



Islamic Banking and Finance

Opportunities across Micro, Small, and Medium Enterprises in the Kyrgyz Republic

IN PARTNERSHIP WITH:



Schweizerische Eidgenossenschaft
Confédération suisse
Confederazione Svizzera
Confederaziun svizra

Swiss Confederation

Federal Department of Economic Affairs,
Education and Research EAER
State Secretariat for Economic Affairs SECO



IFC

**International
Finance Corporation**
WORLD BANK GROUP

IFC, a member of the World Bank Group, creates opportunity for people to escape poverty and improve their lives. We foster sustainable economic growth in developing countries by supporting private sector development, mobilizing private capital, and providing advisory and risk mitigation services to businesses and governments. This report was commissioned by IFC through its Financial Institutions Group in Europe, Middle East and North Africa to highlight the need for Islamic Banking across the region.

The conclusions and judgments contained in this report should not be attributed to, and do not necessarily represent the views of, IFC or its Board of Directors or the World Bank or its Executive Directors, or the countries they represent. IFC and the World Bank do not guarantee the accuracy of the data in this publication and accept no responsibility for any consequences of their use.

This report can be obtained in print or electronic format at the following address:

IFC in the Kyrgyz Republic

Orion Business Center, 4th floor, Erkindik boulevard, 21,

Bishkek, 720040, Kyrgyz Republic

Tel.: +(996 312) 62 61 62

www.ifc.org

Contents

O1.	EXECUTIVE SUMMARY	9
O2.	OVERVIEW OF BUSINESS AND THE MSME SECTOR IN THE KYRGYZ REPUBLIC	15
	Definitions	15
	Structure of Kyrgyz commercial establishments	15
	Contribution of MSMEs to the Kyrgyz economy	16
	Small- and medium-sized business distribution by economic activity	17
	MSME distribution by geography	18
	Enablers of business growth	19
	Key concerns for businesses	21
O3.	CURRENT STATUS OF ISLAMIC BANKING IN THE KYRGYZ REPUBLIC	23
	Overview of the banking sector in the Kyrgyz Republic	23
	Islamic banking in the Kyrgyz Republic	28
	Non-performing loans within the Kyrgyz banking system	31
	Challenges facing Kyrgyz Islamic banking	33
	Overview of micro-finance institutions in the Kyrgyz Republic	34
O4.	ISLAMIC BANKING OPPORTUNITIES PERTAINING TO MSMES	37
	Access to finance for the MSME sector	37
	Obstacles for financial institutions lending to MSMEs	40
	Supply-side analysis – Islamic banking penetration into the MSME sector	40
	Potential for Islamic banking in the MSME sector	41
O5.	CONCLUSION	45
	Research Scope and Methodology	46
	Appendix	48
	Fundamental Concept behind Islamic Laws & Principles	48
	Questionnaire	50
	Bibliography	52

Index of Figures and Tables

Figure 1: Islamic funding and depository potential	8
Figure 2: Reasons cited by MSMEs for not applying for loans	10
Figure 3: Islamic financing potential – ‘new to bank’	12
Figure 4: Depository potential	13
Figure 5: Classification of commercial establishments in the Kyrgyz Republic (2014)	16
Figure 6: MSMEs share of the Kyrgyz economy (2014)	17
Figure 7: Small and medium enterprise classification by economic activity	18
Figure 8: Geographic concentration of MSMEs in the Kyrgyz Republic	19
Figure 9: Recent IFC investments in the Kyrgyz Republic	20
Figure 10: Significant Kyrgyz-focused advisory services provided by IFC	20
Figure 11: Major constraints facing businesses	22
Figure 12: Kyrgyz banking structure (2014)	24
Figure 13: Market share of the country’s commercial banks (2013)	26
Figure 14: Total commercial bank loans and deposits in the Kyrgyz Republic (\$ billions)	26
Figure 15: Classification of loans by sector (2014)	27
Figure 16: Classification of deposits with Kyrgyz commercial banks (2014)	27
Figure 17: Islamic bank penetration in the Kyrgyz Republic (by number of branches)	30
Figure 18: Growth in Islamic loans and deposits (\$ millions)	31
Figure 19: Non-performing loans as a percentage of total lending in the country	31
Figure 20: Growth in micro finance institutional assets and loans (\$ millions)	35
Figure 21: Classification of MFI loans by sector (2014)	36
Figure 22: Purposes of loans sought by MSMEs	38
Figure 23: Reasons cited by MSMEs for not applying for loans	39
Figure 24: Funding potential	42
Figure 25: Depository Potential	42
Table 1: Definition of MSMEs in the Kyrgyz Republic	15
Table 2: Kyrgyz banking penetration (2013)	25
Table 3: SME loans and deposits in the Kyrgyz Republic	28

Abbreviations and Glossary

ATM	Automated Teller Machine
CAGR	Compound Annual Growth Rate
FINSAC	Financial Sector Adjustment Credit
GDP	Gross Domestic Product
IDB	Islamic Development Bank
IFC	International Finance Corporation
KFG	Kompanion Financial Group
KGS	Kyrgyzstani Som
KICB	Kyrgyz Investment and Credit Bank
MFIs	Micro Finance Institutions
MoU	Memorandum of Understanding
MSME	Micro, Small, and Medium Enterprises
NBKR	National Bank of the Kyrgyz Republic
NPL	Non Performing Loan
NSO	National Statistical Office
OJSC	Open Joint Stock Company
USD	United States Dollar
WTO	World Trade Organization

Conversion Rates used in the report (KGS/USD)

2014	0.0188
2013	0.0206
2012	0.0213
2011	0.0217
2010	0.0218
2009	0.0233

Foreword

Islamic banking refers to a system of banking consonant with the basic principles of Islamic Shariah (the rules and values set by Islam). Essentially this means interest-free financing. Shariah principles disallow ‘riba’ or interest on the lending of money. Islamic banking offers the same facilities as the conventional banking system does globally. The difference is Islamic banking’s strict adherence to Shariah rules or Fiqh al Muamlat (Islamic commercial jurisprudence). Until now, however, the presence and reach of Islamic banking institutions is not as widespread as that of conventional banks. This can pose a supply gap issue for Islamic products and services.

The World Bank Group has conducted several studies to more exactly define and quantify this financing gap, and the overall use of banking services among businesses in the Kyrgyz Republic. In fact, though, little clarity has been achieved in determining how many of these businesses have been excluded owing to the unavailability of Shariah-compliant banking products.

To correct this lack of information, IFC commissioned this study to better understand the levels of actual business demand that exist (especially among MSMEs) and the supply of Islamic banking products (asset and liability products along with other banking services) that are available to address it. The scope comprises: (i) gaps in the banking needs of businesses (particularly MSMEs) in the Islamic products space; (ii) supply-side benchmarking to review the current capacity of financial institutions to offer Islamic products to businesses; (iii) demand-side benchmarking to identify key MSME needs for Islamic products to see how well they are being served; and (iv) the current enabling environment, reviewing its readiness levels taking into consideration its regulatory framework and the legislation in place to govern Islamic banking and Shariah compliance.

In particular the report reveals an emergent ‘new-to-bank’ Kyrgyz Islamic funding and depository opportunity, highlighting the un-served and underserved MSMEs who do not borrow from conventional banks owing to the unavailability of Shariah-compliant banking products. In other words, even though there is very strong latent demand for Islamic banking products, this potential is untapped because banks and financial institutions lack the necessary operational capabilities with the extra burden of having to deal with other constraints such as narrow product offerings, limited outreach, and high costs. This report offers recommendations as to what Islamic banks and other financial institutions need to do in order to capitalize on the nascent opportunities represented by the country’s MSME sector.

Almost 80 percent of the country’s MSMEs have indicated their strong preference for and interest in Islamic banking products and services. Thus if banks successfully implement customer acquisition strategies by focusing on financially un-served and underserved MSMEs, they can capitalize on this “new-to-bank” potential, as quantified below:

Description	Funding Potential		Deposit Potential	
	Min (\$mn)	Max (\$mn)	Min (\$mn)	Max (\$mn)
Un-served MSME population – (a)	236.3	315.1	278.0	370.7
Under-served MSME population – (b)	73.3	97.8	86.3	115.0
Total “New to Bank” (a+b)	309.6	412.9	364.3	485.7

In addition to the “new-to-bank” potential there is also a conversion/cannibalization opportunity for “well-served” MSMEs which have access to the formal financing system. This opportunity could be worth an estimated \$38.3-51.1 million over the next few years, understanding that these MSMEs might shift their loyalties once Shariah-compliant products are readily available.

Preface

Micro, small, and medium enterprises (MSMEs), are the drivers of Kyrgyz economic growth and key contributors to sustainable gross domestic product (GDP). Since the country achieved independence from the Soviet Union in 1991, MSMEs became one of the prime supports of the economy as the number of industrial enterprises declined. Most MSMEs are engaged in the trade and trade-related sectors. These generate significant employment opportunities for skilled and unskilled labor alike.

Despite their importance to economic development, however, the growth of the country's MSMEs has been hindered by their limited access to banking services, along with high tax rates, and inconsistent policies. Thus, government support programs and assistance from multilateral agencies and policy makers are essential to MSME growth.

The Bank Advisory Services of IFC's Financial Institutions Group provides advisory services to banks in aid of strengthening their capacity and increasing their outreach to the MSME sector. This is achieved through capacity building, training, knowledge sharing, and dissemination of best practices in MSME banking and risk management. IFC's primary goal is to increase the number of banks that offer banking services to MSMEs in a profitable and sustainable manner. The organization is globally recognized as a market leader in MSME banking, through its various regional engagements. IFC is also recognized for its global expertise and knowledge in this area.

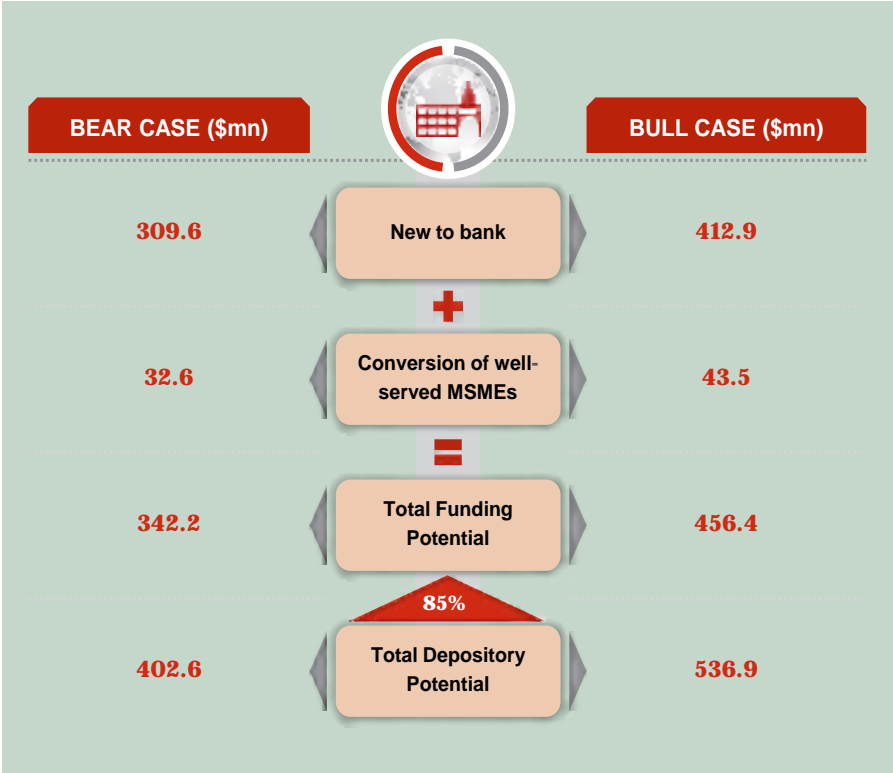
In response to growing market demand, IFC has recently enhanced its advisory services to include Islamic financing. In this respect, the National Bank of Kyrgyz Republic has also expressed an interest in exploring this segment of the market. Indeed, the NBKR is already looking at the possibility of putting regulations for Islamic banking in place.

As a first step, IFC commissioned this study to better understand the demand for and supply of Islamic banking products (asset, liability, and other banking products and services) for the MSME sector in the Kyrgyz Republic. In this study, demand-side benchmarking was conducted to identify key MSME needs for Islamic products and to gauge how well they are being served. Furthermore, IFC made a quick review of the current enabling environment and readiness levels in the country in terms of its regulatory framework and Shariah compliance. Also surveyed were the current capacity of Kyrgyz financial institutions to offer Islamic products to MSMEs.

The study reveals a **funding potential of \$342.2 to 456.3 million for Islamic financing to MSMEs**, with a corresponding **depository potential of \$402.6–536.9 million** over the next few years. This funding potential exists due to the 'new-to-bank' funding opportunity within the un-served and underserved MSME segments. These are either partially served by financial institutions or do not borrow at all for various reasons. Findings include 'new-to-bank' funding potential of \$309.6–412.9 million, which is untapped as banks and other financial institutions lack adequate the strategic focus needed on this segment to offer Shariah-compliant products.

In addition to the 'new-to-bank' funding and depository potential, Islamic banks could convert or cannibalize the existing funding/lending and deposit portfolios of conventional banks that serve MSMEs (primarily mid-sized enterprises). These mid-sized enterprises deal with conventional banks mostly because of the unavailability of the appropriate Islamic banking products. The funding potential within this category of well-served MSMEs could be around \$30.1 to 41.1 million.

Figure 1: Islamic funding and depository potential



The report highlights strategic measures that conventional and Islamic banks could undertake to successfully tap the Islamic banking potential of the country's MSMEs.

It is expected that this study will now form a basis for understanding the need for Islamic banking and finance based on market demand. It also provides an outline of the steps that need to be taken to introduce Islamic banking and finance in the country, something which the Government of the Kyrgyz Republic is very keen to promote.

IFC acknowledges the commitment and cooperation of Israa Capital Management Consultants, Dubai, who carried out this study on their behalf.

Tomasz A. Telma
IFC Regional Director for Europe and Central Asia

01.

Executive Summary

Given the fact that just one bank offers Shariah-compliant products in the Kyrgyz Republic despite the strong preference for Islamic finance by a large segment of the business clientele there, this study aims to determine the number of businesses (particularly MSMEs) that do not borrow from financial institutions due to this preference, and simply because of limited availability; this would seem to underscore an unmet need. How many of these enterprises prefer Islamic banking, but opt for conventional banks due to the limited availability of adequate Islamic banking products? What is the potential for Islamic finance in the country once Islamic banking regulations are strengthened? This study objectively qualifies and quantifies such aspects.



The importance of MSMEs in the Kyrgyz Republic grew significantly after the dissolution of the Soviet Union, primarily because MSMEs generated considerable numbers of employment opportunities for the local population. As well, though, MSMEs can be characterized as the major drivers of economic development. The country's mountainous terrain limits industrial growth. This, in turn, increases the society's dependence on smaller businesses. In 2014, MSMEs employed more than 19 percent of the total Kyrgyz population, a significant rise from the 14.8 percent reported in 2010. The MSME contribution to the country's GDP has been almost constant at around 29 percent since 2010, and the sector accounted for 31.6¹ percent of total exports in 2011².

Although a number of initiatives have been undertaken to promote MSME development, however, a number of challenges remain, preventing companies in this sector from capitalizing on their full potential. The biggest are inadequate access to finance, corruption and bureaucratic sand traps.

Bank lending to SMEs in the Kyrgyz Republic remained fairly stable at around 10 percent³ between 2010 and 2014. And in the latter year, total SME lending in Kyrgyzstan stood at \$148.1 million, while deposits from SMEs totaled \$174.2 million⁴. Over the same period, MFIs advanced loans to more than 500,000 borrowers, with an aggregate value \$370.1 million. Nevertheless, the banking sector's low penetration of the MSME subsector and the small ticket size of MSME loans have restricted bank lending to these small businesses over the years. Banks perceive MSMEs as risky and unattractive, given that MSMEs typically find it difficult to present adequate credit histories, collateral, guarantees, and cash flow projections, all of which are essential for procuring funds from formal financial institutions.

Moreover, although 80 percent⁵ of Kyrgyz MSMEs are interested in borrowing under the aegis of Islamic principles, most refrain from approaching any banks (conventional or Islamic) to help with their funding needs because of the reasons cited in Figure 2 below.

1. Brief Statistical Handbook 2011-2013: National Statistical Committee of the Kyrgyz Republic, 2014

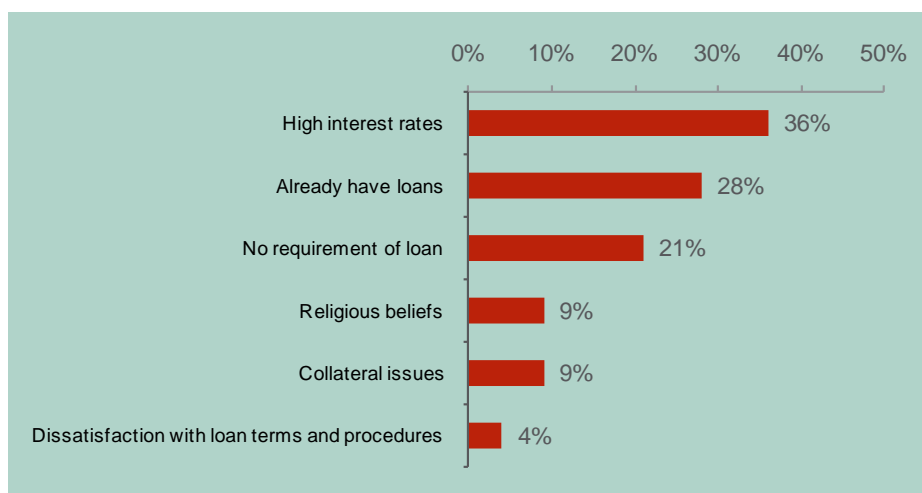
2. Private Sector Assessment Update - The Kyrgyz Republic: Asian Development Bank, 2013

3. Primary research

4. Primary research and National Bank of the Kyrgyz Republic

5. Primary research

Figure 2 : Reasons cited by MSMEs for avoiding formal loans



Source: Primary Research

Around 95 percent of Kyrgyz MSMEs have to rely on informal lenders to access needed financial backing (20-25 percent of these enterprises have only partial access to formal financial channels; the remaining 70-75 percent have no access to these resources at all) And a mere 5 percent of Kyrgyz MSMEs have adequate access to commercial banks and other financial institutions⁶.

There are no separate laws for Islamic finance in the country at present

The government has made efforts to strengthen the regulatory environment by way of amendments that laid down key principles of Islamic Banking in 2009 and 2013. Detailed instructions and regulations relating to Islamic finance, credit institutions and transactions are provided in the normative and legal acts of the NBKR (30 normative and legal acts). As of today, the normative and legal acts of NBKR stipulate requirements on licensing, corporate governance, risk management, model agreements standardization and Procedure for specific types of transactions, which comply with the Islamic principles of financing. To implement the pilot project on introduction of Islamic banking and finance principles, a separate package in normative and legal acts, including taxation issues, has been developed since 2006 for EcoIslamicBank CJSC.

While the general perception of the nascent Islamic banking industry is positive, the high cost of credit and limited knowledge of Islamic banking products are the major factors contributing to weak MSME access to Islamic finance

Almost 86 percent of the Kyrgyz population is Muslim. Furthermore, about 80 percent⁷ of MSMEs have expressed a desire to acquire the financial assistance they need under Islamic principles. Statistically, the demand for Islamic finance is estimated at 5–6 percent of the total banking industry. Considering this untapped potential, many conventional banks in the country, such as Kyrgyzkommertsbank), RosinBank and Bai-Tushum Bank had expressed interest in setting up Islamic operations as of April 2015. However, high borrowing cost and collateral requirements are restricting development of the sector. The average lending rate charged by banks is about 22.4 percent, whereas that offered by microfinance organizations is 38.5 percent⁸. Furthermore, according to the results of the 2013 World Bank Enterprise Survey, 89 percent of those MSMEs that received loans in the Kyrgyz Republic had to provide collateral averaging 187 percent⁹ of their loan's value. MSMEs are even more credit-constrained as their average collateral requirement is usually around 1.5 times that of large corporates¹⁰. Also, the terms associated with collateral requirements are rigid and strictly enforced.

6. Primary research

7. Primary research

8. Asian Development Bank: Private Sector Assessment Update – Kyrgyz Republic 2013

9. The Kyrgyz Republic Strategic Assessment of the Economy: Promoting Inclusive Growth: Asian Development Bank, 2014

10. Asian Development Bank: Private Sector Assessment Update - Kyrgyz Republic 2013

Additionally, Islamic leasing attracts double taxation, increasing the applicant's borrowing costs. This acts to hinder the development of new Islamic banking products. Most MSMEs do not have the capacity to incur such high costs and thus refrain from all banking (conventional as well as Islamic).

Nearly a tenth of Kyrgyz MSMEs prefer not to deal with conventional banks because they believe that paying interest on loans is fundamentally at odds with their values:

Although many of these MSMEs are creditworthy, they are excluded from being able to access funds from Islamic financial institutions because Shariah-compliant products are either not available or not properly understood by the owners of these businesses; and either way they involve lengthy processes. Executing Islamic transactions tends to be cumbersome. The recommendations regarding Islamic finance products to be introduced in the Kyrgyz Republic is available on page 45 of the report.

Applying for Shariah-compliant products as compared to conventional banking products can be a lengthy process due to the documentation; the amount of agreements and the sequence of signing these documents often prolong the overall approval and process time as compared to a Conventional bank's process.

Banking institutions in the country face obstacles in servicing MSMEs

Their informal way of conducting business: A significant number of MSMEs operate informally (which is to say without registering the business and lacking proper documentation). As well most under-report or simply do not report revenue to regulating bodies. Furthermore, operations of these MSMEs generally lack transparency and have virtually no internal controls.

As a result, they are unable to secure financing since banks insist on verifying a business' financial health through registration, title documents and tax reporting. Banks tend to avoid lending to such businesses because the risk of default on such loans is very high. This drives such enterprises to depend on informal channels such as moneylenders, friends, and family to meet their financing needs. It is recommended that MSMEs follow formal business practices by reporting accurate revenue information to regulatory authorities. This would allow for more transparency.

Accessibility issues hinder expansion: The country's mountainous terrain also amounts to a major hurdle for banks as it restricts their efforts to expand beyond large accessible cities. Adding to the obstacles, poor financial infrastructure prohibits the country's commercial banks from effectively utilizing technology to implement mobile or branchless banking services. As a consequence, banks are unable to service the majority of MSMEs operating outside the major urban centers.

The limited capacities of Kyrgyz banks: Due to low financial literacy, MSMEs in Kyrgyzstan lack the necessary knowledge and information regarding financial products and solutions, especially in terms of Shariah-compliant products. Also, the banking sector has not increased its investment in marketing activities and consumer education to address the issue. For instance, investment in marketing activities by EcoIslamicBank, the only Islamic bank operating in the country, is very low. This directly translates into its slow pace of customer acquisition.

These banks also do not have an adequate number of skilled employees or the technological resources required to either scale-up operations or improve operational efficiency.

Limitations on the availability of shariah-compliant products also restricts the generation of MSME business by Islamic financial institutions

Shariah-compliant products offered by Islamic financial institutions are largely restricted to working capital and trade financing based on Mudarabah and Murabaha principles. However, other financing products based on more complex Shariah structures such as Istisna'a, Ijara, Diminishing Musharaka are not available. For instance, Supply Chain Financing (SCF) is a short-term credit facility that optimizes working capital by allowing businesses to lengthen payment terms to their suppliers. It facilitates business expansion and mitigates payment risk benefiting international and local trade.

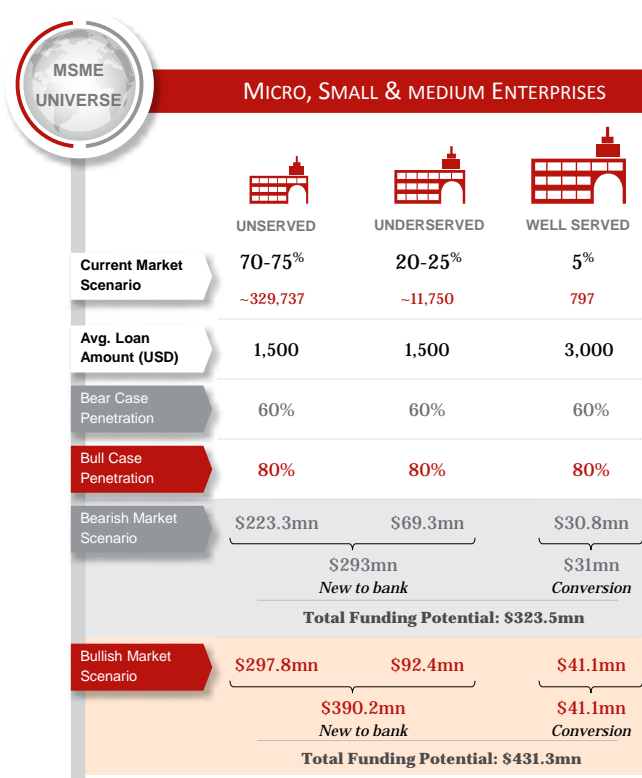
Non-availability of complex products is due to lack of knowledge and expertise in structuring such products. Consequently, MSMEs must either approach conventional financial institutions to access a wider range of financing options or rely on informal channels to meet their financing needs.

The growth in demand for Islamic finance in the MSME sector could result in a funding opportunity of \$342.2–456.3 million over the next few years

Currently, 70-75 percent of the MSMEs operating in the Kyrgyz Republic do not have any access to finance from formal financial institutions. And of the remainder, another 20-25 percent are only able to partially meet their financing requirements from formal financial institutions. Islamic financial institutions could penetrate around 60%-80% of the financially un-served and underserved MSMEs (which represents 95% of the total MSMEs), which could translate into a funding opportunity in the range of \$309.6–412.9 million in the next few years.

Additionally, if Islamic financial institutions were also able to diversify their product portfolio and customize these offerings to suit the requirements of those medium-sized enterprises now banking only with conventional financial institutions, the funding potential inherent in these well-served enterprises could amount to between \$30.1 and \$41.1 million in the short- to mid-term.

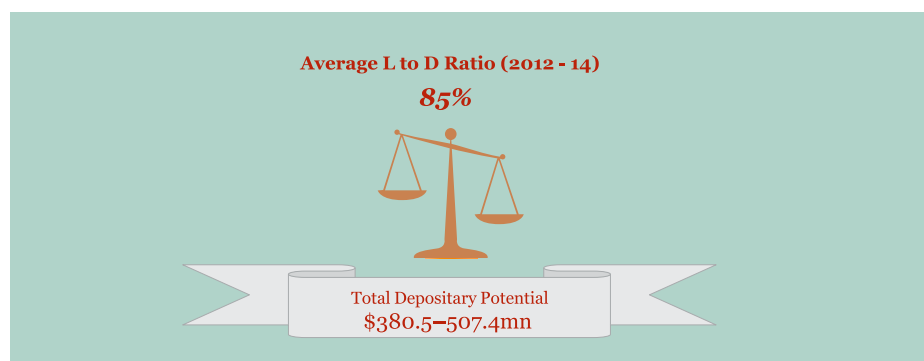
Figure 3: Islamic finance potential – ‘new-to-bank’



Islamic banks could potentially generate deposits of \$402.6–536.9 million from the MSME sector

Assuming the average loan-to-deposit ratio in the Kyrgyz banking sector remains around the 85 percent mark over the next few years, the deposit potential for Islamic banks within the MSME sector in the country would fall between \$402.6 and \$536.9 million.

Figure 4: Depository Potential



Strategic operational adjustments can help both conventional and Islamic banks to target MSMEs more effectively

Regulatory and legislative framework: The Kyrgyz banking laws were amended in 2009 and 2013 through the creation of the normative and legal acts of the NBKR which discuss: licensing, corporate governance, risk management, model agreements standardization and procedures for specific types of transactions, which comply with Islamic finance principles.

These principles discuss the creation of a Shariah Council within Islamic banks and those that would like to establish Islamic windows in their existing conventional bank operations. The Shariah Council is responsible for conformity of transactions (contracts) of the bank with the Islamic principles of banking and financing.

However, the Shariah Governance Regulatory Framework (SGRF) in the Kyrgyz Republic remains under development due to the amendment being silent on the governance of such committees. In large Islamic finance markets such as Pakistan and Malaysia, banking regulators have set up Shariah Advisory Councils at the Central Bank level for effective monitoring and governance of Shariah councils at individual banks. These advisory councils are positioned as apex bodies to interpret Shariah principles and ascertain adherence to these principles by Islamic banks in the country. From a practitioners' perspective, developed Islamic Economies follow a best practice approach where governing parties create a working partnership with banks. Due to the lack of Robust Islamic banks in Kyrgyzstan, this partnership is still in an early stage of development.


Thus, it is recommended that the SGRF sets out specific Shariah governance policies to regulate and monitor Islamic financial institutions in the Kyrgyz Republic. It should provide a comprehensive guidance to the governing bodies, Shariah committees and bank management in discharging duties in matters related to offering Islamic banking products. The SGRF should define policy formulation and directives in addition to the guidelines for compliance of policies required by the Central bank. The deadlines for each Islamic financial institution to comply with the framework should also be elaborated in the SGRF.

The Kyrgyz Republic, being a relatively new entrant into the Islamic Finance Market, can look to more developed Islamic Banking Economies in order to formalize an eco system that promotes Islamic finance in the country.

Human capital and talent development: There is a shortage of quality talent in the Kyrgyz Islamic finance industry. Banks must, therefore, focus on developing the right talent, offering developmental opportunities, providing adequate training, and on retaining their human capital.

Reducing loan-processing times: The time taken by banks to process and disburse loans (from 2 weeks to 1.5 months on average) in the Kyrgyz Republic is a major hurdle that inhibits quick access to finance for MSMEs. Streamlining the administrative process using predictive tools and back-end support would ensure that the loan application procedure is less cumbersome.

Effective targeting and evaluation of MSMEs: Rather than resorting to a one-size-fits-all model, banks must adopt a



differentiated customized process for MSMEs. Branch staff need to proactively approach and engage MSME entrepreneurs rather than relying on them to approach the banks. Moreover, banks need to develop a more MSME-specific risk assessment model in assessing the credibility of MSMEs, adding non-financial approaches such as behavioral scoring.

Increased focus on extended services: To help MSMEs overcome the challenges they face (for instance, a lack of adequate knowledge of financial products, and inefficient financial management), banks should consider providing increased assistance in the form of extended services. For instance, MSME toolkits, helping them to frame their business plans, and providing guidance on legal issues would help MSMEs to function more effectively, and at the same time improve their creditworthiness.

Expanding branch networks and offering non-loan products and services: Branch penetration in the Kyrgyz Republic is relatively low, meaning smaller towns and rural areas often do not have bank branches in their immediate vicinities. Moreover, there is a shortage of quality talent in the Kyrgyz Islamic finance industry. By addressing these issues, banks would realize a significant part of the untapped potential cited above. In addition, banks should also expand their non-borrowing banking services and products, such as current and savings accounts, cash management services and other fee-based transaction banking services.

02.

Overview of Business and MSME sector in Kyrgyz Republic

Commercial establishments, particularly MSMEs, are an important driver of the Kyrgyz Republic's economy. They also play an important role in its development. In the years following the country's independence in 1991, MSMEs supported the economy while the number of industrial enterprises dwindled.

The development of the MSME sector is supported by the government's regulatory reforms and various other initiatives. However, challenges such as inadequate access to finance are hampering its growth.



Definitions

Like most other countries, the Kyrgyz Republic does not have a standard definition by which it classifies micro, small, and medium enterprises (MSMEs). Even though the criteria used in defining these enterprises are similar (for example, metrics detailing the numbers of employees and turnover), various government bodies and ministries have different definitions. For the purposes of this study, we have considered the legislative interpretation provided by the National Statistical Office (NSO).

Table 1: Defining MSMEs in the Kyrgyz Republic

Nature of Business		Number of Employees	Monthly Turnover
Micro Enterprises	Production Sector	up to 15	up to KGS 150,000
	Services Sector	up to 7	up to KGS 230,000
Small Enterprises	Production Sector	up to 50	up to KGS 500,000
	Services Sector	up to 15	up to KGS 500,000
Medium Enterprises	Production Sector	51 to 200	up to KGS 2 million
	Services Sector	16 to 50	up to KGS 2 million

Source: Statistical Yearbook of the Kyrgyz Republic: National Statistical Committee of the Kyrgyz Republic, 2013

Structure of Kyrgyz's commercial establishments

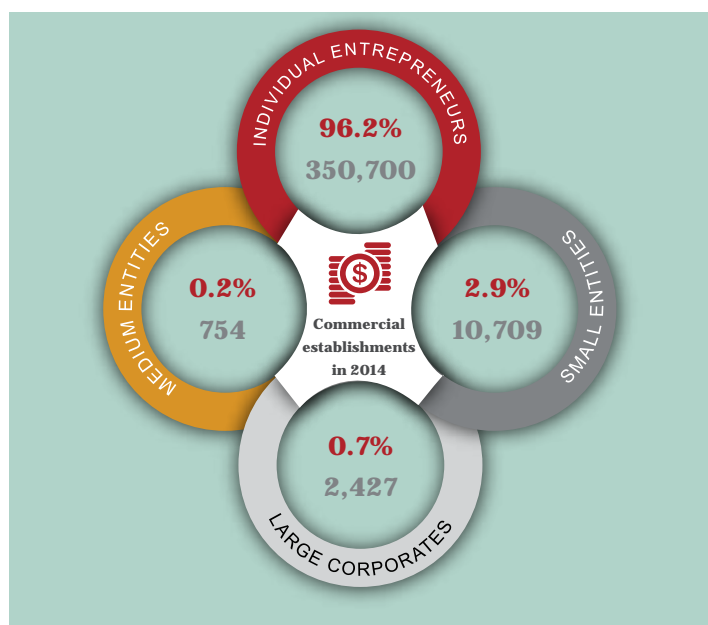
The MSME sector now accounts for approximately 99 percent of commercial establishments in the country; and microenterprises dominate the MSME sector

The fall of the Soviet Union in 1991 had a severe impact on large industries in the Kyrgyz Republic. Most filed for bankruptcy and were forced to either shut down or drastically reduce the scale of their operations. This was largely due to the fact that the country's economy and that of the Soviet Union were closely interlinked. Most of the industrial facilities in the country had major clients in other Soviet republics, especially Russia.

With the disappearance of the Soviet Union, however, MSMEs started to play a major economic role in the Kyrgyz Republic by generating employment opportunities for the local population and upholding the country's economy. In 2014, around 11,500 registered small and medium entities, approximately 350,000 individual entrepreneurs¹¹, and 2,427¹² large corporations operated in the Kyrgyz Republic. Of all enterprises in the country, 97.8 percent are privately owned; another 2.2 percent are state-owned¹³.

Despite their collective significance, most MSMEs continue to operate on a small scale. This is largely due to the business environment in the country, which has become harsher, mostly because of the cost and administrative burden now needed to comply with the standards as entities grow.

Figure 5: Classification of commercial establishments in the Kyrgyz Republic (2014)



«Once regarded as peripheral to the national economy, MSMEs have become a key factor in Kyrgyz economic development,»

Blackburn and Schape in 'The Growth of Export-oriented Small and Medium Enterprises in Afghanistan, Kyrgyzstan and Tajikistan'

Source: Annual publication on Small and Medium Businesses in the Kyrgyz Republic: National Statistical Committee of the Kyrgyz Republic, 2014

Contribution of MSMEs to the Kyrgyz economy

Over the years, the MSME sector has been the major driver of economic growth in the Kyrgyz Republic

MSMEs are considered the major drivers of Kyrgyz economic development, as the country's mountainous terrain limits industrial growth, rendering its economic well-being dependent on smaller businesses.

Although most (65 percent¹⁴) of the Kyrgyz workforce was engaged in peasant farming in 2014, MSMEs employed more than 19 percent of the country's total population, up from 14.8 percent in 2010¹⁵. The contribution of MSMEs to GDP has been almost constant, amounting to about 29 percent since 2010¹⁶. Moreover, the sector contributed 31.6 percent of total exports in 2011¹⁷.

11. National Statistical Office Kyrgyzstan

12. Extrapolated from statistics provided by Sector Assessment (Summary) - Private Sector and Finance: Asian Development Bank, 2010

13. National Statistical Office Kyrgyzstan

14. Country profile – Kyrgyzstan: New Agriculturist, September, 2010

15. Brief Statistical Handbook 2011-2013: National Statistical Committee of the Kyrgyz Republic, 2014

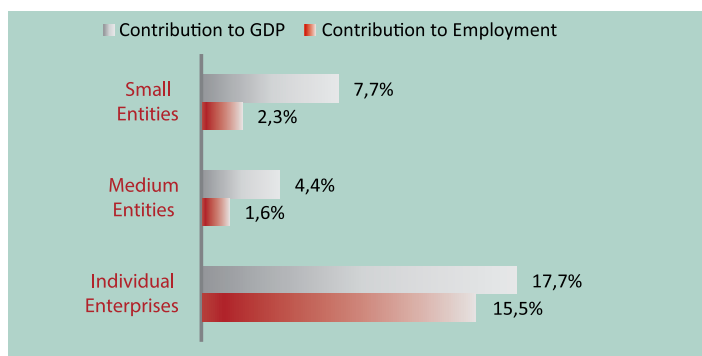
16. Brief Statistical Handbook 2011-2013: National Statistical Committee of the Kyrgyz Republic, 2014

17. Private Sector Assessment Update - The Kyrgyz Republic: Asian Development Bank, 2013

The MSME share of Kyrgyzstan's total GDP and employment might be much higher, though. Many operate informally and are unregistered. They do this to avoid compliance with regulations and their related costs, particularly taxes, and social contributions for workers. According to the Ministry of Economy, as of 2009, almost 100 billion Kyrgyz som (\$2.1 billion) were in circulation in the country's shadow (informal) market. Even more remarkably, almost 70 percent of the total employed population in 2011 worked in the informal sector¹⁸.

The percentage of the MSME share of the national economy does not include the contribution of peasant farms¹⁹, as most of them are likewise unregistered. In 2013, there were around 383,000 peasant farms²⁰.

Figure 6: MSME share of the national economy (2014)



Source: Brief Statistical Handbook 2011-2013: National Statistical Committee of the Kyrgyz Republic, 2014

SME distribution by economic activity

Classified by economic activity, an estimated 26.1 percent²¹ of Kyrgyz SMEs, excluding individual entrepreneurs, are engaged in trading activities. That began in earnest after the Soviet years. Growth in this area has been robust, mainly due to the absence of manufacturing giants.

Unsurprisingly, this market has leaned heavily toward less costly consumer products, such as apparel, mainly imported from China. Clothing and footwear products dominate the Kyrgyz retail trade, accounting for 26 percent²² of the total trade turnover of non-food items. This is informed by the fact that most of the Kyrgyz population falls into the low-income category. Other major product categories include cosmetics, furniture, jewelry, and consumer electronics.

The most popular distribution channel for consumer goods in the Kyrgyz Republic is the bazaar, which makes up 70 percent²³ of the retail space. Other major distribution avenues include shopping malls, grocery stores, and street kiosks. As well, more than 40 percent²⁴ of the society's retail trade is concentrated in the capital city of Bishkek, where the number of shopping malls and grocery stores is noticeably on the rise.

Real estate and related services (24.1 percent)²¹, including all real estate brokerage and agency transactions), accounts for the second largest SME category. These services are primarily driven by the increased demand for residential property, hotels, retail centers, and warehouses, particularly in Bishkek and the tourist center Issyk-Kul.

18. Private Sector Assessment Update - The Kyrgyz Republic: Asian Development Bank, 2013

19. An independent entity that produces agricultural goods at land plot owned or rented by members of the peasant farm

20. Annual publication on Small and Medium Businesses in the Kyrgyz Republic: National Statistical Committee of the Kyrgyz Republic, 2014

21. Annual publication on Small and Medium Businesses in the Kyrgyz Republic: National Statistical Committee of the Kyrgyz Republic, 2014

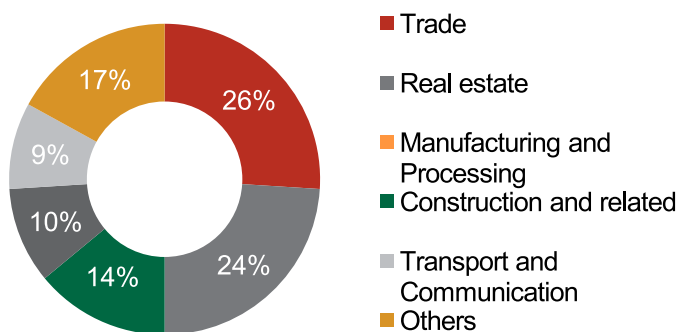
22. Consumer Goods Market in Kyrgyzstan: BISNIS, 2008

23. Consumer Goods Market in Kyrgyzstan: BISNIS, 2008

24. Consumer Goods Market in Kyrgyzstan: BISNIS, 2008

Manufacturing and processing (14.0 percent), mainly led by the sewing industry, is the third largest economic activity by volume in which SMEs are engaged. Construction and related fields (10.3 percent) and transport and communication (9.2 percent) form the fourth- and fifth- largest SME sectors in the country respectively²⁵.

Figure 7: SME classification by economic activity



Source: Annual publication on Small and Medium Businesses in the Kyrgyz Republic: National Statistical Committee of the Kyrgyz Republic, 2014

MSME distribution by geography

Over 65 percent²⁶ of Kyrgyz Republic SMEs are located in Bishkek, mirroring the country's economic distribution. Despite a myriad of political and social disruptions, Bishkek is decidedly the country's economic center and its most dynamic and rapidly- developing city. It boasts four main bazaars: Bishkek-Dordoi, Osh, Orto-Sai, and Alamedin. The geographic location is made more desirable by the country's connection to Siberia via the Turk–Sib railway line; other attractions include its developed infrastructure and ready availability of skilled human resources. These factors have made the Bishkek environment fertile ground for growth. Moreover, modernization development initiatives proposed by the government are concentrated in Bishkek, which adds further luster to its appeal.

Other places in the country with a sizable SME population include Chui Province (11.0 percent) and Osh city (6.2 percent)²⁷. The remaining country's remaining SME roster is spread across various provinces with no distinct concentration pattern.

Interestingly, micro enterprises are mainly concentrated in Osh city (19.4 percent), followed by Bishkek (12.0 percent), and Issyk-Kul (11.9 percent)²⁸.

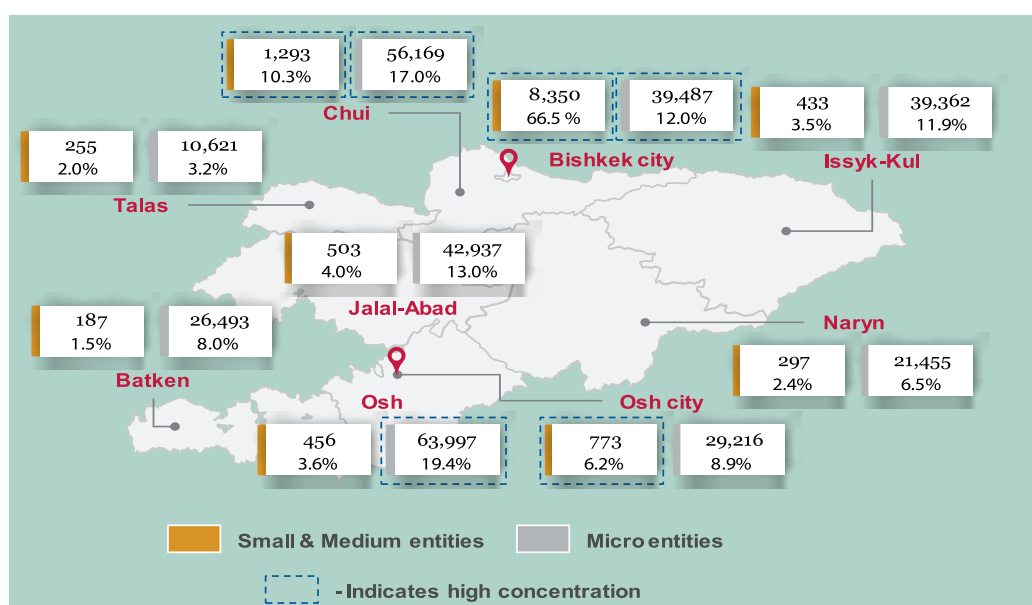
25. Annual publication on Small and Medium Businesses in the Kyrgyz Republic: National Statistical Committee of the Kyrgyz Republic, 2014

26. Annual publication on Small and Medium Businesses in the Kyrgyz Republic: National Statistical Committee of the Kyrgyz Republic, 2014

27. Annual publication on Small and Medium Businesses in the Kyrgyz Republic: National Statistical Committee of the Kyrgyz Republic, 2014

28. Annual publication on Small and Medium Businesses in the Kyrgyz Republic: National Statistical Committee of the Kyrgyz Republic, 2014

Figure 8: Geographic concentration of MSMEs in the Kyrgyz Republic



Source: Annual publication on Small and Medium Businesses in the Kyrgyz Republic: National Statistical Committee of the Kyrgyz Republic, 2014

Enablers of business growth

The Kyrgyz government has introduced several regulatory reforms to bolster the country's business environment and encourage growth, particularly in the MSME space

The Kyrgyz Republic joined the World Trade Organization (WTO) in 1998, and remains the only member among the group of Central Asian countries. In accordance with the terms of that agreement, the Kyrgyz government has funded several special initiatives and programs to spur growth among private businesses. These include supporting infrastructure (business incubators and technology parks), launching consultation and training centers, and introducing special tax regimes, as well as providing financial support through loans and grants. In 1999, The Kyrgyz Republic amended its constitution to allow the private ownership of land, (by passing a new Land Code) The main impetus in making this move was support for small businesses.

In 2009, establishing new businesses was made easier by eliminating the minimum capital requirement, reducing registration time frames, and eliminating certain post-registration fees and the requirement that applicants open a bank account before registration.

The Kyrgyz government also adopted a more business- and investment-friendly tax regime (effective January 2009). Under this code, a unified sales tax replaced several previous taxes while many others were either reduced or abolished. For instance, the value-added tax (VAT) was reduced to 12 percent from 20 percent²⁹. The new code also improved provisions related to collection of duties, introduced automation and e-filing, and established the presumption of innocence regarding taxpayers. As a result, the IFC-World Bank Doing Business Report ranked the Kirgыз Republic the third- and second-best reformer status globally in 2009 and 2010 respectively.

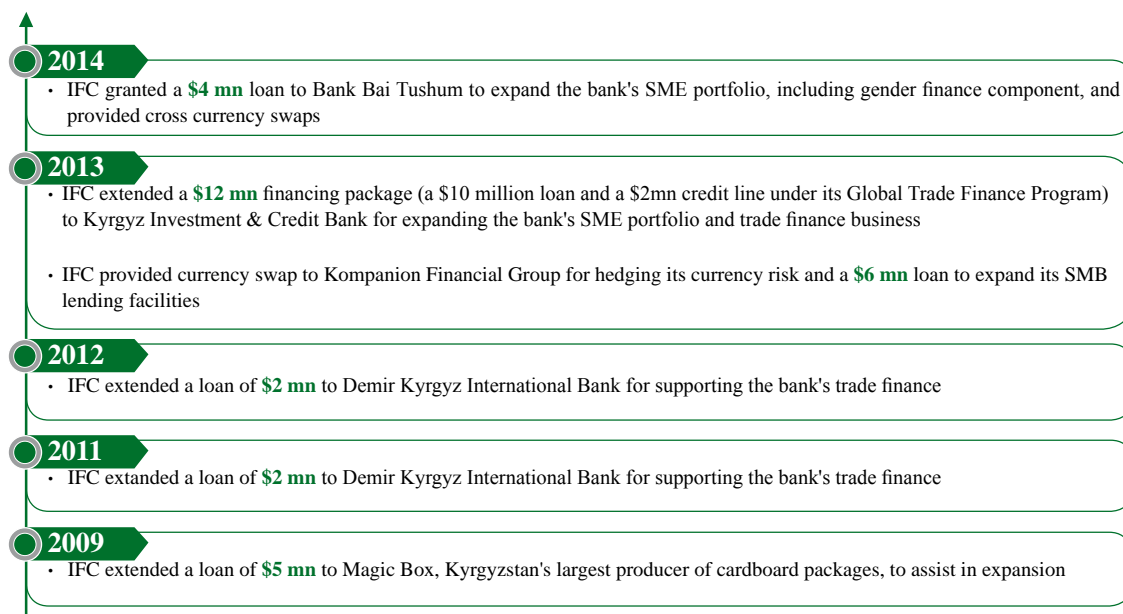
IFC has consistently extended its development support for the Kyrgyz private sector through various investment and advisory support initiatives

29. Asian Development Bank: Private Sector Assessment Update – The Kyrgyz Republic 2013

IFC's main priority in the Kyrgyz Republic is to support the development and diversification of the private sector. The overriding goal in this is increasing the country's competitiveness and employment opportunities. IFC aims to improve corporate businesses practices the better to be able to forge a favorable business environment for private businesses, and especially to provide MSMEs with increased access to the finance they need.

As of June 30, 2015, IFC's Kyrgyz portfolio was valued at some \$27.4 million, with the bulk of that investment deployed in the financial sector and real sectors³⁰.

Figure 9: Recent IFC investments in the Kyrgyz Republic



Source: IFC website

Figure 10: IFC Advisory Services in the Kyrgyz Republic:

Year of Operation	Project	Description
2014-present	Agri Finance Project	Improves access to finance and market for farmers through improved capacity of farmers, supply chain aggregators and financial intermediaries. Donor partner is the Austrian Ministry of Finance. Implements by WBG Finance and Markets Global Practice Group.
2012-present	Central Asia Tax Project	Helps government reduce tax compliance costs for businesses, and promote tax transparency and financial disclosure. Donor partners are the governments of Switzerland and UK. Implements by WBG Trade and Competitiveness Global Practice Group.
2012-present	Housing Microfinance Advisory Services Project	Helps improve housing conditions for low-income Kyrgyz households by introducing an innovative housing microfinance lending product to local financial institutions, enabling them to provide funding for home improvements to low-income residents. Donor partner is the government of Switzerland. Implements by WBG Finance and Markets Global Practice Group.
2009 – present	Financial Markets Infrastructure Project	Aims to expand secure access to finance for individual consumers and MSMEs by improving the financial infrastructure of and regulatory environment for credit bureaus and by developing a Risk Certification Program. Donor partner is the government of Switzerland. Implements by WBG Finance and Markets Global Practice Group.

30. IFC website

2009 – present	Investment Climate Project	Helps the government establish transparent and effective business regulations and create a favorable environment for entrepreneurs. Donor partners are the governments of Switzerland and UK. Implements by WBG Trade and Competitiveness Global Practice Group.
2008 – present	Micro and Responsible Finance Project	Provides advisory services to microfinance institutions in Azerbaijan and Central Asia to support their transformation processes. Donor partner is the government of Switzerland. Implements by WBG Finance and Markets Global Practice Group.
2006 – present	Corporate Governance Project	Helps local companies and banks strengthen their corporate governance practices with a view to improving their operations and increasing ability to attract investment and financing. Donor partners are the governments of Switzerland and UK.

Source: IFC website

To improve financial education standards and ensure better access to funds, IFC has focused on MSMEs in the country, and especially those in rural areas. The organization has done this by encouraging microfinance organizations to reach out to a larger number of MSMEs. It has also collaborated with major lenders such as the Kyrgyz Investment and Credit Bank (KICB) and Kompanion Financial Group (KFG). These collaborations aim to improve financial access by expanding the portfolio of financial products available to MSMEs, including savings plans, money transfers, and cash management services.

Specifically, IFC has significantly contributed to the development of sustainable micro-finance facilities in the Kyrgyz Republic by assisting in setting up FINCA Kyrgyzstan, the largest microfinance institution in the country, and Bai-Tushum in 1995 and 2000 respectively.

Through its advisory services aimed at bettering the investment climate, IFC helps identify and remove regulatory barriers to the entry and operations of private businesses.

«Through its investment and advisory support to local banks, IFC aims to expand the array of financial services offered to business owners and entrepreneurs,»

Edward Strawderman, IFC's Associate Director for Financial Markets in Europe and Central Asia

Key concerns for businesses

Political instability ranked as the biggest hurdle for businesses

The Kyrgyz Republic has experienced significant political tension since independence. Its first two post-Soviet presidents were ousted in the wake of popular discontent in 2005 and 2010. The Kyrgyz Republic had a political instability index³¹ of 7.1 in 2009–10, and according to the Economist Intelligence Unit, a rank of 3 in 2013; both underscored its high political risk³².

Businesses, especially MSMEs, have been severely affected by this political tension. Among other uncertainties, they have produced a demand slump. This has been particularly true in the trade segment, plus the real estate and tourism sectors, which together account for the majority of MSMEs. A high crime rate and inventory carrying costs during periods of political instability have also had a negative effect on competitiveness. And taken together, these things have generally dissuaded entrepreneurs from expanding their businesses.

Limited access to finance has constrained the development of businesses, especially micro and small enterprises, in the Kyrgyz Republic

31. The Political Instability Index shows the level of threat to a particular country's government due to social protest. The index scores were derived by The Economist by combining measures of economic distress and underlying vulnerability to unrest

32. The Economist – Intelligence Unit

Kyrgyz MSMEs find it difficult to procure finance for medium- and long-term investment. This limits their expansion. The high collateral requirement (which on an average was pegged at 187 percent in 2013, but in fact has gone as high as 237 percent), plus, the lending rates charged by commercial banks (~22.4% on average) has put a decided damper on private entrepreneurs approaching banks in aid of securing credit. Instead, they prefer informal sources of funds, such as traditional moneylenders, regardless of the interest rates such lenders demand, which can be as high as 2 percent per month.

Rampant corruption and nepotism are additional and serious barriers to growth for private businesses

The Kyrgyz Republic has consistently scored poorly on the Transparency International Corruption Perception Index. The country ranked 136th among 174 countries in 2014³³. The rampant corruption, which penetrates all levels of the bureaucracy, and nepotism have combined to create a harsh business environment. This discourages entrepreneurs from expanding operations, and thus severely impedes growth.

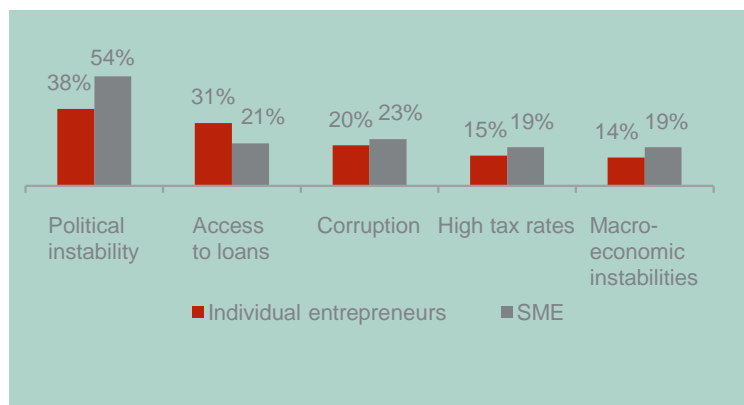
High tax rates, unstable economic growth, and weak infrastructure add up to impaired businesses

Other major hurdles to private sector growth include high taxation rates and the administrative burden involved in paying taxes. The Kyrgyz Republic has witnessed several bouts of macroeconomic instability, as evidenced by fluctuating GDP growth since independence (from a low of -20.1 in 1994 to a high of 10.5 in 2013³⁴). Furthermore, economic growth slowed to 3.6 percent in 2014 due to a decline in production at the Kumtor gold mine (which has contributed an average of 12 percent to GDP each year since 1997³⁵). GDP growth is expected to slow to 1.7% in 2015 before recovering to 2.0% in 2016³⁶.

The country faces infrastructure issues such as unreliable access to electricity (due to numerous power cuts) and the absence of effective coordination in industrial development.

Due to the factors mentioned above, the Kyrgyz Republic has consistently ranked poorly in World Bank Doing Business Reports. In 2014, the country ranked 102nd of 189 countries, dropping three places³⁷ from its standing in 2013.

Figure 11 : Major constraints facing businesses



Source: IFC Investment Climate Advisory Services Project in Kyrgyzstan

33. Corruption Perceptions Index: Transparency International, 2014

34. GDP growth (annual %) - The World Bank website

35. Kyrgyz Gold-Mine Debate Pits Poor Country Against Its Richest Taxpayer : Radio Free Europe Radio Liberty, June 2015

36. Kyrgyz Republic: Economy - Excerpted from the Asian Development Outlook 2015: Asian Development Bank

37. Doing Business 2015: Going Beyond Efficiency - The World Bank Group

03.

The current Status of Islamic banking in the Kyrgyz Republic

The Islamic banking industry has a strong positive image, especially among the country's MSMEs. Fully 80 percent of them are interested in obtaining Shariah-compliant products to address their financing needs. However, the development of Islamic banking in the country depends on increased penetration, as well as the development of a strong regulatory regime.



Overview of the Kyrgyz banking sector

Since independence, the Kyrgyz banking sector has overcome significant challenges, such as the Russian and global financial crises, domestic political turmoil, and corruption within the sector. Owing to these events, growth has been sluggish and the sector remains underdeveloped.

The Kyrgyz banking system has undergone several important stages of development since the National Bank of the Kyrgyz Republic (NBKR), the country's central bank, was established after independence in 1991. Over the period from 1991–95, the country's transition into a market economy had a direct impact on the banking sector, and led to the establishment of several commercial banks.

In 1996, the government introduced the Financial Sector Adjustment Credit (FINSAC) program, with funding support from the World Bank. This was mandated to reform the Kyrgyz banking system. The program downsized the banking system, restructured state-owned banks, and implemented several administrative reforms aimed at increasing operational efficiency. However, in 1998, the Russian financial crisis adversely affected the Kyrgyz banking sector, largely due to the huge foreign currency (mainly Russian ruble) loan portfolios of Kyrgyz commercial banks.

These measures sparked an initial credit boom. However, the Tulip Revolution of 2005 -- which led to the ouster of President Askar Akayev -- bolstered by the global economic crisis of 2008–09, delivered a heavy blow to the country's banking system. To prevent any further crisis development and improve its overall health, the NBKR, in cooperation with the government, introduced the Banking System Development Strategy in 2009. This strategy was activated to enhance the overall growth of the banking sector by means of restructuring insolvent banks and strengthening bank credit policies.

In 2010, despite facing political turmoil after the overthrow of the government led by President Kurmanbek Bakiyev, the interim government initiated some further decisive measures to improve the operations and internal controls of banks reeling under the influence of widespread corruption and the lack of corporate governance. Special regimes were introduced, placing the country's then-largest bank, Asia Universal Bank, and several smaller banks, under NBKR control. This led to the uncovering of numerous irregularities and legislative violations by these banks, such as the distortion of financial statements, to conceal suspicious transactions. The result, in 2011, was that the central bank tabled measures to prevent commercial banks from engaging in such unhealthy practices.

In 2012, the newly-elected parliamentary government undertook several measures once again intended to improve the banking system. The most significant was the introduction of the Medium-Term Development Program, which primarily focused on:

- Enhancing the sustainability of the banking system, and extending overall accessibility to its financial services;
- Improving this new accessibility through the introduction of various new financial instruments, including Islamic finance instruments;
- Preparing the Banking Code of the Kyrgyz Republic; and
- Developing a strategy for the privatization of state-owned banks – among them Zalkar Bank, RSK Bank, and Aiyl Bank – to assure their better management.

The result was improved stability with positive growth among major performance indicators:

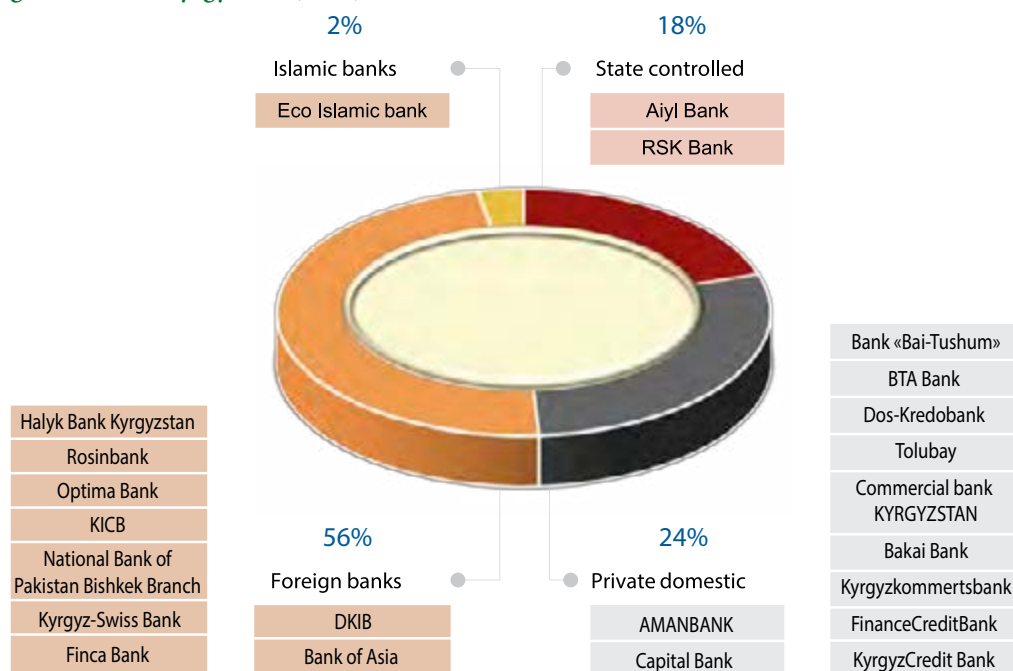
- The total assets of the Kyrgyz banking system increased 8.7 percent YoY to \$2.5bn in 2014³⁸.
- As well the banking sector's capital adequacy and liquidity ratios, as of May 2014, were reported as being above the minimum regulatory requirements of 12.0 percent and 30.0 percent, respectively³⁹.
- Non-performing loans (NPLs) declined to 4.8 percent in May 2014, as compared with 6.7 percent in 2012.

The Kyrgyz banking system comprised 24 commercial banks, all licensed and supervised by the NBKR

As of end of 2014, 24 commercial banks operated in the Kyrgyz Republic. This included 16 commercial banks with foreign share capital. Ten of these have foreign shareholdings of more than 50.0 percent.⁴⁰

The two state-owned banks – Aiyl Bank and RSK Bank – account for 18 percent of the total banking sector by assets. Taken together, these foreign banks accounted for 35.8% of authorized capital of the banking system.

Figure 12: Banking structure in Kyrgyzstan (2014)



Source: National Bank of the Kyrgyz Republic

38. Annual Report: National Bank of Kyrgyz Republic, 2014

39. Kyrgyz Republic Partnership Program Snapshot: The World Bank Group, October 2014

40. Annual Report: National Bank of Kyrgyz Republic, 2014

The last few years have seen a significant rise in the number of branches plus stationary and field cash offices of the various commercial banks. By the end of 2014, there were 293 branches and nearly 800 commercial bank cash offices nationwide⁴¹.

This noted, however, the concentration of bank branches remains low with just 7.98 branches per 100,000 adults, compared with 39.8 and 10.3 branches in Uzbekistan and Azerbaijan, respectively⁴². Moreover, Kyrgyz banking facilities are mostly centered in urban areas.

Additionally, in March 2013 the Kyrgyz Investment Credit Bank introduced mobile banking services to the country for the first time. Nevertheless, mobile banking penetration is still quite low, especially in rural areas.

This explains why a considerable part of the country's economy – and most notably in rural areas – still relies on the financial services offered by the informal banking sector, the most common being currency exchange and ex-officio lending.

Table 2: Banking penetration in the Kyrgyz Republic (2013)

Region	Bank Branches per 100,000 Adults	ATMs per 100,000 Adults
Uzbekistan	39.8	8.2
Azerbaijan	10.3	33.5
Kyrgyzstan	7.9	21.0
Tajikistan	6.6	10.6
Kazakhstan	3.3	71.6

Source: Financial Access Survey: International Monetary Fund, 2013

Optima Bank is the country's largest bank, accounting for more than 15 percent of all loans and deposits

The Kyrgyz banking sector is highly consolidated. The top five banks account for more than half of the total loans and deposits. Optima Bank, Demir Kyrgyz International Bank, and Kyrgyz Investment and Credit Bank, (all of which are foreign-owned), are the three largest banks operating in the country. Other major players include the state-controlled RSK Bank and privately-owned Kyrgyzstan Commercial Bank.

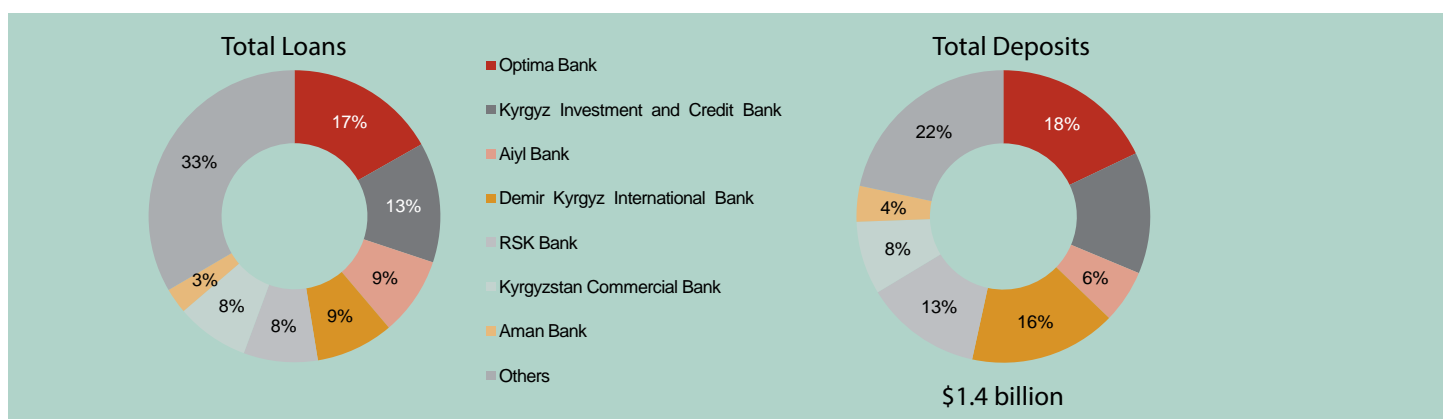
Optima Bank is the leading Kyrgyz banking institution, contributing 17 percent to the sector's loan portfolio and 18 percent to its depository base. The bank also accounts for 15 percent of the total banking assets, plus with 12 percent of total capital, and 28 percent of the banking sector's net profit⁴³.

Figure 13: Market share of commercial banks in Kyrgyzstan (2013)

41. Annual Report: National Bank of Kyrgyz Republic, 2013

42. Financial Access Survey: International Monetary Fund, 2013

43. Optima Bank website

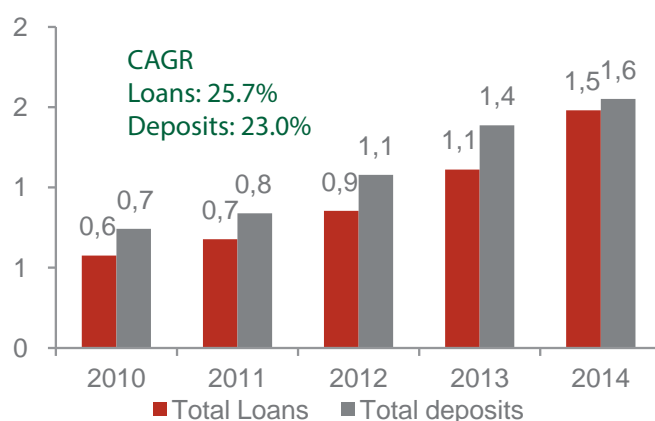


Source: Annual Reports of Commercial Banks

In 2014, bank loans and deposits in the Kyrgyz Republic showed their highest growth in absolute terms since 2010

From 2009–11, banking activity in the country remained stagnant due to structural deficiencies and the lack of internal controls in the banking system. However, regulatory reform initiatives by the central bank, particularly after 2011, as well as the introduction of a new development program by the government in 2012, strengthened the sector overall. As a result, banking activity regained traction, particularly over the 2013–14 period.

Figure 14 : Total Kyrgyz commercial bank loans and deposits in (\$ billion)



Source: National Bank of the Kyrgyz Republic

The trade and agriculture sectors account for more than half of the loans disbursed by Kyrgyz commercial banks

In 2014, the total credit portfolio value of the country's commercial banks increased by 33.2 percent to \$1.5 billion⁴⁴. This rise was mainly due to the buildup of agricultural loans and increased exposure to the trading sector. Together these accounted for almost 54 percent of the total loans disbursed by Kyrgyz commercial banks in 2013⁴⁵.

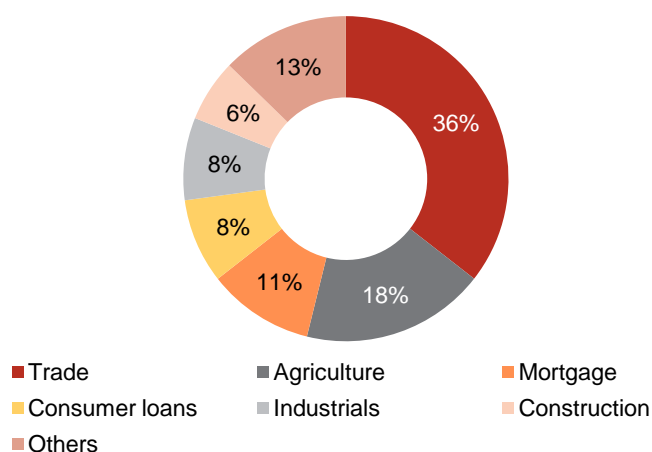
Agriculture is the major source of income for 65 percent of the country's workforce. This drives the high demand for agro loans⁴⁶. Similarly, trade is an essential element of the Kyrgyz economy, in large part a function of the country's traditional strength in this area, because of its strategic location at the commercial crossroads between Russia and China.

Figure 15: Classification of deposits in Kyrgyz commercial banks (2014)

44. National bank of Kyrgyz Republic website

45. National bank of Kyrgyz Republic website

46. Country profile – Kyrgyzstan: New Agriculturist, September, 2010



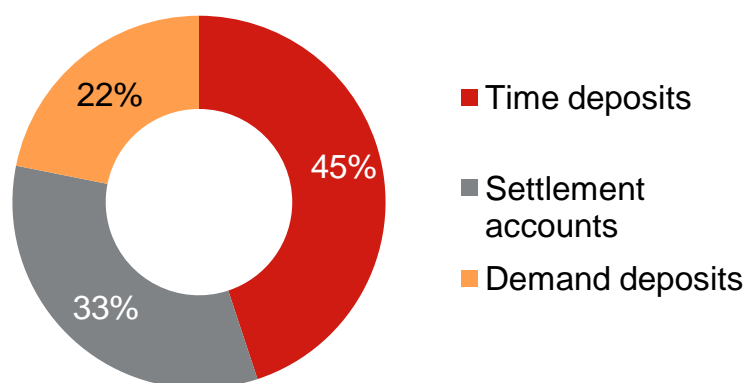
Source: National Bank of the Kyrgyz Republic

Time and demand deposits together account for over two-thirds of total deposits

The total deposit base of Kyrgyz commercial banks totaled \$1.6 billion⁴⁷ in 2014. Significantly, however, most households in the country preferred to keep their money at home rather than in banks. This is changing, though, due in no small part to the impact of financial literacy programs such as those conducted by IFC. Such programs have led to an increase in the number of bank accounts and the overall value of deposits. Moreover, the large number of Kyrgyz migrants sending money home from abroad has encouraged consumers to open savings accounts with banks. Inward remittances to the country have grown steadily from 31 percent in 2013 to 34.1 percent in 2014⁴⁸, making a marked contribution to the expansion of the country's deposit base along the way.

Time deposits accounted for 45 percent of the total deposit value in 2014, up from 39 percent in 2013. Meanwhile, the share of demand deposits declined to 22 percent from 25 percent⁴⁹.

Figure 16: Classification of deposits in Kyrgyz commercial banks (2014)



Source: National Bank of the Kyrgyz Republic

47. National bank of Kyrgyz Republic website

48. World Bank

49. National bank of Kyrgyz Republic website

The SME sector accounts for 10 percent of the loans disbursed by all commercial banks in the Kyrgyz Republic

SME lending forms only a small part of both the conventional and Islamic banking loan portfolios at present. SME segment loans make up approximately 10 percent⁵⁰ of the total loans disbursed by commercial banks each year. This is mainly due to the small ticket size of SME lending. The average amount borrowed by SMEs is about \$1,500⁵¹.

In 2012 the government launched a three-year program under which MSMEs were provided with loans at lower-than-market interest rates. From 2012 until 2015, preferential loans⁵² collectively valued at more than \$150 million⁵³ were issued to over 11,000 MSMEs. However, the coverage of this program was limited as only about 3 percent⁵⁴ of the total number of SMEs could acquire loans on these preferential terms. That is why the program has been extended to 2016–17, to encourage more SMEs to borrow from formal sources.

Table 3: SME loans and deposits in the Kyrgyz Republic

Region	2012	2013	2014
SME lending as a percentage of total lending	10%	10%	10%
Total SME lending (\$mn)	85.4	111.2	148.1
Total SME deposits (\$mn)*	100.5	130.8	174.2

Source: Primary research and National Bank of the Kyrgyz Republic

* based on average loan to deposit ratio for 2012–14 (85%)

Islamic banking in the Kyrgyz Republic

Certain divine restrictions have been imposed on economic activities as per Islamic principles. The intent is to ensure that balance is maintained in the economy, and the concentration of wealth into the hands of a few is avoided

Islamic finance does not negate active market forces nor the natural ebb and flow of the economy. The profit motive is considered acceptable, albeit with some limitations. Private ownership is likewise not totally negated.

There is a basic difference, however, between a capitalist and Islamic economy, namely that in secular capitalism the profit motive or private ownership are given unrestrained power to make economic decisions. Their liberty is not constrained by any divine caveats. And if there are some restrictions, they are those imposed by the society and thus always subject to change through democratically determined legislation.

This has generated a number of practices which result in social imbalances: for example, interest, gambling, and speculative transactions tend to concentrate wealth in the hands of the few. Human instincts are exploited to gain through immoral and injurious products or activities. Furthermore, uncontrolled profit seeking creates monopolies which ultimately paralyze market forces or, at least, hinder their natural operation. Thus, the natural ebb and flow of supply and demand is disturbed as these forces can only function properly in an atmosphere of free competition. They are antithetical to a monopolistic environment.

50. Primary Research

51. Primary Research

52. Preferential loan program is a government sponsored initiative to stimulate capital investment by providing loans at below market interest rates

53. Primary Research

54. Primary Research

After the tacit recognition of private ownership, the profit motive and market forces, therefore, certain divine restrictions have been input as per Islamic principles. These cover economic activities in particular and economic structures in general. Believers hold, as an article of faith, that such restrictions are imposed by Allah the Almighty, whose knowledge has no limits, and so cannot be abridged or removed by any human authority. The prohibition of riba (usury or interest), gambling, hoarding, dealing in unlawful goods or services, short sales and speculative transactions are some examples of these divine restrictions. And taken together, all have the cumulative effect of maintaining the balance, justice and equality of opportunities.

Asset-backed financing is one of the most important characteristics of Islamic finance

Conventional financing assumes that the banks and financial institutions deal in money and monetary papers only. That is why they are forbidden, in most countries, from trading in goods and accumulating inventories.

Islamic finance, on the other hand, does not recognize money as the subject matter of trade, except in some special instances. Money has no fundamental utility; it is only a medium of exchange. Each unit of money is 100 percent equal to another unit of the same denomination; therefore, there is no scope for making profit through the exchange of these units. Profit is generated when something having an intrinsic utility is sold for money, or when different currencies are exchanged, one for another. The profit earned through dealing in money (of the same currency) or the papers representing them is interest, and hence prohibited.

The real and ideal instruments of financing in Shariah-compliant banking are Musharakah and Mudarabah. When a financier contributes money on the basis of these two instruments, it is bound to be converted into the assets. Profits are generated through the sale of these real assets.

Financing on the basis of Salam and Istisna also creates real assets. The financier, in the case of the former, receives real goods and can profit by selling them in the market. In the latter instance, financing is affected through the manufacture of real assets; and as a reward for doing this the financier earns his or her profit.

The instruments of leasing, Ijara and Murabahah, are likewise fully backed by assets and financing through these instruments, and are therefore clearly distinguishable from interest-based financing.

It is evident that every financing in an Islamic system creates real assets. It is known, on the other hand, that interest-based financing does not necessarily create real assets. Hence, the supply of money via loans advanced by financial institutions, does not normally equate with the real goods and services produced in the society. This alludes to loans creating the illusion of an increase in money, without creating real assets in the same quantity. This gap between the supply of money and production of real assets creates and fuels inflation. Hence, financing in an Islamic system is always backed by real assets.

The success of Islamic finance in several Asian and Middle Eastern countries encouraged EcoIslamicBank launched Islamic financing services in 2006. However, the country's Islamic banking sector is still relatively nascent.

After the dissolution of the Soviet Union, the Kyrgyz Republic became the first Central Asian country to join the Islamic Development Bank (IDB) in 1993. Nevertheless, this introduction of Islamic banking in the country faced obstacles that were mainly due to initial apprehensions concerning Islamic finance among the secular elite population and government officials. Nevertheless, the success attained by Islamic finance principles in other Asian and Middle Eastern countries, particularly Malaysia, encouraged the government to introduce Islamic banking in the Kyrgyz Republic in 2007. Furthermore, IDB, which has funded several key Kyrgyz projects, has manifestly assisted the country in implementing a dual banking system (namely Islamic banking in conjunction with traditional banking).

The Kyrgyz Republic signed a memorandum of understanding with IDB and Eco Bank to develop the country's Islamic banking system back in 2007. The MoU was specifically aimed at introducing and implementing the principles of Shariah-compliant finance in the country. Following the signing of the MoU, EcoIslamicBank was established as the pilot project for Islamic banking in the Kyrgyz Republic.

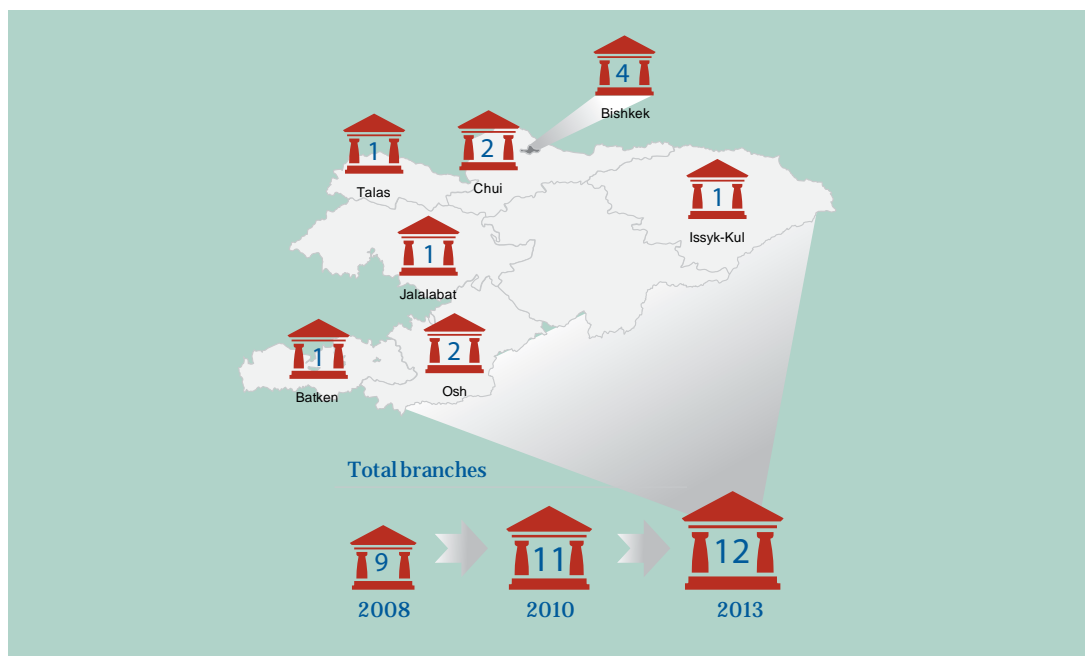
The Kyrgyz Islamic banking system comprises just one commercial bank, with 12 branches licensed and regulated by NBKR

EcoIslamicBank is the only commercial Islamic bank licensed by NBKR to offer Shariah-compliant financial products and services in the Kyrgyz Republic. The bank is regulated and supervised by NBKR. EcoIslamicBank provides several Islamic banking and financial services, including deposit and investment accounts, and financing and credit facilities to individuals and businesses, particularly MSMEs.

Growth in the number of EcoIslamicBank branches has been slow, limiting the bank's outreach. As of 2013, it had 12⁵⁵ branches providing Islamic banking products and services nationwide. The number of branches increased at a CAGR of 5.92 percent from 9 in 2008 to 12 in 2013⁵⁶.

Still, the concentration of EcoIslamicBank's branches remained at just 3.23 branches per million adults in 2013⁵⁷. Bank's branch network is sparse and concentrated in economically important provinces. Within these provinces, branches are located in major cities; rural areas, do not have easy access to Islamic finance.

Figure 17 : The penetration of Islamic banking in the Kyrgyz Republic (number of branches)



Source: National Bank of the Kyrgyz Republic Annual Reports

Despite its slow growth in terms of the number of branches, EcoIslamicBank's business has grown substantially, as evidenced by its loan book and the volume of deposits it has attracted.

The asset base of EcoIslamicBank expanded at a CAGR of 15.9 percent from 2010 through 2014, or to the point where it now accounts for 3 percent of the total banking system's assets⁵⁸. This expansion could be ascribed to growth in the bank's financing activity. The value of financing increased at a CAGR of 18.9 percent over the same time frame. The bank's loan book accounted for 1.6 percent⁵⁹ of the loans provided by all Kyrgyz commercial banks last year. Moreover, consumer loans make up the majority of EcoIslamicBank's loan portfolio. The average size of a loan advanced by the bank is about \$1500.

55. National bank of the Kyrgyz Republic

56. National bank of the Kyrgyz Republic

57. National bank of the Kyrgyz Republic and the World Bank

58. National bank of the Kyrgyz Republic

59. National bank of the Kyrgyz Republic

EcoIslamicBank's deposits increased at a CAGR of 42.1 percent from 2010–14. And these deposits accounted for 3.7 percent of the deposit base of all commercial banks in the country last year⁶⁰.

Figure 18 : Growth in Islamic loans and deposits (\$ million)



Source: National Bank of the Kyrgyz Republic, EcoIslamicBank Annual Reports

Non-performing loans in the banking system

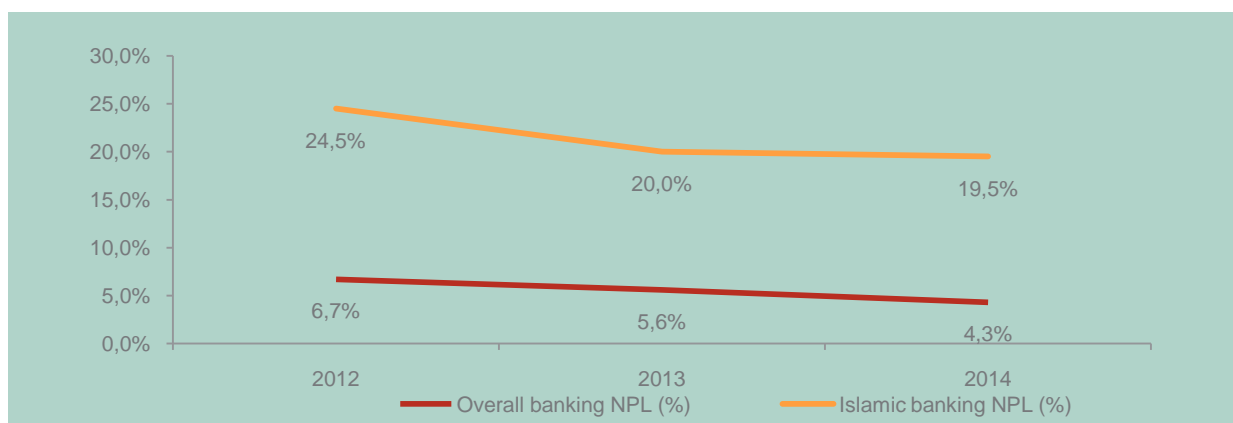
The number of NPLs in the Kyrgyz banking system has improved in recent years; but it remains abnormally high in the Islamic banking sector

The proportion of non-performing loans in the Kyrgyz Republic is low as compared to the levels seen in other Central Asian countries such as Kazakhstan and Tajikistan, which carry NPL ratios of over 10 percent ⁶¹.

The ratio of Kyrgyz NPLs to total loans decreased from 6.7 percent in 2012 to 4.3 percent in 2015⁶². This was largely due to the selective lending practices adopted by most commercial banks. Given that the demand for financing exceeds the availability of funds, the country's banks can simply choose clients with a low chance of non-repayment.

At the same time, EcoIslamicBank has one of the highest NPL ratios among Kyrgyz banks. In 2015, the firm's ratio of NPLs to total loans was pegged at 19.5 percent, down from 24.5 percent in 2012⁶³. This is mainly because the lion's share of the bank's portfolio is made up of small consumer loans, in particular for the purchase of small household appliances. These carry a greater risk of default.

Figure 19 : NPLs as a percentage of total lending in the Kyrgyz Republic



Source: Primary Research

60. National bank of the Kyrgyz Republic

61. OUTLOOK 2014: Eurasia to stand on shoulders of giants: bne IntelliNews

62. Primary Research

63. Primary Research

Factors driving Kyrgyz Islamic banking growth

A increasingly positive perception of Islamic banking among the Kyrgyz population; a simultaneous increase in the interest conventional banks now have in Islamic operations; aid via the IDB's support initiatives; all are driving the visible growth of Islamic banking in the Kyrgyz Republic

A positive perception of Islamic banking: Almost 86 percent⁶⁴ of Kyrgyzstan's population follows Islam. Potential customers are mostly private businesses, with their natural need for banking products. However these generally seek to avoid the offerings and services of conventional banks because they see paying interest as not being aligned with their values.

Around 80 percent of the MSMEs surveyed expressed a desire to borrow, or obtain financing, under the aegis of Islamic principles. This amounts to significant untapped potential, as there is just one Islamic bank operating in the Kyrgyz Republic at present, and it accounts for only 1.6 percent⁶⁵ of all commercial bank lending.

Conventional bank interest in Islamic banking is growing: Considering this untapped potential, many conventional banks in the country, such as Kyrgyzkommertsbank), RosinBank, and Bai-Tushum Bank, had expressed their interest in setting up Islamic banking operations in the Kyrgyz Republic as of April 2015. In fact these banks have already started the process, conducting relevant feasibility studies and appointing experts on regulatory compliance.

Additionally, some foreign banks operating in the country already have significant experience in setting up and operating Islamic banking windows in their home countries. And many of them have been exploring ways to leverage this experience to set up Shariah-complaint Kyrgyz banking operations. Additionally, several traditional banks in the country are looking to attract funds from wealthy Russian Muslims seeking to invest in Shariah-compliant products/opportunities outside of their home country.

IDB's contribution to Islamic finance's development: IDB has contributed to the development of Islamic finance in the country through various initiatives dating back to when the Kyrgyz Republic became a member in 1993. These development initiatives are aimed at forging a suitable regulatory environment likely to increase the presence of Islamic banking and finance. They include:

- Reviewing the existing legal framework pertaining to banking and financial activities, and proposing amendments or drafting a new stand-alone law to enable Islamic finance to operate efficiently;
- Assisting EcoIslamicBank to introduce new Islamic banking products;
- Widespread training at EcoIslamicBank, NBKR, the Ministry Finance, the Ministry of Economy, and the Ministry of Justice as well as at the Financial Market & Supervision Service covering the operation and supervision of Islamic banking; and
- Creating a suitable environment in which to launch Sukuk (the Islamic equivalent of bonds) and Takaful (contributory communal insurance for members against future loss or damage) as further aids in the development of Islamic products in the country.

IDB has been active in financing the construction of Islamic schools and vocational centers. Furthermore, IDB has been an active participant in the social and economic development of the country, and is involved in co-financing important projects in various sectors such as energy, transport infrastructure and agriculture, while at the same time providing credit lines to Kyrgyz banks.

Expansion of the Kyrgyz Islamic financial industry is a key IDB strategic thrust

64. Islam in Kyrgyzstan: Wikipedia

65. National bank of the Kyrgyz Republic

Challenges facing Islamic banking

As Islamic banking expands, the sector must compete with established conventional banks already entrenched in the Kyrgyz banking system. At the same time they have no choice but to deal with a weak regulatory environment and a shortage of products and funds

Taking steps towards the development of a robust regulatory environment: Due to regulatory provisions for Islamic finance in the Kyrgyz Republic, being in the developmental stages, it has restricted growth of the sector. Although the first Islamic bank was established in 2007, EcoIslamicBank had to include operational governance provisions for Shariah compliance in its Articles of Association, due to lack of specific governance laws and local knowledge of Islamic Finance.

Also, the bank currently operates as a pilot project on the basis of a Memorandum of Understanding between Kyrgyz Republic, Islamic Development Bank and EcoIslamicBank which was signed in 2006 with a view to introduce and develop Islamic banking in the country. However, the necessary procedures to convert it into a full-fledged Islamic bank were never implemented due to lack of reflection of the Islamic principles.

Certain amendments to the banking law were introduced in 2009 and 2013 to the Law of the Kyrgyz Republic known as the normative legal acts of NBKR. These laws provided detailed instructions and regulations relating to Islamic finance, credit institutions and transactions.

Given the low market share Islamic banking has garnered to date, regulators have not paid much attention to this issue. Even the Kyrgyz taxation system does not have provisions to support Islamic banking. Moreover, Islamic leasing attracts double taxation, which naturally increases the applicant's borrowing costs. This, in turn, translates into another hindrance in terms of developing new Islamic banking products.

Limited reach and lack of competitive products: Just one Islamic bank services the entire country's Islamic finance requirements. And that bank's reach is limited because of its few branches and the inadequacy of its menu of fully Shariah-compliant products. Thus, in the absence of more operators, Islamic banking growth potential in the country is limited. There is a clear need to increase the number of banks offering the critical mass of Shariah-compliant products required to establish a strong presence for this kind of banking in the Kyrgyz Republic.

Effective profit is usually higher in Islamic banks compared with interest rates charged by conventional banks. So despite the strong demand for Shariah-compliant products, customers are deterred by the higher costs involved. This disparity of costs is bound up with the high cost of structuring Islamic products. Furthermore, the Islamic finance products now offered in the country cannot compete with the product portfolio of the conventional banks.

Shortage of working capital: Obtaining Shariah-compliant funds for working capital requirements has proven a challenge for EcoIslamicBank, since Islamic banks cannot use non-Shariah-compliant funds. Such funds now come from donors and/or other international financial institutions such as IDB. This limits Islamic bank flexibility in terms of financial operations and the replenishment of funds.

Shortage in the skilled workforce: Additionally, Kyrgyz banks and financial institutions find it difficult to hire qualified managers and staff with some level of expertise in Islamic banking. In some instances, recruiting experts, such as accountants and product managers, among others, is challenging because such personnel are simply unavailable locally.

Without the necessary know-how and skilled workforce capability at their disposal, Islamic banks cannot maximize their product portfolio by developing.

The Kyrgyz Islamic banking industry is underdeveloped, primarily due to the lack of legislative and regulatory support from the government and the country's central bank. Although the latter amended its banking rules to permit the operation of Islamic banks and windows, it has not yet been able to establish the stand-alone legislation which would encourage development of the sector. The current banking rules -- created for conventional banks -- also need to be followed by Islamic banks, restricting their ability to manage investments and raise capital through avenues that are compliant with Shariah principles.

Although several existing foreign banks operating in the country have been evaluating the possibility of setting up an Islamic bank (or window), the present environment does little to encourage them in accelerating their plans.

Overview of micro-finance institutions in the Kyrgyz Republic

The establishment of FINCA in 1995 signaled the arrival of microfinance in the Kyrgyz Republic. Even so, the industry was largely characterized by foreign institutions providing grants on the basis of international agreements until August 2002, when the government adopted the legislation 'On Microfinance Organizations in the Kyrgyz Republic'.

Historically, microfinance developed swiftly dating back to the latter part of 1990s; in fact, the country is among Central Asia's leaders in this segment. Since 1995, international financial institutions and donor organizations, such as The Foundation for International Community Assistance (FINCA), have been focused on improving the loan access which would enable many more micro enterprises to obtain financing. Microfinance institutions are an important part of the Kyrgyz credit sector as they are generally the sole finance providers in rural areas. This is mainly because MFIs offer unsecured loans, whereas banks focus on urban borrowers who can put up collateral.

Kyrgyz MFIs are well-regulated; the NBKR is responsible for licensing and supervising all MFIs in the country. The law 'On Microfinance Organizations in the Kyrgyz Republic', introduced in June 2002, led to the mandatory registration of all MFIs and the need for appropriate certification or a license from NBKR for all legal entities conducting microfinance activities.

Furthermore, the Kyrgyz government passed a law in 2012 to address the parallel loans issue (multiple borrowings by the same customer) in the MFI sector. This piece of legislation was intended to limit such parallel loans by mandating the MFIs providing them to make clients aware of the possible negative effects. The regulation also mandated MFIs to regularly report loan details to the Credit Bureau. This resulted in an 8 percent⁶⁶ reduction in the number of parallel loans, yet without disrupting MFI operations.

To address growing concerns over rising interest rates, the government passed a Law On Restrictions on Usury Activities in the Kyrgyz Republic in 2013 to protect the rights of borrowers by capping interest rates in excess of the maximum allowable percentage as prescribed by the NBKR. This sparked a sharp decline in the interest rates charged by MFIs, to 31.0 percent in 2013, down from 38.8 percent in 2010.⁶⁷ This law has also affected the number of MFIs in the country.

The Kyrgyz MFI sector is highly concentrated; around 5 percent of the total 277 licensed micro finance institutions account for more than 85 percent of total MFI loans, and boast of having about 90 percent of the total number of borrowers

277 MFIs have been operating in the Kyrgyz Republic since October 2013. That is a considerable reduction from the 454 reported in 2011. Of these, 212⁶⁸ were microcredit companies (MCCs)⁶⁹, among which two were Islamic institutions, while 65⁷⁰ were microcredit agencies (MCA)⁷¹.

66. Microfinance Barometer – Convergences, 2014

67. Sector Assessment (Summary) – Multisector for Private Sector Development: Asian Development Bank, 2013

68. Microfinance in Kyrgyzstan: Legal Barriers to Development, Kalikova Associates, 2014

69. A licensed MFI established as a legal entity in any organizational and/or legal form of a commercial organization

70. Microfinance in Kyrgyzstan: Legal Barriers to Development, Kalikova Associates, 2014

71. A licensed MFI established as a non-commercial entity

Kyrgyz MFIs now service over 500,000 borrowers; and an estimated 16 percent of these borrow from more than one MFI. The 15 largest institutions account for 87 percent of the total MFI loan portfolio and 93 percent of the total number of micro borrowers.⁷² The top MFIs are relatively well-capitalized, having access to wholesale funding from domestic and international markets.

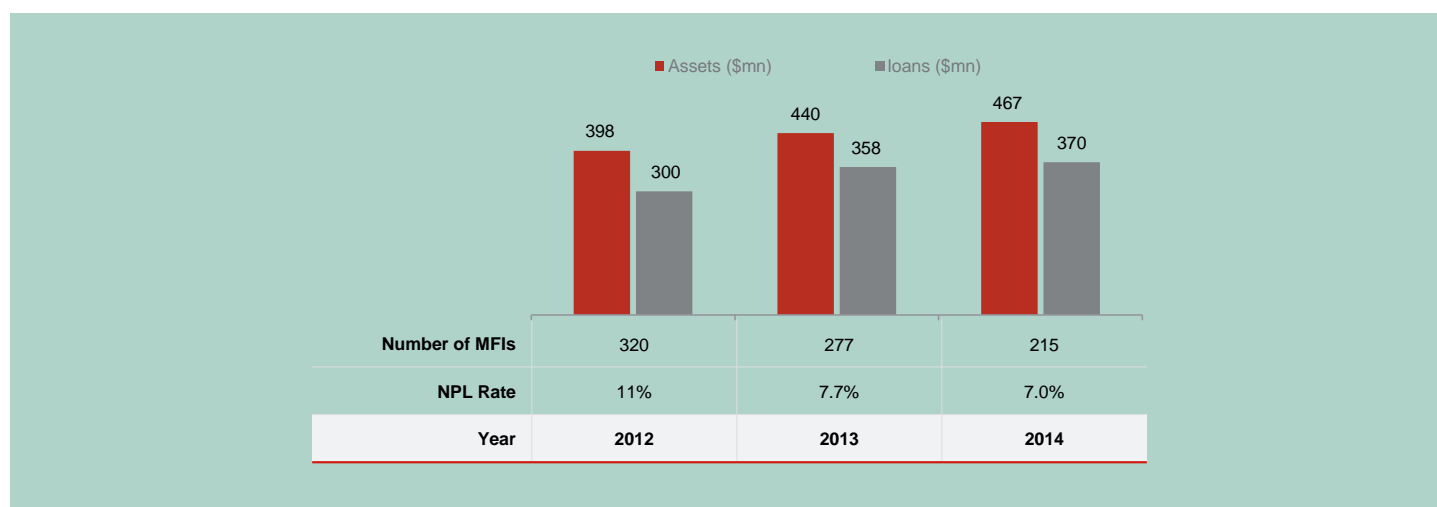
MFI assets and loans have been growing since 2012, largely in lock-step with an expanding customer base

From 2012–14, MFI assets grew at an average annual rate of 8.4 percent to \$467 million. Despite strong growth, however, MFIs currently account for a modest 20 percent market share in the Kyrgyz financial sector by asset value. MFI assets amounted to 6.8 percent of Kyrgyz GDP in 2013.

During the 2012–14 period, the value of loans provided by such institutions increased at an average annual rate of 11.4 percent, up to \$370.1 million. This growth was mainly driven by the expansion of the MFI customer base, given that the average individual loan size has remained fairly flat.

The quality of loans disbursed by MFIs have also improved in recent years, as evidenced by the marked decline seen in the NPL rate from 11 percent in 2012 to 7 percent in 2014.

Figure 20 : Growth of MFI assets and loans (\$ million)

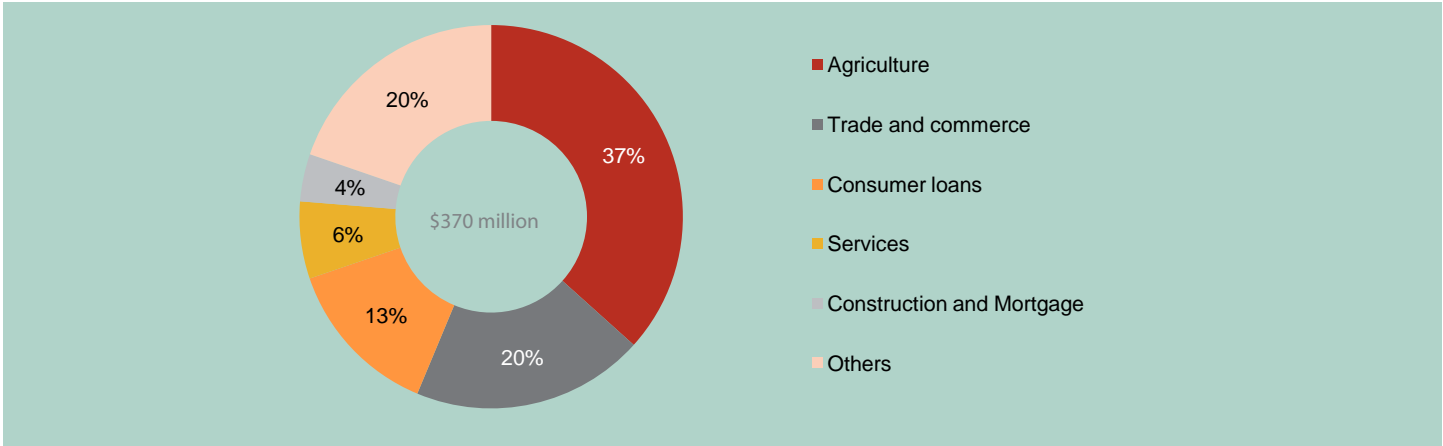


Agricultural lending dominates MFI loan portfolios, with over a one-third share by value

In 2014, the agriculture sector accounted for around 37 percent of the total loans disbursed by microfinance organizations, compared with 18 percent for banks. This was followed by trade (20 percent), consumer loans (13 percent), the service sector (6 percent), and the construction industry (4 percent).

72. Sector Assessment (Summary) – Multisector for Private Sector Development: Asian Development Bank, 2013

Figure 21: Classification of MFI loans by sector (2014)



04.

Islamic Banking Opportunities among MSMEs

Because 95% of MSMEs are unable to meet their financial needs through formal channels, a significant opportunity for Islamic banks exists in the Kyrgyz Republic. And over the next few years, the Islamic financing opportunity represented by these MSMEs is projected to be worth \$342.2 to \$456.3 million, with deposit potential in the range of \$402.6 to \$536.9 million.



Access to finance for the MSME sector

MSME penetration of formal financing channels in the country is low. Moreover, the banking facilities are largely concentrated in urban areas. Thus, easy access to finance is a major constraint for the MSME sector

Kyrgyz MSME lending has picked up momentum over the last few years, driven by certain government initiatives, such as the introduction of preferential loans. Nevertheless, banking activity in the country remains weak because of the relatively small number of bank branches and ATMs. In addition, a pronounced lack of financial literacy and low confidence in the banking system has led the majority of the Kyrgyz population to opt for keeping their money at home rather than in banks.

Bank funding in the country is among the lowest in Eastern Europe and Central Asia. According to a 2011 World Bank Group study, the Kyrgyz Republic ranked 24th among 29⁷³ Eastern European and Central Asian countries pertaining to its access to bank credit for investment. Moreover, the country had the lowest levels of credit provided to the private sector over the same vast region (12.9 percent of GDP in 2011⁷⁴). Simply put, businesses rely less on bank financing and more on internal sources of funding.

As a consequence, access to finance is a major issue for MSMEs in the country. Only 5 percent⁷⁵ of MSMEs are able to adequately meet their financing needs through banks and other formal financial institutions. Moreover, those MSMEs able to do so are generally mid-sized enterprises concentrated in urban centers. The other two MSME categories, classified by their access to finance, are as follows:

- **Under served MSMEs:** Barring a few small enterprises with established track records, the financing needs of a significant portion of the country's MSMEs are only partially met. These enterprises (representing 20–25 percent⁷⁶ of the total number of MSMEs) avail themselves of formal financing (Islamic or conventional), which amounts to less than 20 percent of their requirements.
- **Unserved MSMEs:** These are the mostly small enterprises in either rural or urban areas with no access to formal sources for loans and funding. That is simply a result of banking products and services being unavailable in their locales. Thus this category of MSMEs largely relies on informal sources, such as family and friends. And it represents some 70–75 percent⁷⁷ of the MSME population, who do not borrow at all for various reasons. Included among these is the fact that their Islamic beliefs prohibit them from paying interest on loans.

73. Asian Development Bank: Private Sector Assessment Update - Kyrgyz Republic 2013

74. Asian Development Bank: Private Sector Assessment Update - Kyrgyz Republic 2013

75. Primary Research

76. Primary Research

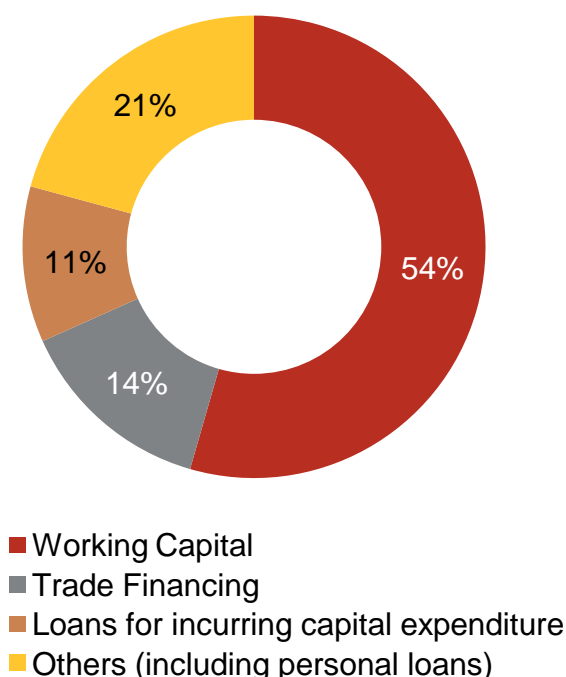
77. Primary Research

MSMEs in Kyrgyzstan mostly borrow to meet working capital requirements

The needs of Kyrgyz MSMEs in terms of banking services and financial requirements are basic. For most (irrespective of their business category) this means current accounts for day-to-day transacting and cash management services are their top priorities, followed by loans for working capital purposes (54 percent), trade financing (14 percent), and loans for capital expenditures, such as land, buildings and machinery (11 percent)⁷⁸.

Other forms of financial support, such as leasing and factoring, issuing letters of credit, payment cards, and guarantees have not yet become prominent. Hence, only a few banks offer such services (and on a limited scale). Moreover, the low financial literacy quotient among MSME entrepreneurs in general, and their ambiguity in terms of understanding operational requirements, help to keep the demand for such financial products to a minimum.

Figure 22: Purposes of loans taken out by MSMEs



Source: M-Vector Survey of MSMEs, March 2015

Reasons behind the popularity of informal funding channels among Kyrgyz MSMEs

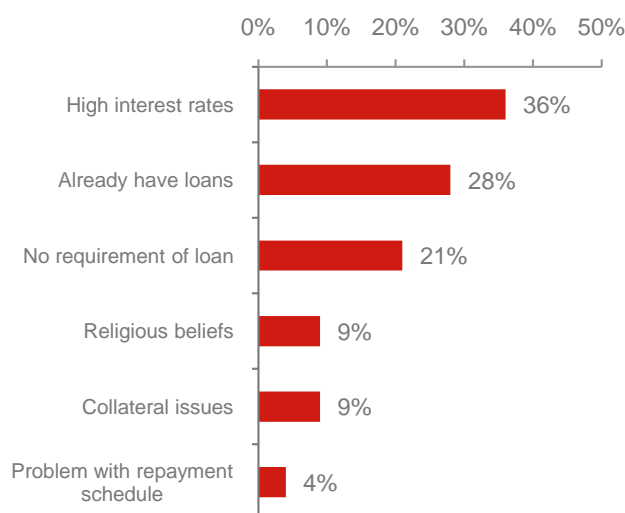
Because of the low levels of financial literacy in this segment, and their characteristically informal manner of conducting business (particularly in the rural areas), a large segment of Kyrgyz MSMEs prefer to acquire any additional funds they require through informal channels. These business owners are more comfortable in dealing with informal lenders, given that funding by this route is based on acquaintanceship and trust. In addition, such informal lenders require limited-to-no-paperwork and offer flexible repayment terms, unlike financial institutions.

The time taken by banks to disburse loans varies from 2 weeks to 1.5 months, which is not an ideal fit vis-à-vis the often urgent funding requirements of MSME businesses.

High collateral and guarantee requirements prevent MSMEs from applying to banks and microfinance companies

78. M-Vector Survey of MSMEs, March 2015

Figure 23: Why MSMEs avoid applying for loans



Source: Primary Research

The high lending rate is the main reason cited by MSMEs for not availing themselves of loans from financial institutions. The average lending rates charged by banks and microfinance organizations in 2014 were 22.4 percent and 38.5 percent, respectively; moneylenders, on the other hand, charge 2 percent per month⁷⁹.

MSMEs are subject to even stricter terms. Their average collateral requirement is usually around 1.5 times that of large corporations. According to the results of the 2013 World Bank Enterprise Survey, 89 percent of the MSMEs receiving loans in the Kyrgyz Republic had to provide collateral averaging 187 percent of the loan value⁸⁰. The average collateral value ranged from 164 percent for firms in the services sector to 237 percent for those in the manufacturing and processing sector.⁸¹

As a result, the majority of the funds came from the retained earnings of existing enterprises and household savings, rather than banks and other formal financial institutions.

A significant minority (9 percent⁸² of Kyrgyz MSMEs do not deal with the conventional banking system because their faith prohibits them from paying interest on loans.

Although many of these MSMEs are creditworthy, they are excluded from being readily able to obtain funds from Islamic financial institutions either because Shariah-compliant products are unavailable or are not properly understood by the owners of these businesses; and in either case such applications tend to involve lengthy processes, making the execution of Islamic transactions cumbersome.

Bank preference for lending to the trade sector, leads to the lessened availability of funds for MSMEs operating in other sectors

Of the total bank credit issued in the Kyrgyz Republic in 2014, almost 36 percent⁸³ was concentrated on the trade sector. Similar inequality prevails with respect to access to finance for the MSME sector, with banks preferring to lend to businesses involved in trade.

79. Asian Development Bank: Private Sector Assessment Update - Kyrgyz Republic 2013

80. The Kyrgyz Republic Strategic Assessment of the Economy: Promoting Inclusive Growth: Asian Development Bank, 2014

81. The Kyrgyz Republic Strategic Assessment of the Economy: Promoting Inclusive Growth: Asian Development Bank, 2014

82. M-Vector Survey of MSMEs, March 2015

83. National Bank of the Kyrgyz Republic

That is because few MSMEs from other sectors are profitable enough to afford the country's high financing costs. Moreover, with bank loan terms averaging about two years, only frequent cash-flow investment projects (typically for those engaged in trade) are able to repay this type of short-term loan. Thus, the majority of MSMEs in other sectors are overlooked for financing by the formal financial institutions in the country.

Obstacles for financial institutions in lending to MSMEs

Their informal manner of conducting business

A large number of Kyrgyz MSMEs operate in the informal sector. Most of them either do not report, or under-report revenues to regulating bodies. This effectively bars such businesses from accessing the financing they need since banks need to verify a business' financial viability through registration, title documents and tax reporting.

Most MSMEs (formal as well as informal) are owned and operated by a single individual or their family members. Such businesses rarely have a long-term plan or business strategy. They also tend to lack transparency and internal controls.

All of this inclines banks to avoid lending to them, given the perception that the risk of loan defaults is high.

Accessibility issues hinder expansion

Banks in the Kyrgyz Republic face another major hurdle in the form of the country's mountainous terrain. This has prevented several of the country's banks from expanding beyond the few large accessible cities. Additionally, poor financial infrastructure prohibits commercial bank usage of the full technological suite in launching the most effective mobile or branchless banking services in more remote areas. In effect this means that banks are simply unable to service the majority of MSMEs, who operate outside of the major urban centers.

Limited capacities of Kyrgyz banks

Due to their limited financial literacy, Kyrgyz MSMEs do not have sufficient knowledge and information regarding financial products and solutions, particularly Shariah-compliant products. As well, the banking sector has not increased its investment in marketing activities and consumer education to counter this limitation. For instance, the investment in marketing activities by EcoIslamicBank (the only Islamic bank operating in the country) is noticeably low, as is reflected in its slow rate of customer acquisition.

Also, the banking sector generally does not have an adequate number of skilled employees or the technological resources needed to scale up operations or improve operational efficiency.

Supply side analysis – penetration of Islamic Banking into the MSME sector

The Islamic banking sector in the Kyrgyz Republic is underdeveloped. As noted above, there is only one fully-fledged Shariah-compliant bank along with three Islamic MFIs operating in the country. Thus despite the favorable perception such lenders enjoy (especially among MSMEs), their product portfolio does not match conventional bank offerings.

The Islamic banking sector in the Kyrgyz Republic is underdeveloped. As noted above, there is only one fully-fledged Shariah-compliant bank along with three Islamic MFIs operating in the country. Thus despite the favorable perception such lenders enjoy (especially among MSMEs), their product portfolio does not match conventional bank offerings.

EcoIslamicBank's banking products are focused on both individual (retail segment) and corporate (especially small businesses) customers. And within the corporate banking segment, the bank concentrates on the MSME group in particular,

as is evidenced by the bulk of the loans in its portfolio being small loans. Other products offered include deposit accounts, safety deposit boxes, and currency exchange services plus product financing. The bank also provides trade finance and bank guarantees to businesses operating in the country

MFIs, by comparison, offer group loans (the minimum amount being \$65 for 3-18 months), unsecured loans (up to \$3,200 over the maximum tenure of a year), secured loans (up to \$31,200 for 3 months to 3 years), home purchase and home improvement loans (up to \$15,500 for a maximum of 10 years), and education loans (in collaboration with USAID).

Most of these products are structured based on Mudarabah and Murabaha principles. Other Shariah-compliant financing products based on more complex structures are not available, though, due to the under-developed banking infrastructure and lack of personnel with sufficient know-how pertaining to Islamic banking principles and structures.

Islamic banking potential in the MSME sector

The Islamic banking sector could potentially fill a funding gap ranging between \$342.2 and \$456.3 million.

At present, there are a total of 362,163⁸⁴ MSMEs operating in the Kyrgyz Republic. Of these, only 5 percent (generally mid-sized) have sufficient access to finance through formal channels to be considered financially well-served. By contrast, 20-25 percent⁸⁵ of these enterprises (generally small businesses) have limited financial access and are financially underserved, while another 70-75 percent⁸⁶ (generally micro and small businesses) have little access to finance to be deemed financially un-served, at least by formal financial institutions.

The funding potential for Islamic banking in the MSME sector seen from both bull and bear case standpoints:

The bull case scenario: This rests on the assumption that Islamic banking institutions prove capable of implementing a model which extends branch networks to all areas, urban and rural alike; and that they further, improve understanding and knowledge of Shariah-compliant products amongst SMEs, while hiring skilled professionals who can structure Islamic products, and offer competitive Shariah-compliant products under more favorable conditions (for instance with flexible tenure and collateral requirements, at lower cost, and with less documentation) compared to conventional banks. In such a scenario, approximately 80 percent⁸⁷ of MSMEs have already exhibited their interest in availing themselves of Shariah-compliant financing.

- In the above scenario, Islamic bank penetration over the next few years is estimated as capable of reaching 80 percent of the un-served and underserved MSME market (which, again, represents 95 percent of the total number of MSMEs). At an average loan size of \$1500 each, the resulting aggregate value would be \$412.9 million.

The bear case scenario: Assumes that the penetration of Islamic banking remains primarily limited to urban areas, offering more diversity in Islamic-structured products while making loan processing easier for MSMEs.

- Given the above conditions, Islamic banking institutions have been estimated as capable of tapping into at least 60 percent of the un-served and under-served market (meaning 95 percent of the total number of MSMEs); thus, with an average loan size of \$1500 each, the resulting value would total \$309.6 million.

Islamic banks may also expect to cannibalize or convert the existing well-served MSME portfolios of conventional banks anticipating that these MSMEs might migrate elsewhere for better products or quality of services. To be able to achieve this, however, Islamic financial institutions would have to ensure that they are able to diversify their product portfolios and

84. Annual publication on Small and Medium Businesses in the Kyrgyz Republic: National Statistical Committee of the Kyrgyz Republic, 2014

85. Primary Research

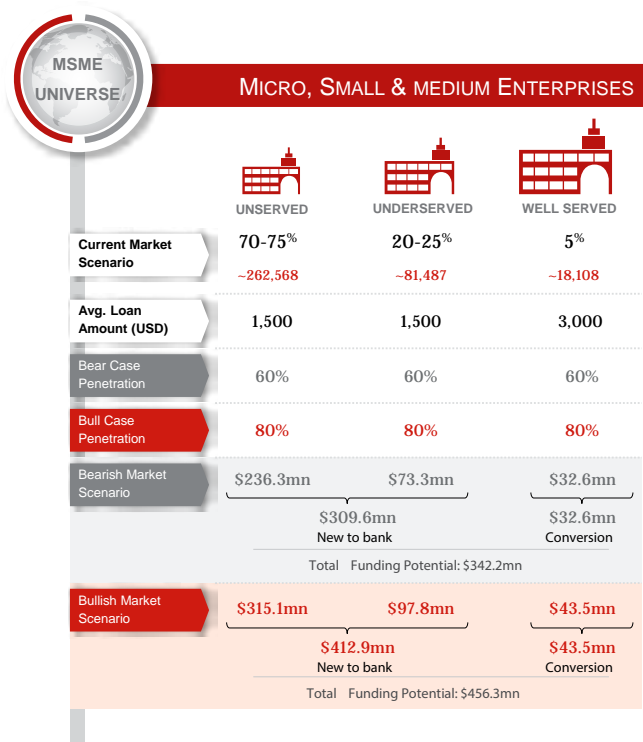
86. Primary Research

87. Primary Research

customize these offerings to suit the financing requirements of this segment, as well as offer an end-to-end banking solution to these businesses. Assuming a penetration rate of 60–80%, the funding potential within this category of MSMEs could be worth \$32.6–\$43.5 million.

Thus, the total funding potential for Islamic banking in Kyrgyzstan would likely range from \$342.2 million in a bear case scenario to \$456.3 million in a bull case scenario.

Figure 24 : Funding potential

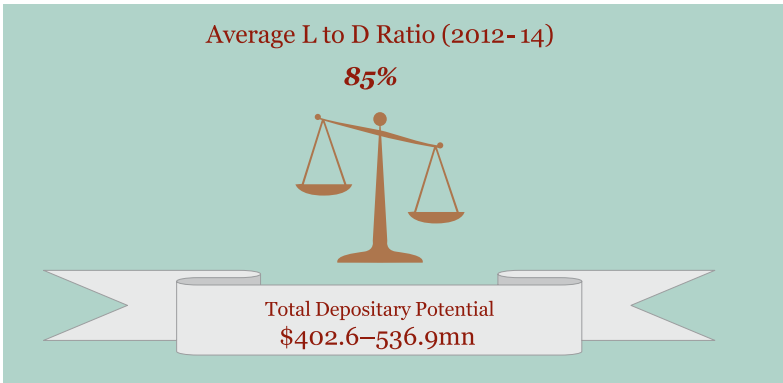


The deposit potential for Islamic banking from MSMEs could be \$402.6 to \$536.9 million over the short- to mid-term future.

The loan-to-deposit ratio of the banking sector in the Kyrgyz Republic averaged 85 percent over the last three years (2012–14). Assuming this continues at the same level, the resulting depository potential for Islamic banks within the MSME sector in a bull case scenario, where Islamic banking penetration is high in both the urban and rural environments, and the regulatory environment remains favorable for Islamic banking, would be \$536.9 million over the next few years.

On the other hand, if Islamic banking continues to lack strong penetration of the country’s rural areas, its deposit potential is expected to amount to about \$402.6 million, (applying the same loan-to-deposit ratio).

Figure 25 : Depository Potential



Strategic operational adjustments can help both conventional and Islamic banks target MSMEs more effectively

The regulatory and legislative framework: The government has made efforts to strengthen the regulatory environment by way of amendments that laid down key principles of Islamic Banking in 2009 and 2013. Detailed instructions and regulations relating to Islamic finance, credit institutions and transactions are provided in the normative and legal acts of the NBKR (30 normative and legal acts). As of today, the normative and legal acts of NBKR stipulate requirements on licensing, corporate governance, risk management, model agreements standardization and Procedure for specific types of transactions, which comply with the Islamic principles of financing. To implement the pilot project on introduction of Islamic banking and finance principles, a separate package in normative and legal acts, including taxation issues, has been developed since 2006 for EcoIslamicBank. To address the issue, certain amendments were made in normative and legal acts of NBKR, which mandated the establishment of a Shariah Council at Islamic banks and those banks that would like to establish Islamic windows in their existing conventional bank operations. This council would be responsible for compliance of banking operations with Islamic principles.

However, the Shariah Governance Regulatory Framework (SGRF) in Kyrgyzstan is still in the development phase. As discussed earlier, in comparatively matured Islamic finance markets such as Pakistan and Malaysia, regulatory bodies assisted the Central Banks by establishing Shariah Advisory Councils to monitor Shariah operations of banks. This has allowed Central Banks and their Shariah Council to implement the principles of Islamic Banking.

A robust and comprehensive SGRF is required to communicate Shariah governing policies to the Islamic financial institutions and closely monitor all operations from management to product development of the Islamic financial institutions assuring strict adherence to its regulations and policies. The framework should also develop a roadmap for policy formulation and implementation, in addition to drafting guidelines for compliance of policies required by the central bank.

From a practitioners' perspective, the Kyrgyz Republic is accurately following the roadmap to building a Robust Islamic Banking eco system. By looking at more developed Islamic Banking economies the Kyrgyz Republic can build on its existing Islamic Banking regulations and work closely with banks in order to formalize said ecosystem.

Human capital and talent development: Unsurprisingly, there is a shortage of quality talent in the Kyrgyz Islamic finance industry. Well-educated and experienced human resources within it are, unsurprisingly, in high demand. That is why banks must focus on developing the right talent, offering development opportunities, and providing adequate training if they are to stand the best chance of retaining their human capital. By addressing these issues, they should also be able to realize a significant part of their untapped potential.

Reduction of loan-processing time: The time taken by banks to process and disburse loans is a major hurdle miring access to MSME financing. Thus banks need to streamline their administrative processes to ensure that loan application procedures become less cumbersome in terms of both the documents required and processing time taken. To accomplish this, frontline staff need to be provided with predictive tools, and back-end support to ensure faster loan processing.

Effective segmentation, targeting and evaluation of MSMEs: Banks need to frame better methods of segmenting and targeting potential MSME customers and evaluating the lending risk they represent. Rather than resorting to a one-size-fits-all business model, they must adopt differentiated customized business models and processes for varied MSME targets. In addition, their branch staff needs to proactively approach and engage MSME entrepreneurs rather than passively relying on these people to approach the banks.

In particular, banks need to develop a more MSME-specific risk assessment and underwriting model to assess the credibility of MSMEs via bank statements, utility payments, property lease agreements, technology and/or other such methods. There is also a need to apply cash flow forecasting tools, and non-financial approaches, such as behavioral scoring, to better understand the risks. Effective targeting should parallel continuous monitoring of asset (borrower MSME) quality bolstered by an effective collections mechanism to ensure low default rates.

Increased focus on non-financial extension services: To help MSMEs overcome the challenges they face (for instance their lack of knowledge regarding financial products, their informal methods of conducting business and inefficient financial management), banks should consider providing increased assistance in the form of non-financial extension services. For instance, MSME toolkits, assistance in framing business plans, guidance on legal and tax rules and regulations, and information on other related topics, such as finance and management, would help these MSMEs function effectively while improving their creditworthiness.

Expanding branch networks and offering non-borrowing products and services: Branch penetration in the country is relatively low, meaning smaller towns and rural areas often do not have bank branches in their immediate vicinities. Therefore, increasing the number of branches is essential to increase banking opportunities in the Kyrgyz Republic.

Additionally, banks should evaluate the viability of offering non-borrowing banking services and products such as current and savings accounts, cash management or payment management, payroll management, and other fee-based transaction banking services.

Widen the range of products available: As Kyrgyz MSME sector develops further, the range of Islamic products available in the country would have to become broader. A few examples of Islamic banking products are explained below:

- **Simple products:** Trade finance products such as LC (letter of credit) Musharkah and letter of guarantee which will promote international trading and allow banks to act as guarantors and help facilitate businesses; asset finance products such as securitized loans and lease finance which will allow MSMEs to participate in economic development as well as infrastructure development of the country.
- **Complex products:** Complex working capital loans such as supply chain financing (SCF) on Bai Ajal or Murabaha. SCF is a short-term credit facility that optimizes working capital by allowing businesses to lengthen payment terms to their suppliers. It facilitates business expansion and mitigates payment risk.

05. Conclusion

Although Islamic banking in the Kyrgyz Republic is still in its infancy, there is strong interest in Shariah-compliant financing, particularly among MSMEs. With continued development and improvement in the regulatory and legislative environment, and in strengthening institutional capacities to meet growing MSME demand, the Islamic financing market opportunity is estimated to reach between \$342.2 and \$456.3 million going forward.



Despite the political upheavals and volatility within Kyrgyz banking generally as a result of irregularities and legislative violations, the sector stabilized in recent years after the implementation of regulatory measures by the NBKR and the introduction of an effective development initiative (the Medium-Term Development Program) by the government. At present there are 24 commercial banks operating in the country, with a combined asset base of \$2.5 billion (as of 2014). Foreign banks account for 45 percent of the total assets. These are followed by private domestic banks (with 34 percent) and state-controlled banks (with 18 percent). Meanwhile, the only Shariah-complaint bank, EcoIslamicBank, accounts for the remaining 3 percent of the assets⁸⁸.

Although the level of banking sector activity from 2009 through 2011 remained stagnant due to structural deficiencies, regulatory and legislative reforms continued apace, strengthening the system as a whole. This resulted in a significant increase in banking activity during 2013 and 2014, with both the industry's loan book and deposit base growing at an average annualized rate of more 20 percent.

The Islamic banking sector, in particular, has likewise witnessed strong growth over the past few years. Its financing activity increased at a CAGR of 18.9 percent, while its deposit base grew at an even more rigorous CAGR of 42.1 percent from 2010 to 2014⁸⁹. Although the Kyrgyz authorities introduced certain changes to the banking law (in 2006, 2009 and 2013) to facilitate the functioning of Islamic banks, the government should attempt to improve the regulatory landscape to boost development of the sector in view of the increasing demand for Islamic finance by local businesses. About 5–6 percent of the total population (about 10 percent in the southern provinces and 5.4 percent in the north)⁹⁰ have signaled their interest in Shariah-compliant financing. This is even higher among businesses, with 80 percent⁹¹ of MSMEs expressing strong interest in borrowing from Islamic financing institutions. As a result, several conventional banks, such as Kyrgyzkommertsbank), RosinBank, and Bai -Tushum Bank, are now evaluating the feasibility of setting up Islamic banking operations within their businesses in the country.

At the same time, high costs and their lack of capacities have curtailed penetration of MSMEs by the Islamic banking sector. In fact, even the large conventional banks have not been active in lending to SMEs in the Kyrgyz Republic. Total lending by the banking system to SMEs stands at only about 10 percent of the total (\$148.1 million in loans and \$174.2 in deposits), despite the remarkable fact that the segment accounts for approximately 99 percent of all commercial establishments in the country.

88. National Bank of Kyrgyz Republic

89. National Bank of Kyrgyz Republic

90. Primary Research

91. Primary Research

At the same time, high costs and their lack of capacities have curtailed penetration of MSMEs by the Islamic banking sector. In fact, even the large conventional banks have not been active in lending to SMEs in the Kyrgyz Republic. Total lending by the banking system to SMEs stands at only about 10 percent⁹² of the total (\$148.1 million in loans and \$174.2 in deposits), despite the remarkable fact that the segment accounts for approximately 99 percent of all commercial establishments in the country.

At the present time, only 5 percent⁹³ of the 362,163 MSMEs have adequate access to formal financing. Otherwise, the financing requirements of the remaining MSMEs are either only partially met by financial institutions (20-25 percent of these businesses are financially under-served) or not met at all (70-75 percent of the total number of MSMEs do not have any access to financial support)⁹⁴.

To effectively target the MSME sector, Islamic banks need to focus on expanding their reach while diversifying product offerings, training their workforces regarding Islamic banking products and MSME banking, and implementing SME-specific risk assessment tools while simplifying loan procedures. However, if Islamic financing institutions are able to capitalize on the positive interest in Shariah-compliant banking through such initiatives, then they stand to tap into a funding opportunity estimated at \$342.2 to 456.3 million within these un-served, underserved, and, indeed, well-served categories of MSMEs over the next few years.

Research Scope and Methodology

IFC, a part of the World Bank Group, provides a combination of advisory and investment services to MSMEs through its Financial Institutions Group (FIG). These services are offered with the following objectives:

Advisory Services:

- Building the capacity of financial institutions in strategy, market segmentation, credit risk management, and product development by taking new approaches and introducing new systems to scale up their financing for MSMEs on a sustainable basis
- Promoting sub-sector focus, especially on women-owned SMEs, sustainable energy SME projects, agricultural SMEs, and leasing
- Raising awareness about best practices in the SME finance space
- Developing credit reporting infrastructure based on country needs
- Supporting the development of secured transactions, collateral registries, and legal and regulatory frameworks
- Building the capacity of public/private stakeholders through advice and training


Investment Services:

- Making equity investments in financial institutions/equity funds for SMEs
- Funding lines to expand investment and working capital lines, especially in illiquid markets
- Blending finance options to support the expansion of IFC risk appetites, for example; extending grace periods, performance-based pricing, subordination, higher risk/lower security or in limited cases, local currency positions) for selected projects

92. Primary Research

93. Primary Research

94. Primary Research

- 
- Increasing the focus on underserved segments, for example pertaining to gender, fragile/conflict, agriculture, climate
 - Providing risk sharing facilities/partial credit guarantees to enhance risk-taking capacity and offer capital relief via low-risk weightings; avoiding FX mismatches and encouraging domestic resources for SME financing.

The primary objective of this report is to enable IFC to determine the market opportunity for Islamic finance in the Kyrgyz Republic. The main questions the report addresses are:

- What is the overall number of MSMEs and businesses in the country and how are these establishments structured?
- Is Islamic banking there mature enough to adequately cater to the finance and banking needs of MSMEs and other businesses?
- What are the products and services that MSMEs want from banks?
- What is the size of the MSME market opportunity for Islamic finance?

To get data on the above, we devised a questionnaire to be used in discussions with industry experts (Appendix – II).

Appendix

Fundamental Concept behind Islamic Laws & Principles

The basic belief around which all Islamic laws and principles revolve is that the whole universe has been created and is controlled by only one God. He created man and appointed him as His vice-regent on Earth to fulfill certain objectives.

The assumption behind this belief is that human reason, despite its immense capabilities, cannot claim to have the unlimited power needed to reach absolute truth and justice. Rather it has definite limits beyond which it either cannot function fully or is bound to make mistakes.

It is thus evident that the sphere of the work delegated to humanity by its Creator is not unlimited. There are areas where human reason simply cannot give appropriate guidance or may fall prey to errors. And it is in these areas that Allah Almighty, the Creator of the universe, has provided guidance through His revelations sent down to His prophets. On the basis of these divine revelations it is the firm belief of every Muslim that the commands given through the last Messenger are to be followed and cannot be violated or ignored on the basis of one's rational arguments or inner desires.

Therefore, all human activities must always be subject to these commands and must work within the limits prescribed for them. Islam is not confined to some moral teachings, some rituals or some modes of worship. Rather it contains guidance pertaining to every sphere of life, including socio-economic fields and activities. Obedience by the servants of Allah is required not only in worship, but also extends to their economic activities, even though this may be at the expense of some apparent benefits -- because these apparent benefits may go against the collective interest of the society.

The origin of the Islamic banking system can be traced back to the advent of Islam when the Prophet himself carried out trading operations for his wife. The “Mudabah” or Islamic partnerships have been widely appreciated by the Muslim business community for centuries; but the concept of “Riba”, or interest, gained very little traction in regular or day-to-day transactions.

Early experiments with Islamic banking took place in Malaysia in the mid-1940s and in Pakistan in the late 1950s. However, the first Islamic banking model was introduced by Mit Ghamr Savings Bank in Egypt in 1963. Ahmad Al Najjar was the chief founder of this bank and the key features it introduced were profit sharing on the non-interest based Shariah philosophy. In 1974, the Organization of Islamic Countries established the first fully Islamic bank called the Islamic Development Bank. Its basic business model was to provide financial assistance and support on profit sharing.

By the end of 1970s, several Islamic banking systems had been established throughout the world, including the first private commercial bank in Dubai (1975), followed by the Bahrain Islamic Bank (1979) and the Faisal Islamic Bank of Sudan (1977). By 2003 Islamic banks had become increasingly popular in the Arab world and in countries like Malaysia.

In more recent times, Shariah-compliant finance has been the fastest-growing area of finance globally and has evolved into two forms:

- Restructuring of the whole financial system of the country in accordance with Shariah principles.
- Islamic financial institutions operating alongside conventional financial institutions, either autonomously or as ‘windows’ within conventional banking set-ups.

By April 2013, there were more than 500 financial institutions worldwide that were either fully Islamic or provided Islamic financial products to their customers. Beyond these, there are several hundred Islamic investment banks and insurance companies, or takaful,

The following products are available under Islamic finance:

Islamic forms of deposits

Mudarabah: This is a partnership between the "capital provider" and the "entrepreneur," whereby the former receives a share of the profit against his capital and the latter receives a share of the profit against his labor and management.

Wakala: This is one of the contracts used in Islamic banks to invest money. Under Wakala, the client gives the bank the authorization to invest his money in Islamic activities for a certain percentage of the capital to be deducted from realized profit.

Islamic types of financing

Murabha: This is defined as 'a sale at the original price plus a profit'. In Murabaha, the bank buys and owns the commodities identified by the customer, including consumer goods and production assets according to specifications determined by the customer. After assuming ownership, the bank sells these goods to the client for a price including the purchase cost plus a determined profit against the efforts exerted for the purchase and the expenses borne by the bank. The commodity is then delivered to the customer within the required specifications.

The client pays for the commodity in periodic installments, subject to the contract of sale. Murabaha sale is offered to companies by providing local or foreign raw materials, equipments and machinery with the aim of establishing and expanding production lines.

Musharakah: In Musharakah financing, the client requests financing for a particular project where the bank shares the anticipated profits or losses of the project with the client. The Musharakah contract is done according to a previously arranged, mutually agreed upon set of distribution rules and principles, in compliance with Shariah. Unlike the case of loans, in Musharakah financing, there are no interest rates.

The concept of 'Musharakah financing' is based on the idea that the bank provides the financing required by the client for a particular project without a fixed interest rate, contrary to loans. The realized financial outcome is shared between the bank and the customer, as per the percentages they have mutually agreed.

Ijara: An Ijara lease is defined as a contract that allows the customer to lease a particular asset and utilize it for a specific period of time. After completion of the specified period, the asset can be owned by the customer. This financial lease is adopted in response to the customer's inability to buy a particular asset in cash.

Istisna'a: This is a contract under which the client asks the bank for construction of a manufacturing unit with certain specifications. The bank has to meet the desire of the client and to provide that unit according to specifications set by the client who then pays the price in installments.

The above products have various applications in diverse fields, including within the corporate sector. Of these, Murabaha and Ijara are particularly used by retail customers for buying or leasing cars, home, electronic appliances and home furniture.

Questionnaire

MSME access to finance:

- How do you define micro, small and medium enterprises in your institution? (by number of employees?)
- How do MSMEs typically access finance in the Kyrgyz Republic? Is it easy for a MSME to obtain financing?
- If access to finance is limited, what are the main reasons why?
- Does access to finance vary by the type of enterprise, sub-segments or sector?
- Does what is required mutate with the various segments? Do micro and medium differ significantly when it comes to getting funded? Are manufacturing units, for instance, less reliable than service enterprises?

Products offered by the institution:

- What are the comparable market shares of the various banks based on their loans and deposit bases?
- Do you offer Islamic banking services?
- If yes, what products and services do you offer, and to which segments?
- To what degree is your business exposed to MSME's? (in terms of total loans disbursed/amount of loans disbursed)
- If you do not offer Islamic banking products, what other products and services does your institution offer to MSME's at present? What are the products most eagerly sought by the various MSME segments?
- What are the documentation and approval procedures? What guarantees/collateral does your institution demand?
- In your opinion, are the products now on offer by the banking adequate to meet MSME needs – presently and in the years to come?
- In your opinion what are the products most likely to be in high demand looking out five years?
- What challenges do you face when dealing with the MSME sector?

Islamic banking and MSMEs:

- How many full-fledged Islamic banks operate in the Kyrgyz Republic? What are their names?
- How many conventional banks operate Islamic windows? Any detail you can provide on this aspect would be appreciated.
- What are the comparable market shares of these Islamic banks (both full-fledged and 'window' operations), as informed by loans, financing and deposits?
- How far up the development curve is Islamic banking in the Kyrgyz Republic?
- To what degree are the businesses of Islamic banks exposed to MSME's? (for instance, in terms of total loans disbursed/amounts of loans disbursed)
- What factors hamper the growth of Islamic banking in the country?
- Has the government undertaken any initiatives to promote its development?
- What size is the Islamic banking business and presence, as indicated by assets, loans and deposits?
- How would you classify Islamic loans, by sector?

- What percentage of loans extended become non-performing in Islamic finance? And what is the percentage, among these, of NPLs specifically linked to Islamic loans granted to MSMEs?
- What of the current Islamic banking regulatory environment? (We need to understand the current rules, how they compare other markets, and what, if any, amendments might be expected)
- What initiatives has the central bank initiated to promote Islamic bank development in the country? Has any effort been made, or plans mooted, specifically to encourage Islamic bank lending to the MSME sector?
- Do Islamic banks/financial houses have a significant role to play in MSME sector development?
If not, could you cite some of the reasons for the low adoption pace of Islamic finance products in this segment? What might be the best strategy options to counteract these problems?
- Do these banks have products specially designed for the MSME sector? What are the different products/services they now offer?
- Is there real latent demand for Islamic finance products on the part of Kyrgyz MSME enterprises? (Y/N – and why?).
- What do most MSMEs require, by category, in terms of their financing needs? Does this vary much by sub-segments within their sector?
- Specifically, what are the most promising MSME sectors where Islamic banking products are most likely to play a major role?
- If yes, which specific products would be best suited to which segments, in terms of the overall offering?
- What, in your opinion, are the biggest opportunities for banks in the MSME sector, and specifically for Islamic finance products?

Bibliography

Annual publication on Small and Medium Businesses in the Kyrgyz Republic: National Statistical Committee of the Kyrgyz Republic, 2014

Sector Assessment (Summary) - Private Sector and Finance: Asian Development Bank, 2010

Brief Statistical Handbook 2011-2013: National Statistical Committee of the Kyrgyz Republic, 2014

Private Sector Assessment Update - The Kyrgyz Republic: Asian Development Bank, 2013

Consumer Goods Market in Kyrgyzstan: BISNIS, 2008

The Economist Intelligence Unit

Corruption Perceptions Index: Transparency International, 2014

GDP growth (annual %) - The World Bank website

The Kyrgyz Republic: Economy - Excerpted from the Asian Development Outlook 2015: Asian Development Bank

Doing Business 2015: Going Beyond Efficiency - The World Bank Group

Annual Report: National Bank of Kyrgyz Republic, 2013

Kyrgyz Republic Partnership Program Snapshot: The World Bank Group, October 2014

Financial Access Survey: International Monetary Fund, 2013

National Bank of Kyrgyz Republic website

Country profile – Kyrgyzstan: New Agriculturist, September, 2010

The Kyrgyz Republic Strategic Assessment of the Economy: Promoting Inclusive Growth: Asian Development Bank, 2014

Microfinance Barometer – Convergences, 2014

Sector Assessment (Summary) – Multisector for Private Sector Development: Asian Development Bank, 2013

Microfinance in Kyrgyzstan: Legal Barriers to Development, Kalikova Associates, 2014

Notes



Notes

Lined area for taking notes, consisting of multiple horizontal lines.



Notes

Lined area for taking notes, consisting of multiple horizontal lines.

Xavier Reille
Financial Institutions Group
Advisory Services Manager
Europe, Middle East and North Africa
E-mail: xreille@ifc.org

Kaiser Naseem
Program Manager
Banking Advisory Services
Middle East and North Africa
E-mail: knaseem@ifc.org

Bishkek, Kyrgyz Republic 720040
Business Centre Orion, 4th Floor
Tel.: +996 312 626162
Fax: +996 312 626165

February, 2016