



ADBI Working Paper Series

**FINANCIAL INCLUSION, FINANCIAL
REGULATION, FINANCIAL LITERACY, AND
FINANCIAL EDUCATION IN THE KYRGYZ
REPUBLIC**

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Abstract

This paper discusses recent developments in financial inclusion and financial literacy in Kyrgyz Republic. While financial inclusion is considered one of the key drivers of today's development, it is quite new to Kyrgyz Republic. The first attempts to introduce the notion of financial inclusion arose after a violent power shift in 2010. The economy experienced an overall decline, the banking sector shrank, and financial intermediation slowed down. The National Bank introduced a number of regulatory measures to tighten the supervision of financial sector and increase consumer protection. Some of the efforts have worked well: the banking sector has rebounded, savings have been mobilized, and financial markets have started developing. However, national development patterns, such as unstable economic growth, a high poverty rate, and weak governance are the key vulnerabilities for increasing inclusivity of financial products and services. Income inequality, especially when comparing rural versus urban areas, is substantial and restricts access to financial services for the rural population. Small and medium-sized enterprises face barriers for getting sufficient financing because of high collateral requirements. The population has a low level of financial literacy and is reluctant to use modern financial services. Our analysis suggests that there is an urgent need for consolidated efforts to include more people and businesses into financial activities, mobilize their savings, and improve access to credit.

Keywords: financial inclusion, financial institutions, government policy and regulation, economic development, financial markets, saving and capital investment, financial literacy, personal savings, Kyrgyz Republic

JEL Classification: G2, G21, G28, O16, A2, D4

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1. INTRODUCTION

After its independence from the Soviet Union in 1991, the Kyrgyz Republic followed a path toward democratic and economic reforms. The country signed multiple agreements with international donors, introduced a national currency, and followed macroeconomic reforms according to International Monetary Fund's structural adjustments. Since then, the Kyrgyz Republic is considered as the most open economy in the region and is a member of more than 75 international organizations and cooperation agreements. After the Russian Federation crisis in 1998, the Kyrgyz Republic experienced an overall economic decline, and in 2000, the level of poverty hit its peak of 62.6%. To address economic and social problems, a donor community supported the development of a microfinance sector. A large number of microfinance organizations and credit unions emerged and have become one of the contributors to poverty reduction. At the same time, the banking system was evolving quite quickly. During 1990s, the National Bank issued a license to over 30 commercial banks. Impetuous transformations in the banking sector, along with management problems, eventually led to a huge lack of adequate capital, and the regulator withdrew almost half of the licenses. After that, the Kyrgyz Republic's banking and microfinance sectors evolved gradually, and the share of foreign capital started to increase.

While financial inclusion is considered as one of the key drivers of today's development, it is quite new to the Kyrgyz Republic. The first attempts to introduce the notion of financial inclusion arose after a violent power shift in 2010. A large number of entrepreneurs suffered from pogroms and there was an overall decline in the economy after events in April 2010. The majority of those entrepreneurs were small and medium enterprises in sectors of retail, construction, and services. The banking sector suffered from expropriation of former president-affiliated banks and their capital. These events induced people to protest against the high interest rates of microfinance companies and banks. At that time, many microfinance organizations charged interest rates of above 50%–100%, which led to bankruptcy of many borrowers and social unrest in many regions of country. Some borrowers created associations of suffered borrowers and initiated protest against microfinance institutions (MFIs) and banks in front of the Parliament.

After those events, the government initiated a discussion about adopting a program to increase financial literacy, provide financial education, and reform regulatory frameworks. Many of the donors, private banks, and financial institutions supported those initiatives. A donor community started their own projects on improving financial literacy and promoting financial inclusion, but the government initiatives were never realized. The majority of efforts implemented by the government included improvement of legislation, simplification of procedures, and increasing consumer protection. Only in 2016 was the program on increasing financial literacy in the Kyrgyz Republic adopted.

As of today, unstable economic growth, a high poverty rate, and weak governance are the key vulnerabilities for increasing inclusivity of financial products and services. Over 25% of Kyrgyz's population lives below the poverty line, with 13.9% living in multidimensional poverty.¹ Income inequality, especially when comparing rural versus urban areas, is substantial and restricts the access to financial services for the rural population. Our analysis suggests that there is an urgent need for consolidated efforts

¹ UNDP, National Human Development Report: Human Development and Trade in Kyrgyz Republic. Bishkek, 2016, p. 27.

to include these poor people into financial activities, mobilize their savings, and improve access to credit.

This paper provides an overview of the financial sector in the Kyrgyz Republic, recent trends in its development, and discusses vulnerabilities and perspectives of the banking and microfinance sector. The paper also discusses the status of financial inclusion, penetration of financial products, and accessibility of finance to small and medium-sized enterprises (SMEs). Among others, the paper gives special focus to financial literacy and financial education and discusses some policies to promote financial inclusion in the Kyrgyz Republic. The final section provides conclusive remarks and recommendations.

2. OVERVIEW OF THE FINANCIAL SECTOR

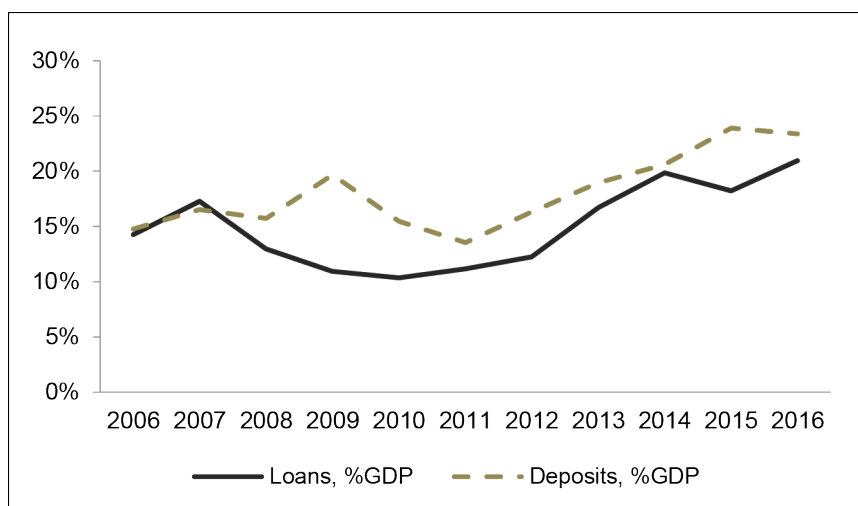
The financial sector in the Kyrgyz Republic is represented by the banking sector and non-bank financial institutions, including microfinance organizations, insurance companies, stock exchange, and other minor financial institutions. For the past decade, the financial sector has been evolving moderately, but stably. At the end of 2016, assets of the financial sector amounted to 195.2 billion of soms² or 42.6% of GDP. Although there are a substantial number of non-bank financial institutions, banks dominate the financial sector. The share of banks in total financial assets is 91.2%, non-banking financial institutions – 7%, and others – 1.8%. Eighty percent of the non-cash money stock of the economy is concentrated in commercial banks. As a result of macroeconomic conditions, social development and lack of financial literacy and education, other financial markets and institutions are poorly developed, weakly integrated in the world financial system, and do not play a significant role in the country's economy.

2.1 Banking Sector

As of 2016, assets of commercial banks constitute 39% of the GDP; the number of banks is 25, with two of them being state-owned. Five major banks hold 55% of the banking sector assets and 49% of the credit portfolio.

The amount of both loans and deposits has been increasing and the level of financial intermediary is rising (see Figure 1). The share of loans to GDP increased from 14% in 2006 to 21% in 2016, and the share of deposits increased from 15% to 23% of the GDP. For the first half of 2017, the National Bank reports the increase of individual deposits by 11%, an increase of credit by 9% and increase in total banking assets by 3.2%. The level of liquidity of the banking sector is 64.4% compared to 45% of National Bank requirement.

² National currency. The average exchange rate in 2016 was \$1=69 soms.

Figure 1: Commercial Banks' Loans and Deposits, % GDP

Source: Estimations based on data published in Bulletin of the National Bank of the Kyrgyz Republic. Bishkek: National Bank of the Kyrgyz Republic, 2017. Accessed 12 October 2017. <http://www.nbkr.kg/index1.jsp?item=137&lang=ENG>

The slowdown in 2008–2011 is attributed to overall economic decline due to the financial crisis in 2008 and political events in 2010. After violent power shift in April 2010, the volume of deposits in commercial banks declined by 31% within a few months.³ This sharp decline in the number of deposits was due to the running of money out of the country by five banks related to the former president and his affiliations, as well as the population's withdrawal of deposits. As for the credit volume, major contributors to the increase of the credit portfolio from 2013 are three former large microfinance companies, which obtained banking licenses. Despite on some positive trends, however, the level of savings mobilization and credit to GDP is still low relative to the Caucasus and Central Asian regions, particularly when compared with the lower middle income country average.⁴

2.1.1 Vulnerabilities of the Banking Sector

The economic slowdown in 2015–2016 attributed to the entry of the Kyrgyz Republic into Eurasian Economic Union, affected the banking sector as well. Customs duties for one of the main trade partners—the People's Republic of China—were increased, the level of international trade turnover dropped, and the amount of remittances substantially decreased, causing a decline in aggregate demand and purchasing power of population. Furthermore, the devaluation of the national currency imposed additional risks on dollar loans repayment and increased the number of non-performing loans. According to the Credit Bureau, **the share of non-performing loans (NPLs) of the total banks' loans amounted to 8% in 2016.**⁵ Three percent of NPLs were non-performing within 90 days and more. NPLs are somewhat higher in the trade, construction, and mortgage sectors. NPLs are sensitive to exchange rate movements,

³ R. Gaidarov, C. Alamanova, and G. Kasymov, Formation and Development of the Deposit Protection System in the Kyrgyz Republic. Bishkek. 2015, p. 60.

⁴ International Monetary Fund, Kyrgyz Republic: Selected Issues (IMF Country Report No. 16/56. Washington, DC.: 2016).

⁵ The credit bureau's purpose is to collect, process, and store the credit information of borrowers, their liabilities, and credit history in order to forecast and minimize credit risks in the financial sector.

reacting with a one-month lag.⁶ There is also a risk of borrowers' insolvency: 10% of commercial banks' borrowers have active parallel credits in one or two credit organizations.

Dollarization of loans has been declining since 2006, but remains high. As of 2016, the share of dollar credits decreased by 10.5% and constituted 44.5% of the credit portfolio. After a sharp depreciation of the national currency in 2015 (over 50% within one year), borrowers with dollar credits struggled to repay their loans. In order to ease the burden of the population, the government issued a decree on conversion of dollar mortgage loans into the national currency. Along with that, a number of de-dollarization initiatives were implemented by the National Bank, including a ban on lending in foreign currency for mortgage and consumer credits, higher reserve requirements for loans in USD, and conversion of mortgage loans from USD to national currency under a lower exchange rate.⁷

With that, there are a number of vulnerabilities emerging from structural problems of the sector, including:

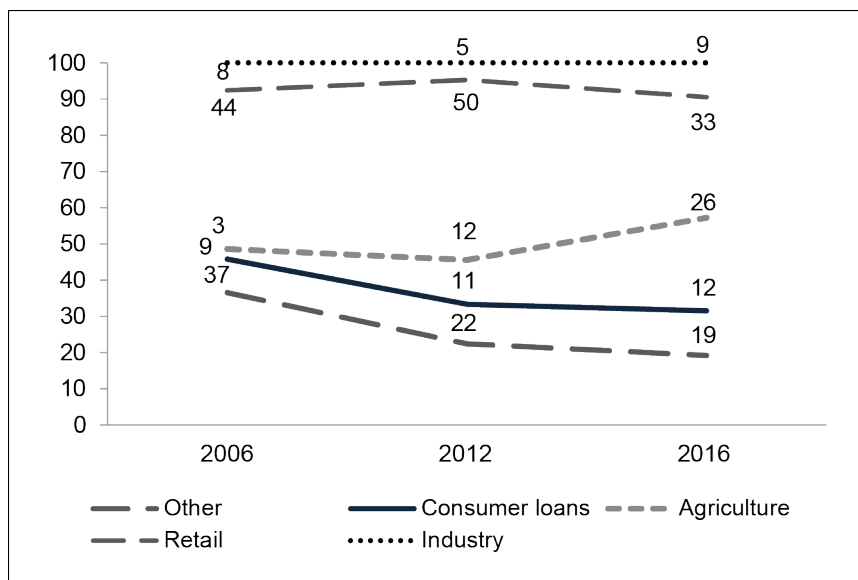
- **High credit concentration.** The role of banks in the Kyrgyz Republic economy is a little bit twisted. Commercial banks are not viewed as locomotives of the real sector's development, but banks follow the most developed sectors in order to gain the highest profit and maximal clients share. Loans in retail trade, agriculture, and industry constitute 68% of total credit portfolio and the concentration tends to grow (see Figure 2). Given the fact that key bank clients may be connected and there is a risk of potential default of the largest borrowers, this may become a source of vulnerabilities for commercial banks in the case of economic external and internal shocks.
- **Lack of long-term finance is a big problem.** For the past three years, the weighted average interest rate on loans in national currency has been increasing, which is attributed to the rising costs of credit resources (the weighted average interest rate for loans in national currency increased by 4.4 percentage points and amounted to 24.5% in 2016). Commercial banks have a deficiency of long finance and therefore long-term loans over three years constitute only 7% of the total loans (it was 10% in 2014). In fact, the dynamics of interest rates on loans correlate with deposit interest rates, meaning that banks do not have sufficient resources to satisfy the demand. At the same time, the majority of deposits are demand deposits (about 55%) and only 12% of total deposits have a maturity of over a year.⁸ Banks are in high demand for attracting additional cheap credit resources.

⁶ International Monetary Fund, Kyrgyz Republic: Selected Issues (IMF Country Report No. 16/56. Washington, D.C.: 2016).

⁷ National Bank of the Kyrgyz Republic. Report on Stability of the Financial Sector of the Kyrgyz Republic (Bishkek: National Bank of Kyrgyz Republic, 2017).

⁸ International Monetary Fund, Kyrgyz Republic: Selected Issues (IMF Country Report No. 16/56. Washington, DC.: 2016).

Figure 2: Structure of Credit Portfolio
(%)



Source: Bulletin of the National Bank of the Kyrgyz Republic. Bishkek: National Bank of the Kyrgyz Republic, 2017. Accessed 12 October 2017. <http://www.nbkr.kg/index1.jsp?item=137&lang=ENG>

2.2 Development of Microfinance

The development of the microfinance sector in the Kyrgyz Republic started in the mid-1990s, when international donors supported the majority of MFIs, particularly credit unions. Relatively liberal requirements for MFIs' registration led to the transformation of an informal microfinance sector into formally operating business⁹. Most of the MFIs have been practicing group lending. According to the estimates, over half of the credit portfolios of MFIs are group, collateral-free loans (from 53% to 71% of the total loans).¹⁰ Having restricted access to collateral, women became the majority of MFIs borrowers – on average 70% during 2006–2016. The accessibility of loans, simplified procedures of obtaining them and branches in rural areas have made microfinance attractive for the low-income rural population.

By 2011, the number of MFIs reached its peak of 651 units and the share of loans reached 8% of GDP. A number of political events and economic conditions in 2010 caused the National Bank to tighten regulations. As a result, the National Bank withdrew the licenses from 117 MFIs, most of which were small and had few clients.¹¹ Furthermore, after 2013, the three largest microfinance organizations started to obtain banking licenses and the microfinance sector began to shrink. As of 2016, the share of MFOs loans to GDP is less than 3%, and the share of total loans is 12% (see Figure 3). With transformation of MFOs “Bai Tushum,” “Finca” and “Companion” into banks, their clients have also been transformed, which led to a drop of almost 275 thousands of borrowers in the microfinance sector. The number of credit unions has been declining

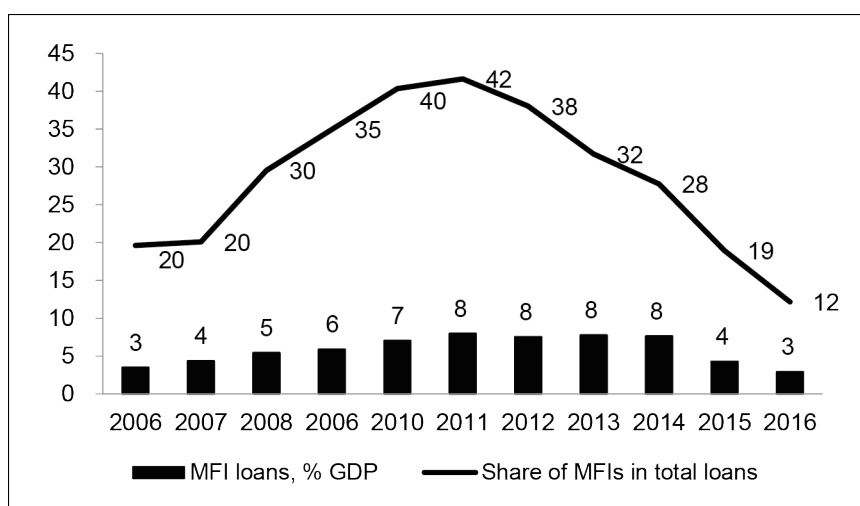
⁹ Davlesov, A., and Ibrayev, N. The Role of the Microfinance Market in the Kyrgyz Republic: Prospects and Threats. Bishkek: National Institute for Strategic Studies of the Kyrgyz Republic, 2014, p. 3.

¹⁰ Estimates based on data from The Kyrgyz Republic's Stock Exchange: Accessed 20 December 2017. <http://www.kse.kg/ru/IndexAndCapitalization>

¹¹ A. Davlesov, and N. Ibrayev. The Role of the Microfinance Market in the Kyrgyz Republic: Prospects and Threats. (Bishkek: National Institute for Strategic Studies of the Kyrgyz Republic, 2014).

as well. Since the very beginning of credit unions, the main lender to the system was a company funded by the Asian Development Bank's project. With the end of the project in 2006, financial resources of credit unions decreased, as did the number of credit unions. As of 2016, the number of operating MFIs equals 278, out of which 162 are microfinance organizations and 116 are credit unions.

Figure 3: Role of MFIs (%)



Source: Estimations based on National Statistics Committee's data on the volume of microcredits of population. Accessed 1 October 2017. <http://stat.kg/ru/statistics/finansy/>.

2.2.1 Perspectives of MFIs

The major problem of MFIs is access to financial resources. Half of the credit resources of MFIs are loans. Most of the funding comes from international donors, who were (are) co-founders of the largest and oldest microfinance organizations in Kyrgyz Republic. At the same time, according to Kyrgyz laws, MFIs may perform only a limited number of activities. For example, up until 2013, MFIs were not allowed to lend in foreign currency and therefore their costs for hedging resources were high. Today only microfinance companies (6 out of 162) and credit unions are allowed to attract deposits and to do so, they are required to obtain a license. Therefore, it is not a surprise that big microfinance companies with substantial number of borrowers tend to transform their statuses to banks in order to have access to a wider range of financing sources. Experts believe that as of today, this tendency will slow down, because there are only one or two microfinance companies left that are able to comply with the National Bank requirements of applying for a banking license.

Lack of capital and absence of free money resources affect the interest rate as well. On top of that, operating costs of MFIs are quite high (on average 20% of the credit portfolio). Consequently, the interest rate on microcredits is higher by an average of 10%. At the end of 2016, the weighted average interest rate of MFIs was 31.42%. From the one side, the borrowers benefit from ongoing transformation. Although the new banks continue to work with their borrowers on previous terms, one of the former microfinance company reported that it was ready to re-finance loans of their borrowers at a reduced rate. On the other side, it is still hard for banks to compete with MFIs in terms of simplicity of procedures, paperwork, collateral-free loans, and accessibility of credit in remote areas. If one wants cheap and long one goes to the bank, for

expensive and fast, to MFIs. This means that MFIs and credit unions do have perspectives in the future. From one side, MFIs will cover the niche of micro-loans, which could not be covered by banks due to strict compliance with standards of the National Bank. From other side, small MFIs will be transformed into pawnshops, which are not subjected to the National Bank's license requirements. Whether or not the borrowers will come back to MFIs depends on commercial banks' willingness to cover the segment of micro-loans. Meanwhile the MFIs should concentrate their efforts on attracting new borrowers.

2.3 Other Financial Institutions and Markets

Except for banking and microfinance sectors, other financial institutions play a marginal role. Capital markets, e.g. bonds and securities, government securities, and the insurance market are very shallow. The stock of government securities is 3% of GDP, of which banks hold 1.3% of GDP, and institutional investors (social fund and deposit protection agency) hold 1.4%.¹² In 2016, the trading volume of a stock market reached its peak of 9.9 billion of soms,¹³ but according to 2017 estimates, the market capitalization of the stock market constitutes only 4% of GDP.¹⁴

The gradual development of a stock market started in 2008–2009. Since then, the State Service for Financial Market Regulation and Supervision has registered 15 issues of corporate bonds, of which eight are effective. Issue of corporate bonds allowed domestic companies to attract home investments and, as a result of investing in the stock market, investors were able to improve their financial well-being. The investors' interest amounted to KGS 240 million, of which individuals received 80%.¹⁵

All corporate bonds at today's bond market are present on a Kyrgyz Stock exchange listing. The majority of investors in corporate bonds are individuals (68%), followed by companies (25%), and commercial banks (7%). The procedure for buying the corporate bonds is very simple – one can just show up at a financial company with his/her ID and become an investor. Unfortunately, the population demand for corporate bonds is very low, and there are problems from the supply side as well.

Experts¹⁶ point out several reasons for this. From the investors' perspective, it is because of low financial literacy, unawareness about the bond market, unwillingness to take risks, an itch for quick gain, and lack of access to financial companies in regions (majority of financial companies have branches in Bishkek only). From the issuer's side, there is a high level of shadow economy, and a company must reveal all its money flows in order to get into the listing. Referring to latest events (2010) many of enterprises do not believe in legislation on property rights and are afraid of illegal corporate raid. Lack of free float at the shares market is an issue – only 6%–7% of the large companies' shares are available for public investors. Furthermore, some of the initiatives of the legislative are controversial. In 2016, the legislators proposed to revoke preferential terms on paying income taxes for individuals who buy securities.

¹² International Monetary Fund, Kyrgyz Republic: Selected Issues (IMF Country Report No. 16/56. Washington, DC.: 2016).

¹³ Senti. Financial market of Kyrgyz Republic – development prospects. Bishkek, 2014. Accessed 1 September 2017. http://www.senti.kg/article/financoviy_rinok_kirgizctana_percpektivi_razvitiya_

¹⁴ Estimates based on data from The Kyrgyz Republic's Stock Exchange. Accessed 20 December 2017. <http://www.kse.kg/ru/IndexAndCapitalization>

¹⁵ Program to Increase the Financial Literacy of the Population of the Kyrgyz Republic for 2016–2020 (Approved by Resolution of the Government of the Kyrgyz Republic # 319, 15 June 2016).

¹⁶ Interview with representatives of financial companies.

Fortunately, these amendments were not introduced; otherwise, it would have negatively affected further development, popularization, and promotion of the stock market in the country. Finally, there is a lack of trust to the system as whole.

The insurance market does not play an essential role in the economy. Despite some positive tendencies – the number of insurance companies increased from 12 in 2006 to 19 in 2016 – assets of the insurance sector constitute only 0.6% of GDP.¹⁷ The majority of insurance contracts are personal voluntary insurance, i.e. life insurance, medical insurance, and accident insurance. Unfortunately, low levels of the population's income, lack of demand, and lack of insurance culture restricts the development of the insurance market. There is also a lack of investment opportunities for insurance companies, professional actuaries, and legislation gaps. The government is implementing a number of concepts and strategies for the development of stock and insurance markets, but their sustainable development depends on macroeconomic, social conditions, development of the financial sector as a whole, financial literacy, and renaissance of the population's trust. Another problem is that the development of the stock and bonds market in Kyrgyz Republic is a part of the government's activities. Currently the State Service for Financial Market Regulation and Supervision is a key state body for developing the stock market, insurance, and pension sector. However, this agency does not have the human and financial capacity to develop the financial market.

2.4 Status of Financial Inclusion in Kyrgyz Republic

Financial inclusion in Kyrgyz Republic can be assessed mainly by the levels of credit and deposit coverage, the number of bank branches, ATM and bank cards per 100,000 adults (see Table 1). According to the Credit Bureau,¹⁸ the number of active commercial borrowers in 2016 was 329,151, and the preliminary data for 2017 indicates that the number of borrowers exceeded 550,000. This constitutes 14% of adult population or 13,598 per 100,000 adults. Thirty-two percent of the loans are micro-loans of up to 50,000 of soms (approx. \$725) 57% are loans of up to 500,000 soms (approx. \$7,250) and 10% are large credits.

The number of depositors is currently 49,254 per 100,000 adults, but the National Bank's regulation classifies payroll money as a deposit, which exaggerates the statistics on the number of deposits. Given the high level of poverty in Kyrgyz Republic (officially 25.4% in 2016), many of people do not have enough income to make savings and the majority of depositors constitute upper middle class. Furthermore, as indicated by the Global Findex, the population is reluctant to use formal financial institutions for borrowing and saving.¹⁹ Around 40% of the adult population had an account at financial institution in 2017, 6% of which was identified as inactive. One-third of the population borrowed any money in the past year, but only 10% of them borrowed from a financial institution. Almost quarter of the population saved some money, but only 3% of them saved it at financial institution (see Table 2).

¹⁷ Estimated based on the data published in Report on Activities of Insurance Companies. Statistical publication. Bishkek: National Statistical Committee of the Kyrgyz Republic. Accessed 20 September 2017. <http://www.stat.kg/ru/news/o-deyatelnosti-strahovyh-kompanij-kyrgyzskoj-respubliki-v-2010-2014gg/>

¹⁸ Data of the Credit Bureau may slightly differ from the National Bank and official statistics. The Credit Bureau collects data from banks and non-banking financial institutions that are registered in the bureau's database. Today all major banks, MFOs, and credit unions are members of the Credit Bureau.

¹⁹ World Bank Group. The Little Data Book on Financial Inclusion. Global Findex. 2018. Accessed 10 March 2018. https://globalfindex.worldbank.org/#data_sec_focus

Table 1: Status of Financial Inclusion

	2006	2012	2016
Deposits ²⁰ per 100,000 adults	7,075	24,645	49,254*
Borrowers per 100,000 adults	n/a	n/a	13,598**
MFO borrowers per 100,000 adults	4,991	14,096	5,968
Women/MFOs borrowers	78%	72%	57%
Number of branches per 100,000 adults	5	7	8
Bank cards per 100,000 adults	973	7,210	40,276
ATM per 100,000 adults	1	12	32
POS terminals per 100,000 adults	14	54	195

Note: adult is a person of age 16 and above. *Estimations based on the national statistics **Preliminary data for 2017.

Sources: Estimations based on data published in Report on the Status of the Payment System of the Kyrgyz Republic for the 1st quarter of 2017. Bishkek: National Bank of Kyrgyz Republic, 2017. Accessed 1 October 2017. <http://www.nbkr.kg/index1.jsp?item=98&lang=RUS>; Statistical reviews of the Credit Bureau. Accessed 1 October 2017. <http://www.ishenim.kg/ru/Page/statisticalreviews>

Table 2: Selected Indicators of Financial Inclusion in Kyrgyz Republic, Global Index

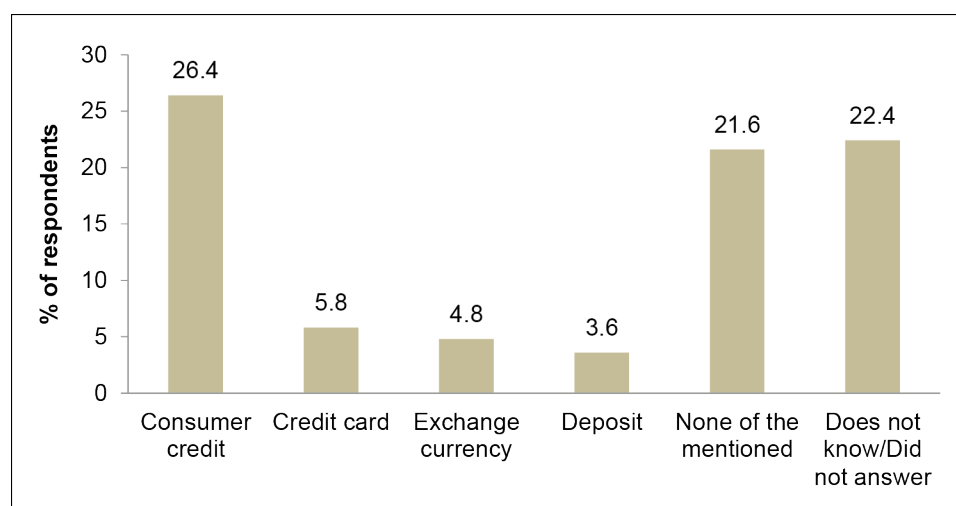
Financial Inclusion Indicator	% of age 15+
Financial institution account	38.3
No deposit and no withdrawal from a financial institution account	6.1
Saved any money	23.7
Saved at a financial institution	3.0
Borrowed any money	32.2
Borrowed from a financial institution or used a credit card	10.2

Source: World Bank Group. *The Little Data Book on Financial Inclusion*. Global Index. 2018. Accessed 10 March 2018. https://globalfindex.worldbank.org/#data_sec_focus

Indeed, the research shows that the population prefers to borrow rather than save. The official data shows that the ratio of debt to disposable income increased two times: from 13.2% in 2008 to almost 26% in 2016.²¹ On the one hand, given the social-economic conditions of Kyrgyz Republic, a high share of the population simply does not have enough income to save. On the other hand, given the low level of financial literacy and trust in the financial system, people prefer to keep their “nest egg” under the mattress. Given such philosophy, the most popular financial product for households is consumer credit, and the use of other financial products is very low (see Figure 4).

²⁰ The National Bank’s regulation classifies payroll money as a deposit, which exaggerates the statistics on the number of deposits.

²¹ Report on the Stability of the Financial Sector of the Kyrgyz Republic. Bishkek: National Bank of Kyrgyz Republic, 2016. Accessed 12 October 2018. <http://www.nbkr.kg/DOC/30062016/00000000042895.pdf>

Figure 4: Use of Financial Products by Households

Source: M. Abakirov et al., *Financial Literacy of the Population of the Kyrgyz Republic: Facts and Conclusions*. Bishkek: National Bank of the Kyrgyz Republic. 2015, p. 30.

Penetration of bank services is expanding, but it remains low. The number of commercial bank branches increased slightly over the past decade: from five in 2006 to eight per 100,000 adults in 2016, which is significantly lower than in developed world. Furthermore, access to banking services, especially to ATMs and payment terminals in the capital region, is significantly higher than in the other regions (see Table 3). Credit is mostly concentrated in big cities; over half of the loans and over 80% of deposits are registered in Bishkek (capital city). Except for bank branches, the number of bank cards, ATMs, and POS terminals is the highest in Bishkek. South oblasts (regions) – Batken, Jalal-Abad, and Osh – have the lowest rates of bank services penetration. Chui oblast has also less access to bank services, but this is explained by its proximity to Bishkek (Bishkek is a part of Chui oblast).

Table 3: Penetration of Bank Services

Region	Bank Cards per 100,000 Adults	ATMs per 100,000 Adults	Payment Terminals per 100,000 Adults	Branches per 100,000 Adults
Batken	26,105	16	48	8
Jalal-Abad	29,891	19	64	7
Osh (and Osh City)	25,891	18	74	6
Issyk-Kul	37,969	37	174	13
Naryn	48,060	26	69	12
Talas	35,217	28	76	11
Chui	23,258	17	117	7
Bishkek city	94,064	88	720	9
Kyrgyz Republic	40,276	32	195	8

Source: Estimations based on data published in Report on the Status of the Payment System of the Kyrgyz Republic for the 1st quarter of 2017. Bishkek: National Bank of Kyrgyz Republic, 2017. Accessed 1 October 2017. <http://www.nbkr.kg/index1.jsp?item=98&lang=RUS>

In order to increase non-cash payments, a Unified Interbanking Processing Center was established in 2006 as a step toward creation of centralized system for non-cash payments and a first national payment system – Elcart – was introduced. State workers started receiving their wages on payroll cards, and a significant number of bank cards were issued – nearly 40% of bank cards in the country belong to Elcart.²² The majority of account holders have two or more cards – because of the expansion of the national system Elcart and Golden crown – they have one card for account in national currency and another card for foreign currency.

With that the problem persists: the Kyrgyz economy remains a cash-based economy. Currently the National Bank is attempting to increase the non-cash turnover by obliging the retail trade sector to introduce non-cash payments.²³ However, despite all the measures to introduce non-cash payments, cash withdrawal constitutes 90% of operations with bank cards (over 96% of the volume).

The development of internet-banking started in 2012, and in 2013 only 13 of 24 commercial banks provided internet-banking services to their clients.²⁴ At that time, the costs associated with introducing internet-banking were quite high, at the unawareness of population about the service was insufficient. As of 2017, almost every bank has its own internet-banking services, but few of them are providing services for mobile banking (e.g. internet-banking access through mobile application). According to the Global Findex data, **only 5.8% of the adult population** uses a mobile phone or internet to access their accounts. The same development patterns are observed with electronic wallets. According to the Union of Banks of the Kyrgyz Republic, there are six electronic wallets offered by commercial banks (including the most popular one – Elsom), two of which were developed only in 2017. At the end of 2015 the number of Elsom's users amounted to almost 285,000 of users, or 7% of the adult population.

Kyrgyz Republic still favors stationary self-service payment terminals. Self-service payment terminals are established all over the country's regions in shopping centers and small shops, government agencies, and financial institutions. There are 20 licensed providers of self-service payment terminal services, over 4,000 terminals and nearly 30,000 agents. The volume of operations with self-service terminals in 2016 exceeded 23 billion of soms and constituted 52% of the non-cash money stock.

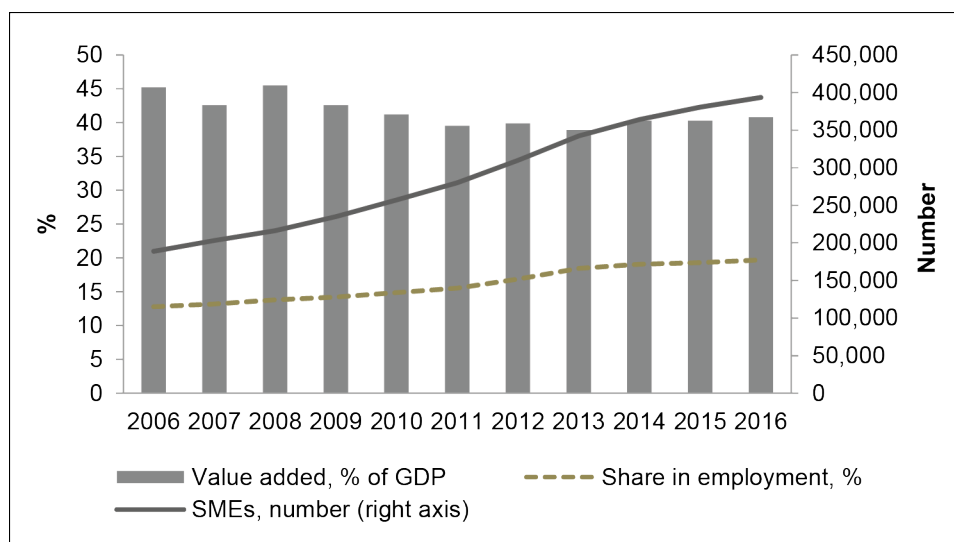
2.5 SME Finance

Consistent development of the small and medium enterprises sector (SMEs) is an essential driver of Kyrgyz Republic's economic development. SMEs stimulate domestic demand, create jobs, and facilitate competition. The number of SMEs in Kyrgyz Republic is approximately 400 thousands (including individual entrepreneurs). In 2016, SMEs contributed 40.8% of GDP, out of which individual entrepreneurs (micro-business) have the highest share of value added – 21.7%. For the past ten years the number of SMEs has grown on average by 5% annually; however, their contribution to GDP has somewhat declined (see Figure 5).

²² <http://www.nbkr.kg/DOC/26122017/000000000048958.pdf>

²³ Resolution of the Government of KR, "On measures of consumer protection rights" # 869 (23 December 2015).

²⁴ <http://finsabat.kg/wp-content/uploads/2015/05/Uchebnoe-posobie-Osnovy-finansovoi-gramotnosti.pdf>.

Figure 5: Development of SMEs

Source: Small and Medium-sized Business in the Kyrgyz Republic: 2011–2015. Statistical publication. Bishkek: National Statistical Committee of the Kyrgyz Republic, 2016, p. 24.

The national statistics do not provide data for the share of SME loans in the total loans. According to some estimates, 20% of small firms and 27% of medium firms use bank loans as a source of business financing.²⁵ In Kyrgyz Republic, every bank has several types of loans and credit lines for small and medium businesses, and many SMEs, especially micro-firms, borrow from microfinance institutions, however borrowing based on informal deals is fairly common.²⁶

The bank-dominant system makes SMEs more vulnerable to financial shocks because these firms do not have an opportunity to diversify their funding during crises.²⁷ Banks in Kyrgyz Republic remain reluctant to lend to small firms due to a higher perceived risk and high transaction costs for the bank. The majority of credit lines are offered for 12 months, and there are loans which can be repaid in five years. The most popular credits are express business credits that are provided for three to 18 months and that do not exceed \$5,000. Almost every commercial bank is required to provide a list of confirmation documents (up to 10) and collateral in the form of real estate, movable property or, rarely, a personal guarantee. At least 44% of businesses are in need of financing purchase of their input materials and only 39% of firms indicated that access to finance was not a problem for them.²⁸

²⁵ OECD, *Improving Access to Finance for SMEs in Central Asia through Credit Guarantee Schemes* (Private Sector Development Policy Handbook, 2013).

²⁶ Neufeld, B. M. and Earle, J. *The Growth of Export-Oriented Small and Medium Enterprises in Afghanistan, Kyrgyz Republic and Tajikistan*. Working paper No. 30, Bishkek: University of Central Asia, Institute of Public Policy and Administration, 2014, p. 16.

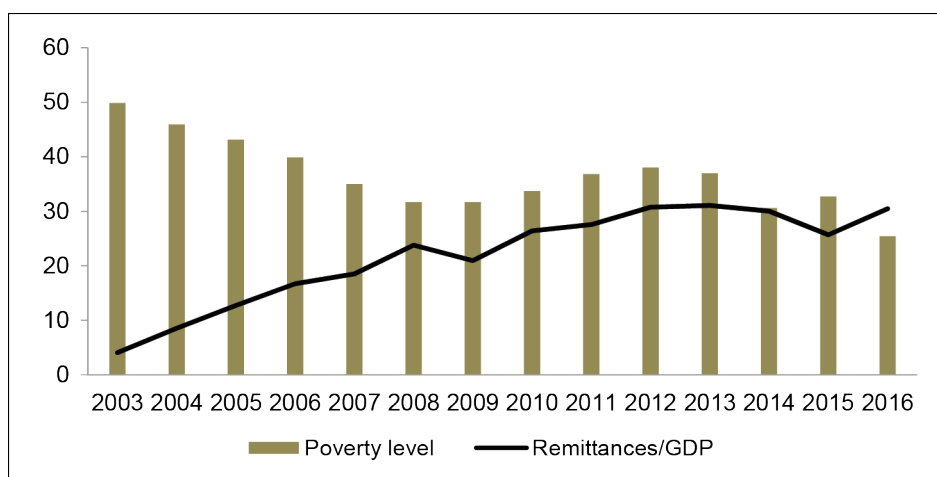
²⁷ United Nations, *Small and Medium Enterprises Financing* (ESCAP, 2014).

²⁸ World Bank Group. *Kyrgyz Republic: BEEPS at a Glance 2013*. Bishkek: February 2014.

2.6 Financial Inclusion of Migrants

For the past ten years, the inflow of remittances to the Kyrgyz Republic has been increasing (see Figure 6), contributing significantly to the poverty reduction in the country. During 2003–2007 the increasing amount of remittances contributed to a 15% reduction of absolute poverty in the country.²⁹ Approximately 1 million migrants work abroad, predominantly in the Russian Federation, and the macroeconomic impact of remittances in the Kyrgyz Republic is very high. The devaluation of the ruble, sanctions, and the recession of the Russian Federation's economy in 2015 led to the decline in migrants' remittances. However, partly because of its membership in Eurasian Economic Union, the Kyrgyz Republic became the only country in Central Asia, whose remittances increased in 2016, reaching \$1.99 billion. The amount of remittances to GDP reached 30.5% and according to the World Bank, the Kyrgyz Republic was ranked first in the world by the level of remittances to GDP.³⁰

Figure 6: Poverty³¹ and Remittances
(%)



Source: The World Bank. Migration and Remittances Data. Accessed 31 August 2018. <http://www.worldbank.org/en/topic/migrationremittancesdiasporaissues/brief/migration-remittances-data>

The positive anticipated effects from growing remittances are development of the banking sector, increase of deposits and savings, and growth of internal investments. The extent to which positive effects are realized depends on the spending patterns. Given the high poverty rates in the country, most remittances were spent on current consumption needs. Since 2010, spending patterns have slightly changed. According to the National Bank's study, households receiving remittances spend 2.7% less on

²⁹ M. Braunbridge, and S. Kanagaraja, Remittances and the Macroeconomic Consequences of the Global Economic Crisis in the Kyrgyz Republic and the Republic of Tajikistan. *China and Eurasia Forum Quarterly*, Volume 8, No. 4 (2010), p. 5.

³⁰ World Bank Group, Migration and Remittances: Recent Developments and Outlook. Special Topic: Global Compact on Migration (2017).

³¹ The poverty headcount ratio at a national poverty line – a percentage of population whose annual consumption is below the officially established poverty line (the poverty line in 2016 was 31,151 soms (approx. \$450)).

food products.³² The study also argues that remittances-receiving households tend to spend more on education and healthcare, as well as invest in construction. The study concludes that under certain assumptions, the investment potential of remittances is realized, but the effect is very small in comparison with other remittance-dependent countries. Other studies suggest that 63% of migrants spend money on consumption, only two percent invest in education of their family members, 3% opened their own business and made savings.³³ There is also a tradition, especially in rural areas, to invest extra income in livestock.³⁴ Overall, migrant families prefer non-deposit forms of savings, i.e. cars, livestock, or keeping cash “under the mattress.” Therefore, the population reluctantly brings this additional money to the financial sector.

As of today, banks lack special financial products for migrants. With the increasing amounts of remittances, banks were more interested in establishing money transfer systems or providing services on money transfers and earning commission income. Migrants send money via money transfer services without opening an account, and their families receive cash. Only some banks try to introduce special services for migrants in order to attract this money into banks. They are explaining to migrants' families the advantages of opening an account and offering different kinds of deposits in national currency or rubles for them. However, these instruments have not become popular among migrants: given the low propensity to invest remittances, their impact on the development of financial system is minor.

3. BARRIERS TO FINANCIAL INCLUSION

Opportunities to improve financial inclusion in the Kyrgyz Republic depend on many objective and subjective factors. The current economic and social development patterns, lack of institutional capacity, high level of corruption, political will, and continuity of ongoing reforms – all together limit advancing financial inclusion in the country. The large informal sector is one of the most influencing factors – according to the surveys, the level of shadow economy amounts up to 40% of GDP.³⁵ Plenty of entrepreneurs operate in quasi-formal sector. Not having completely transparent accounts and activities makes it so that entrepreneurs are getting sufficient finance and the population receiving informal wages cannot prove their credit creditworthiness, and would therefore rather borrow from pawnshops or relatives.

Low standards of living, poverty, and lack of financial literacy hold back the growth of savings and internal investment opportunities. Current consumption constitutes over 80% of households' expenditures.³⁶ Data suggests that transfers, including migrants' remittances can account on average for 15% in poverty reduction in rural areas.³⁷ With that, the dependence of rural households on remittances imposes risks on those

³² A. Muktarbekkyzy, C. Seyitov, and N. Zhenish, *Effect of Remittances on the Household Expenditure Structure in the Kyrgyz Republic* (Bishkek: National Bank of Kyrgyz Republic, Center for Economic Research, 2015).

³³ <http://www.gallup.com/poll/159572/labor-migration-doesn-always-pay-off-fsumigrants.aspx>

³⁴ I. Lukashova, and I. Makenbaeva, *Prospects for the Development of Banking Products for Labor Migrants. Experience of Kyrgyz Republic* (Bishkek: The OSCE Center in Bishkek, 2011).

³⁵ <http://www.gov.kg/?p=52448&lang=ru>

³⁶ National Bank of Kyrgyz Republic, *Report on Stability of the Financial Sector of the Kyrgyz Republic* (Bishkek: National Bank of Kyrgyz Republic, December 2016).

³⁷ National Statistical Committee. *Level of poverty in Kyrgyz Republic* (Bishkek: National Statistical Committee, 2016). Accessed 20 December 2017. <http://stat.kg/media/publicationarchive/01b28ef9-9e8c-4d84-9fae-4b1b58b1aa5a.pdf>

households in case of a reduction of such source of income. Research suggests that, finance over half of the total expenditures in rural areas.

Another major problem is the population's low level of trust in the financial system. Political instability, high corruption, and poor implementation of laws undermine the population's trust in governance institutions. According to the National Statistics Committee's Index of Trust, state institutions regulating the financial sector have the lowest level of trust after police service.³⁸ Ministry of Finance, Ministry of Economy and State Service for Financial Market Regulation and Supervision have a score of 19 (with maximum 100) of population trust, while financial police has only 12.9. In Bishkek, where the population has more of a tendency toward critical thinking and higher education, the level of trust is much lower and even has negative signs (Financial police and Tax service). In comparison, other institutions, regulating, for example, culture and sports, have a score 2.5 times higher (see Table 4).

Table 4: Index of Trust for Government Financial Institutions

	KR	Bishkek	
Ministry of Internal Affairs	13.0	3.0	lowest
Ministry of Finance	19.9	5.8	
Ministry of Economy	19.1	6.0	
State Tax Service	18.5	-0.9	
State Service for Financial Market Regulation and Supervision	19.3	7.4	
Financial Police	12.9	-2.5	
State IT Committee	49.4	49.9	highest
State Agency for Youth, Culture, and Sports	48.6	43.6	

Note: scores take values from (-100) to 100.

Source: Statistical data on the Index of trust in the 1st quarter of 2017. Bishkek: National Statistical Committee of the Kyrgyz Republic. Accessed 8 October 2017. <http://stat.kg/ru/indeks-doveriya-naseleniya/>

After the violent power shift in April 2010 (the so-called "revolution"), expropriation of former president-affiliated banks led to uncertainty in the banking sector. Due to instability of the situation, the National Bank took over six commercial banks. Two of them – "Asia Universal Bank" and "Manas Bank" – were afterwards nationalized. The interim government claimed that these two banks were affiliated with the son of the previous president Bakiev and were engaged in money laundering and criminal activities. By the end of 2010, the government attempted to restructure and restore the assets of Asia Universal Bank, but as it laid a big burden on the budget, a liquidation process was initiated. The Government of the Kyrgyz Republic also filed a claim in the court about the main shareholder of Manas Bank, a Latvian citizen. He and his team were accused of affiliation with Maxim Bakiev, money laundering, and other criminal schemes. The arbitrage court proceedings are still ongoing.

The situation in the banking sector had a negative effect on level of trust – many depositors withdrew their money from banks and the demand for bank services declined sharply. The volume of deposits decreased by 14% and credit portfolio grew by only 3.7% (in contrast, a year later in 2012, the increase in credit portfolio was 40%). The decline of deposits was also due to the running of money out of the country of the former president and his affiliations.

³⁸ National Bank is not a member of the Kyrgyz Government.

Political instability and low level of trust are not the only factors affecting level of financial inclusion. SME face a substantial number of barriers in getting sufficient finance. One of them is lack of collateral. About 40 to 50% of borrowers³⁹ asking for credit do not get sufficient amount of lending because they cannot provide the required collateral. Prices for real estate vary in rural areas and the market is unstable, which leads to an inadequate assessment of collateral. Some banks revise collateral with the fall of real estate prices, and occasionally ask borrowers to pledge additional collateral or repay the loans.⁴⁰ Most of collateral is in the form of real estate, which is mostly owned by men. This restricts the access of women to finance.

More obstacles to SME growth have been identified, such as weak regulatory frameworks, few other alternatives for financing start-ups, young SMEs, and lack of long-term finance. At the early stage of growth, SMEs attract finance from family and friends, or, for many in the Kyrgyz Republic, from MFIs. Growth-oriented SMEs need long-term finance, while the banking sector provides mostly short-term credit. Entrepreneurs simply do not have sufficient time to make a profit and start repaying the loans. This indicates a strong need for the development of adequate measures to support finance of SMEs.

With great importance of all of the above, the main problem remains – lack of financial knowledge and insufficient knowledge of business processes. Both entrepreneurs and the general population do not use bank accounts or non-cash payments. This lowers the credit limits for them or even leads to rejections. Starting from business-plan preparation, entrepreneurs are lacking knowledge of how to open, run, and effectively operate a business. They do not know how to manage financial resources or plan costs and revenues, which leads to parallel borrowing.

4. REGULATION AND CONSUMER PROTECTION

The National Bank of the Kyrgyz Republic (NBKR) is a central bank and a main regulator of financial institutions in the country. Powers and function of the National Bank include: i) determination and implementation of the monetary policy in the Kyrgyz Republic; ii) issuance of licenses for all types of banking operations; iii) exercise of currency regulation, including issuance of guidelines for foreign currency transactions as well as purchase, sale and exchange of foreign currency in accordance with Kyrgyz law; iv) exercise of other functions and powers in accordance with Kyrgyz law.

There are no regulations or targeted programs for financial inclusion in the country. The majority of efforts implemented in this regard are de-centralized; a large number of projects are implemented with donor support. Accessibility of financial products and services depends mainly on the expansion of banking and microfinance sectors subject to the National Bank's regulation and supervision.

The Kyrgyz legislation establishes the ground for the operation of banks, microfinance organizations, and other financial institutions. Activities of MFIs are regulated in accordance with the main law on "Microfinance organizations" and a number of supplemented acts, which were adopted with the expansion of microfinance in the beginning of 2000s. These include Law on Credit Unions in 1999 and Law on

³⁹ Concept of Development of Guarantee Funds of the Kyrgyz Republic until 2020 (Approved by the Resolution of the Government of the Kyrgyz Republic #325, 15 June 2016).

⁴⁰ International Monetary Fund, Kyrgyz Republic: Selected Issues. (IMF Country Report No. 16/56. Washington, DC.: 2016).

Microfinance Organizations in 2002. According to the Law on Microfinance Organizations, the term “microcredit” only applies to a loan provided by microfinance organizations. Depending on their scope of activities, microfinance organizations can be registered as microfinance company, microcredit company, or microcredit agency. A microfinance company is a company licensed by the National Bank and has a right both to provide credit and to attract deposits. Microcredit companies and microcredit agencies have the right to provide credit only, and the difference between them is that a microcredit company has the right to make currency exchange operations and perform factoring and some other retail banking services. Microcredit agencies’ operations are limited mostly only to providing credit.⁴¹

Since 2010, the National Bank has been strengthening control over MFIs. The first initiative of the National Bank was to consolidate the microfinance market by introducing higher requirements for capital. This was done to reduce number of non-working and small MFOs.

Another issue to control was the fact that the existing group lending technique of MFIs does not take into account financial position of borrowers. This led to a high rate of parallel borrowing, when a borrower had two or more loans. MFIs tend to encourage people to apply for more loans, which are usually repaid by obtaining new loans from other MFIs or banks. The National Bank implemented a number of measures to reduce multiple borrowing by focusing on client protection activities, limitation of interest rates and introduction of maximum level of fines (20% of principal amount) that could be charged from borrower.

Banking activities are regulated by the Law of the Kyrgyz Republic “On the National Bank, Banks and Banking Activities.” Starting from 2013, banking legislation has been completely revised and an attempt to introduce a bank code was made. In 2016 the Law on National Bank, the Law on Banks and Banking activities were combined into one complete document – Law “On National Bank of the Kyrgyz Republic, Banks and Banking Activities.” Under the new Law, banking regulations are structured and optimized, control over commercial banks is strengthened, and consumer protection is improved.⁴²

The National Bank regulates the interest rates of loans for both commercial banks and MFIs. Under the law, the maximum allowable interest rate on loans is set according to the weighted average nominal interest rate calculated by NBKR, plus 15%. The weighted average nominal interest rate is a weighted average of interest rates on loans in national and foreign currency of commercial banks, microfinance organizations, and credit unions. The National Bank sets minimal collateral size, maximal ratio of credit payments to borrower’s income, etc.

A number of legislative acts regulate the protection of financial consumers’ rights. The Deposit Protection Agency under the government, Department of Rights of Banking, and microfinance services consumers under the National Bank, State Service for Financial Market Regulation and Supervision, etc. are members of the consumer protection system. There is also a Credit Bureau, which was established in 2003. Its main function is to manage a database of borrowers and their credit history. The Deposit Protection Agency was established in 2009. Participation in deposit protection system is mandatory for all resident and non-resident commercial banks. Banks’ annual contribution to deposit protection system constitutes 0.2% of their deposit base.

⁴¹ On Microfinance Organizations in the Kyrgyz Republic. Law of the Kyrgyz Republic #124. 23 July 2002.

⁴² On National Bank of the Kyrgyz Republic, Banks and Banking Activities. Law of the Kyrgyz Republic #206. 16 December 2016.

In 2013 the level of adequacy of deposit protection system was insufficient and amounted up to only 8.5% of the deposit base⁴³. In order to increase the coverage of deposit protection, the amount of guaranteed deposits was doubled from 100,000 soms to 200,000 soms in 2016. Table 5 summarizes activities of financial consumers' protection in the Kyrgyz Republic.

Table 5: Regulation of Financial Consumers' Rights

	Regulator	Legislation	Functions
Deposits	Deposit protection agency under the Government KR	Law on Deposit Protection (2008)	Guaranteed amount of 200,000 soms (approx. \$2,900)
Interest rate	National Bank KR	Law on Limitation of Usury (2013)	Cap: 15% limit over weighted average interest rate, calculated by NBKR
Credit risk	National Bank	Regulations on assets classification and minimal reserves	Assets must be regularly classified Reserves are created to cover unexpected expenses
Collateral		Civil Code, Law on Collateral (2005)	The only dwelling can be foreclosed upon court proceedings
Transparency of information	Department of rights of banking and microfinance services consumers under NBKR (2014) Credit Bureau (2003)	Law on Microfinance Organizations (2002), Order of NBKR on Minimal requirements for financial services provision and consumer complaints (2015), Law on National Bank, banks and banking activities (2016)	Department handles complaints, participates in development of legislation, and interacts with supervision department. Financial institutions must ensure clear contracts, transparent information, amount of fines must not exceed 20% of loan, complaints must be responded within ten working days, contract must have list of rights and schedule of all payments, including fines, commissions, etc.
Bonds and securities	Stock exchange	Law on Stock Market (2009)	Listing
Bank secrecy	National Bank State Service for Financial Market Regulation and Supervision	Law on National Bank, banks and banking activities (2016) Law on Counteracting Terrorism Financing and Legalization (2006)	Sets the requirements for bank secrecy disclosure, responsibilities

Source: Based on analysis of the Kyrgyz Republic's legislation.

Activities of the National Bank in regard to consumer protection are based on the newly amendments to the Law on National Bank, Banks and Banking Activities and other regulatory acts. These measures are based on clients' complaints and not on a systematic approach or research/analysis of specific services and products. In fact, some experts point out that measures proposed by the National Bank are considered excessive, making distortion of the market and increasing complexity of services provision to final consumers, increasing number of documents that a client needs to read, understand, and sign.

⁴³ R. Gaidarov, C. Alamanova, and G. Kasymov, Formation and Development of the Deposit Protection System in the Kyrgyz Republic. Bishkek: Kyrgyz-Russian Slavic University, 2015, p. 67.

5. POLICIES TO PROMOTE FINANCIAL INCLUSION

The notion of financial inclusion in the Kyrgyz Republic was introduced by donor organizations. The majority of efforts on promoting financial inclusions were implemented with their support. There are no regulations or targeted programs on financial inclusion in the country. Accessibility of financial product and services depends mainly on the expansion of banking and microfinance sectors. Nevertheless, the government is implementing a number of sectorial programs aimed at developing microfinance and banking sectors, increasing accessibility of financial products, and expanding the coverage of the vulnerable population. Most of the efforts in this regard are concentrated around legislation improvement, simplification of collateral, and application procedures, improving the capacity of local authorities and financial consumer protection. For the past decade, two strategies for the development of microfinance sector were implemented (2006–2010, 2011–2015),⁴⁴ as well as a number of mid-term strategies for the development of banking sector (2006–2008, 2009–2011).

Facilitating the non-cash payments in the Kyrgyz Republic is also among one of the priorities. The 5-year state program aimed at increasing the share of non-cash payments in the economy has just ended. The program attempted to introduce non-cash payments in favor of the state (taxes, customs duties, and utility bills), transfers of wages, and payments for goods and services by population. The program succeeded in terms of infrastructure – the number of payment terminals, POS terminals, and bank branches has grown. Banks have created multiple opportunities for digital payments for utilities, fines, taxes, etc., including internet and mobile banking. The number of issued bank cards increased by six times. However, as discussed previously, still 90% of the operations using bank cards are cash withdrawal. The population prefers to withdraw money from their accounts and pay for their goods and services in cash. This is the same with the development of financial markets. A number of strategies and programs were implemented in financial markets, including Concept for Stock and Bonds Market Development until 2018, Concept for Insurance Market Development for 2013–2017.⁴⁵ Yet the population rarely invests in stock and bond market, and reluctantly buys insurance.

Another priority of the Kyrgyz Government is to increase provision of cheap access to finance for businesses and individuals. In 2015 the government registered a State Mortgage Company and adopted a government program on affordable dwelling for 2015–2020. The program is aimed at providing cheap mortgages for state workers by subsidizing the mortgage rate. For now this program is not available to the general population, which has become one of its main criticisms. At the end of 2017 some light but positive impact is observed: the amount of mortgage loans increased more than two times and the share of mortgage loans in total loans increased from 3% in 2016 to 6% in 2017.

In 2017, the President announced the adoption of the program “Taza Koom,” which is aimed at digital transformation of the Kyrgyz economy within the framework of the National Development Strategy 2040. At the same time, the government adopted the supplementary program “Forty steps for 2018–2023.” Both initiatives are aimed at

⁴⁴ Microfinance Development Strategy for 2011-2015. Approved by Resolution of the Government of the Kyrgyz Republic and the National Republic of the Kyrgyz Republic #150/40/6. 28 February 2012.

⁴⁵ The Concept of Development of the Securities Market in the Kyrgyz Republic for the Period until 2018. Approved by the Decree of the Government of the Kyrgyz Republic #33. 26 January 2016.

establishing open government, introducing digital government and institutions, and boosting non-cash payments. It is too soon to assess the results of these initiatives.

Meanwhile, while some gradual improvement in financial inclusivity in the Kyrgyz Republic is observed, the majority of the efforts are decentralized, and programs are rather fragmented, while financial inclusion requires a complex touch. This indicates that more complex measures are needed for the population in order to improve their financial literacy and increase the level of their trust in the financial system, as well as to motivate people to keep their savings in financial institutions.

5.1 State Support of SMEs

The government has always recognized the role that SMEs play in the country's development. In the late 1990s, a number of legislative acts were adopted in order to support the development of SMEs, followed by the Concept for SME development for 2001–2005 and a state program for entrepreneurship development for 2004–2005. These documents underlined the necessity of reforms aimed at reducing administrative barriers, creating a favorable investment environment, and promoting export opportunities for SMEs. Later, the program underlined that there is a need to consolidate financial resources and integrate SME finance mechanism into the financial system.

In 2007, the President signed a law on state support of small enterprises. Among other measures, the law laid the foundation for annual implementation of state programs on SMEs support and establishment of the Entrepreneurship Development Fund, as well as grounds for cheap lending. However, most of the efforts of SMEs support included reduction of administrative barriers and simplified taxation regimes.

The majority of efforts on state support of SME finance started in the past 3–4 years. These initiatives included a number of sectorial strategies, establishment of guarantee funds, and agreement with the Russian Federation's government.

5.2 Guarantee Funds

In order to support SMEs, the Law on “Guarantee funds in the Kyrgyz Republic” was signed in 2013.⁴⁶ Guarantee funds act as mediators between borrowers and commercial banks in order to provide guarantees when a borrower does not have sufficient collateral. As of 2016, six guarantee funds were operated in four regions. In 2017, the government established an open joint stock company “Guarantee Fund” with capital formed from the budget (25%) and the Asian Development Bank (75%). The Fund has representatives in every region, working with seven commercial banks and the Russian Kyrgyz Development Fund. As of September 2017, the Guarantee Fund issued 140 guarantees, out of which 114 are SMEs and 51 are projects run by women. The total amount of lending provided by commercial banks under the guarantees of the Fund constituted almost 651 million soms. The majority of entrepreneurs were supported in retail trade (31%), the manufacturing sector (24%), and agriculture (15%).⁴⁷

⁴⁶ On Guarantee Funds in the Kyrgyz Republic. Law of the Kyrgyz Republic #167. Bishkek, 30 July 2013.

⁴⁷ The Guarantee Fund. Information about issued guarantees. Accessed 20 December 2017. <http://gf.kg/about/informatsiya-po-vydannym-gara/>

Currently the State Guarantee Fund's position in regulation of the National Bank is weak, as any guarantee of the Fund is considered as a guarantee of an unrated private company with reserve requirement of 100%. Unless the regulation is changed, an improved perspective of the State Guarantee Fund for cooperation with commercial banks will be on the lower side and limited to capital level.

5.3 Russian Kyrgyz Development Fund

At the end of 2014, through an agreement between the Russian Federation and the Kyrgyz Republic governments, the Russian Kyrgyz Development Fund (RKDF) was established. The RKDF's mission is to contribute to the economic development of the Kyrgyz Republic by lending in priority sectors at interest rates below market rates and to contribute to financial sector development by introducing new products and services. The capital of the Fund is \$500 million and is formed solely from the resources of the Russian Federation's Government.

In 2016, RKDF supported 614 SMEs with total finance of \$82 million. The Fund, via nine commercial banks, has credited SMEs in agricultural, textile, manufacturing, and transport sectors. Credits were issued at a final rate of 12% for national currency, and 5% for foreign currency, which is 2.5 times less than the market level.⁴⁸ According to the development strategy of the Fund, it will operate within the framework of Eurasian integration at least up until 2021.

5.4 Support of Agricultural Sector

The agricultural sector remains one of the important sectors in employment. Although the share of agricultural sector in GDP declined for the past ten years (from 29% in 2006 to 14% in 2016), it still holds the highest share of employed population – around 30%. The number of small farmers ("peasant farms") in 2016 reached 414 thousand, and their contribution to GDP reached 8.4%. In 2013, the government launched a project on financing of the agricultural sector (FAS) to support the development of manufacturing agriculture by subsidizing the interest rates on loans provided by commercial banks. The final rate on the loans was 10%.

Currently, the fifth phase of the FAS is being implemented.⁴⁹ Along with the 10% lending in the sphere of cattle breeding and plant growing, FAS 5 provides lending to export-oriented agricultural production at a rate of 6%. According to the Ministry of Finance, 53,590 farmers received loans of a total amount of 17.1 billion soms since 2013.

5.5 Entrepreneurship Development Fund

The Fund was established in early 1990s; since then it has been reorganized several times. Today the Entrepreneurship Development Fund (EDF) has the status of microcredit company with 100% capitalization of the Kyrgyz government. The EDF provides lending to SMEs and farmers and consumer credits to population. The fund is a profit-making microcredit company. There are no preferential interest rates and the Fund operates by market rules. In 2015, the discussion started about transformation of

⁴⁸ Russian Kyrgyz Development Fund, Annual Report 2016. Start Ltd., Bishkek. 2017 p. 8. Accessed 30 September 2107. http://www.rkdf.org/ru/o_nas/otchet

⁴⁹ State Program on Financing of Agriculture – 5, approved by the Resolution of the Government of the Kyrgyz Republic #58. 3 February 2017.

the EDF's status from a microcredit company to the Entrepreneurship Development Fund under the Government of the Kyrgyz Republic and to provide interest-free loans to SMEs. The discussion is still ongoing.

5.6 Warehouse Receipts and Contract Financing

Alternative collateral instruments, such as warehouse receipts and contract financing are not common for the Kyrgyz Republic. There have been attempts to introduce contract financing in the agricultural sector's value chain. The project is supported by the donor organizations and is now covering only few chains.

Another pilot project is warehouse receipt as a form of collateral. Within this pilot, commercial banks agree to use the warehouse receipts, which justify that a farmer has a certain amount of agricultural commodities stored in a warehouse, as collateral for a loan. As of March 2018, the president signed a law on "Warehouses and Warehouse Receipts," establishing a legal ground for introduction this type of collateral.

Table 6: Coverage of the State Support

	Number of SME Borrowers	Sum, Million Soms
Guarantee Fund	114	651
Russian Kyrgyz Development Fund	614	5,732.9 (\$82 million)
Financing of agriculture sector: total for 5 years	53,590	17,100
	Share in SMEs	Share in total loans
Guarantee Fund	0.03%	0.60%
Russian Kyrgyz Development Fund	0.16%	5.25%
Financing of agriculture sector: total for 5 years	12.92%	15.65%

Source: Own analysis based on data from Kyrgyz-Russian Development Fund, and Guarantee Fund.

Table 6 summarizes the coverage of major state initiatives providing support for SME financing. Evidently, the coverage is extremely small. So far, the number of SMEs financed through the Guarantee Fund and RKDF is less than 6%. Meanwhile the total coverage of FAS 5 year program is 13% of the total number of small farmers in the country. Despite the proclamations of the government about the importance of SME development and the law on SME support,⁵⁰ there are no centralized efforts that support SME financing. Even though there is a governmental EDF, it operates as profit-making microfinance organization. National strategy for sustainable development for 2013–2017 envisaged measures for SME development, improving access to long-term loans for women entrepreneurs and the development of the program for women's entrepreneurship development. So far, none of these measures have been implemented. The majority of state measures on SME development involved reduction of administrative barriers and introduction of preferential taxation regimes. Additional efforts are necessary to ensure adequate access to financing resources for SMEs.

⁵⁰ On State Support of Small Business (Law of the Kyrgyz Republic #73, 25 May 2007).

6. FINANCIAL LITERACY AND FINANCIAL EDUCATION IN THE KYRGYZ REPUBLIC

Financial literacy is one determinant of success in the development of not only financial system, but of the country as a whole. Financial literacy contributes to a person's financial well-being and affects the level of financial involvement (inclusion) and development of fair and efficient financial institutions that offer suitable and acceptable financial services, and consumer protection systems ensuring protection against financial fraud.⁵¹

The institutionalization of financial literacy and education has not been popular among policy makers until recently. There have been a number of projects implemented by international organizations and commercial banks aimed at increasing financial literacy among the population and providing financial education. These include EBRD, ADB, and World Bank's initiatives on increasing financial inclusion starting from 2012, participation in the Global Money Week from 2014, and cooperation with OECD on development of the national strategy for financial education.

6.1 Financial Literacy

In 2015, the National Bank conducted a study on financial literacy. The study covered respondents in all regions, representative of level of income, age, and education. It included a survey on various aspects of financial markets and a test to determine the level of basic financial knowledge.

Overall, the study revealed insufficient level of financial knowledge among the population. Only 19.3% assessed their level of financial knowledge as good. 40.3% of respondents stated that they did not have any financial knowledge or possessed a low level of it.

The test scores showed that only 17% of respondents managed to answer two-thirds of the questions correctly, while only 1% gave correct answers to all of the assignments. The study concludes that 22% possess unsatisfactory knowledge, while 12% do not have any knowledge at all. Furthermore, almost half of the population does not keep a record of their expenses and income, 74% borrowed to repay their loans and almost 40% have financial liabilities, including bank or microfinance credits (see Table 7).

There is a high correlation between level of financial literacy and income, which is reasonable. Individuals with low income are deprived of savings and investments and therefore have fewer incentives to learn about financial products. There is also a correlation between financial literacy and level of education in the Kyrgyz Republic. Individuals with a higher level of education are more likely to diversify the use of their money. The level of basic financial knowledge is also higher due to a higher level of general knowledge.

The population also tends to use passive forms of savings (see Figure 7). Only 11% had a "safety cushion" and are able to afford unexpected expenses.

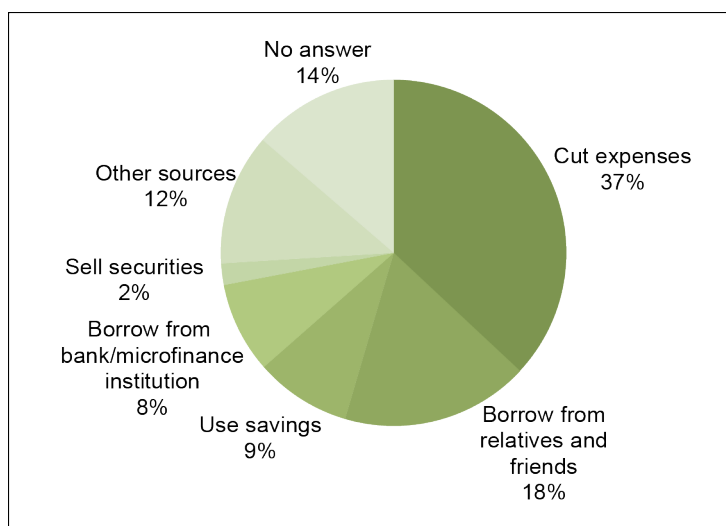
⁵¹ Program to Increase the Financial Literacy of the Population of the Kyrgyz Republic for 2016–2020. (Approved by Resolution of the Government of the Kyrgyz Republic # 319, 15 June 2016).

Table 7: Basic Results of the Survey on Financial Literacy

	% of Respondents
Do not have any financial knowledge or poor knowledge	34
Financial test: 66% of correct answers	17
Do not keep record of income and expenses	45
Borrowed to pay back debt	74
Have debt	39

Source: M. Abakirov et al., *Financial Literacy of the Population of the Kyrgyz Republic: Facts and Conclusions*. Bishkek: National Bank of the Kyrgyz Republic. 2015, p. 8–14.

Figure 7: “What Would You Do if Your Income Suddenly declined?”, % of Respondents’ Answers



Source: M. Abakirov et al., *Financial Literacy of the Population of the Kyrgyz Republic: Facts and Conclusions*. Bishkek: National Bank of the Kyrgyz Republic. 2015, p. 22.

However, the majority of the population is passive and not interested in obtaining information about financial markets, services, and products. To quote the study on financial literacy “it feels contradictory, but despite having a low level of financial literacy, the majority of Kyrgyz citizens are not interested in any financial topics.” There is a need for complex measures aimed at stimulating and motivating people to exploit the advantages of financial literacy.

6.2 Financial Education in the Kyrgyz Republic

Centralized initiatives to provide financial education are new for the Kyrgyz Republic. The first attempt to institutionalize the problem of financial literacy in the Kyrgyz Republic was in the Microfinance Development Strategy for 2011–2015. The strategy emphasized the need for national efforts to improve financial literacy, and emphasized the need for inter-ministerial coordination. In 2016, the Program to Improve Financial Literacy in the Kyrgyz Republic for 2016–2020 was adopted for the first time. Before that, several participants of the stock market attempted to create a “saving and investment culture among citizens of the country.” A small number of existing financial companies and brokers issued corporate bonds and conducted PR campaigns in order to attract investors to market. Along with that, one of the financial companies has

systematically been organizing training to improve the basic financial knowledge of the population. Commercial banks and MFIs periodically informed their clients about financial products by providing consultations and trainings, disseminating information materials. In 2015, one of the former microfinance companies published the “Basics of Financial Literacy” book⁵². Of course, the coverage, particularly of the rural population, of the private sector’s initiatives was rather small, and the effect was not sustainable. In an attempt to increase financial literacy, most of the projects and initiatives were implemented with the support of international donors.

As a preliminary stage for the program⁵³ implementation, the government established a working group to deal with issues related to financial education. The National Bank launched the specialist financial literacy web-site, called “Monetary ABC,” and carries out various educational activities on financial literacy.

The Program to Improve Financial Literacy aimed at working at three pillars: financial literacy of school children and youth, financial literacy of adults, and ensuring equal and full access to financial information and services for all citizens. The program will employ an inter-sectoral approach and will involve multiple governmental bodies, private sector, and donors.

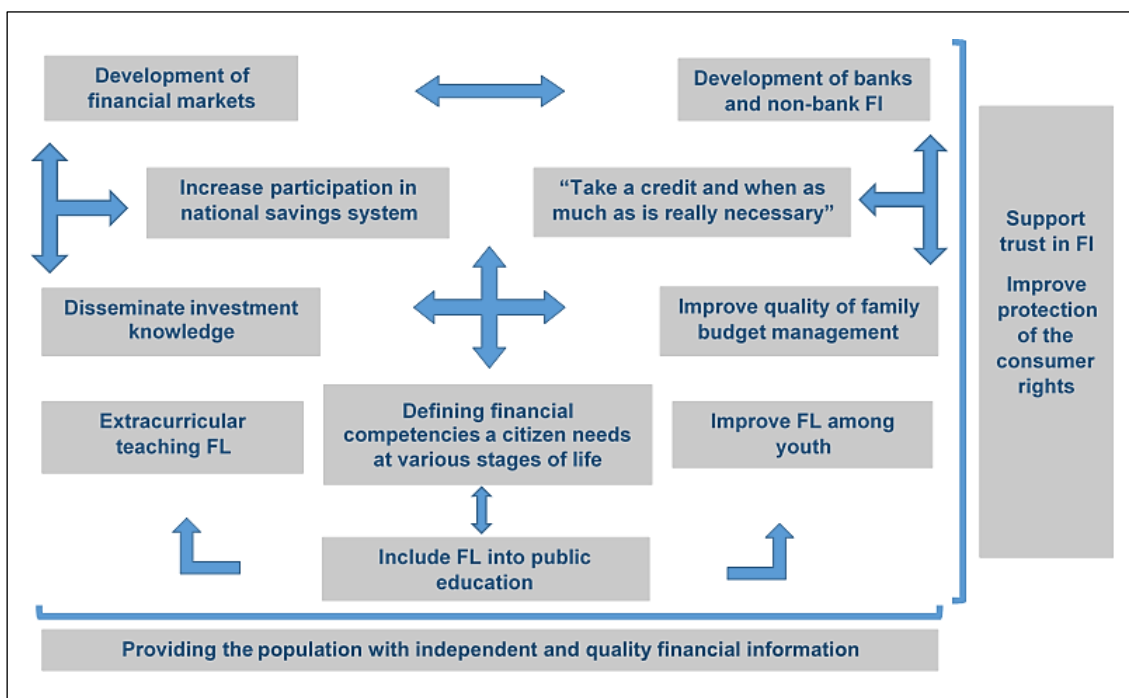
One of the most important things is that the new curriculum for school education will be introduced, so that responsible financial behavior will be inculcated at a young age. It is intended that financial education centers will be established in every rural district, where trainers will be representatives of local authorities and teachers. Several web-instruments will be developed in order to determine citizens’ level of credit stability. A set of activities aimed at increasing trust in financial institutions and an inventory of the legislative and regulatory framework regarding protection of the rights of financial service consumers are also on the list (see Figure 8).

So far, the program is lacking the description of detailed measures and activities. It is not clear from the action plan, how and which, for example, amendments will be introduced to the legislation in order to increase consumer protection. The same is with other measures – the National Bank is planning to call for proposals while achieving one or another task of the program. There is no clear monitoring and assessment plan of the program’s effectiveness. Furthermore, improvement of financial literacy is not a sole elixir for financial and economic development. There should be complex measures, not just to improve financial literacy, but also to raise financial inclusion. The government should initiate a discussion with interested parties and stakeholders in order to identify a complex strategy and systematic approach toward increasing financial literacy in the Kyrgyz Republic.

⁵² Khikmatov, U., and Koichueva, M. *Fundamentals of Financial Literacy*. Bishkek: Kyrgyz-Russian Slavic University, 2015.

⁵³ Program to Increase the Financial Literacy of the Population of the Kyrgyz Republic for 2016–2020 (Approved by Resolution of the Government of the Kyrgyz Republic # 319, June 15, 2016). Accessed 31 August 2017. <http://www.gov.kg/?p=77010&lang=ru>.

Figure 8: Scheme of the Program to Improve Financial Literacy



Note: FL = financial literacy, FI = financial institutions.

Source: developed by author based on the Program to Increase the Financial Literacy of the Population of the Kyrgyz Republic for 2016-2020. Approved by Resolution of the Government of the Kyrgyz Republic No. 319 of 15 June 2016. Accessed 12 October 2017. <http://www.gov.kg/?p=77010&lang=ru>

7. CONCLUSION AND RECOMMENDATIONS

While there has been progress toward financial inclusion in the Kyrgyz Republic, access to financial products and services remains insufficient. Since 2006 the shares of credit and deposit to GDP have increased, but numbers are still low when compared to the other lower middle income countries. Given that banks constitute 90% of the financial sector assets, they are now the main providers of financial services to population. Penetration of bank services is expanding, but access to financial services differs across regions. Credit is mostly concentrated in the capital region. South regions have the lowest rates of bank services penetration. The use of mobile banking is rare – research suggests that only slightly over 12% of population use mobile phones to conduct bank operations. The accessibility of digital services is also limited by restricted access to broadband internet in rural areas.

Up until 2011, the microfinance sector played an important role in providing inclusive finance to the population. Relatively liberal requirements for MFIs’ registration led to the transformation of informal microfinance sector into formally operating business. Having restricted access to collateral, women became the majority of MFIs borrowers. The accessibility of loans, simplified procedures for obtaining them, and branches in rural areas have made microfinance attractive for the low-income rural population. After 2010, a number of regulatory measures decreased the number of MFIs, and after 2013, three largest microfinance companies obtained banking licenses. As a result, the share of MFOs loans in total loans dropped from 42% to 12%, and over half of MFOs’ clients have become clients of the banking sector.

With that, the “real” financial inclusion does not imply lending of banks and MFIs only. Access to other financial institutions, such as insurance companies, pension funds, and the stock and bonds market is very limited. Financial markets are poorly developed and very shallow: assets of the insurance sector are lower than one percent of GDP, and the volume of operations in the stock market is slightly over two percent of GDP.

Boosting financial inclusion in the Kyrgyz Republic has many challenges. The current economic and social development patterns, lack of institutional capacity, high level of corruption, political will, and continuity of ongoing reforms all limit advancing financial inclusion in the country. The large informal sector is one of the most influencing factors. Not having completely transparent accounts and activities does not allow entrepreneurs to get sufficient finance, and the population receiving informal wages cannot prove their credit creditworthiness, and would rather borrow from pawnshops or relatives.

Development of SME finance has its own bottlenecks. Lack of collateral, lack of long-term credit, and lack of financial knowledge significantly restrict access to finance. Despite the proclaimed importance of the SME sector for economic development, the government does not have any state programs for supporting SME finance. With the Kyrgyz Republic entering the Eurasian Economic Union, the Russian Kyrgyz Development Fund was established, which now acts as the main provider of cheap credit resources to small and medium businesses.

Financial literacy is a big issue. Many people do not have basic financial knowledge, do not keep records of their cash flows and do not make formal savings. Over 90% of transactions with bank cards are cash withdrawal. The population prefers to withdraw money from their accounts and pay for their goods and services in cash. The positive anticipated effects from growing remittances, such as development of the banking sector, increase of deposits and savings, and growth of internal investments are not realized in the Kyrgyz Republic. Remittances have played a significant role in poverty reduction, but their investment potential is very low. Few banks have financial products oriented toward migrants’ families. With that, the financial behavior of population is such that it prefers to invest in real estate, livestock, or spend the remittances on current consumption.

The Kyrgyz Republic did not implement any centralized efforts for providing financial education. The majority of initiatives for improving financial literacy were implemented in a disjointed fashion by the private sector and donors. In 2016, the National Bank launched the mid-term program on improving financial literacy. However, it is not clear from the program’s action plan which measures exactly will be implemented to achieve its objectives.

Financial inclusion should become part of the government’s strategy, which should aim to increase the level of involvement of the population in economic activities, improve access to SME finance, and create opportunities for inclusive growth. The strategy should have a component for spreading the complex knowledge about financial institutions and markets to encourage the population to make formal savings and to invest in financial instruments.

Financial inclusion needs efforts on financial literacy at all levels of secondary, graduate, and postgraduate education. At the same time, financial literacy should be positioned in the day-to-day efforts of all society levels, media, and financial intermediaries.

Greater financial inclusion can help reduce income inequality and raise the incomes of poor families, which is particularly important for the Kyrgyz Republic given its high poverty and inequality rates.⁵⁴ Therefore it is necessary to increase the level of financial inclusion of migrants and their families. Efforts to provide financial education and promote a culture of formal saving among remittances recipients are necessary to mobilize this huge amount of money.

The government should develop state programs for women entrepreneurship development and for SMEs development (as was proclaimed in the National Sustainable Development Strategy for 2013–2017). Rather than rely on donors' funding, the government should find opportunities to establish a State SME development fund, or transform the existing Entrepreneurship Development Fund into non-profit company in order to provide cheap SME finance. Given the importance of collateral issues, it is necessary to consider broad (not just pilot) introduction of alternative collateral instruments. Overall, policies to promote financial inclusion must be in line with the proclamation by the government of a path toward digitization of the economy. Such efforts, along with newly adopted strategic documents will enhance financial inclusion, reduce cash payments, and boost the financial sector.

⁵⁴ Yoshino, N., and P. Morgan. *Financial Inclusion, Regulation, and Education Asian Perspectives*. Tokyo: Asian Development Bank Institute, 2017.

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