20.5 percent for agricultural loans and 22.28 percent for all types of credit).

14. In 2008, the Government announced plans to privatize the bank by selling a 67 percent stake in the bank. Importantly, the proposed LOC is linked to specific agreed upon triggers aimed at the privatization of the bank. As well, the funds under the credit line would be on-lent

[68] As of end June 2011, regulatory capital is KGS 1,152,302,000. Source Aiyl Bank prudential report.

under well defined sub-loan eligibility criteria to ensure that sub-loans made under the credit line are on commercial basis.

Prudential Policies, Administrative Structure and Business Procedures

15. Aiyl Bank fully complies with NBKR prudential normatives and generally complies with its own internal business procedures. The bank has detailed manuals, policies and procedures with adequately defined responsibilities and processes for loan appraisals.

Subsidies and on-lending rate

16. OP 8.30 states that "Bank funds are priced to be competitive with what the participating FIs and the sub borrowers would pay in the market for similar money, taking into account, as relevant, maturities, risks, and scarcity of capital". The funds under the credit line would be on-lent at market rates. There are no subsidies envisaged under the credit line.

Use of Bank Funds

17. OP 8.30 requires that LOCs be used to finance investments in subprojects for increased production of goods and services and value addition. The project is in compliance with these provisions of OP8.30. The Bank funds under this LOC would be used to finance projects that fall within the agricultural portion of Aiyl Bank's lending policy. The credit line beneficiaries will receive sub-loans in accordance with agreed eligibility criteria. To be eligible, a borrower must be at least 75 percent privately owned. The average working capital loan size is expected to be around US$5,000, while the average investment loan is expected to be in the range of US$25,000 equivalent, with a maximum of US$50,000 per loan under this LOC. In addition, funds would be used to finance technical assistance aimed at strengthening the deposit mobilization capacity of Aiyl Bank.

Monitoring arrangements

18. In order to ensure compliance with the eligibility criteria set out under OP 8.30, an ongoing review will be carried out during project implementation. This review will include, inter alia, (i) assessing capital adequacy, profitability; and asset quality, (ii) compliance with prudential and regulatory requirements of NBKR; and (iv) corporate governance and risk management.

19. Specifically the following indicators will be regularly monitored:

Compliance with the NBKR prudential normatives[69]

Normative	Prescribed value
Maximum exposure to one borrower (K1.1)	Maximum 20% of capital
Maximum exposure to bank's related parties relative to capital (K1.2)	Maximum 15% of capital
Capital adequacy ratio (K2.1)	Minimum 12% of risk-weighted assets

[69] These are based on current NBKR prudential requirements and are subject to change.

Tier 1 Capital Adequacy ratio (K2.2)	Minimum 6% of risk-weighted assets
Capital to total assets ratio (leverage ratio - K2.3)	Minimum 8%
Liquidity ratio (K3)	Minimum 30%
Total open foreign currency exposure toward capital (K4.1)	Maximum 15% of bank's net total capital for each currency positions
Total long or short open foreign currency position (K4.2 and K4.3)	Maximum 20% of bank's net total capital.

20. Aiyl Bank will be required to provide an on-going proof of compliance with the above listed compliance criteria – every quarter by its management and annually through auditor certification.

21. In addition the core indicators for SME finance will also be monitored that would include the portfolio quality indicators.

<u>Consultation with IFC</u>

22. This credit line has been coordinated with the IFC, which is not currently providing any credit lines to Aiyl Bank and has no plans to do so in the near future. The IFC is providing support to other financial institutions in the Kyrgyz Republic, including Bai Tushum (an MFO), Demir Bank, Kyrgyz Investment and Credit Bank (KICB), FINCA (an MFO), and Unicredit Bank.