Updated Project Information Document (PID)

Project Name: KYRGYZ REPUBLIC - Payments and Banking System Modernization
Region: Europe and Central Asia Region
Sector: Payment systems; securities clearance and settlement (80%); Banking (10%); General finance sector (10%)
Theme: Infrastructure services for private sector development (P); State enterprise/bank restructuring and privatization (S)
Project: P074881
Borrower(s): KYRGYZ REPUBLIC
Implementing Agency(ies): GOVERNMENT OF KYRGYZ REPUBLIC
National Bank of the Kyrgyz Republic
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1. Country and Sector Background
The Kyrgyz Republic, with a population of about 5 million, had a GDP of about $1.78 billion at end 2002. Since independence, the country has made substantial progress in achieving overall macroeconomic stability and has taken major steps to introduce the conditions necessary for the development of a market-based economy. This includes equitable land reform, liberalization of trade and membership in WTO, and financial sector reform. During this time, however, progress has been hampered by a number of external shocks, especially the turmoil that followed the 1998 Russian financial crisis, which led to high inflation, currency devaluation and macroeconomic instability. Since then, the Government has reaffirmed its commitment to economic growth and poverty reduction. The details of the Government's program are presented in its National Poverty Reduction and Strategy (NPRS) (September 2002), which was prepared in close coordination with international donors. The NPRS recognizes that private sector development is the primary means for achieving sustainable growth.

Although many measures were taken to strengthen the banking sector early on, critical weaknesses remained and were exacerbated by the 1998 crisis. Following the crisis, several measures were taken to address the problems and restore stability in the system. These included bank closures and consolidation, portfolio carve out, and strengthened supervision. There are now 19 banks, of which 2 -- Savings and Settlement Corporation (SSC) and Kairat -- are state-owned. The reforms to date have resulted in some improvement but much more needs to be done. The banking sector is small, with US$150 million of total assets, or about 9.1 percent of GDP, at end-2002. Basic infrastructure is poor, depositors' confidence is weak, quality and range of banking products and services are limited, and financial intermediation remains low.
The National Payments system is operated by the National Automated Clearing House (NACH), an affiliate of the National Bank of the Kyrgyz Republic (NBKR). The NACH, which provides for the clearing and settlement of large and small payments, was recently automated. However, the improved NACH has a number of weaknesses. It does not support a complete standardized and automated interface between banks and the settlement system, and there are no documented plans or back-up facilities should the NACH become inoperable for an extended period of time. Moreover, it is running at full capacity and cannot accommodate further increases in volumes and functions. These weaknesses impede banks efforts to provide and develop affordable, convenient and reliable payment services for their customers. The few individual card systems that exist in the country provide mostly debit cards services. There is no nationwide Automated Teller Machine (ATM) network.

In regard to the state-owned banks, SSC is a narrow (non-lending) state-owned bank, with the largest branch network in the country. Through this network, SSC operates as a banking and payments services delivery mechanism and provides fiscal and quasi-fiscal payments for the Social Fund and other budgetary services for households. However, its operating costs are high as it lacks modern facilities, systems and banking practices. Kairat was established in 1999 from the remains of three liquidated banks. Subsequently, in 2000, to save the bank from collapse, the inherited bad loan portfolio was carved out, the bank was recapitalized, its lending activities stopped, and a robust restructuring plan initiated. The bank is now generating profits and, in accordance with the banking sector reform program, the authorities aim to offer the bank for privatization at end 2003 and are already moving ahead with this program with support from both the PHRD Grant and the FIRST Initiative.

Strengthening the banking sector, especially financial infrastructure, is recognized as a high priority in the NPRS, as a fundamental requirement for stimulating private sector development and investment, improving access to banking services and improving confidence in the banking sector.

2. Objectives
The main objective of the proposed project is to develop a modern integrated national payments system that is accepted and used by the commercial banks. This would provide basic infrastructure that is essential for the development of a modern banking system that will increase the efficiency of payment services and facilitate the growth of financial intermediation. The new payments system infrastructure will enable commercial banks to process a larger volume of transactions in a more reliable, secure and affordable manner.

3. Rationale for Bank’s Involvement
Consistent with the NPRS, the Bank would provide technical assistance in priority areas of the Government’s banking sector reform agenda. The project would focus on payments infrastructure reform and improvements in access to banking and electronic payment services, which are basic requirements for establishing an environment conducive to private sector growth and investment. The Government and the NBKR, for the most part, have in place the policy framework for improving the banking sector.

The IMF, through its Poverty Reduction and Growth Facility (PRGF), provides the policy umbrella for implementation of the Kyrgyz Republic’s financial sector reform agenda. The authorities look to the World
Bank to provide guidance and technical assistance in the implementation of specific areas of this program. Additional support is also provided by other donors, especially the Asian Development Bank (ADB). In the financial sector, ADB focuses on the development of credit unions, the regulatory environment for microfinance and the strengthening of commercial banking skills. The European Bank for Reconstruction and Development (EBRD) and the International Finance Corporation (IFC) are also involved in the financial sector, with ownership interests in commercial banks and through lines of credit.

The Bank involvement helps the government coordinate the support of the donor community and to ensure maximum transparency in the policy decision-making and implementation process.

4. Description
The proposed project comprises six components, the first four of which support the national payments system modernization program. It will also support two banking sector reforms, as part of the Government’s overall financial sector reform program. The payments system program aims to improve the efficiency and security of payments in the Kyrgyz Republic through a bulk clearing system (BCS), an inter-bank card system (Card Processing Center), a real time gross settlement system (RTGS) and the general ledger (GL) of the NBKR. With financing from the PHRD Grant, consultants are completing a business plan, strategy and cost-benefit analysis for this infrastructure, which is expected to be implemented over about four years. The proposed project would provide resources for the investment costs (primarily the hardware and software and project support) incurred by the NBKR for establishing these systems, as well as technical advisory services, such as for the development of technical specifications and bidding documents, evaluation of bids, and the associated support needed for the implementation of such systems. The framework for this program has been designed taking into account similar reforms in other countries (especially Azerbaijan).

(1) Bulk Clearing System (BCS) (a low-value electronic clearing system): technical assistance for advisory services and establishment of a modern, fully automated bulk-clearing system. This will enable commercial banks to process debit and credit orders for high volume/low-value transactions, including utility payments, salaries, pensions and other fiscal and quasi-fiscal payments, in a more secure, reliable and fast manner. This will, in turn, enable banks to attract more clients and possibly increase their deposit base. The project would also include advisory services to ensure that the necessary arrangements (legal, management and other) are in place to enable the BCS to operate effectively and securely.

(2) Inter-bank card system, supported by a Card Processing Center (CPC): technical assistance for advisory services and establishment of a national card inter-bank arrangement supported by a shared processing center. This would coordinate and strengthen Kyrgyz commercial banks’ initiatives in card activities, thus enabling bank customers to use any card accepted in the scheme in any ATM or merchant’s equipment (Points of Sale - POS). All banks participating the system will share the operational and investment costs and the management of associated risks. A nationally operating scheme will reduce the need for cash payments and will improve access to banking services (cash withdrawal, payment and short-term advances) to a large share of the population.

(3) Real-time gross settlement system (RTGS): technical assistance for advisory services and establishment of a RTGS to provide timely settlement of large-value or urgent inter-bank transactions. The RTGS will enable banks to settle their large-value transactions in a more secure and timely fashion eliminating paper based-recording, meanwhile providing the NBKR with an accurate risk management tool to better monitor intra-day liquidity positions, and, exceptionally, overnight collateralized credit. The RTGS will speed up transactions and reduce their costs and establish a safe and reliable system that is essential for business activity. Furthermore, it will enable bank management to manage and optimize their
liquidity positions (particularly in the central bank) on a real-time basis.

(4) **General ledger of the NBKR:** feasibility study, as well as advisory services and investment costs to enhance and strengthen NBKR’s General Ledger (GL) so that it is fully compatible and consistent with the requirements of the improved payments system. It will provide full automation and real-time interface between all components of the payments system and the NBKR. It would enable the NBKR to integrate and adapt its accounting, treasury and financial information systems to accommodate the increased flows and volumes generated by the improved payments system infrastructure.

(5) **Banking sector reform:** to help implement other areas of the Government’s banking sector reform program, the proposed project would support the strengthening of the SSC, to improve its efficiency in delivering banking and payment services, as well as assistance for the privatization of Kairat Bank.

   (i) **Strengthening of SSC.** The proposed project would help strengthen SSC and improve its financial services delivery functions and thus better fulfill the banking needs of its customers. To this end, the project would support long term advisory services (management contract) as well as specialized assistance to complete an IT needs assessment and to implement the agreed recommendations, with a view to lowering SSC’s operating and transactions costs and improving its outreach to the rural population. Project support is expected to include software and hardware for improving the banks information systems. In addition, to help improve SSC’s outreach and the access of rural populations to banking services, the proposed project will explore the possibility for SSC to enter into a partnership agreement with the Kyrgyz Postal System (Kyrgyz Pochtasy) to use selected post office windows for the delivery of its payments services. This may be carried out on a pilot basis; and

   (ii) **Kairat Bank privatization:** The proposed project would provide down-stream support for the privatization of Kairat Bank, helping to ensure that best international practices are applied. In particular, the proposed project will provide funding for advisory services for contract negotiations. In addition, it will include a provision for the development and implementation of a contingency plan in the event that a fit-and-proper strategic investor is not identified.

(6) **Project management and administration:** This component would include support for the management of the payments infrastructure modernization program as well as for the implementation and administration of the overall project.

   (i) **Project management support:** NBKR is committed to completing a complex payments system within a tight timeframe. The project would provide project management support services, including studies and the establishment of a monitoring and evaluation system, so that these activities can be carried out using a professional project management approach. This assistance, which would include local and international experts, would be provided to NBKR’s Payments Systems Department (which would be responsible for the technical aspects of the payments system program. It would be closely coordinated with the work of the Project Implementation Unit (PIU).

   (ii) **Project implementation and administration:** long- and short-term advisory services, training and equipment for project implementation. In addition, a provision would be included to cover operating costs incurred by the PIU and to cover the costs of the project audit. The Directorate on Investments and Technical Assistance Coordination (DITAC) of the NBKR will be the PIU for the proposed project.
5. Financing

Source (Total (US$m))
BORROWER ($1.05)
IDA ($9.00)
JAPAN: MINISTRY OF FINANCE - PHRD GRANTS ($1.30)
LOCAL SOURCES OF BORROWING COUNTRY ($1.40)

Total Project Cost: $12.75

6. Implementation

The proposed project would be implemented over about four and one-half years, although many of the activities are designed to be completed in the early years of implementation. The Directorate for Investments and Technical Assistance Coordination (DITAC) in the NBKR will be the Project Implementation. DITAC is already managing the PHRD Grant and has built up some capacity in the management and administration of IDA-financed projects.

Special arrangements are also being put in place to manage and monitor implementation of the payment system program, including the establishment of a steering committee, which would oversee the implementation of these activities. Given the importance and scale of the payments system program, the steering committee, with executive powers under NBKR chairmanship, would monitor implementation of this subcomponent. It would review progress and make decisions as appropriate during project implementation. It would meet at least quarterly and report to NBKR's Chairman.

7. Sustainability

The payments system infrastructure is designed to be technically and financially sustainable. Technicians required to operate and maintain the systems would receive on-the-job training from specialized consultants and systems suppliers. In addition, each participating institution would ensure that its staff is fully conversant with the new technologies. The operating costs of the new systems would be recovered from participating institutions, based on new income and fees received from their clients for the improved payment services. In the longer run, it is envisaged that the operations of both the bulk clearing and card processing systems will be transferred from the NBKR to the private sector (with commercial bank ownership), with NBKR focusing on the oversight of the systems. The overall banking sector reform program, which is supported by the proposed project, would help implement measures that are crucial in helping to establish a healthy and sound financial sector.

8. Lessons learned from past operations in the country/sector

Technical assistance projects have a mixed record. This experience has been taken into account and reflected in the design of the proposed project. The main lessons learned are summarized below:

a) Ownership of and commitment to the project are critical for its success. NBKR is the main stakeholder of the proposed operation and has been the driving force in its design. Furthermore, it has established a large team (including steering committees and working groups) that is dedicated to its realization. In addition, NBKR has developed the user requirements for each of the components in close cooperation with the expected participants in the system (commercial banks, utilities, government agencies, etc.) The involvement and participation of the working groups will continue throughout the project to coordinate the activities and monitor performance.

b) a key condition for the success of a complex program is that implementation capacity is adequate and a professional project management approach is used. The technical management of the program will be handled separately from the administrative and fiduciary functions. The project would provide adequate
resources to strengthen both the technical and administrative capacity of NBKR. The planned monitoring and evaluation system would provide an early warning system to identify any weaknesses and deficiencies.

c) recent experiences have demonstrated that synergies can be achieved by implementing payments system reform programs in a comprehensive manner. The proposed project will address the key elements of the payments system infrastructure; in line with a similar approach that is being successfully implemented in West Africa and the Central Africa Region.

d) project design should simple and provide for flexibility in implementation, to allow for adjustments to better adapt the assistance to evolving priorities. Limiting this operation to the banking sector has streamlined the project. The project design is straightforward and the components are logically linked and inter-dependent. Furthermore, the functional design of each component of the payments system infrastructure is well known, clear interfaces have been defined and tested in similar projects, and experience shows that this apparent complexity is manageable. In addition, to maintain flexibility, activities for the first year have been agreed in detail; those subsequent years would be fully defined as part of project supervision;

 e) delays in project implementation are a reality but need to be minimized in order to avoid jeopardizing the timely achievement of project objectives. The project design allows a reasonable period to complete the project investments although the NBKR intends to realize the payments system in a much shorter timeframe. To reduce the risk of serious delays, activities to be financed under the proposed project have been designed to be completed in about three years and bidding documents for the key components of the payments system are at an advanced stage of preparation. However, the proposed project will provide about one additional year to overcome delays.

9. Environment Aspects (including any public consultation)
   Issues : not applicable

10. List of factual technical documents:

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Note: This is information on an evolving project. Certain components may not be necessarily included in the final project.