Banking in the Eastern Neighbours and Central Asia

Challenges and Opportunities

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The papers in this document were discussed at the ENCA banking sector roundtable hosted by the EIB's Economics Department in Luxembourg on March 29th, 2012.

About the Economics Departement of the EIB

The EIB Economics Department mission is to provide economic analysis and studies to support the Bank in its operations and in the definition of its positioning, strategy and policy. The EIB Economics Department consists of a team of 25 economists and staff, under the responsibility of the Director **Debora Revoltella**.

Disclaimer

The views expressed in this document are those of the authors and do not necessarily reflect the position of the EIB.

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PREFACE

The global financial crisis did little to diminish the belief in the importance of the banking sector for economic growth and prosperity in the ENCA region (Eastern Neighbours and Central Asia). Some countries were affected more than others by the crisis and some banking sectors faced a considerable setback, but the region is still regarded as one of untapped growth potential, where the under-provision of banking services in many areas is constraining development of the private sector and in particular small and medium-sized enterprises. Managing credit quality, deleveraging and developing a stable source of funding are important challenges for banks in the region, together with structural transformation and diversification. Still, forecasts for 2012 and 2013 show GDP growth of around 4% for Russia and the Eastern Partners and around 6% for Central Asia, among the highest around the world. Such strong growth provides a good base for addressing those challenges.

Therefore, the EIB was pleased to receive a revision last year of its lending mandate from the European Union extending coverage of the Bank's operations to include interventions in the banking sector to support small and medium enterprises, as well as development of social and economic infrastructure and climate action and mitigation. The EIB has a long track record of this kind of financial sector activity in the EU as well as 130 countries outside the Union and we expect to see rapid growth in operations in partnership with banks in the ENCA region which will complement the Bank's long-standing commitment to investment in infrastructure.

This study was prepared for the EIB's ENCA conference in Vienna in May. It was put together by the EIB's economics department to support the Bank's new initiatives in the regional banking sector and to contribute to better understanding of the recent market developments in the sector. The study was a collaborative effort with contributions from, and discussions with, some of the leading international and private sector institutions active in the region. We look forward to your participation in the Vienna conference and your contributions to the discussion of the challenges and opportunities ahead

Wilhelm Molterer Anton Rop
Members of the EIB's Management Committee responsible for ENCA

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Banking in the Eastern Neighbours and Central Asia Challenges and Opportunities

EXECUTIVE SUMMARY

Growth expectations for the Eastern Neighbourhood and Central Asia[2] (ENCA) region have been revised downwards following the global financial crisis, but the financial sectors of these economies are still showing more potential for growth versus those of the mature western European economies, driven by the catch-up in banking penetration and differences in GDP growth. Forecasts for 2012 and 2013 show GDP growth of around 4% for Russia and the Eastern Partners and around 6% for Central Asia. Penetration levels are at 43.3%, when measured in terms of loans over GDP and 45.6% in terms of deposits over GDP.

Banking sectors were affected to varying degrees by the global crisis and now face a diverse set of challenges and opportunities.

- In Russia, the authorities responded quickly with liquidity and capital support for the banking sector and although a major crisis was averted there was nevertheless an important structural impact. The Russian state owned banks gained market share in the domestic market, being among the most dynamic in providing lending growth. Their strengthened capital and liquidity positions also played a role in supporting a renewed ambition for growth throughout the region, at a time when privately-owned local or foreign banks were restructuring following the crisis. Going forwards, challenges in the Russian banking sector include further strengthening, which means consolidation among the smaller institutions, but also diversification among the leading players, as well as addressing credit quality issues and developing a stable funding base.

- Among the other Eastern partner countries Armenia, Moldova and Georgia all suffered significant economic shocks in 2009, but avoided major banking crises. The openness of these economies and progress with market reform mean that they have good future growth potential. On the other hand Ukraine and Kazakhstan had major banking crises as international funding dried up, exchange rates depreciated and the pre-existing banking sector vulnerabilities came to the surface. GDP contracted by 14.5% in Ukraine in 2009 while Kazakhstan with buoyant oil and gas revenues only slowed to 1.2%. Although GDP growth recovered in the subsequent years and the long term growth potential is good, these two countries face challenges relating to the overhang of non-performing loans and the resolution of the worst affected banks, which in spite of the booming oil sector in Kazakhstan, are likely to put downward pressure on private credit and economic growth for several years to come. Belarus was also severely affected, though internal factors also played an important part in the resulting balance of payments problems.

- The smaller economies of Central Asia were the least affected due to their weak European trade connections and low levels of access to international markets. However, in Kyrgyzstan a political crisis led to significant financial and economic disruption and GDP growth slowed 0.5%. In several Central Asian countries the role of the state increased, partly as a result of government responses to the crisis but also in part due to a shift towards more state control per se. In Uzbekistan, for example, the state has an important role in the allocation of resources, and there are tight controls on the use of cash and foreign exchange. Further structural reforms are needed in those countries to have a financial sector able to proactively support economic growth.

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[2] The Eastern neighbourhood as defined by the European Union includes the Eastern partnership countries (Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine) and the Russian Federation. Central Asia includes Kazakhstan, Kyrgyztan, Tajikistan, Turkmenistan and Uzbekistan.

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More generally, important new constraints have emerged for the regional banking sector, as regards international funding, development of a more stable local funding base and credit quality. Although some of the more exuberant pre-crisis expectations have been moderated, the ENCA region still provides many new opportunities in the sector.

One of the key challenges that applies across the ENCA region is to provide an enabling environment for the development of the private sector. With large investment needs estimated to reach a total of EUR 1.0 trillion over the two-year period 2012-2013, which implies an increase of EUR 265 bn over the previous two years, the private sector will have an increasingly important role to play in mobilizing resources. Growth of the private sector will be a key factor in determining whether the ENCA economies achieve their full long term growth potential or remain on a low-growth trajectory.

The banking sector has to play a key role: while lending is relatively secure in the large corporate segment where the presence of the state is still heavy in many ENCA countries, diversification of the economy requires much faster growth in smaller corporate and SME segments.

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REGIONAL OVERVIEW

By Geoffrey Frewer, Deputy Advisor in Economics, European Investment Bank

Key messages

- Growth expectations for the ENCA region have been revised downwards following the global financial crisis, but the financial sectors of these economies are still showing potential for growth versus those of the mature western European economies, driven by higher GDP growth and the catch-up in banking penetration and financial intermediation.

- Countries in the region differ in terms of macroeconomic challenges. Access to finance is a problem for the weaker oil-importing economies, some of which have levels of external debt in the range 50-60% of GDP. The oil and gas exporters are in a generally stronger financial position and their needs are different with an emphasis on the transfer of technology and know-how rather than financial resources. The oil and gas exporters also face specific policy challenges relating to economic diversification as well as the region-wide challenges of building a sustainable economic model.

- Banking sectors differ in terms of their level of development and sophistication, the impact of the crisis and prospects for future strengthening and growth. While some of the more exuberant pre-crisis expectations have been moderated, and important new constraints have emerged as regards international funding, development of a more stable local funding base and credit quality, the ENCA region nevertheless provides substantial new opportunities in the banking sector.

- Access to finance is one of the key constraints on the creation and growth of SMEs in the ENCA region. However, the SME segment also faces structural problems in many countries due to the legacy of state control in the economy at large, and in some cases a large cash-based shadow economy which is unable to meet the collateral and credit conditions of potential lenders. Moreover, throughout the region there are widespread problems in the business environment and regulatory constraints, some of which were further aggravated by the response to the global financial crisis.

Macroeconomic Overview

The ENCA region is a diverse group of countries which share a common connection as states of the former Soviet Union. Since the break-up of the Soviet Union many of the countries have made substantial progress in economic growth and transition. The challenges of transition were particularly acute in Central Asia where the newly sovereign states had to establish new administrative and political systems at a time of dramatic economic collapse, and in the case of Tajikistan, civil war. Moreover, the level of intra-regional cooperation after the break-up of the Soviet Union has proved insufficient to maintain the integrated regional systems of transportation, energy and natural resource management. Therefore, an enhanced level of regional cooperation will be required to establish a sustainable basis for transition and development in the long term.

Economic recovery over the region as a whole has gained momentum over the last three years. In virtually all of the countries recovery took hold in 2010, following the shock of the 2008/9 global financial crisis, with positive rates of GDP growth (for all countries except Kyrgyzstan which declined by -1.4%) and the aggregate growth for the region was 4.5% (**see chart 1**). In 2011 the latest estimates show that the recovery was maintained with growth of 4.5%. Within the regional aggregate, the Russia accelerated in 2011 to 4.3% as the increase in commodity-driven production was only partly offset by surging import demand. Elsewhere in the region growth slowed to 3.9% in the other Eastern Neighbours, and 6.9% in Central Asia. The prospects for the region are for continued growth in 2012 and 2013 with forecasts of moderate growth of around 4% in Russia and the Eastern Partners while growth in Central Asia is faster at around 6%.

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In virtually all of the ENCA countries the economic recovery implies substantial new investment needs. Investment has recovered along with economic growth and gross fixed capital formation in the ENCA region is expected to reach a total of EUR 1.0 trillion over the two-year period 2012-2013 which implies an increase of EUR 265 bn over the previous two years. These incremental investment needs are distributed EUR 208 bn in Russia, EUR 33 bn in the Eastern Neighbours and EUR 24 bn in Central Asia. These forecasts of substantial new investment volumes reflect the growth and structural change in the economies including a wide range of infrastructure investment.

Table 1: ENCA Economic Indicators

	GDP $ billion	GDP per capita	Transition indicator	Infrastructure reform	Current account	Geopolitical / energy security relevance	Private sector/GDP	FDI/GDP
Russia*	1,479.8	10,356	3.1	2.7	4.8	1	61.5	1.8
Eastern Partner Countries								
Armenia	9.4	2,840	3.2	2.7	-13.9	3	73.1	6.1
Azerbaijan*	54.4	6,008.2	2.7	2.0	27.7	3	69.2	--
Belarus	54.7	5,771	2.2	1.3	-15.5	2	56.2	2.4
Georgia	11.7	2,629	3.2	2.7	-9.6	4	65.2	--
Moldova	5.8	1,630	3.1	2.3	-8.3	4	59.2	3.0
Ukraine	137.9	3,013	3.2	2.3	-2.1	2	51.5	4.0
Central Asia								
Kazakhstan*	148.0	9,009	3.0	2.7	2.9	3	77.5	1.7
Kyrgyz Republic	4.6	843	3.1	1.7	-7.2	4	61.9	9.5
Tajikistan	5.6	734	2.6	1.7	2.1	4	73.9	--
Turkmenistan*	21.1	3,677	1.5	1.0	-11.7	3	84.4	18.2
Uzbekistan*	39.0	1,380	2.2	1.7	6.7	4	65.6	4.7

High | Medium | Low

Transition indicators and infrastructure gap are on scale from 1 to 4 (1=least transition)
Geopolitical / energy security relevance 1 = most relevant, 4 least relevant
Source: IMF, World Bank, EBRD
*Oil and gas exporters

Within the ENCA region there are important difference between countries (see table). Russia is by far the largest economy and is comparable in size to the entire group of new member states (**see chart 2**). In addition, Russia accounts for 75% of total ENCA GDP and has made good progress with transition. On the other hand some of the Central Asian economies, where progress with transition has been slower, are constrained by the small size of their domestic markets. The smallest is the Kyrgyz Republic with GDP of USD 4.6 bn which accounts for 0.3% of total ENCA economic activity.

The oil and gas exporters are in a generally stronger financial position than the importers who face fiscal and current account constraints (**see chart 3**). The exporters also have different needs, particularly in terms of energy infrastructure, they face different policy challenges, and projects in these countries have a different geopolitical and energy-security context. Development of the private sector and consolidation of the post-crisis recovery are priorities across the region. In addition, the oil and gas exporters face the challenges of managing potentially volatile revenues and diversification of the economy.

While the oil and gas exporters with substantial current account surpluses do not face external financial constraints, access to finance is a problem for the weaker oil-importing economies, some of which have levels of external debt in the range 50-60% of GDP. At the macroeconomic level the challenge is to maintain prudent fiscal and monetary policies consistent with the potentially volatile external environment and commodity price uncertainties. For these economies in particular, foreign investment will have an important role to play.

In general, **FDI is an important resource for the region with a total flow of over EUR 31 billion in 2011 which is likely to grow with recovery in the global investment climate and improvement in the business environments.** Russia is by far the largest recipient of FDI in

absolute terms with an inflow of EUR 19 bn in 2011, mostly targeting the energy and raw materials sectors and there are good prospects for further growth following the relaxation of controls by the Russian authorities on foreign acquisition of strategic assets. Other ENCA countries are also becoming more open to FDI. In Kazakhstan, for example, there have been significant improvements in the business environment (the rank in the World Bank Doing Business Index rose from 74th to 59th in 2011) and the government recognizes the role of FDI in the modernization of enterprises.

Financial Sector Overview

Structural drivers

The level of financial sector development varies considerably from country to country. **The small economies of Central Asia have underdeveloped banking systems** where the presence of the state remains heavy and normal market conditions do not apply. On the other hand, some of the Eastern neighbour countries, such as Armenia and Azerbaijan, and to a lesser extent Moldova and Georgia have more dynamic financial sectors with potential for development of banking services over the short to medium term which should further strengthen the role of banks in financial intermediation. Ukraine and Kazakhstan are constrained by the legacy of NPLs from their recent financial crises which will continue to limit the effectiveness of the sector over the coming years. In Russia, the banking system has been more stable, though the interventions of the authorities in response to the crisis tended to favour the leading state-controlled banks and there remains a long tail of small institutions which are focused on specific sectors or companies and have no clear role in broader financial intermediation.

According to international benchmarks**, banking intermediation has important weaknesses in all of the ENCA countries.** The ratio of banking sector assets to GDP is 74% in ENCA in comparison to 155% in EU. However, taking account of differences in the level of GDP per capita, the ENCA region is more in line with the aggregate positions of EU and the new member states (**see chart 4**). Some countries, such as Ukraine, appear to have relatively high banking sector assets on the basis of the official data. However, these comparisons must be treated with caution, and are likely to be biased by the presence of shadow economies. In Ukraine, for example, if the shadow economy is 40% of GDP, the aggregate ratio of banking assets to GDP would be adjusted from 81% to 58%. Moreover, there are important sectoral and regional differences within the economies themselves. Although banking services are relatively well-provided in the major urban centres, even in the more developed economies such as Russia there are remote regions where banking services are extremely limited. Similarly the national aggregates, particularly for the resource rich countries, are skewed by the prosperous sectors which face few financial constraints while access to finance is more problematic in other sectors such as SMEs.

The ENCA financial systems face diverse challenges in terms of improving the ability to attract deposits and building the internal capacity of the financial system to provide credit. The more developed financial systems such as Russia, Ukraine Moldova and Kazakhstan have relatively high levels of deposits to GDP which are not far behind the European new member states (**see figure 5**). This indicates the relatively strong capacity of these economies to generate savings which are channelled into the banking system. However, Azerbaijan and some of the less developed economies in Central Asia have very low levels of deposits to GDP and for these economies the challenges are to generate more savings and to build confidence and capacity in the banking system.

The high ratio of loans to deposits in a number of countries indicates that deposit-raising capacity lags behind the needs of fast-growing banking activities. Pre-crisis growth was financed via access to international capital markets or foreign funding from the parent companies of the banks. The new challenge in a post-crisis environment is to stimulate domestic savings and domestic fund-raising, while at the same time rebuilding confidence on the market to stimulate more stable and broadly integrated financial. Addressing the maturity mismatch of banks and promoting more long term funding in local currency are additional challenges.

The impact of the global financial crisis

Prior to the global financial crisis the gap in banking sector penetration rates between the ENCA countries and more mature markets gave a strong indication of market growth potential. In the Eastern partner countries European banks that had expanded in the new member states prior to the crisis saw an opportunity for further expansion. Expectations of economic growth were high, and although there was a range of uncertainty around the forecasts it seemed reasonable to assume that the process of transition would imply higher growth over the medium term than could be expected in the mature European economies. Moreover, banking services were under-provided and with their recent experience of successful expansions in the new member states the West European banks made a number of acquisitions and expanded in the eastern partner countries in the years prior to the crisis.

Because of the structural differences between countries in the pre-crisis situation and different levels of financial liberalisation and integration, the growth potential was realized in some countries (particularly Ukraine, Kazakhstan and Russia) while others remained relatively isolated (notably the smaller economies of Central Asia). Whereas some of the eastern partner countries had good access to capital markets, and funding from foreign parent banks supported expansion of credit, the smaller Central Asian economies remained more isolated. Some received substantial inflows related to the oil and gas sector (Kazakhstan, Turkmenistan and Uzbekistan), and remittances (Tajikistan and Kyrgyz Republic), but for the most part these flows were sector specific and did not support a more broad-based development of the banking sectors. With lower levels of per capita income, more difficult business environments, less progress with market reform, and worse sovereign risk ratings (**see table 2**) these economies were less attractive to international banks. As a result they remained isolated from international markets and their banking sectors remained underdeveloped.

	Moody's Current Rating	# of notches changed since Jan 2010	Fitch Current Rating	# of notches changed since Jan 2010	Standard & Poors Current Rating	# of notches changed since Jan 2010
Armenia	Ba2		BB-		--	
Azerbaijan	Baa3	+1	BBB-	+1	BBB-	+1
Belarus	B3	-2	--		B-	-2
Georgia	Ba3		BB-	+1	BB-	+1
Kazakhstan	Baa2		BBB	+1	BBB+	+2
Kyrgystan	--		--		--	
Moldova	B3	+1	--		--	
Russia	Baa1		BBB		BBB	
Tajikistan	--		--		--	
Turkmenistan	--		--		--	
Ukraine	B2		B	+1	B+	+3
Uzbekistan	--		--		--	

Growth in the banking sector was to a large extent externally financed. In Ukraine foreign banks took the lead while in Kazakhstan and Russia capital markets played a more important role.

With the benefit of hindsight, it is clear that pre-crisis expectations were over-optimistic and that growth overshooting contributed to what are now painful adjustment processes. Ukraine and Kazakhstan had banking sector crises as the global events revealed the pre-existing financial vulnerabilities. They had accelerated growth in the years immediately leading up to the crisis, which to some extent contributed to their vulnerability. In addition both countries had high levels of dependence on foreign funding and exposures to foreign exchange risks. These banking crises resulted in a legacy of non-performing loans and bank resolution problems which are not yet resolved and are likely to constrain the recovery of credit and growth in the real economy for several years to come. Some of the smaller ENCA economies, particularly in Central Asia had fewer connections with international markets and were therefore less affected. Kyrgyzstan had a banking sector crisis in 2010 which was largely due to internal causes. Georgia, Moldova and Armenia suffered significant economic shocks in 2009, but avoided major banking crises. The openness of these economies and progress with market reform mean that they have good future growth potential, and relatively dynamic banking sectors.

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In the post-crisis environment, Russian banks are growing rapidly in the region supported by strong positions at home, while the European banks have a more focused approach maintaining significant positions in Russia and adopting a more prudent stance and restructuring in Ukraine and Kazakhstan. In other parts of the region, some of the international players as well as the local private banks may be constrained by lack of support given the overall downturn in expectations.

Russia also avoided a major banking crisis as the authorities responded rapidly with liquidity support and capital injections in the state-owned banks. This avoided serious damage in the short run, having however some important structural consequences over the coming years. The large state-owned banks were clear winners, and gained market share in the years following the crisis, with consequences for diversification and competition. Moreover, whereas in many other economies the crisis was followed by de-leveraging which set the scene for renewed growth, this de-leveraging did not take place in Russia, and the legacy of high debt levels, particularly in the non-resource sectors, is likely to constrain the recovery of credit over the medium term.

Access to finance and the constraints on SMEs

Access to finance is one of the key constraints on the creation and growth of SMEs in the ENCA region. However, the SME segment also faces structural problems in many countries due to the legacy of state control in the economy at large, and in some cases a large cash-based shadow economy which is unable to meet the collateral and credit conditions of potential lenders. Moreover, throughout the region there are widespread problems in the business environment and regulatory constraints, some of which were further aggravated by the response to the global financial crisis.

From the point of view of the commercial banks, the SME sector remains much less developed than lending to large enterprises where relationships are closer and for the larger state-owned enterprises there may also be implicit state guarantees. The lack of collateral and the intrinsic risks of this activity for the banks mean that SME lending is mostly concentrated in working capital loans, often to entities in trade and agricultural sectors. These loans are short term and are seldom used to finance fixed capital formation.

The main reasons for this are low transparency of SME sector, poor business climate and high tax and regulatory burden on the enterprises. The lack of transparency and the poor financial reporting standards in the SMEs make it difficult for the banks to make adequate credit risk assessments. As a result of the economic crisis, the lending conditions for SMEs that were already hard have deteriorated further as banks became increasingly concerned with portfolio quality.

While the banks tightened credit conditions **in the post-crisis environment, the authorities tightened regulations, and in many cases this put further downward pressure on the SME segment.** In Ukraine, for example, the adoption of a new Tax Code substantially increased the regulatory burden on SMEs. Furthermore, some countries responded by taking retrograde steps in basic reforms that are a vital part of the SME business environment, such as price and foreign exchange liberalisation. For example, in Armenia, Belarus and Kazakhstan price controls were re-imposed on some items, in part in an attempt to control commodity-driven, while Belarus and Uzbekistan tightened controls on foreign exchange.

From the point of view of the SMEs, **access to credit is only one of the constraints in the business environment.** Rankings from the Doing business survey are shown in table 3. For 7 out of the 11 countries that participated in the survey the country's ranking for access to credit is better than the country's ranking for overall ease of doing business. Furthermore, the survey shows that access to credit is generally better in the eastern neighbours than in Central Asia (with the exceptions of a very low ranking in Belarus and high ranking in Kyrgyzstan). Georgia in particular has high rankings in many categories: first in registering property, fourth in dealing with licences, seventh in starting, and eighth in getting credit. However, for many countries in the region there are important shortcomings in the business environments including problems with trading across borders, paying taxes, and getting electricity in many countries, and specific problems with dealing with licences in Azerbaijan and Moldova. On the other hand registering

property has generally high rankings with the exceptions of Ukraine and Uzbekistan, and enforcing contracts scores highly with exception of Armenia.

Conclusions - Challenges and Opportunities

Growth expectations for the ENCA region have been revised downwards following the global financial crisis, but the financial sectors of these economies are still showing potential for growth versus those of the mature western European economies, driven by higher GDP growth and the catch-up in banking penetration and financial intermediation. While some of the more exuberant pre-crisis expectations have been moderated, and important new constraints have emerged as regards international funding, development of a stable source of local funding and credit quality, the ENCA region nevertheless provides substantial new opportunities in the banking sector. Development of the private sector is the key unlocking these opportunities both in the banking sector and the economy as a whole. Growth of the private sector will be a key factor in determining whether the ENCA economies achieve their full long term growth potential or remain on a low- growth trajectory. It will also be a key factor in the banking sector: while lending is relatively secure in the large corporate segment where the presence of the state is still heavy in many ENCA countries, diversification of the economy requires much faster growth in smaller corporate and SME segments.

International banks have played a role in the pre-crisis growth of markets in the region, and they face a number of key challenges over the coming years. For the west European banks the challenge is to rebuild asset quality and re-focus on collection of local deposits as the basis for funding while international funding is significantly. On the other hand, the international Russian banks do not face the same external constraints, and in many cases they entered the ENCA markets after the downturn and therefore do not have a legacy of non-performing loans. The challenges for these banks are to manage growth and build sustainable long term businesses. In some cases this means extending beyond the traditional trade connections with Russia. There are also opportunities for the domestic players to expand, but for them the challenge is one of transformation from niche market players (and in many cases business with related parties) to competitors at the regional and national levels.

One of the key challenges for regulators is to further enhancing the enabling environment for the private sector. At the macroeconomic level this means continuing to pursue prudent fiscal and monetary policies consistent with the potentially volatile external environment and commodity price uncertainties. At the level of banking sector regulation, there are country-specific vulnerabilities where regulators are active as well as on-going programmes of regulatory reform which in many countries are moving ahead against a background of volatile foreign exchange markets and high levels of lending concentration. At the micro level, the challenges are possibly even greater. Measures to improve the business environment and reduce the administrative burden on the SME sector require not just administrative and legislative changes, but in some cases also what are likely to be more long term institutional reforms.

IFIs are active in the region across a wide spectrum of activities, from debt sustainability to institution-building with a broad range of objectives from European cooperation, democracy and human rights, to growth, climate action and market transition. One of the key challenges for IFIs is the coordination of these activities and the allocation of effort by IFIs according to their different specialisations, resources and competencies. Partnership will be a key factor in determining the success of the IFI interventions: partnerships both between IFIs, and between IFIs and national or regional entities. The analysis in the chapters of this book show the diversity of needs in the regional banking sectors and the complex relationships of the state and private sectors, and therefore IFI partnerships will encompass both public and private institutions.

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Figure 1: Real GDP growth rate, 2010, 2011, 2012 forecast

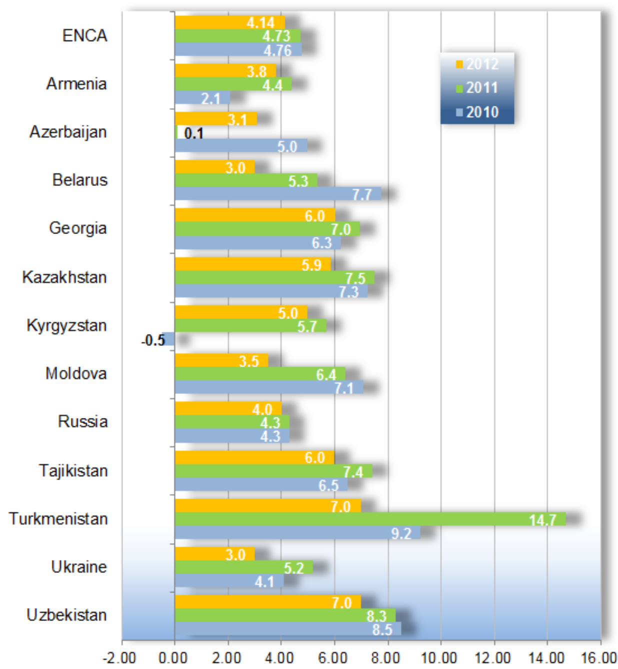


Figure 2: Population (Millions) vs GDP per capita (U.S. Dollars), the size of the ball indicates GDP (Billions, U.S. Dollars), 2011

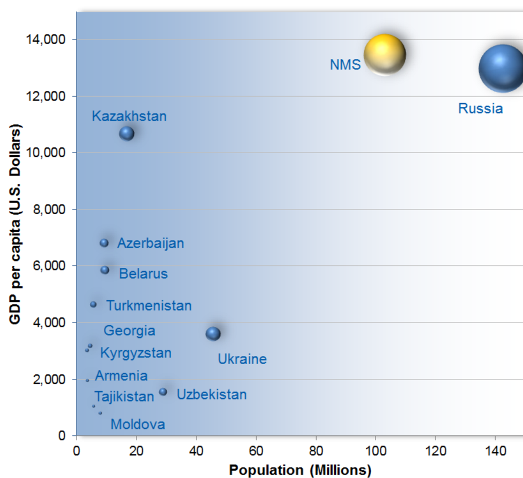


Figure 4: GDP per capita (U.S. Dollars) vs Credit to private sector (% of GDP)

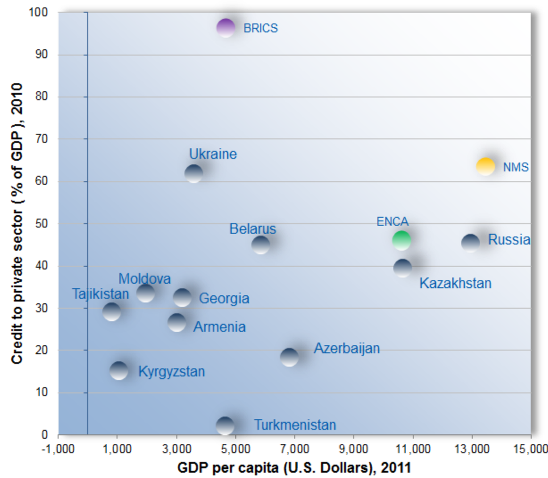


Figure 5: Total Loans (% of Total Deposits), Total Deposits (% of GDP)

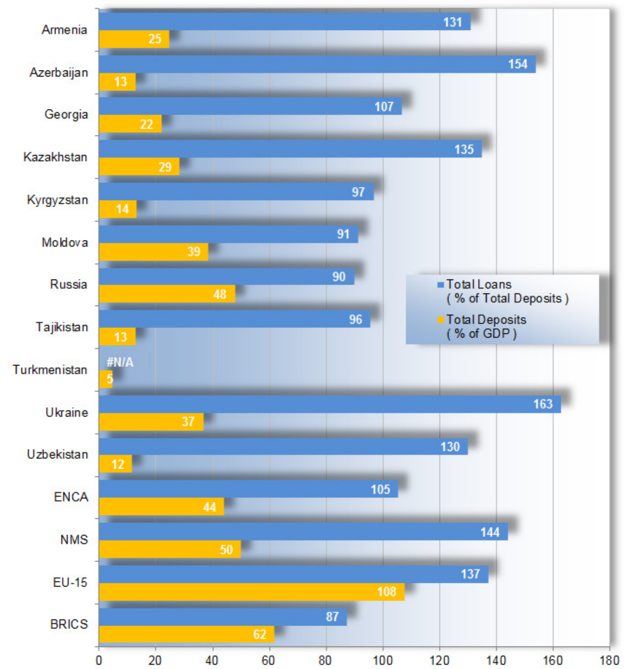


Figure 3: Current Account Balance (% of GDP), 2011 vs Fiscal Balance (% of GDP), 2011

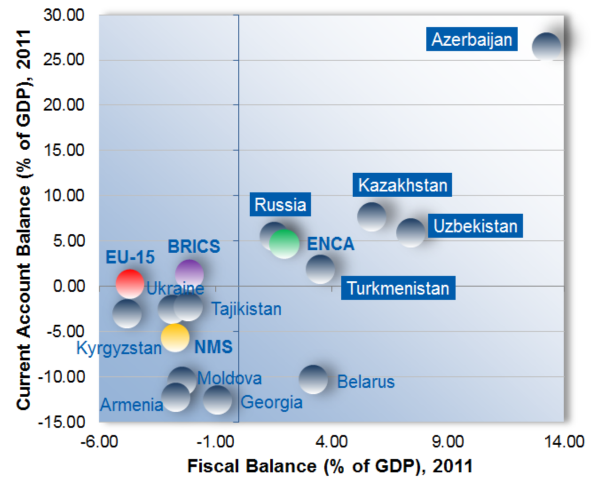
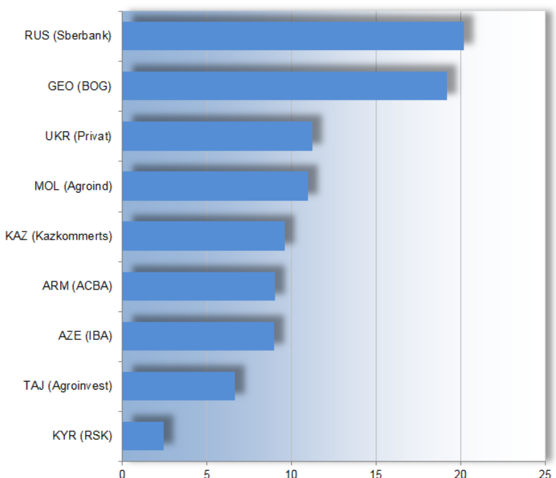


Figure 6: Largest Banks by Country (Assets % of GDP)



ARMENIA

By Burcu Hacibedel, Economist, European Investment Bank

Key messages

- The Armenian economy was affected notably by the global financial crisis despite its rapid growth in the 2000s. In 2009, the economy contracted by 14.1%. Since then, it has recovered and there are no major imminent risks. However, risks from a potential slowdown in Russia and/or the EU are still significant given the country's remittance and trade linkages.

- The Armenian banking sector is well capitalised, highly liquid and profitable. Foreign commercial banks as well as international financial institutions are active market players.

- Unlike the rest of the economy, the banking system weathered the global financial crisis relatively well, given its low exposure to toxic assets and low financial integration with advanced markets. However, it has suffered from the second-round effects through Armenia's high exposure to Russia. Total assets of the banking system accounted for 53% of GDP in 2011, and have grown rapidly since 2008.

- Despite its recent growth, the banking sector remains relatively small and unsophisticated, leaving room for further financial deepening and enhancement of financial intermediation. High dollarisation and high dependence on external funding may increase the sector's vulnerability to external shocks in the long run.

- Both the government and the banking system have been putting increasing emphasis on SME financing. In particular, the funding from international organisations and donors are being used to serve this end. Furthermore, the sector is expected to continue to grow rapidly in the near future via further financial deepening and intermediation.

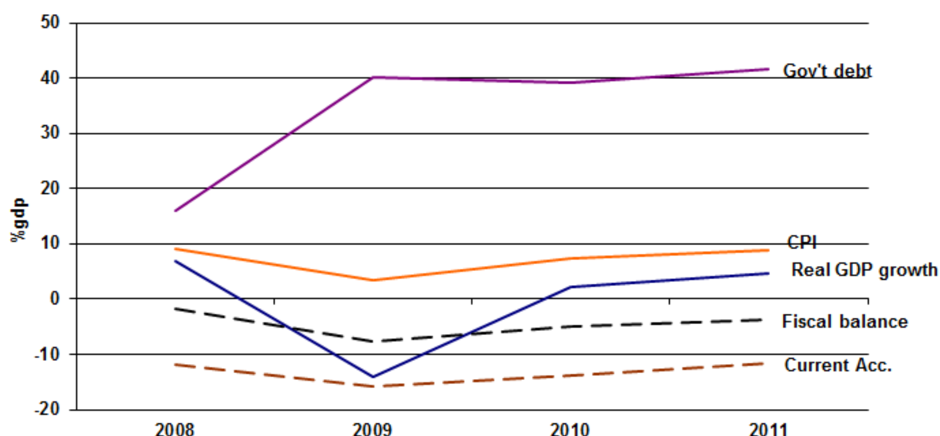
Macroeconomic Overview

Armenia is a landlocked economy in the South Caucasus, with a population of about 3.3 million. It is a relatively small-sized economy with total GDP of USD 10.2 billion and GDP per capital of around USD 3,000 ($5,400 in PPP terms) as of 2011. The country has been assigned sovereign risk ratings of Ba2 (negative outlook) and Ba3 (stable) by Moody's and Fitch, respectively.

Despite the high GDP growth in the 2000s, the Armenian economy was one of the countries most affected by the global financial crisis. While only slowing down in 2008, the economy contracted notably in 2009 by 14.1 percent, driven mainly by the economic turmoil in Russia and the sudden stop of the remittance-fuelled construction boom. The government reacted to this by implementing aggressive counter cyclical policies both fiscal and monetary, which resulted in a significant increase in the government debt-to-GDP ratio as well as the deterioration of government finances, resulting in a fiscal deficit increasing from 1.8% to 7.7% in 2009. Since then, measures for fiscal consolidation have been put in place decreasing both the fiscal deficit and inflation. General government debt increased from 16 percent of GDP in 2008 to over 40 percent in 2009, and stayed around this level until now. The upcoming elections in 2012 and 2013 may put further fiscal consolidation plans under pressure over the next two years.

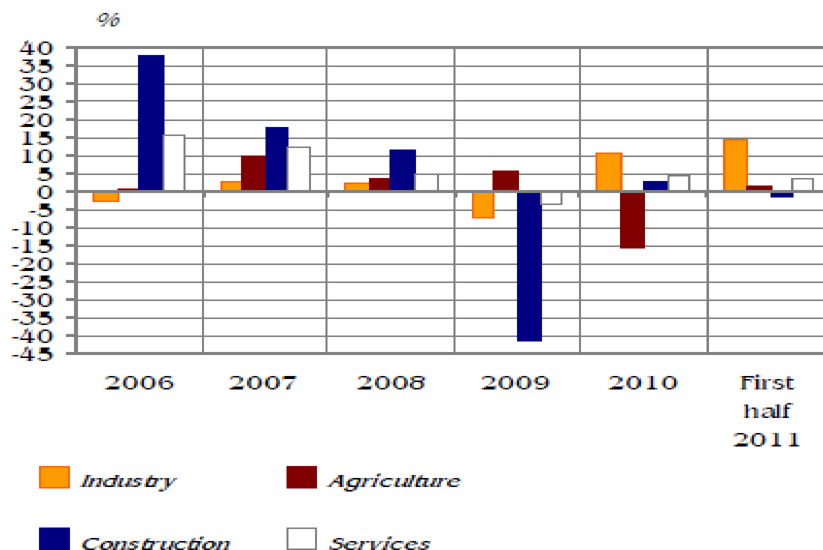
The Armenian economy has recovered from the 2009-crisis and fared well in 2011. The economy started showing signs of recovery in 2010 by a real GDP growth of 2.1 percent, which has reached up to 4.6 percent in 2011 and is expected to retain this level of economic growth in 2012. The recovery has been led by the export-oriented sectors including mining and services. In the recent past, surging commodity prices have also contributed notably to the country's economic growth.

Figure 1. Macroeconomic Indicators *(Source: CBA, IMF WEO)*



The Armenian economy is closely interlinked with the global economy particularly the EU and Russia, which increases its susceptibility to external shocks. This became even more pronounced after the global crisis, when the economy experienced severe secondary effects. In 2011, exports to the EU countries represented around 50% of the country's total export revenue. Similarly, exports to as well as remittances from Russia are quite large for the Armenian economy. However, given that Armenia's exports to the EU consists of precious metals, the EU-originated demand for the country's exports are forecasted to stay stable even in case of any problems in the EU.

Figure 2: Sectoral Breakdown of GDP growth *(Source: CBA)*



Main pillars of the Armenian economy have traditionally been agriculture, construction and mining. While agriculture and construction are expected to contribute less to the economy over the coming years, mining and manufacturing as well as services are expected to hold larger shares of GDP. Moreover, remittances account for a significant portion of Armenia's GDP at above 10 percent. This further augments the country's vulnerability to external shocks. Similarly, FDI inflows as well as multilateral donor support matters greatly for Armenia's economy and government finances. Particularly given that tax revenue is miniscule with a revenue-to-gdp ratio of 0.6 percent, external financing provides the government with room to implement counter cyclical policies. For example, in 2009 Russia granted a USD 500 million loan to be facilitated by the banking sector to support SMEs.

The Armenian economy still faces risks posed by a high current account deficit. Despite the recent improvements in the country's current account balance, the deficit remained to be high at 11.7 percent in 2011. This can be attributed partially to Armenia's large dependence on remittances and exports. With high levels of export growth and further fiscal tightening, the current account is expected to improve slightly over the next few years.

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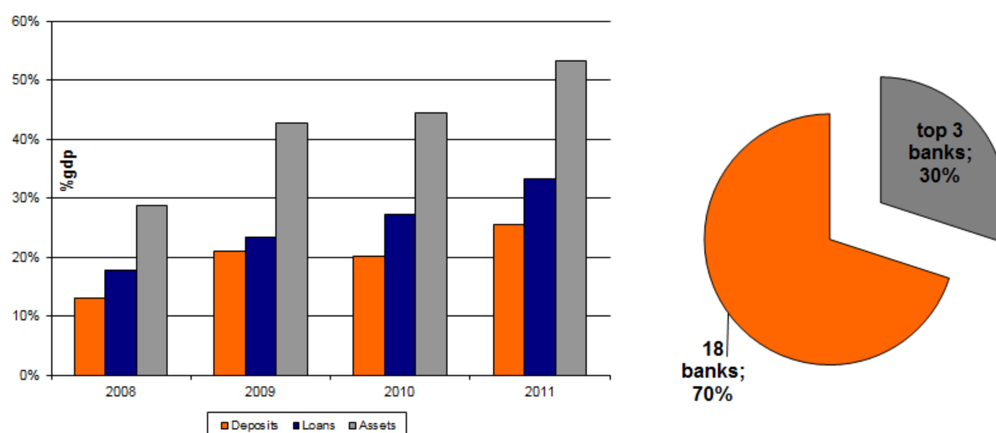
Armenia has moved up in Doing Business rankings in 2012 from 61th in 2011 to 55th in 2012, out of 183 economies. While the economy ranks very high in the areas of 'Starting a Business'(10), 'Registering Property'(5), and 'Getting Credit'(40), it has low rankings in 'Paying Taxes'(153), 'Enforcing Contracts'(91) and 'Trading across Borders'(104). The country also ranks very low on the corruption indicator.

Banking Sector Overview

The financial sector is dominated by commercial banks. Banks in Armenia account for more than 90% of the financial sector. Other financial sector participants such as insurance companies, and securities markets are small. In 1993, the banking sector was composed of more than 70 banks. This number decreased sharply through consolidation and more prudent financial sector supervision. As of April 2012, there are 21 commercial banks in Armenia, which are all 100-percent privately owned. There seems to be no centralisation in the sector; the largest three banks have been holding 30 percent of total assets and this applies to 2011-year end figures as well. Three out of these twenty-one banks are open joint stock companies and 74 percent of the shares in the banks are held by non-residents. Foreign ownership is quite widespread: only in six banks, shares of non-residents are less than 50 percent.

Figure 3a: Banking Sector Indicators / Figure 3b: Banks' Share of Total Assets, 2011

Source: CBA, IMF



Among foreign investors, international organisations are also active participants: EBRD holds between 15-25% of total shares in four Armenian banks. Similarly, IFC holds 10% of shares in two banks. KFW has ownership of around 15% in two banks, in addition to the OPEC Fund for International Development has 10% ownership in an Armenian bank. Additionally, international organisations including the World Bank, EBRD and Black Sea Trade and Development Bank have been investing heavily in financial sector development in Armenia.

Foreign capital inflows are also significant for the financial sector, particularly through the remittances channel. In 2011, this amounted up to USD 2 million, i.e. 10% of GDP. However, not all of the remittance inflows come through the banking system. In this respect, Armenia has strong ties with Russia and the US. Since 2008, total remittances inflow to Armenia has exceeded USD 7 billion.

The banking system weathered the global financial crisis relatively well, given its low exposure to toxic assets and low integration with advanced markets. However, it has suffered from the second-round effects through Armenia's high exposure to Russia.

The Armenian banking sector grew notably over the last decade. Between 2006 and 2010, while total deposits and assets increased by 144 percent and 186 perfect respectively, total loans grew by almost 300 percent. The 186 percent growth on the asset side was partially driven by the growth in deposits, but mainly triggered by the increase in funding from IFIs and international donors to the economy. Given that the latter provides long term and concessional funding to the banking sector both in local and foreign currency, the high growth on the asset side doesn't pose neither an imminent nor a significant risk for the banks. However, the growth

in total loans by 300 percent is striking, and may imply a risk of potential credit boom for the sector. Only in 2011, the banking system's total assets grew by 33% while its total deposits grew by 39%. On a side note, the banking sector still remains small with relatively low access to finance; there are 13 branches and 0.67 banks available for every 100,000 persons.

Despite its recent growth, the banking sector remains relatively small and unsophisticated, leaving room for further financial deepening and enhancement of financial intermediation. At year-end 2011, total assets amounted to around 53 percent of GDP, which documents a rapid growth since 2008, while the assets-to-GDP ratio was much lower at 28 percent. This was accompanied by a significant increase in total deposits, from 13 percent of GDP in 2008 to 25 percent in 2011 while the loan-to-deposit ratio has remained relatively stable at around 130 percent. The sector is still small compared to the other economies in the ENCA region. The Central Bank (CBA) requires 60% of customer deposits to be held in liquid assets.

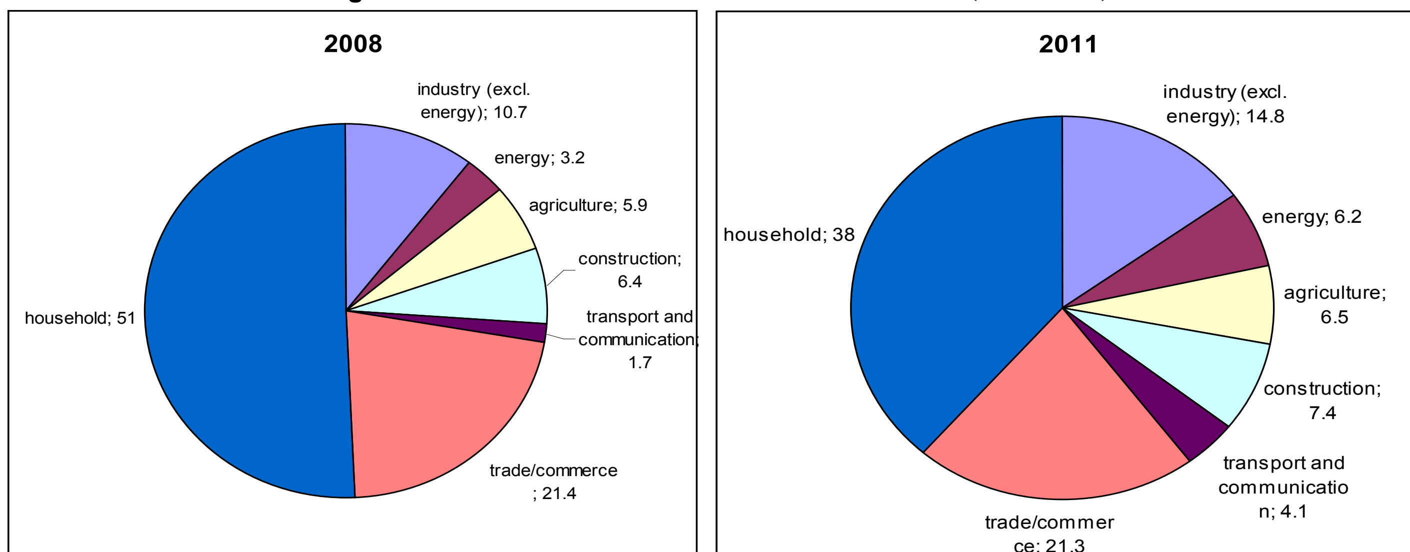
Banks' lending activity, i.e. credit growth, was also affected negatively in 2009 during the downturn. The government used monetary policy tools, such as easing of official interest rates, to improve the lending activity, however given the liquidity constraints imposed by the CBA, monetary policy only had limited impact. Rather, the lending recovery was driven by government guarantees on lending and on-lending through the banking system to SMEs. Since then, annual credit growth has been increasing, reaching 37% in 2011.

Commercial funds can mostly provide shorter term funding to the economy due to the normative measures implemented by the Central Bank. Commercial banks have to retain 60% of their customer deposits in liquid assets. This, as a result, limits the amount of medium and long term lending that can be offered to the economy by these banks. Most of these types of funds are provided by international financial institutions, such as EBRD, IFC.

The banking sector remains sound; however, the recent credit growth raises concerns about potential future risks. The Armenian banks so far have had strong financial soundness indicators regarding the 'regulatory capital to risk-weighted assets' ratio, with CARs at above 20, higher than the official requirement of 12 percent. Though still at high levels, as a result of the recent credit growth, capital adequacy has decreased from 27.5% in 2008 to 19.6% in 2011. The ratio of capital (net worth)-to-assets has been stable around 20 percent. As of the fourth quarter of 2011, it is 18.5 percent.

Since 2008, there have been slight changes to the breakdown of the banks' credit portfolio (see Fig.4 below). The sectoral breakdown of total lending shows that credit to households have decreased from over 50 percent of total lending in 2008 to 38 percent in 2011. This difference has been evenly distributed among other sectors: transport and communications, energy and industry. Apart from the households, the sectors that hold major shares of total lending are trade/commerce (with 21.3% in 2011) and industry (with 14.8%).

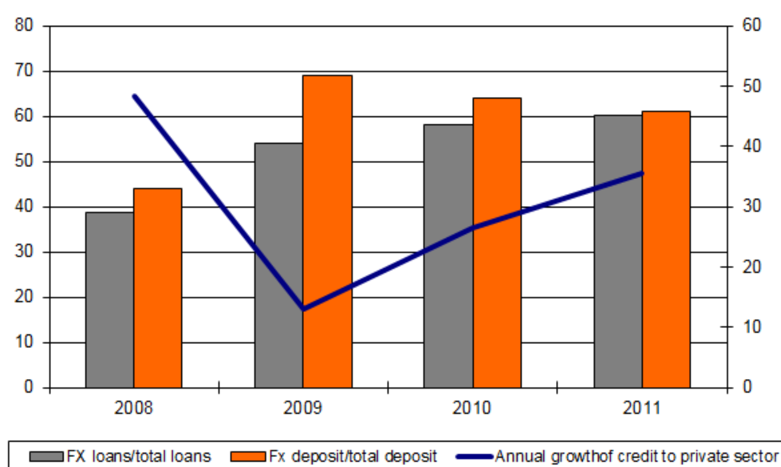
Figure 4: Breakdown of Total Loans: 2008 vs. 2011 *(Source: CBA)*



The profitability of the Armenian banking system is high though has been decreasing. The profitability ratio recovered from its sharp drop (to 3.4%) in 2009 to 9.8% in 2011. However, it is still below the pre-2009 levels, which were above 13%. Compared with the regional average in 2010, the profitability of the Armenian banking system was around the average profitability (RoE) of the ENCA region. This decreasing trend in the sector's profitability is expected to result in further consolidation and higher leverage.

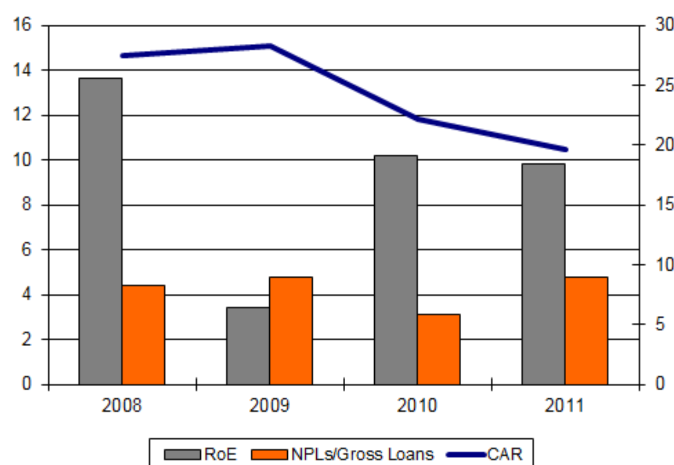
The level of non-performing loans (NPLs) is low and much below the regional average. The asset quality has been high with non performing loans constituting 4.8% of total loan portfolio. However, the NPL indicators show an upward trend, signalling to a deterioration of asset quality since 2010. Concurrently, bank provisions to non-performing loans have also been decreasing from 56.7% in 2010 to 41.3% in 2011. Loan loss provisions are below the regional average (63% in 2010) as well as other developing regions.

Figure 5: Banking Sector Foreign Currency Denominated Loans and Deposits and Credit to Private Sector (right axis) ***Source: CBA***



The banking system can be characterised as well capitalised with capital-adequacy ratio (CAR) of 19.6 percent in 2011. The system's capital adequacy has been traditionally high, above the official requirement of 12 percent, however has been slightly decreasing from 27.5% since 2008. Furthermore, the CBA is planning to implement Basel III framework in the near future.

Figure 6: Banks' Performance Indicators (CAR-right axis) ***Source: CBA***



The liquidity of banks has been high, particularly since 2009. The 'liquid assets to total short-term liabilities' ratio was 142 in 2009 and 125 in 2011.

Banks' loan-to-deposit ratio has been high at above 1.3, except the sharp decrease to 1.12 during the 2009 crisis. This has again been supported by the increase in total liabilities of the system through long-term and low cost IFI and international funding. Thus, does not constitute any immediate risks for the system. However, the enhancement of local funding is vital to sustainable development of the banking sector.

The problem of high dollarization is also evident in the Armenian economy and banking system, as it is in almost all ENCA countries. Deposit and lending dollarisation remain high, increasing the system's currency risk with rapidly growing foreign currency lending. The high level of dollarisation has been a major risk for the Armenian banking sector on both sides of the balance sheet. This has been a common problem across the ENCA region, however, foreign currency denominated deposits and credit in Armenia are above the regional average. While dollarisation of the banking system was decreasing before 2009, this trend has been reversed since the crisis. As of the fourth-quarter of 2011, 66 % of total deposits and 60.2% of total loans were foreign currency denominated. While the increase in FX loans has been striking from 38% in 2008 to 60% in 2011, the levels of FX deposits have been relatively stable during the same period increasing from 55% to 66%. Moreover, the banking system also faces a maturity mismatch with respect to FX deposits and loans: while on average, FX deposits have an average maturity of 6 months, average maturity for FX loans is around 2-3 years. Despite high exposure to exchange rate fluctuations, both gross and net open positions in FX to capita have been improving and low at 3.4% and -0.2% in 2011, respectively. Thus, as they stand, the banking sectors sensitivity to market risk with respect to FX is low.

The Central Bank of Armenia is the sole supervisory and regulatory authority of the banking sector. The CBA is actively involved in ensuring the soundness of the financial system. Commercial banks require a license from the CBA. The CBA has established requirements for capital adequacy, minimum statutory capital requirements and minimum regulatory capital requirements. The minimum statutory capital required to register a bank is AMD 5 billion. In October 2011, the threshold standard of capital adequacy was lowered to 12% from 19%, which was previously 29.1%. In December 2011, the Central Bank toughened the deposit reserve requirements: 12% of foreign exchange deposits and 8% of AMD deposits have to be reserved in the local currency (AMD). This increase in reserve requirements to be held in local currency has induced AMD funding pressure on the banks. In Armenia, banks have relatively easy and low-cost access to funds denominated in foreign currencies, and they face the problem of scarcity with respect to funds in local currency. This has led to a sharp increase in the AMD interest rates deposits as a result of this requirement to keep AMD reserves for both FX and AMD deposits. In a way, this pronounces the need for local currency funding in Armenia and increases the competition for local currency deposits to be held by the banks.

Notwithstanding its current small size and low level of sophistication, there is considerable room for improvement and enlargement of the banking sector in Armenia. The incumbent market players expect an annual average growth of 20-30% over next five years. Given that this rate of growth is higher than the expected real GDP growth, this could be achieved via further financial deepening. In its current state, the banking sector still suffers from red tape inefficiencies and low access to financial services. Most of the bank branches are located in Yerevan and other parts of the country have limited access to financial services. Furthermore, the banking sector is expected to benefit significantly from the introduction of mandatory insurance and pension schemes. Mandatory insurance was introduced in 2011, and the pension scheme is expected to be implemented in 2014. This will increase total funds available to the banking system. Armenia has a sizeable shadow economy, and the government is expected to implement policies to formalise this part of the economy. Achievement of this goal would lead to further growth of the banking system.

Decreasing profitability is expected to lead to further consolidation in the banking sector. The latest consolidation had taken place in 2010 and both the CBA and banks expected a few more over the next few years. On a similar note, banks are expected to increase their leverage to sustain their profitability at reasonable levels. Additionally, some banks distort competition in the market, with the growing need for local currency and the existing government guarantee on deposits up to USD 5,000.

In the case of Armenia, the government actively channels funds to SMEs and agriculture industry through banks by introducing government-supported programmes. There has been a recent initiative to support the agriculture industry through the launch of the Government's

"Subsidised Agricultural Lending Programme" in 2011. Similar programmes are in place for SME financing, and were also used during the 2009 crisis.

Leading Market Players

The largest banks in Armenia, ACBA, HSBC and VTB, all have foreign capital at varying degrees. Each currently serves a different clientele, but nonetheless competes in various segments of banking.

Table 1. Largest Armenian Banks (in EUR mln.)

	ACBA-Credit Agricole	HSBC	VTB
Total Capital	81.81	51.37	61.11
Assets	349.54	301.25	264.86
Loans	235.40	182.1	177.5
Liabilities	267.73	249.9	203.8
Deposits	66.20	152.7	73.8
Net Profit	8.78	9.5	8.9
Branches	41	7	69

Source: UBA (Union of Banks of Armenia)

ACBA-Credit Agricole, which was set up within TACIS Programme of the EU in 1996 with Credit Agricole as its biggest shareholder, is the largest bank in Armenia in terms of assets. The bank has one of largest branch networks in the country with 41 branches. Its operations have been primarily focused on financing agriculture in Armenia. The government backed support has so far been mainly directed to the real economy through ACBA. For example, 96% of the Government's 'Subsidised Agricultural Lending Programme' in 2011 has been used by ACBA. Of its total loan portfolio in 2011, 28 % is in agriculture, 22% in consumer loans, 4% in mortgages and 45% in business loans consisting of both loans to SMEs and corporations (the latter started in 2011). The banks focus more on SMEs and microcredit customers, with an average loan size of USD 2,000. Its total loan portfolio grew by 47% in 2011. Since 2009, NPL ratio has increased from 2.5% to 5-6%. Though it is still low compared to the other banks, this has been ACBA's highest NPL figures. In 2011, it had a profit ratio of 14.4% (RoE), below its competitors.

HSBC Armenia, which was established in 1996, is a subsidiary of the HSBC Group. Currently, it is a joint venture between the HSBC Group, which has 70% of ownership, and members of overseas Armenian businesses with 30% ownership. It is the largest and most profitable foreign bank in the country. In 2011, its profitability was high with RoE of 23.76%. With more of a focus on international business and trade, HSBC Armenia does not target the lower end of potential customers such as the agriculture industry, SMEs (only the larger ones) or microcredit clientele. The bank's loan portfolio has increased by 40% over the last two years reaching a total asset figure of USD 320 million (AMD 179 billion) as of December 2011.Among the largest Armenian banks, HSBC has the largest amount of deposits.

VTB, CJSC "VTB Bank (Armenia)" is a subsidiary of the VTB financial group in Armenia, acquired by the Russian parent company in 2005. Currently, VTB Bank holds 100% of its shares. Being the largest retail bank in Armenia, the bank has the largest branch network in the country with 68 branches: 24 in Yerevan and 44 in the rest of the country. In 2011, it had 18.8% of return on equity, documenting high profitability. Additionally, NPLs constituted only 2-3% of total loans. Its loan portfolio has the following breakdown: 10% small businesses, 15% medium businesses, 45% large businesses and 30% retail. Its loans to large corporation is currently only 18% of the market. Although lending to SMEs has just begun in 2010 and constitutes only 10% of total loans, VTB aims to increase this to 30% in 2012. Most of VTB's SME lending is to the trade sector, given the small number of manufacturing projects and ACBA's dominance in lending to the agriculture industry. While penetrating the SME market, VTB plans to increase its exposure by innovative products and loan packages.

Summary and Conclusions

The Armenian economy was affected negatively and significantly by the global financial crisis despite its rapid growth in the 2000s. While only slowing down in 2008, the economy contracted notably in 2009 by 14.1 percent, driven mainly by the economic turmoil in Russia and the sudden stop of the remittance-fuelled construction boom. The economy started showing signs of recovery in 2010 with a real GDP growth of 2.1 percent, which has reached up to 4.6 percent in 2011 and is expected to remain around this level of growth in 2012. However, risks from a potential slowdown in Russia and/or the EU are still significant.

The Armenian banking sector, constituting more than 90% of the financial sector, is well capitalised, highly liquid and profitable. Total assets of the banking system accounted for 53% of GDP in 2011, and have grown rapidly since 2008. Despite its recent growth, the banking sector remains relatively small and unsophisticated, leaving room for further financial deepening and intermediation. High dollarisation and high dependence on external funding may increase the sector's vulnerability to external shocks in the long run. Profitability has recently been decreasing, while NPLs have been increasing. Further consolidation is expected in the medium term.

Both the government and the banking system have been putting increasing emphasis on SME financing. In particular, the funding from international organisations and donors are being used to serve this end. Notwithstanding its current small size and low level of sophistication, there is considerable room for improvement and enlargement of the banking sector in Armenia. The incumbent market players expect an annual average growth of 20-30% over next five years.

Table 2. Selected Macroeconomic and Financial Sector Indicators

	Armenia				2010 median values for Emerging Regions			
	2008	2009	2010	2011	ENCA	EE	East Asia	Latin America
GDP per capita $	3605	2647	2840	3048	3013	8926	2549	6980
Real GDP growth (% change)	6.9	-14.1	2.1	4.6	6.4	1	7.7	5.3
CPI inflation (% change)	9	3.5	7.3	8.8	7.4	2.8	4.5	4
Current account balance (% GDP)	-11.8	-15.8	-13.9	-11.7	-8.3	-4.4	2.5	-2.1
Fiscal balance (% GDP)	-1.8	-7.7	-4.9	-3.8	-2.4	-3.9	-2.6	-2.0
Gross govt debt (% GDP)	16.1	40.2	39.2	41.5	26.6	41.4	49.4	36.3
Population (mln.)	3.3	3.3	3.3	3.4	9.5	5.9	132.9	14.6
Banking Sector								
Assets/GDP	29%	43%	45%	53%				
Deposits/GDP	13%	21%	20%	25%	32	53	68	31
Loans/Deposits	136%	112%	135%	131%	145	99	76	87
Asset concentration (top 3 banks)	35%	33%	30%	30%				
Number of banks	22	22	22	21				
NPLs/Gross Loans	4.4%	4.8%	3.1%	4.8%	12.5	11.9	3.6	2.4
CAR	27.5%	28.3%	22.2%	19.6%	20.5	15.8	16.0	16.4
RoE	13.6%	3.4%	10.2%	9.8%	10.7	3.3	16.7	18.7
Loan loss provisions/NPLs	38.2%	46.7%	56.7%	41.3%	63.2	54.6	74.2	140.8
Capital/Assets	23%	21%	20.4%	18.5%	14.6	10.2	9.6	10.1

Source: IMF, CBA

Table 3. Total Bank Lending Breakdown

% of total loans	2008	2009	2010	2011
Industry (excl. energy)	10.7	16.5	17.7	14
Energy	3.2	4.5	5.3	6.2
Agriculture	5.9	6.3	5.9	6.5
Construction	6.4	7.7	8.4	7.4
Transport and Communication	1.7	2.2	2.9	4.1
Trade/Commerce	21.4	20.8	20.9	21.3
Households	51	42	29	38

Source: IMF

AZERBAIJAN

By Burcu Hacibedel, Economist, European Investment Bank

Key messages

- Following the onset of the oil boom in 2003, the Azeri economy grew rapidly, with an annual average growth rate of 10.1%. However, in 2011, the economy contracted by 1.1% amid a sharp decrease in oil output due to maintenance problems.
- The economy enjoys a strong macroeconomic stance and outlook with high current account, fiscal and trade surpluses, backed by surging oil prices and revenue. The government has been implementing successful policies towards poverty reduction and inclusive growth, as well as other social reform packages.
- A major weakness of the Azeri economy is the lack of economic diversification. To overcome this problem, the government has been putting considerable emphasis on promoting growth in the non-oil industries (8.9% in 2011)
- The financial sector is dominated by banks. The banking system is highly centralised and can be characterised by low competition. Banking sector penetration is lower than its regional peers, with an assets-to-GDP ratio of 27% in 2011.
- Banks are well capitalised and have sufficient liquidity positions although they have recently been experiencing decreasing profitability and increasing NPLs. As most of the countries in the ENCA region, the banking system is highly dollarised.
- Banks rely on domestic sources of funding including customer deposits (more than 50% of banks' funding), the Central Bank and interbank loans, term-funding from government organizations and international bilateral term borrowings. Most of the funding from the state is used to finance government sponsored projects.
- The government's active involvement in promoting development and deepening of the financial sector is expected to have a positive impact on financial sector development. In the near future, SME financing is expected to increase as a result.

Macroeconomic Overview

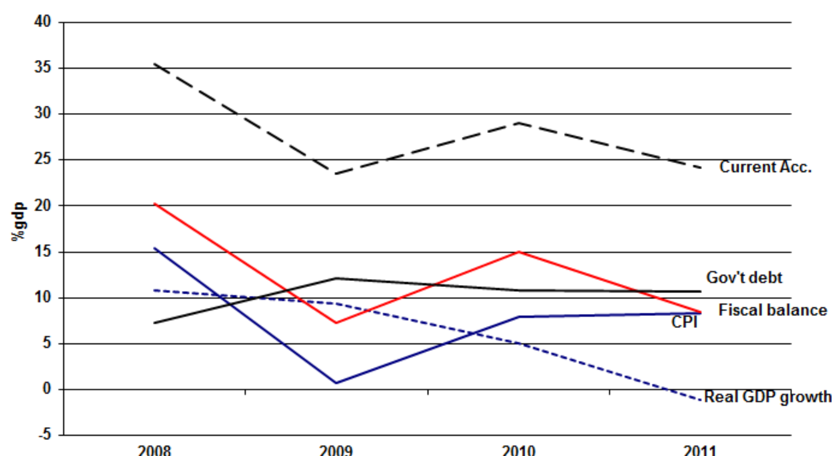
Azerbaijan is an upper-middle-income country with a population of about 9.2 million and a GDP per capita of around USD 7,500 in 2011 (USD 10,200 in PPP terms). Since the onset of the oil boom in 2003, the economy has grown rapidly, with an annual average of 10.1%. After reaching extremely high levels in 2007, economic growth started to slow down from 2008 onwards. In 2011, the growth rate was unexpectedly low at -1.1% amid a sharp decrease in oil output due to maintenance problems. Otherwise, the country weathered the global financial crisis well, and outperformed most of its regional peers as well as advanced economies. Azerbaijan has been assigned a sovereign risk rating of Baa3 by Fitch, Moody's and S&P.[3]

Macroeconomic indicators of Azerbaijan are strong, fuelled by the recent oil boom and surging oil prices. Since 2005, the economy has consistently experienced very large trade surpluses ranging between 25-47% of GDP. Between 2001 and 2010, exports increased fourteen-fold. As oil and gas production constitute a major part of the country's exports, the current account balance has been in surplus. In 2011, the current account surplus was around 24%. There was a sharp decrease in inflation in 2009, and consumer price index has been lower ever since: 8.3% in 2011. However, recently there have been signs of inflationary pressure, driven both by the increases in food prices and domestic demand fuelled by high public spending. Government debt is low at around 10% and does not present a major risk. The existing debt is the result of pro-cyclical government spending, especially towards developing the domestic economy and deepening the financial and capital markets. Similarly, government finances have been strong with a fiscal balance of 8.5%of GDP in 2011. Fiscal surplus

[3] Moody's and S&P: Baa3 with stable outlook, Fitch: Baa3 with positive outlook.

decreased since 2008 from 20% as a result of targeted high public spending. Overall, the Azeri economy has a strong outlook, except its high vulnerability to oil price volatility. The large foreign assets provide a strong buffer against external shocks.

Figure 1. Macroeconomic Indicators *(Source: IMF)*

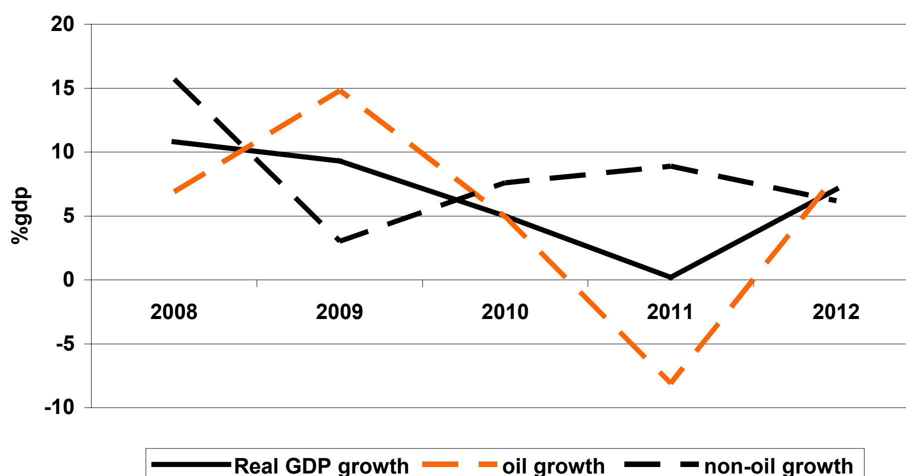


The national currency, the manat, has been effectively fixed against the US dollar. Foreign exchange reserves held by the Central Bank of the Republic of Azerbaijan (CBA) are quite high, amounting to 6.7 billion USD in 2011(12% of GDP). However, gross reserves, which provide a sufficient buffer, include both the CBA's reserves and those held by the State Oil Fund of the Republic of Azerbaijan which reached to 30.3 billion USD by the third quarter of 2011. In this respect, the fixed exchange rate regime does not pose any significant risk. This regime provided a stable exchange rate; however, it limits the Central Bank of Azerbaijan's ability to control inflation by monetary policy. With an added risk of appreciating real exchange rate, the country may also face the risk of endangering the growth and development of industries producing tradables other than oil. There are plans of switching to a more flexible exchange rate regime in the near future. In 2012, the government will start working with the IMF on this issue.

During this period of high growth, government spending has been procyclical and increased substantially. The government implemented successful policies towards poverty reduction and inclusive growth, as well as other social reform packages. While the share of population living below the poverty line was around 50% during 2001-2003, it decreased to 15% during 2006-2008. Income inequality and unemployment have also decreased since the start of the oil boom. Moreover, a significant part of the oil-driven increase in government revenue has been invested in the national stabilisation fund.

A major source of vulnerability in the Azeri economy is the lack of economic diversification, which may lead to unsustainable dependence on oil production and revenue. To overcome this problem, the government has been putting considerable emphasis on promoting growth in the non-oil industries. With the exception of an annual growth of 3% in 2009, non-oil GDP growth has been high since 2000. The first half of the decade witnessed growth figures higher than 10% p.a. and in 2010 and 2011, non-oil growth recovered to 7.6 and 8.9%, respectively. This has also helped the economy notably in 2011 as the contraction in oil GDP by almost 9% was offset by a strong growth in non-oil GDP. As a result, total GDP contracted just by 1.1%.

Figure 2. Oil vs Non-oil GDP Growth *(Source: IMF)*



The business environment has been improving, even if gradually. In 2012, Azerbaijan was ranked the 66th out of 183 countries, moving up 3 places since 2011 by the World Bank's Doing Business Indicators.

Banking Sector Overview

The financial sector is dominated by banks. There are currently 44 banks in total: consisting of one state owned (The International Bank of Azerbaijan, IBA henceforth) and forty-three privately owned banks. The banking system is highly centralised and suffers from low competition. The IBA is the largest bank, holding 36.5% of total assets in the system, with 50.2% of state ownership. The largest three private banks account for 20% of total assets and the remaining 38 banks account for the rest, 43.5%. There are 23 banks which have foreign capital, seven of which are majority foreign owned. The CBA stated its long term objective to decrease the number of banks to 15-20 through consolidation and optimisation.

Banking sector penetration is relatively low in Azerbaijan, also when compared with the other ENCA countries. In 2011, total assets of banks accounted for only 27% of GDP. The sector is characterised by low deposits and credit relative to the size of the economy; 13% and 20% of GDP, respectively. In this regard, the Azeri banking system is below the averages for the ENCA region: 32% and 38% of gdp in 2010. The banking sector has weak intermediation in terms of supporting the private sector as well as SMEs. The banking system remains modest compared to the overall needs of the economy. While the figures for total assets and loans peaked in 2009, they have been decreasing since then. The underlying reason is the expansion of credit to state-owned enterprises in 2009,and CBA's active involvement in this through commercial banks.

Figure 3a. Banking Sector Indicators *(Source: CBA, Fitch)*

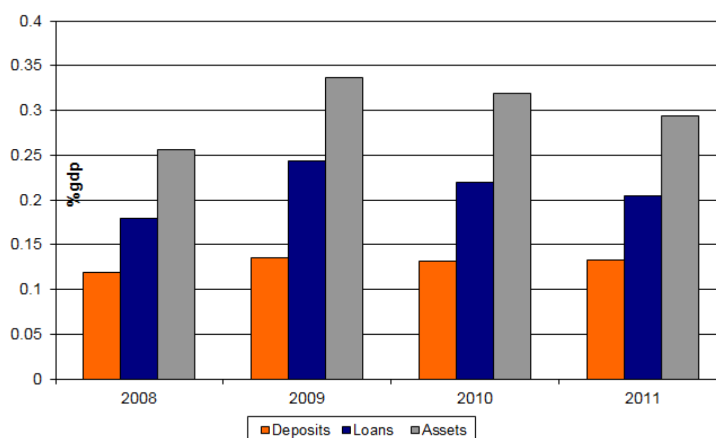
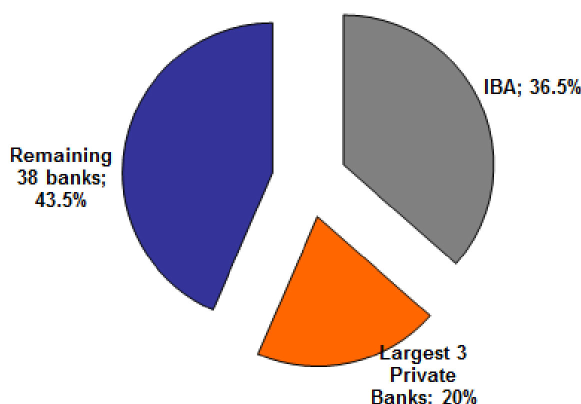


Figure 3b. Banks' Share of Total Assets, 2011 *(Source: IMF)*



The IMF and rating agencies have recently pointed out the International Bank of Azerbaijan as a source of vulnerability for the Azeri banking system. The IBA faces the problem of deteriorating asset quality, and is in immediate need of strengthening of its capital and liquidity. Given its systemic importance and the fact that it is the largest and only public bank in Azerbaijan; this may impose a burden on both government finances and the banking system. Its privatisation is being considered, however, no concrete plans have yet been decided upon. Excluding the IBA, the banking sector's financial indicators present a stable picture with high capital adequacy and profitability[4].

The global crisis only indirectly affected the banking system. While none of the banks had any exposure to the toxic assets in advanced economies and haven't suffered any direct effects of the crisis, they had to bear the burden of rolling-over the short term foreign liabilities of the state-owned enterprises in Azerbaijan. Additionally, the Central Bank bailed out several state owned enterprises through commercial banks. After the outbreak of the global crisis, the banking system suffered a temporary crisis of confidence which resulted in the CBA providing liquidity support, introduction of government guaranteed credits and increase in deposit insurance coverage.

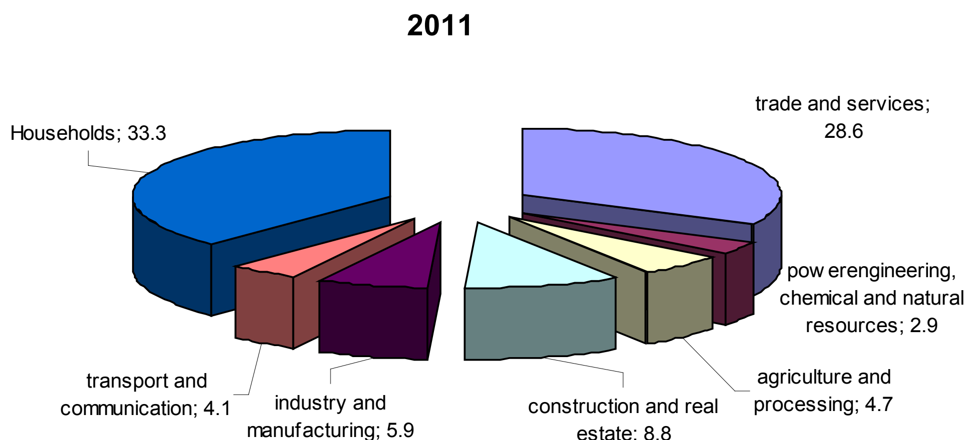
The government's recent efforts to promote growth in the non-oil economy have also contributed to the banking sector's growth and are expected to continue to do so. While the main pillar of the Azeri economy remains oil and gas production, the government continues to support other sectors against potential disruptions to the oil sector's growth and economy's high vulnerability to external shocks. In this respect, enhancement of economic diversification remains to be a prevailing issue. The growth of the non-oil sector has been largely fuelled by increases in government spending on large scale infrastructure and development projects in the areas of construction, accommodation and upgrading of the transportation systems. The high level of capital expenditure supports the banking sector development through boosting the non-oil sector and increasing the demand for further financial intermediation. Moreover, government-sponsored infrastructure projects are expected to create externalities as new lending opportunities for banks. The expected growth in both the oil and non-oil sectors of the economy will have implications for multiple sections of the economy including SME, corporate and retail: indirectly affecting the borrower's repayment capacity, improving the sector's asset quality and stimulating growth in the medium term.

The credit portfolio of Azeri banks has not changed much since 2008 and has been geared more towards retail lending. In 2011, 67% of total loans were allocated to retail loans, while 33% was non-retail. The sectoral breakdown of banks' consolidated loan portfolio shows that the largest share (33%) is held by households, mostly as consumer loans. This is followed by loans allocated to trade & services (28.6%) and to construction/real estate (8.8%). When compared with the 2008 figures, the most noticeable drops were in shares of loans allocated to 'power engineering' and 'transport/communication', which used to be 11.9% and 9.3% in 2008, respectively. Annual growth of credit to private sector has declined sharply in 2009 (See Fig.6), when credit to state-owned enterprises was increased by the government and CBA to overcome

[4] This issue was recently raised by the IMF, in its Article IV report on Azerbaijan, dated January 2012. Further information can also be found in 'Azerbaijjan: Banking System Outlook' published by Fitch Ratings, 2011.

the short-term funding difficulties encountered by these SOEs. This response decreased the amount of funds available to the private sector. Since then, credit to the private sector has been increasing, though it still has not reached the pre-2009 growth rate. Moreover, credit growth in local currency in the banking system has been driven by private banks since 2009. During this period, the share of credit provided by the state remained the same.

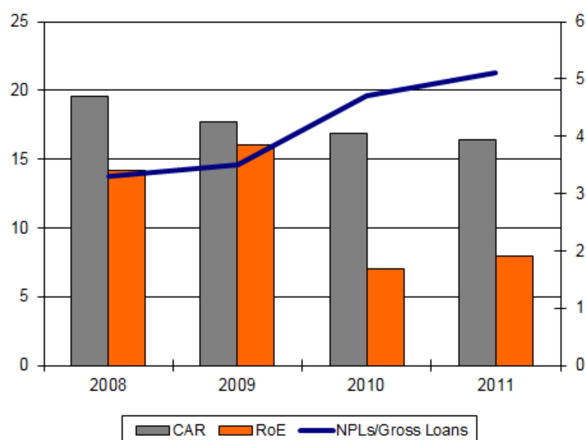
Figure 4. Sectoral Breakdown of the Credit Portfolio *(Source: CBA)*



The banking sector is well capitalised, particularly when IBA is excluded. The capital adequacy ratio of the consolidated banking sector has been above the regulatory minimum at 16.9% in 2010, except the IBA which has been historically undercapitalised, with a Tier-1 capital ratio of 7.6% at year-end 2010 and total CAR of 10.7%.

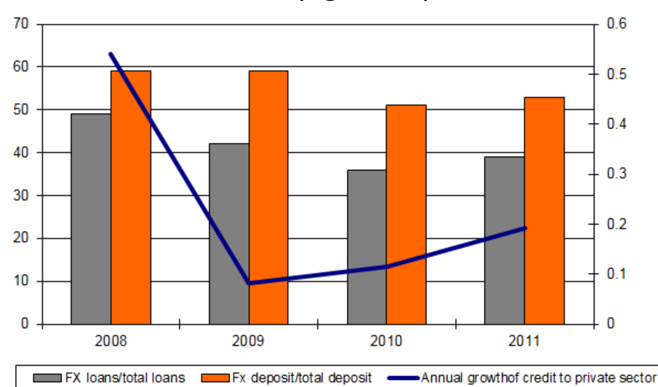
The profitability of the Azeri banking system has been decreasing. Banks' average return on equity was 7.9 in 2011, decreasing from much higher figures in the 2000s. During 2007-2009, bank returns on equity were above 14%, peaking at 16% in 2009. The recent drop in profitability may be partially explained by the IBA's poor performance and by rising loan loss provisions. Compared with rates of returns on equity in the rest of the ENCA region, Azeri banks have been less profitable in 2010 and 2011 with averages around 7% against 10%.

Figure 5. Banks' Performance Indicators (CAR-right axis) *Source: IMF, Fitch, CBA*



The level of non-performing loans (NPLs) has been on the rise since 2007, increasing from 3% of total loans to 5.1% of total loans in 2011. Though the details of official figures on banks' NPLs are not fully available, data at hand shows that NPLs started to increase during the 2008-2009 global crisis. This was followed by the deterioration of IBA's asset quality and increasing number of NPLs in its portfolio. Loan loss provisions were at 78% in 2011, above the regional average (63% in 2010) as well as above other developing regions except Latin America (140%).

Figure 6. Banking Sector Foreign Currency Denominated Loans and Deposits and Credit to Private Sector (right axis) *Source: CBAZ, IFS*



The problem of high dollarization is also evident in the Azeri economy and banking system, as it is in almost all ENCA countries. High dollarization as well as high credit concentration has been a key long-term vulnerability of the banking sector. The share of foreign currency denominated (FX) lending has decreased from over 50% in 2008 to 35.8% in 2010. Similarly, the share of FX deposits over total deposits has decrease from 66% in 2008 to 51% in 2010. The drop in FX lending decreases the unhedged currency risk and increases the overall asset quality of the banking sector. However, it is worth mentioning that the overall currency risk for the Azeri economy does not present a short-term risk given the high level of FX revenues.

Banks have sufficient liquidity positions: in 2011, the share of liquid assets in total assets was between 14-19%. However, as banks use liquid assets to finance credit growth, this high liquidity is likely to weaken. Banks' loan-to-deposit ratio has been high at above 1.4, except the sharp drop to 1.12 during the 2009 crisis. Given the limited access to international markets, banks tend to rely on domestic sources of funding including customer deposits (accounting for more than 50% of banks' funding), the CBA and interbank loans, term-funding from government organizations and international bilateral term borrowings. The reliance of banks on funding from the CBA increased to 17% of liabilities in 2010. Most of this type of funding is being used to finance government sponsored projects.

The Central Bank of the Republic of Azerbaijan Azerbaijan (CBA) operates as the central banking authority with supervisory control over the banking system. Azerbaijan has a two-tiered banking system, where the CBA makes up the first tier and the remaining banks make up the second. In addition to managing the monetary policy and inflation targeting, the CBA sets the banking prudential requirements including the reserve fund requirements. Though it is declared as an independent body, in practice there are strong linkages between the state, the central bank and state owned enterprises. For example, CBA funded around 15% of loans in 2011 under guarantees from the government. The central bank's strategic plan for 2011-2014 includes developing a risk-based supervisory framework as well as introducing new laws to facilitate financial sector growth through new instruments such as investment funds.

The minimum capital requirement for all the banks is AZN 10 million (USD 12.6 million). Raising capital requirements in 2007 has been a key tool for increasing the number of consolidations in the banking sector, encouraging smaller banks to merge. Under statutory capital adequacy guidelines, banks must maintain a minimum Total Regulatory Capital Ratio of 12% and a minimum Tier 1 Capital Ratio of 6%. In 2010, in order to prevent any future asset bubbles that may be induced by unbalanced growth of assets and capital, the CBA required the banks to maintain a maximum leverage ratio of 8%[5]. In 2011, the reserve requirements for banks' foreign currency liabilities were increased to 3%.

[5] Calculated as Tier 1 capital of the banks to balance sheet assets and off-balance sheet liabilities.

The largest market players in terms of assets and lending activity in the banking system are the International Bank of Azerbaijan (IBA), Kapital Bank, Bank Standard and Xalq Bank. Except the IBA, they are all privately owned. The largest bank in Azerbaijan, the IBA holds 36.5% of total assets.[6] As mentioned above, it dominates the banking system, and recently its asset quality and profitability as well as other performance measures have been deteriorating. The next largest banks account for much smaller portion of the system's assets and liabilities. The IBA and Kapital Bank have been assigned stand alone credit ratings of B2 (stable outlook) by Moody's, while Bank Standard and Xalq Bank have a rating of B3 (stable outlook).

Table 1. Largest 4 Banks' Market Position (as of the end of 3Q2011)

	Total Assets	Market Share			NPL	Net Profit/Capital
	(AZN mln.)	*% assets*	*% loans*	*% deposits*	*% total loans*	*%*
International Bank of Azerbaijan	4790	36.5	35.6	39	n/a	3.2
Kapital Bank	1170	8.9	9.8	9.6	n/a	3.7
Bank Standard	735	5.6	4.9	7	n/a	
Xalq Bank	668	5.1	5.7	6.2	2.9	3.5

Source: CBA

Going forward, the government's active involvement in promoting development and deepening of the financial sector is expected to have a positive impact on financial deepening. In the near future, SME financing is expected to increase through increasing intermediation through commercial banks and targeted government programmes. Facing this problem, the government announced plans of privatising the IBA. In addition, the strong linkages between the Central Bank and the government implies that there is an increasing need for a stronger banking supervision in the economy, for improving financial intermediation and increasing competition. The latter should help to eliminate the inefficient market players. Moreover, Azerbaijan and the financial sector would benefit greatly from decreasing red tape, better financial system infrastructure such as setting up a credit registry/bureau. Given the economy's strong outlook, supported by large oil revenue windfall, the government currently has the room and funds to invest into financial sector development, which should contribute notably to sustainable economic growth in the long-run.

Summary and Conclusions

Following the onset of the oil boom in 2003, the Azeri economy grew rapidly, with an annual average of 10.1%. In 2011, the growth rate was unexpectedly low at -1.1% amid a sharp decrease in oil output due to maintenance problems. Otherwise, the country weathered the global financial crisis well, and outperformed most of its regional peers as well as advanced economies. The economy enjoys a strong macroeconomic stance and outlook with high current account, fiscal and trade surpluses, fuelled by the surging oil prices and demand. During this period of high growth, government spending has been procyclical and increased substantially. The government implemented successful policies towards poverty reduction and inclusive growth, as well as other social reform packages. A major weakness of the Azeri economy is the lack of economic diversification, which may lead to unsustainable dependence on oil production and revenue. To overcome this problem, the government has been putting considerable emphasis on promoting growth in the non-oil industries (8.9% in 2011).

The financial sector is dominated by banks. There are currently 44 banks in total, only one of which is state-owned. The banking system is highly centralised and suffers from low competition. Banking sector penetration remains relatively low in Azerbaijan, also when compared with the other ENCA countries. In 2011, total assets of banks accounted for only 27% of GDP. Banks are well capitalised and have sufficient liquidity positions although they have recently been experiencing decreasing profitability and increasing NPLs. As most of the countries in the ENCA region, the banking system is highly dollarised. Given the limited access to international markets, banks tend to rely on domestic sources of funding including customer deposits (accounting for more than 50% of banks' funding), the CBA and interbank loans, term-

[6] The table below is based on data available at the end of October 2011, CBA.

funding from government organizations and international bilateral term borrowings. Most of the funding from the state is used to finance government sponsored projects.

Going forward, the government's active involvement in promoting development and deepening of the financial sector is expected to have a positive impact on financial deepening. In the near future, SME financing is expected to increase as a result of higher financial intermediation through commercial banks and targeted government programmes. The strong linkages between the government, the Central Bank and State Owned Enterprises imply that there is an increasing need for a stronger banking supervision in the economy.

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Table 2. Selected Macroeconomic and Financial Sector Indicators

	Azerbaijan				2010 median values for Emerging Regions			
	2008	2009	2010	2011	ENCA	EE	East Asia	Latin America
GDP per capita $	5213	4798	6008	7510	3013	8926	2549	6980
Real GDP growth (% change)	10.8	9.3	5.0	-1.1	6.4	1	7.7	5.3
CPI inflation (% change)	15	0.7	7.9	8.3	7.4	2.8	4.5	4
Current account balance (% GDP)	35.5	23.6	29.1	24.2	-8.3	-4.4	2.5	-2.1
Fiscal balance (% GDP)	20.3	7.2	15.0	8.5	-2.4	-3.9	-2.6	-2.0
Gross govt debt (% GDP)	7.3	12.1	10.8	10.7	26.6	41.4	49.4	36.3
Population	8.9	9.0	9.0	9.1	9.5	5.9	132.9	14.6
Banking System								
Assets/GDP	25%	43%	45%	53%				
Deposits/GDP	10%	21%	20%	25%	32	53	68	31
Loans/Deposits	176%	112%	135%	131%	145	99	76	87
Asset concentration (top 3 banks)				51%				
Number of banks	46	46	45	44				
NPLs/Gross Loans	3.3	3.5	4.7	5.1	12.5	11.9	3.6	2.4
CAR	19.6	17.7	16.9	16.4	20.5	15.8	16.0	16.4
RoE	14.2	16	7	7.9	10.7	3.3	16.7	18.7
Loan loss provisions/NPLs	0.67	0.77	0.79	0.78	63.2	54.6	74.2	140.8
Capital/Assets	0.16	0.18	0.17	0.17	14.6	10.2	9.6	10.1

Source: IMF, CBA, Fitch

Table 3. Total Bank Lending Breakdown

	2008	2009	2010	2011
% of total loans				
Trade and services	26.7	21.8	24.1	28.6
Powerengineering, chemical and natural resources	11.9	18.1	10.7	2.9
Agriculture and processing	3.7	4.7	4.8	4.7
Construction and real estate	6.4	6.9	7.2	8.8
Industry and manufacturing	6	6.4	7.4	5.9
Transport and communication	9.3	6.2	5	4.1
Households	32.6	27.7	29.5	33.3
Annual growth				
Trade and services	60.1%	-4.0%	-0.5%	55.9%
Powerengineering, chemical and natural resources	183.1%	78.0%	-0.2%	-80.9%
Agriculture and processing	32.7%	50.7%	-0.8%	19.4%
Construction and real estate	47.9%	24.8%	-0.3%	52.5%
Industry and manufacturing	38.8%	25.4%	-1.3%	10.2%
Transport and communication	42.7%	-22.3%	1.9%	-22.7%
Households	40.9%	-0.3%	-0.1%	42.6%
Retail	68%	72%	71%	67%
Non-retail	32%	28%	29%	33%

Source: CBA, Fitch, IMF

GEORGIA

By Andreas Kappeler, Economist, European Investment Bank

Georgia is a small transition economy with a GDP per capita of US$ 2,926 (US$ 5450 at PPP). It is rich in resources, with fertile land and a favourable climate that enable diverse agricultural production as shown by its long history of viticulture. Georgia has a considerable tourism potential with its Black Sea coast, snow-capped mountains and rich cultural heritage.

For the future, the main macroeconomic challenges are as follows:

- Georgia's resource potential has yet to be fully exploited and the economy remains constrained by a low level of diversification.
- Mastering the transition from recovery to durable growth is challenging. The authorities have to continue their efforts to take a proactive approach to economic growth, with emphasis on structural reforms in agriculture and reviving private investment.
- Despite recent progress toward bringing the external current account to a sustainable level, the deficit remains high. Further efforts to encourage foreign direct investment (FDI) are needed.
- Public debt is comparatively high. A significant adjustment is still required to reduce the fiscal deficit.

The banking sector of Georgia is small but comparatively sound, providing a buffer to face future challenges. Banks are endowed with comfortable liquidity and capital levels as well as a reasonable pace of credit growth. Moreover, it benefits from a relatively good business environment.

Although progress has been made in strengthening financial sector supervision, several challenges remain:

- The banking sector remains small and unsophisticated.
- As in many countries in the region, Georgia's banking sector is highly dollarised. This poses a significant indirect foreign currency risk on Georgian banks.
- Despite an otherwise comparatively sound banking sector, deposits and lending rates as well as the spread between them remain high, as does the profitability of banks. Compared to other countries in the region, this suggests that economic inefficiencies might exist moving interest spreads beyond a justifiable risk premium.
- Increasing credit growth while maintaining the quality of the loan portfolio in terms of NPLs will to stimulate the real economy. In this context, the loan portfolio should be diversified away from the construction sector.

Macroeconomic overview[7]

Georgia is a small, lower-middle income country. Its GDP per capita is at US$ 2,926 (US$ 5450 at PPP). It is rich in resources, with fertile land and a favourable climate that enable diverse agricultural production as shown by its long history of viticulture. Georgia is also rich in mineral deposits such as manganese, iron, coal, copper, gold, granite and mineral water. Its location along the silk route between Europe and Asia makes it a key transit conduit. Although Georgia was one of the Soviet Union's main agricultural producers, the break-up of collective farms has not been replaced by a market-based system and agriculture is now to large extent small-scale subsistence farming, accounting for 10 percent of GDP. The economy is dominated

[7] Main references: Partners for Financial Stability (2011) Moldova High Level Financial Sector Review. USAID; EIU (2012) Country Report Georgia, December 2011; WB (2011) Georgia - Country Development Agenda and Priorities.

by services, which account for approximately 69 percent of total production and are concentrated in trade, communications, financial intermediation and real estate. Industry accounts for roughly 21percent of GDP, comparable to the World average. Georgia has a considerable tourism potential with its Black Sea coast, snow-capped mountains and rich cultural heritage. Georgia is rated Ba3 stable by Moody's, S&P and Fitch.

Economic activity in Georgia collapsed after reaching independence in 1991. After independence in 1991, Georgia's economy collapsed under the impact of civil war, the loss of preferential access to the Former Soviet Union market and the loss of large budget transfers from Moscow. Output fell by 70 percent and exports by 90 percent, the worst decline suffered by any transition country. In November 2003, the peaceful Rose Revolution forced the resignation of former President Eduard Shevardnadze in favour of current President Mikhail Saakashvili.

During 2004-2008, the new government implemented far reaching strategic reforms centred on anti-corruption, economic stabilisation and fiscal management. Economic policies were guided by reliance on the private sector for growth in a highly liberal trade, investment and business environment and the country moved up to 16th out of 183 economies rated by the Doing Business Report 2012. Georgia's investment environment is among the best in the region. Growth in the past decade has contributed to a moderate reduction of poverty. Georgia is 75th out of 185 countries ranked by the 2011 Human Development Index; the poverty headcount is estimated at 24 percent. As a result, Georgia attracted substantial FDI, which was one of the main driving forces behind the strong economic growth and enabled the financing of a large current account deficit. Economic growth was strong during this period, averaging 10.5 percent per year, fuelled mainly by FDI and credit expansion in the real estate sector.

Georgia has suffered from the compounded effects of the global economic crisis and the military conflict with Russia in August 2008. In August 2008, Saakashvili attempted to regain control of the breakaway province of South Ossetia by force, leading to a brief but very damaging conflict with Russia. The armed conflict, coupled with the effects of the global crisis, has taken a toll on Georgia's economy, seriously dampening investor and consumer confidence, and has weakened support for the President and his administration. The economy contracted by 3.8 percent in 2009. However, due to counter-cyclical policies and low initial debt levels, the economy has rebounded strongly with GDP growth at 5.5 percent in 2011 and expected growth of 5.2 percent in 2012.

The budget deficit increased substantially during the crisis. It peaked at 6.5 percent of GDP in 2009, but is expected to remain below 2 percent of GDP in the mid-term. Government debt rose sharply from 27.6 percent of GDP in 2008 to 41.7 percent in 2010. However, due to robust growth expectations the debt burden is expected to steadily decline over the next few years.

In light of rising inflation, the main objective of the NBG remains price stability. Inflation has declined temporarily during the crisis but started to increase soon again. Declining to 1.7 percent in 2009, inflation has started to increase after the crisis but is expected to remain between 5 and 7 percent in the next few years. The National Bank of Georgia (NBG) has cut its main policy rate to 7.25 percent in several steps. Money growth has decelerated as expected after the post-crisis surge. Given that headline inflation has started to decline earlier than projected and that core inflation remains subdued, the authorities consider the current monetary stance to be appropriate. Though the Central bank has periodically intervened, the authorities remain committed to a flexible exchange rate. Looking ahead, the foreign exchange policy will be guided by the objective of increasing net international reserves.

Georgia's external position is characterised by a large current account deficit and FDI inflows. The current account balance has improved notably, from -22.6 percent of GDP in 2008 to -13 percent of GDP in 2011. Exports have increased from 28.6 percent of GDP in 2008 to 33.8 percent of GDP in 2010, imports declined from 58.4 percent of GDP in 2008 to 53.0 percent of GDP in 2010. Georgia's biggest export partner has traditionally been Russia (particularly for wine and mineral water). However following the 2006 embargo, Georgia has successfully re-oriented exports and today its biggest trading partners are Turkey, Azerbaijan, Ukraine China and the US. Private capital inflows – including FDI - have been financing the current account at the beginning of the global financial crisis. During the crisis these capital inflows have declined by almost 60 percent but started to pick up soon again. Having said this,

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remittances increased during the crisis and declined only recently (6.9 percent of GDP in 2010 compared to 7.6% in 2008).

For the future, the main macroeconomic challenges are as follows:

- Georgia's resource potential has yet to be fully exploited and the economy remains constrained by a low level of diversification.
- Mastering the transition from recovery to durable growth is challenging. The authorities have to continue their efforts to take a proactive approach to economic growth, with emphasis on structural reforms in agriculture and reviving private investment.
- Despite recent progress toward bringing the external current account to a sustainable level, the deficit remains high. In this context, further efforts to encourage foreign direct investment (FDI) are needed.
- Public debt is comparatively high. Further adjustments are required to reduce the fiscal deficit.
- Public sector management and budgetary processes have to be strengthened. This also includes necessary judiciary reforms as well as the implementation of anti-corruption measures.
- Municipal and other infrastructure should be improved. Major challenges include rehabilitation of physical infrastructure and restructuring of municipal enterprises to improve efficiency.

Table 1: Macroeconomics Indicators

	2007	2008	2009	2010	2011	2012
GDP per capita (USD)	2,326	2,937	2,455	2,629	3,098	3,358
Real GDP growth (% change)	12.3	2.4	-3.8	6.4	5.5	5.2
CPI Inflation (% change)	9.2	10.0	1.7	7.1	9.6	5.0
Current Account Balance (% of GDP)	-19.7	-22.6	-11.2	-9.6	-10.8	-9.2
Fiscal Balance (% of GDP)	0.8	-2.0	-6.5	-4.8	-2.2	-2.3
Gross government debt (% of GDP)	21.5	27.6	37.3	39.1	36.8	38.0
Population (Millions)	4.4	4.4	4.4	4.4	4.5	4.4

Source: IMF, WB

Banking Sector Overview[8]

The Georgian financial system is overwhelmingly dominated by commercial banks. Indeed, banks account for 93 percent of total assets. Other market segments are underdeveloped. There are currently 19 banks, 18 credit unions, 59 micro-finance institutions, 15 insurance companies, 7 pension funds, 1 stock exchange and 9 brokerage companies operating in Georgia.

[8] Main references: Partners for Financial Stability (2011) Moldova High Level Financial Sector Review. USAID; IMF (2011) Georgia: Ninth Review Under the Stand-By Arrangement… IMF Country Report No. 11/146; NBG (2011) Financial Stability Report Georgia, Tbilisi.

Table 2: Characteristics of the Financial System

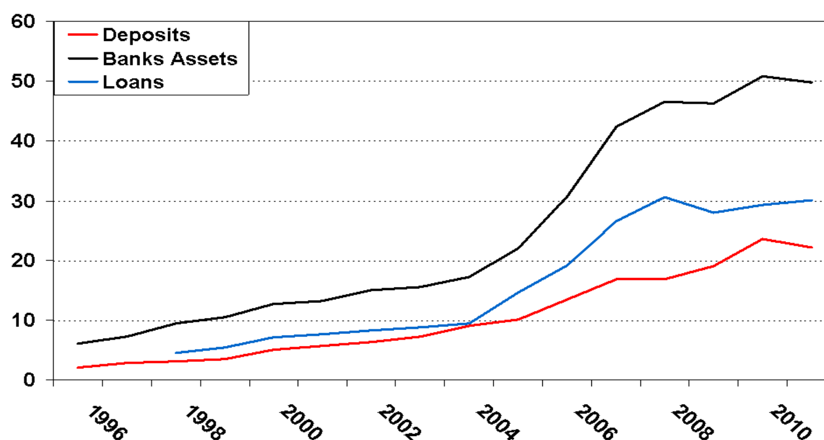
	Assets/GDP (%)	Market share (% of total assets)	Private ownership (% of total)	Foreign-ownership (% of total)	Number of institutions
Commercial Banks	50.8	93.4	100	82	19
Micro-Finance Institutions	1.5	2.7	n/a	n/a	59
Credit Unions	0	0	n/a	n/a	18
Insurance Companies	2.1	3.9	100	n/a	15
Pension Funds	0	0	n/a	n/a	7

Source: NBG

Although the non-bank financial sector has been growing rapidly, it remains unsophisticated and small by any standards. Non-bank financial institutions account for only 6.6 percent of consolidated assets of the financial system. Having said this, the micro-finance sector has grown rapidly in recent years. The insurance market is very small with total assets equal to 2.1 percent of GDP. The stock market is also underdeveloped. As of February 1, 2011 138 companies were traded, with total market capitalization of USD 1.1 billion and the average daily turnover of USD 9 949. Although there are 18 credit unions, their total consolidated assets as of June 2011 were a mere GEL 3.2 million.

Georgia's banking sector has undergone extensive structural changes but remains small. The number of commercial banks decreased from over 200 to 19 in 2011. Today, the Georgian state has no ownership in the banking system. But there are several banks, which have state ownership of other countries. Foreign owned banks dominate the banking sector (82 percent of capital is externally owned). Concentration is high with the two largest banks (TBC Bank and Bank of Georgia) accounting for 60 percent of total assets. As the chart below shows the banking sector has increased considerably but remains small by any standards. Total loans are at 30.1 percent of GDP and deposits at 22.2 percent of GDP. This is below the regional average and well below what can be observed in most Eastern European countries.

Georgia – size of the banking sector *(Source: NBG)*



Regulation and Supervision

The NBG is responsible for the supervision of banks and non-bank financial institutions. The NBG has a high degree of independence and its activities are directed by the Constitution of Georgia and by the law on the National Bank of Georgia. The NBG also acts as lender of last resort.

Banking legislation reflects the Basle I principles, however in practice requirements to banks remain more conservative. The supervisor is progressing toward risk-based supervision, which should increase the efficiency of supervision and allow risk to be better reflected in the intermediation margins of banks. Under the new law on commercial banks, the

supervisor is authorised to adjust regulatory requirements based on bank-by-bank risk assessments. In the near future NBG will introduce new capital adequacy requirements, which will be in line with Basel II standardized approach. These requirements will already incorporate some elements of Basel III including liquidity coverage ratio (LCR) and net stable funding ratios (NSFR).

A series of measures were and are in the process of being adopted to strengthen financial sector supervision: enhanced monitoring of banks, notably by re-organizing the banking supervision department, and conducting regular stress tests; adoption of a contingent plan for dealing with crises scenarios and bank resolution and expansion of central bank's powers over banks under temporary administration granted through the amendment of the NBG's organic law. Other regulatory changes include: transparency regulation, regulation on internal audit and internal risk management. NBG will also revise asset classification/provisioning, as well as regulation on interest conflict and high risk concentration. In order to strengthen banking sector reliance NBG will introduce more prudent regulation on bank licensing.

Performance and Soundness of the banking Sector

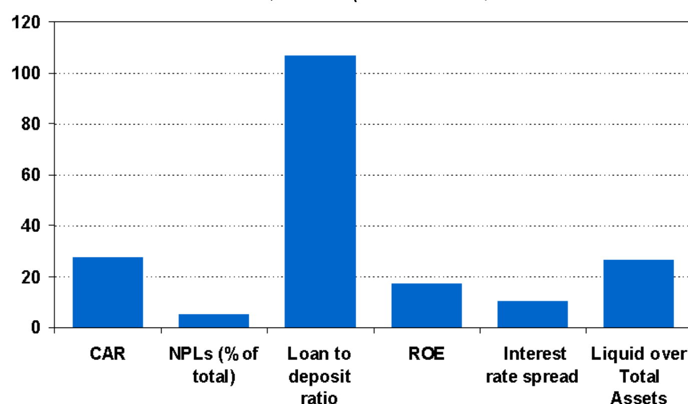
The banking sector of Georgia is comparatively sound, providing a buffer to face future challenges. The sector entered the crisis with large capital buffers, which combined with more than US$300 million capital and liquidity injections by the IFC and EBRD as well as emergency liquidity provided by the NBG after the conflict, enabled the banking sector to weather both the liquidity shock and the large deterioration in the quality of the loan portfolio. Georgia's banking sector is well capitalised compared to other countries in the region, with a regulatory capital adequacy ratio of 27.5 percent according to Basle I definition - well above the 12 percent requirement.

Banks in Georgia are characterised by a high level of liquidity. After declining during the crisis, indicators are back to comfortable levels and continue to improve: Liquid-assets to 6-month and shorter liabilities are at 42.3 percent of total assets - well beyond the minimum liquidity ratio requirement, which has been raised back to 30 percent after the crisis.

Although the ratio of NPLs increased considerably during the recent financial crisis, it remained below the level in other countries in the region. NPLs were at 4.4 percent in mid-2011. Provisioning seems adequate.

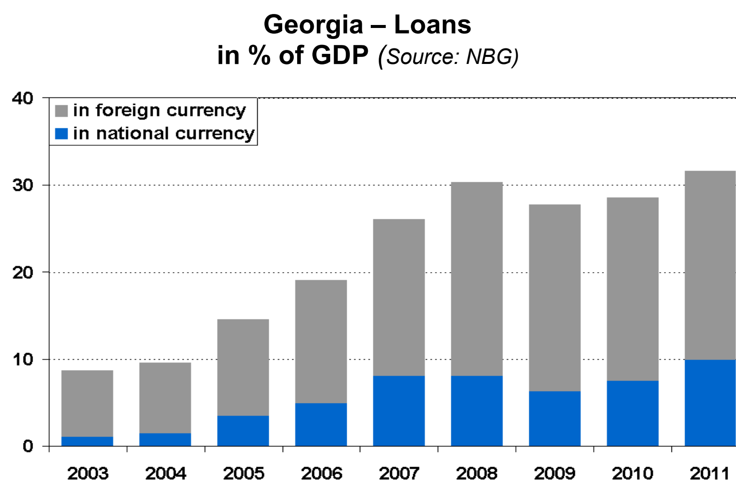
Profitability of banks has declined sharply during the crisis but recovered quickly thereafter. After turning negative in 2008, return on equity reached 17.3 percent in 2011. One reason for the high profitability of banks is the high spread between lending and deposit rates (10.4 percent in 2011). Domestic lending rates and deposit rates taken individually are also high (14.9 and 10.9 percent, respectively). Compared to other countries in the region, this suggests that economic inefficiencies might exist, which move interest spreads beyond a justifiable risk premium. Having said this, because of increasing competition and improved regulation it is expected that banks' profitability will remain markedly lower than it was 5-10 years ago.

Financial Sector Indicators, Georgia
in %, 2011 *(Source: NBG)*



The chart below shows that Georgia's banking sector is characterised by extremely high dollarisation. In 2011, 73.4 percent of loans (and 70.8 percent of deposits) were nominated in foreign currency (mainly US$). Since the currency denomination of assets largely matches that of liabilities, the direct exposure to exchange rate risk is limited. Indirect exposure through the balance sheets of unhedged borrowers however is substantial. In addition dollarisation limits the use of exchange rate as a policy instrument in crises and limits monetary policy effectiveness.

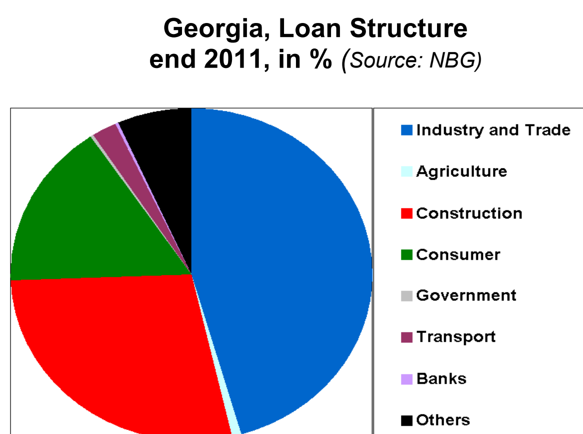
Georgia – Loans
in % of GDP *(Source: NBG)*



Credit growth remains subdued. The compounded effects of the August 2008 conflict with Russia and the global financial crisis resulted in a confidence shock and a decline in credit to the private sector, especially to SMEs. Since 2010, the loan to GDP ratio has been increasing again, though more moderately than prior to the crisis. Access to credit and the cost of finance are perceived as major obstacles to private sector activity.

As to the loan structure, loans to industry and trade make up 45 percent of all loans, construction accounts for 28 percent. Recently, however, banks have become more cautious in providing loans to risky real estate and construction sectors, as rapid pre-crisis growth in these sectors led to major asset quality problems during the crisis of 2008-2009.

Georgia, Loan Structure
end 2011, in % *(Source: NBG)*



Deposit growth has outpaced credit growth since 2008. The loan to deposit ratio is currently at 106.9 percent, compared to 155.9 percent in 2008. However, the simultaneous increase in deposits in foreign currency (63 percent of total in 2007 vs 76 percent in 2011) is not without problems: While non-resident deposits can provide diversification benefits, they may also create new financial stability risks, owing to the potentially volatile nature of these inflows. To limit reliance on non-resident deposits as a funding base for domestic lending, the authorities are planning to introduce a 100-percent marginal liquidity requirement on non-resident deposits in excess of 10 percent of the deposit base.

Challenges

Although a series of measures were adopted in recent years and progress has been made in strengthening financial sector supervision, several challenges remain:

- The banking sector remains small and unsophisticated.
- Despite the easing of liquidity conditions, deposits and lending rates as well as the spread between them remain high. Compared to other countries in the region, this suggests that economic inefficiencies might exist moving interest spreads beyond a justifiable risk premium.
- As in many countries in the region, Georgia's banking sector is highly dollarised. This poses a significant indirect foreign currency risk on Georgian banks.
- Increasing credit growth while maintaining the quality of the loan portfolio in terms of NPLs is necessary to stimulate the real economy. In this context, banks have to find a way to diversify their loan portfolio away from the construction sector.

Table 3: Banking Sector Indicators

	2007	2008	2009	2010	2011
Assets / GDP	26.6	30.6	28.0	29.3	30.1
Deposits / GDP	16.8	16.9	19.1	23.6	22.2
Loans / GDP	26.6	30.6	28	29.3	30.1
Loans / deposits	120	155.9	124.2	107.6	106.9
Asset concentration (top three banks)	66.5	66.3	64.8	69.3	68.7
Number of banks	18	20	19	19	19
NPLs/Gross loans	0.8	4.1	6.3	5.4	5
CAR	30	24	25.6	23.6	27.5
Return on Equity (ROE)	11.3	-12.6	-4.3	9.6	17.3
Loan-loss provisioning / gross loans	1.3	6	9.8	6.5	6.3
Capital / Assets	16	13.9	19.1	17.4	16.2

Sources: NBG and IMF

Analysis of the leading banks

This section focuses on the 10 largest banks in Georgia. The 10 largest banks account for 95 percent of the total banking sector (in terms of assets). The two largest banks, BOG and TBC together have a market share of 61%.

As to the ownership structure, there are no publicly owned banks in Georgia. However, the chart below shows that Georgian banks are mainly foreign owned. Cartu Bank is the only bank without any foreign ownership. The bank with the second largest share of domestic ownership is TBC bank, which at the same time is the bank with the largest involvement of IFIs (EBRD, IFI among others).

Table 4: Shareholder - origin

	Local	Foreign	IFI
BOG	0%	100.0%	0%
TBC	35.9%	64.1%	54.7%
ProCredit	0%	100.0%	24.6%
Liberty	1.1%	98.9%	0%
Republic	7.5%	92.5%	8.5%
Privat	0%	100.0%	0%
Cartu	100.0%	0.0%	0%
VTB	0%	100.0%	0%
KOR	0%	100.0%	0%
IBA	12.5%	87.5%	0%
Total Banking Sector	18.0%	82.0%	

Sources: NBG

A considerable variation of Non-performing loans and profitability is reported by the 10 largest banks. Cartu and Privat Bank reported the highest ratio (30 % and 20% respectively). The lowest NPL ratio was reported by Privatbank (4.3 %). Also profitability varies considerably across banks. Bank Republic was the only bank reporting a negative ROE in 2011. TBC was the bank with the highest ROE (30%).

Table 5: Major banks

BOG	The principal shareholder is BNY (NOMINEES) LIMITED. The bank is rated BB- by Fitch and S&P and B1 by Moody's.
TBC	The bank operates primarily in Georgia but is also active in Azerbaijan through a subsidiary. The EIB signed is up to sign a 50 mln SME loan with TBC bank in the first half of 2011. The main final beneficiaries are TBC HOLDINGS LTD, EBRD, IFC, Mamuka Khazaradze. The bank is rated B+ by Fitch and B1 by Moodys.
ProCredit	The bank is 100 percent owned by the German based ProCredit Holding AG The main final beneficiaries are IPC, KfW, DOEN, IFC, TIAA-CREF. The bank is rated BB by Fitch
Liberty	The bank is rated B by Fitch
Republic	The principal shareholder is Societe General
Privat	Final beneficiaries are two individuals: Gennadiy Bogolyubov and Igor Kolomoisky
Cartu	The only shareholder is Jsc "Cartu Group" which is owned by a Georgian oligarch.
VTB	The principal shareholder is the Russian JSC VTB Bank, The bank is rated BB by Fitch
KOR	The principal shareholder is H.H Sheikh Nahayan Mabarak AL Nahayan
IBA	The principal shareholder is OJSC "International Bank of Azerbaijan"

Sources: banks' websites, annual reports, Internet research.

The next chart shows that banks also vary considerably in terms of loan structure. Note that the loan structure is approximated by the interest income from each sector. The two largest banks, BOG and TBC show a relatively similar loan structure with half of their interest income stemming from individual loans, followed by services. In contrast, interest income from services is more important for ProCredit and CARTU. IBA does not offer individual loans; the share of individual loans is small for CARTU and KOR.

Georgia, Loan Structure by Bank
In %, September 2011 *(Sources: NBG)*

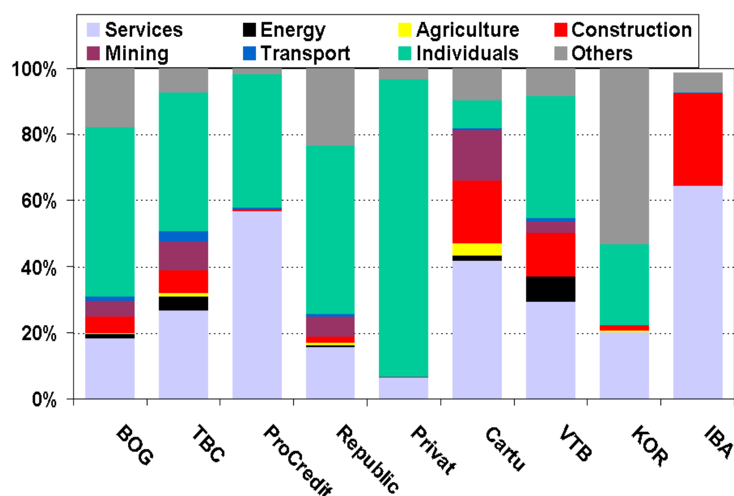


Table 6. Analysis of Leading Banks, December 2011, monetary values in mln GEL

	Market Share (Assets)	Assets	Loans	Deposits	ROA	ROE	NPLs (% of total)	Regulatory Capital Ratio	Ownership structure	Liquid assets (% of total)
BOG	35.62%	4515.7	2669.7	2621.1	3.81%	22.64%	8.04%	15.04%	foreign owned	21.89%
TBC	25.43%	3224.1	2019.5	2078.7	4.46%	29.93%	5.55%	12.82%	foreign owned	19.46%
Procredit	7.68%	973.8	680.6	524.2	1.92%	14.20%	4.27%	15.47%	foreign owned	21.56%
Libery	5.91%	749.5	358.5	616.7	1.88%	21.36%	n/a	13.37%	foreign owned	22.12%
Republic	5.39%	683.7	472.1	366.2	-2.54%	-18.79%	19.72%	13.16%	foreign owned	20.68%
Privat	3.60%	457	255.2	250.4	0.90%	7.50%	9.15%	13.95%	foreign owned	42.61%
Cartu	3.42%	433.8	366	82.5	3.01%	10.62%	30.06%	35.44%	private	10.77%
VTB	3.38%	428.9	304.1	185.9	2.71%	15.62%	16.48%	20.08%	foreign owned	19.89%
KOR	3.17%	401.5	195.9	309.3	0.77%	3.83%	6.68%	15.46%	foreign owned	37.56%
IBA	1.33%	168.8	66.3	132.1	1.55%	8.18%	11.02%	56.32%	foreign owned	59.68%
Sector	100.00%	12679.1	7739.1	7352.2	2.85%	17.26%	11.90%	17.30%		22.41%

Source: NBG

Conclusions

The transition from recovery to durable growth against an external environment that remains unsettled remains challenging. Georgia came through the crisis in relatively good shape. The authorities have taken a more proactive approach to economic growth, with emphasis on structural reforms in agriculture and targeted public investment to improve productivity and attract private investment. Despite the significant external adjustment already achieved since 2008, the current account deficit remains high. This is a consequence of the country's reliance on external borrowing and remittances.

Given the income level of Georgia its banking sector looks healthy with comfortable liquidity and capital levels. Georgia's banking sector has emerged from the crisis in a relatively solid position. Moreover, it benefits from a relatively good business environment.

Nevertheless, looking forward the banking sector faces a number of challenges. The banking sector remains small and unsophisticated. Moreover, the dollarisation of the economy remains extremely high and poses a significant indirect foreign currency risk on Georgian banks. Deposits and lending rates are high as is the interest rate spread and the profitability of banks. Compared to other countries in the region, this suggests that economic inefficiencies might exist moving interest spreads beyond a justifiable risk premium. Having said this, competition in the banking sector has recently intensified, which is likely to put pressure on banks' margins. Increasing credit growth while maintaining the quality of the loan portfolio in terms of NPLs is necessary to stimulate the real economy. Moreover some banks have to find a way to diversify their loan portfolio away from the construction sector.

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KAZAKHSTAN

By Hans Holzhacker, Chief Economist, ATF Bank - Unicredit Group

Kazakhstan's banking system: in need of faster fixing and of more long-term liquidity

- Kazakhstani real GDP growth impressively recovered to 7.3% in 2010 and 7.5% in 2011 from only 3.3% and 1.2% in 2008 and 2009, respectively. However, in 1Q 2012 economic growth slowed to 4.6% yoy. The danger of not reaching the 7% growth target set by the President might prompt the authorities to ease economic policy and to speed the solving of banking system problems.

- Since late 2010, economic growth has been accompanied by credit growth. Demand for loans by manufacturing, renewed loan demand by trade after significant deleveraging and demand for loans by construction because of large government-sponsored infra-structure projects and a recovery in the housing market that began in late 2010 should keep lending growth significantly above inflation also over the coming years.

- Growth in deposits has slowed in 2011 as fast growth in household deposits still largely compensated relatively weak growth in corporate deposits. However, the increase in household deposits was thanks to income increases at a pace that hardly will be repeated. Companies in turn will to a larger extent than previously draw down their savings when investment will pick up more broadly-based. Hence deposit growth is likely to decelerate further. Liquidity, though still at comfortable levels, has become scarcer.

- Deposits account for almost 70% of liabilities now. Most of them can be withdrawn easily and fast due to legislation typical for CIS countries. Measures to make the funding base more stable would ease the introduction of Basel 3 regulations intended by the authorities already for 2013. More importantly, stable long-term funding would help avoid maturity mismatches and thus make financial intermediation more efficient and cheaper.

- In particular for long-term funding some re-increase in foreign financing of the banking system is desirable. Given the current international environment, there is little danger that foreign refinancing would reach again the excessive volumes seen in 2006-2007. Bringing down the high share of non-performing assets and solving the open issues around the country's formerly largest bank, BTA, would be supportive for a revival of foreign funding. Financing by the International Financial Institutions has to play a role in making Kazakhstan's funding base more stable and long-term.

Kazakhstan's economic growth was mostly consumption driven in 2010-2011; investment growth still needs to accelerate

Kazakhstan's real GDP growth impressively recovered to 7.3% in 2010 and 7.5% in 2011 from 3.3% and 1.2% in 2008 and 2009, respectively. This was made possible by strong terms of trade gains thanks to high global commodity prices, which fuelled income growth and consumption. Investment has by contrast remained rather weak. The Kazakhstani currency, the tenge, has remained broadly stable since February 2009 when it was devalued by about 20% against the USD. Sufficient international reserves have allowed the central bank to keep tenge fluctuations minimal since. The central bank appears to unwilling to let the tenge deviate very much from its current parity to the USD at least in the absence of significant shocks, e.g. large RUB devaluation. It might however allow slightly higher volatility in future. We forecast real GDP growth to slow to 5.5% in 2012 as increases in incomes and consumption continue, but at somewhat slower pace. In order achieve the 5.5% growth in 2012 and higher growth long-term, investment has to pick up however, particularly in the oil industry.

In 1Q 2012 economic growth slowed to 4.6% yoy, according to the Statistical Agency's short-term economic indicator, based on 67-68% of GDP, industrial output rose a mere 2.9 % yoy. Investment outlays increased only 3.1% yoy in real terms in 1Q and fell 6.5% yoy in mining. Inflation eased from a peak of 9.0% in August 2011 to 5.9% yoy in January 2012 and further to 4.7% and 4.6% in February and March, significantly below the central bank's 6-8% inflation

target. In response, the central bank cut its 1W-refinancing rate from 7.5% to 7.0% as of 14 February 2012 and to 6.5% as of 1 April 2012.

The recent growth weakness endangers the 7% real GDP growth target set by President Nursultan Nazarbayev and discussions on how to respond have intensified. The 7% growth target is also underlying the government's 2012-2015 growth and diversification plan (table 1). The President hinted in his annual address to the nation in January that more of the National Oil Fund should be used for domestic purposes instead of being invested in low yielding foreign government paper and that a series of new industrial projects should be financed by this. Central bank governor Grigory Marchenko said that large industrial projects must also seek financing through public-private partnership. The central bank's Financial Stability Report, published end-January, points out that Kazakhstan may have to loosen bank regulation to sustain economic growth and to encourage investment.

Table 1. Planned growth by sector

% yoy	2011	2012	2013	2014	2015
Agriculture	5	4.5	4.4	5	4.9
Industry	6	6.5	6.2	7.8	9.1
Mining	3.6	3.8	2.2	4.3	10.9
Manufacturing	9.7	11.5	12.6	13.2	7.5
Electricity, gas, water	6.4	3	3.8	4.4	5.6
Canalisation, waste disposal	4	2.7	3.5	4.1	5.3
Construction	2.5	3.1	1.8	1	0.7
Services					
Trade	12	10	9	8.6	8.2
Transportation	7	7.5	7.2	8	7.7
Telecom	7	8	8	9	8
GDP	7	6.9	6.5	7.1	7.4

Source: Direction of social-economic development 2011-2015, adopted by the government on 23 June 2011

Table 2. Investment spending envisaged and funds identified by the government

KZTbn	2011	2012	2013	2014	2015	2011-2015	2011-2015 Eurbn
Required investment outlays	5763	6113	6399	6989	7565	32829	159
Identified, among them	5628	5313	5133	5259	5289	26622	129
Own funds of companies (amortization)	2573	2530	2680	2467	2665	12916	62
Budget	1230	1055	853	1258	1280	5675	27
Own new funds of companies	897	796	661	593	399	3346	16
Private funds for upgrading housing	29	32	38	42	45	185	1
FSI	900	900	900	900	900	4500	22
Not yet identified	136	800	1266	1730	2276	6207	30

Source: Direction of social-economic development 2011-2015, adopted by the government on 23 June 2011

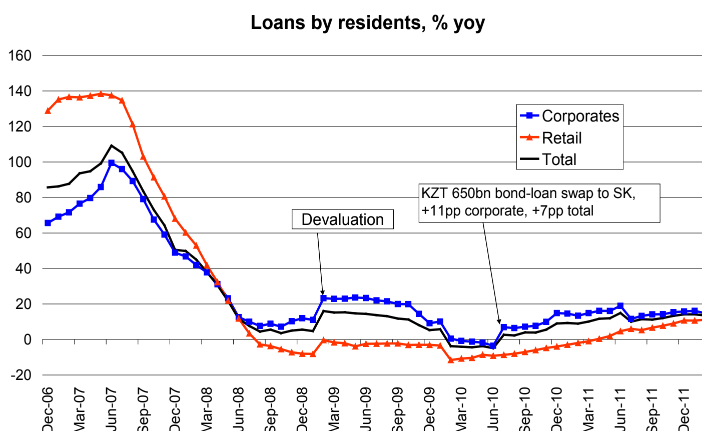
The government estimates that investment outlays of about EUR 160bn are required in 2011-2015 to achieve the government's growth targets (table 2). Of this amount, 50% are envisaged to come from own funds of companies and individuals, 17% from the budget, 24% from foreign funding, and 19% from other sources. The "not yet identified" part shall be provided via PPP, bank loans etc. Actual financing shifted in early 2012 towards own company means and budget funds. Financing by own company resources increased to 55% from 46% a year earlier in Jan-Feb 2012, financing by the state from to 12% from 8%, financing by investment from abroad fell to 24% from 36%. Financing by loans from domestic banks has remained unchanged at 10%. We believe that a combination of sources will be needed to finance the "unidentified" EUR 30bn, including National Oil Fund spending, bilateral government and IFI loans, as well as foreign funding along with the mobilization of private domestic means.

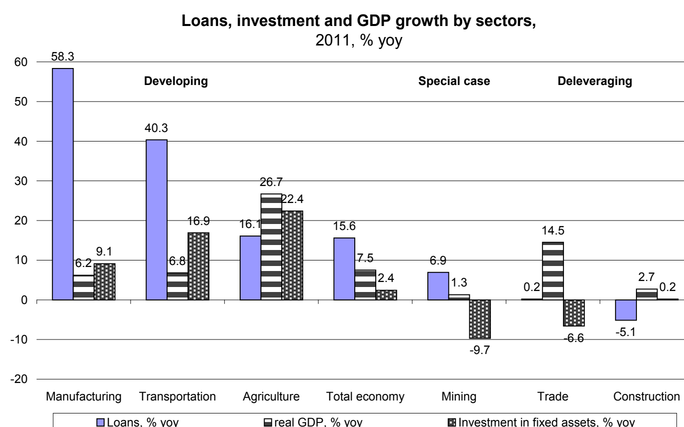
Credit growth has accelerated

Since late 2010, economic growth has been accompanied by higher lending. Credit growth (to residents) accelerated to 14.2% yoy in Dec 2011 from 9.0% yoy in Dec 2010. Loans to companies (75% of the total) were up by 15.6% in 2011 and loans to individuals (24% of the total) up 10.7% (chart 1). The narrowing in the gap between lending and deposit growth has reduced banking system liquidity from abundant to normal.

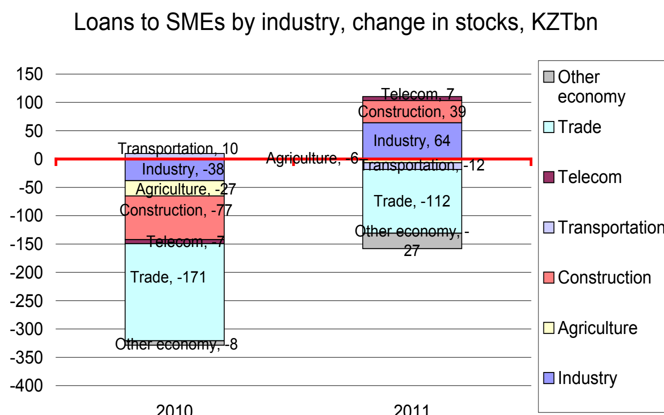
Loans grew fast to manufacturing and transportation, while stagnating or declining to trade and construction (chart 2). There is an increase in lending to industry-related SMEs, but ongoing deleveraging to SMEs in trade and some other services (chart 3). Lending to households for consumption purposes (including cars) rose fast in 2011, whereas lending for housing has picked up only slightly (chart 4).

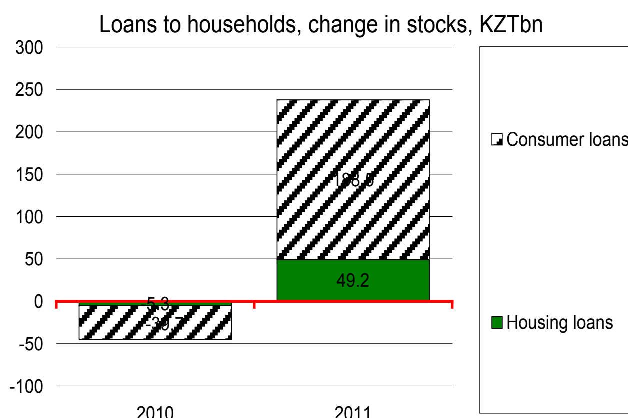
Charts 1 and 2: Economic growth has been accompanied by loan growth, particularly to manufacturing and transportation *(Source: NBRK, ASRK, ATFBank Research)*





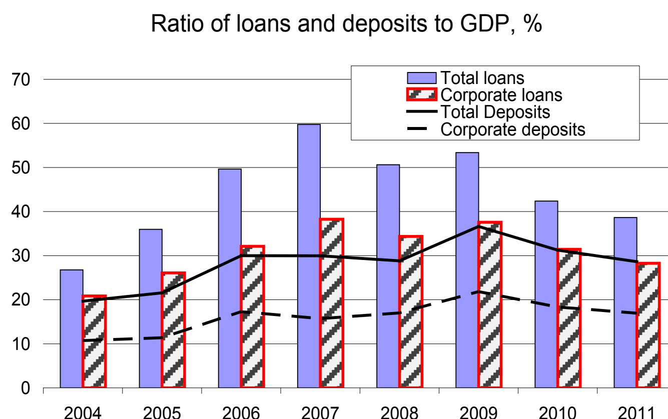
Charts 3 and 4: While lending to SMEs in industry has increased, SMEs in trade still deleverage; lending to households was predominantly for consumption purposes
(Source: NBRK, ATFBank Research)





We expect loan growth to remain significantly above inflation also in 2012, even though many banks continue to focus on work-out and companies remain cautious not to re-increase their debt burden. Loans over GDP have significantly fallen from the 2007 peak (chart 5). There should not be much of a further decrease, at least not for standard loans (chart 6).

Charts 5 and 6: Loans over GDP are almost back to 2005 levels; standard loans have not increased since 2006 *(Source: NBRK, ATFBank Research)*



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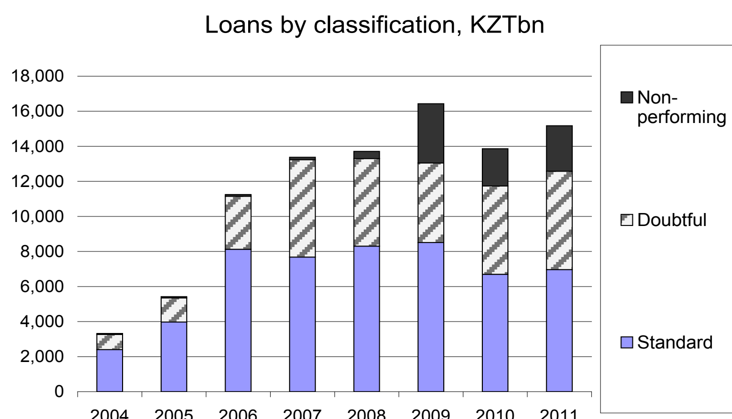
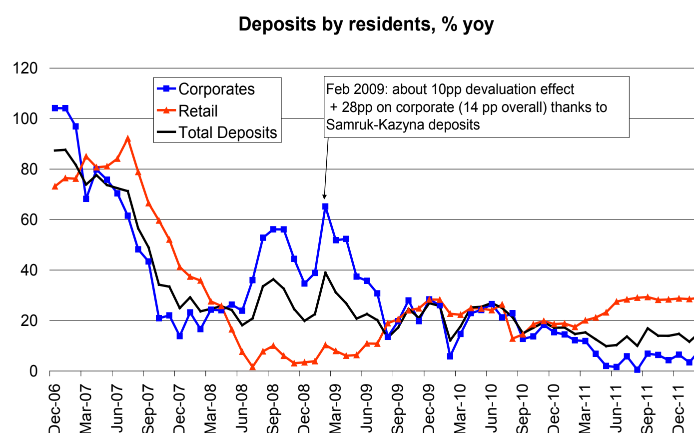


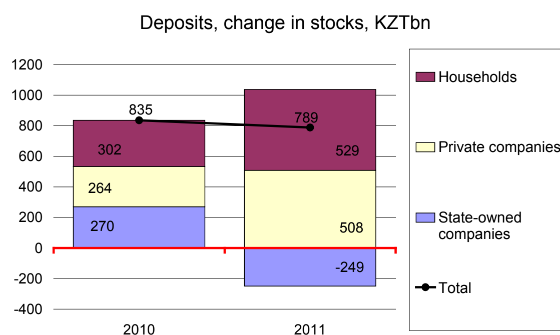
Demand for loans should continue to come from manufacturing (particularly metals, food, and chemicals) while large government-sponsored infra-structure projects and also the recovery in the housing market that began in late 2010 should revive lending to construction. Trade contributed much to GDP growth in 2010 and 2011. Thanks to little investment while revenues recovered the trading industry obviously managed to run its business with little new borrowing (on average while many businesses deleveraged). Such a situation cannot last for very long however and we believe that 2012 will be a turning point.

Deposit growth has slowed

Growth in deposits by residents slowed to 14.7% in 2011 from 17.1% in 2010 (chart 7). Fast growth of household deposits compensated for weak growth in corporate deposits in 2011 (chart 8). Growth in corporate deposits decreased to 6.5% from 15.4%, whereas growth in retail deposits accelerated to 28.7% yoy in 2011 from 18.6% in 2010. However, this was driven by wage hikes resulting in 22.5% higher nominal wages in December 2011 than the year before and 10.1% yoy higher wages in real terms. Though wage growth will continue, this will be hardly at the pace of 2011. Companies will to a larger extent than previously draw down their savings when investment picks up. 2012 will thus likely see a further deceleration in deposit growth.

Charts 7 and 8: Growth in corporate deposits has slowed, household deposits have stepped in to some extent *(Source: NBRK, ATFBank Research)*



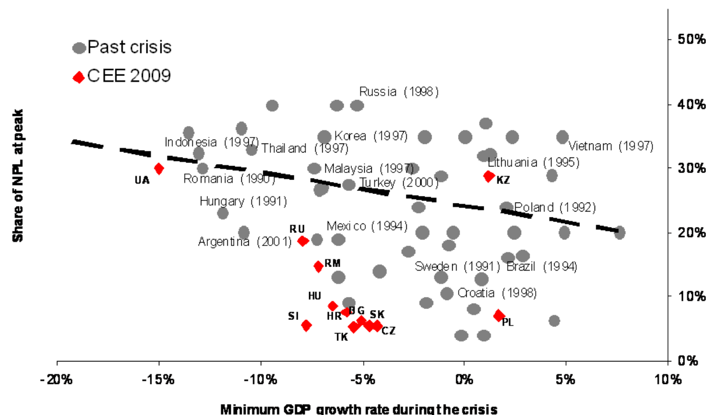


Faster tackling of bad loans and measures to stabilize the long-term funding base would support growth and diversification

Bringing the banking system back to more normal levels of non-performing assets and securing a long-term stable funding base would make financial intermediation more efficient and would contribute to making lending cheaper not only to a small number of prime borrowers but also to the broader economy. This in turn would help spur economic growth and diversification.

The drying up of foreign funding in the 2007 sub-prime crisis let the Kazakhstani real estate bubble collapse and left the banking system with a very high share of non-performing assets. Until 2007, Kazakhstan's economic growth was predominantly based on two components: fast growth of the oil and gas industry with the help of foreign direct investment and cheap foreign funding of the banking system channeled to a large extent into real estate projects. Only Ukraine "achieved" among the CEE countries a comparably high NPL figure in 2009, however this was at GDP growth of -16% vs +1.2% for Kazakhstan (chart 9).

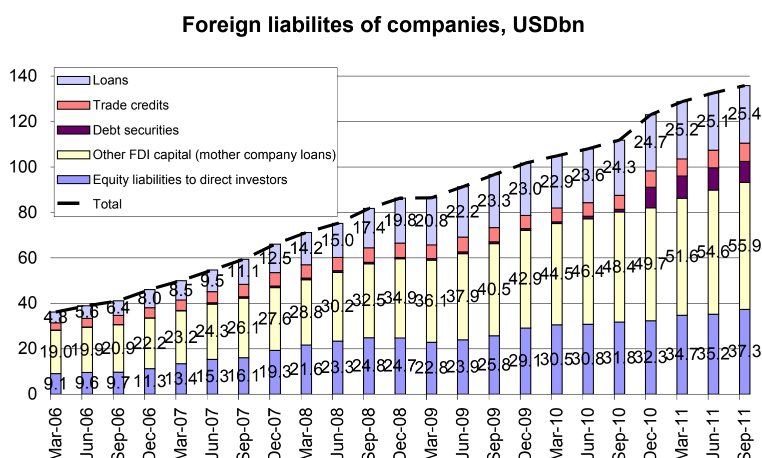
Chart 9: Only Ukraine has an NPL ratio comparable to Kazakhstan



Source: Bloomberg, National Statistics Agencies, Unicredit Research

The reason that Kazakhstan weathered the 2008-2009 crisis nevertheless quite well is Kazakhstan's two sector (resources and non-resources) economy, with the oil sector depending relatively little on bank lending. It is noteworthy that foreign funding of the Kazakhstani corporate sector (other than through the domestic banking system) is at USD 140bn (chart 10) almost 3 times the funding by loans from domestic banks (KZT 7.9trn, about USD 54bn). Little of this was withdrawn, only in 1Q2009 there is a marginal dent in the curve. The bulk of foreign investment goes to the oil industry, with a high share of financing by mother companies. The abundance of oil, and the fact that oil field development is in its early stages, stabilized the Kazakhstani economy. The stable economy and the deposits by the resources companies with the banks stabilized in turn the banking system. No major bank run took place, although the baking system as a whole had negative equity from May 2009 until August 2010.

Chart 10: Foreign financing of companies held up well during the crisis



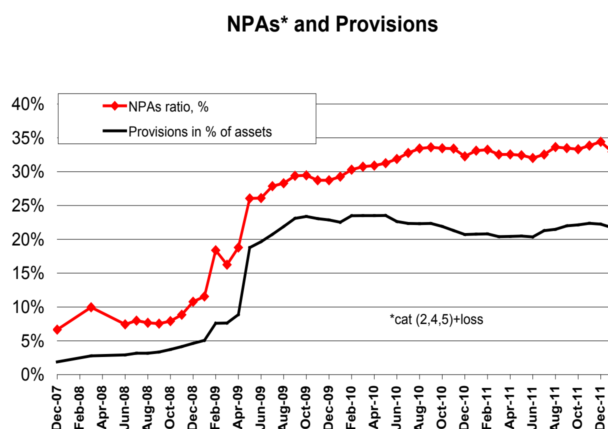
Source: NBRK, ATFBank Research

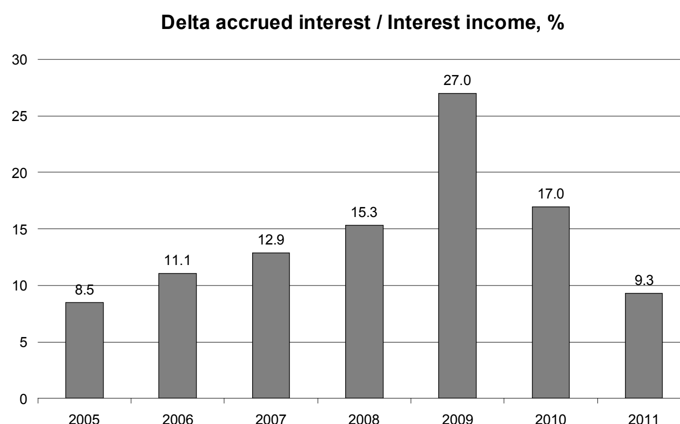
National Oil Fund spending in the magnitude of 8% of GDP financed the capitalization by the state of the four largest banks of the country as well as liquidity support and housing and SME programs. The overall amount of anti-crisis spending was about 13% of GDP, including tax reductions equivalent to 3% of GDP, 7.5% of GDP of Oil fund spending, 3.6% by the budget, 1.4% by pension funds and other sources. The establishment of the "National Oil Fund" in 2000 was by far the most important measure by the Kazakhstani authorities to mitigate economic risk.

A second "source of funding" (another 10% of GDP) was however the default by 3 majority state-owned banks on their foreign debt with subsequent restructuring. The most prominent case is Kazakhstan's formerly largest bank by assets, BTA. The restructuring allowed the government to avoid even higher recapitalizations while domestic deposits remained safe. The defaults despite sufficient means in the National Oil Fund to bail out banks have been controversial. However, some praised Kazakhstan for rightly bailing in private investors, who should have assessed risk correctly in the first place.

Despite the foreign debt restructurings, the share of non-performing assets have remained very high (chart 11), particularly if loans "restructured" by simply extending maturities were taken into account. Though we do not expect a significant reduction in the official NPL ratio in Kazakhstan in the near future unless there will be some carving out by the Impaired Assets Fund, we also do not expect a substantial further increase. There is some progress in the working out of bad (restructured) loans: the share of accrued interest income (booked but not cashed in) in total interest income has fallen (chart 12). We expect the banking system to return to (very moderate) profitability in 2012. However, without additional (centralized) measures, the return of the Kazakhstani banking system to a healthy status would be a protracted slow one. The high load of non-performing assets negatively impact to funding possibilities of Kazakhstani banks, particularly form abroad, and thus reduce the development potential Kazakhstan otherwise had.

Charts 11 and 12: Non-performing assets have remained high; some progress in the work out is visible





Source: NBRK, ATFBank Research

In order to tackle the bad debt, the authorities launched a series of initiatives. The MinFin drafted a new law separating rehabilitation and bankruptcy processes and introducing creditor councils. Amendments to the tax law have been adopted, which should ease the writing off of bad loans. The central bank set up an Impaired Assets Fund in early 2012, which is to be independently managed and financed in three tranches by pension funds, the banks and the central bank itself. The DFA will not purchase loans related to real estate however, i.e. the larger part of problem loans. For dealing with real estate, banks are envisaged to set up several types of SPVs. These can manage assets in a way banks are not allowed to under the banking license. The central bank might increase pressure now for an agreement with the commercial banks on the terms of bad asset transfers to the fund. Outsourcing by banks of real estate loans and collateral to SPVs should also progress. Supported by its majority owner, the state holding Samruk-Kazyna (SK), BTA has asked foreign creditors to restructure a second time. BTA is currently drawing up a new business plan. After reviewing the plan SK will decide to what extent BTA will be re-capitalized and what other measures are to be taken. All the initiatives are still in early stages however, and often lack concretization to be put into practice. The road to banking system health is probably still quite lengthy and bumpy, given the magnitude of the accumulated problems.

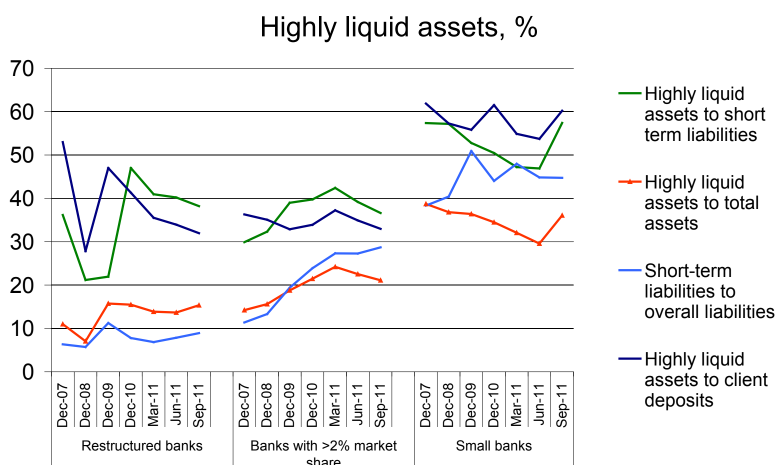
In line with the global trend, also the Kazakhstani authorities plan to apply the Basel 3 regulations. They are even more ambitious than most: the introduction has been scheduled for 1 January 2013. The net effect of applying Basel 3 on capital is not clear yet: while some capital requirements might become tighter than currently, some types of provisioning requirements might be less stringent than under the current rules. Given a capital adequacy ratio of 18.1% as

of 1 March 2012 (local standard k1-2) and little use of hybrid capital, capital adequacy seems not to be the big problem under Basel 3 at first sight, at least for the system as a whole. For some banks problems might be aggravated however. Discussions will intensify over the coming months how concretely to implement Basel 3 in Kazakhstan. Though no principal deviation from the envisaged route is likely, the current danger of an economic slow-down might influence the phasing-in and regulation details such as dynamic provisions etc.

Liquidity, though still at comfortable levels, has become scarcer while capital seems not to be the critical issue under Basel, liquidity definitely is.

For the large, un-restructured banks the liquidity situation has changed already in the second half of 2011, the central bank hinted in its 2011 Financial Liquidity Report. Liquidity was not as abundant in 1H20012 as in the months before (chart 13). Banks began to reduce their holdings of (low-yielding) government paper to make means available for other purposes (table 3).

Charts 13: Liquidity has become less abundant among the large, un-restructured banks



Source: NBRK

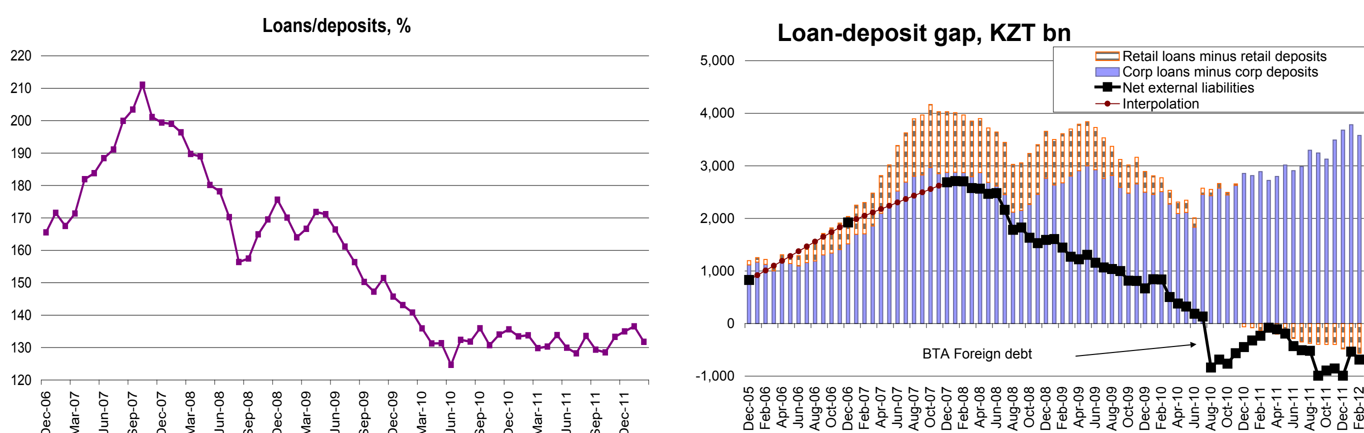
Table 3. Banks have begun to reduce their holdings of government paper

	1.1.11		1.1.12			
	KZTbn	% of total	KZTbn	% of total	% yoy	Delta, KZT bn
Cash money, refined precious metals and correspondent accounts	845.6	5.6	1396.4	8.4	65.1	550.8
Deposits in other banks	1002.6	6.6	604	3.6	-39.8	-398.6
Securities	2221.7	14.6	1859	11.1	-16.3	-362.7
Bank loans and "reverse repo" operations	9065.9	59.5	10425.5	62.4	15	1359.6
Capital Investments	376.1	2.5	381	2.3	1.3	4.9
Other assets	1722.5	11.3	2039.6	12.2	18.4	317.1
Total gross assets	15234.4	100	16705.5	100	9.7	1471.1

Source: KFN

The loan/deposit ratio has remained little changed since early 2010 (chart 14) after having fallen drastically during 2008-2009, but the underlying structure has substantially changed. The net borrowing of the corporate sector (loans minus deposits) is meanwhile significantly above the 2007 level (chart 15). The loan/deposit ratio has not risen only because households stepped in: they are now net lenders as opposed to the years before 2011. Wholesale funding and particularly foreign funding have lost much in importance as banks reduced their reliance on foreign debt to 19% of total liabilities by February 2012 from a pre-crisis peak of over 50% according to banking data or to USD 14.6bn at end-2011 from USD 45.9bn at end-2007, according to foreign debt statistics.

Charts 14 and 15: The loan-deposit ratio has remained stable since 2H2010, but the underlying structure has changed



Source: NBRK, ATFBank Research

Client deposits account now for almost 70% of liabilities (table 4). Though this has some advantages such as being less vulnerable to capital market shocks and being less prone to bubble creating lending excesses (such as in 2006-2007), there are also shortcomings: Given that volatile corporate deposits account for a large part of deposits and given that household term-deposits are not really fixed, the funding base for Kazakhstani banks is no very stable. Retail clients have by legislation typical for CIS countries the right to withdraw term deposits up to a small amount at any time. The banking system's Basel 3 Net Stable Funding Ratio (NSFR) is significantly below the required 100%, according to our rough estimates. Deposit are insured up to 5mn tenge (EUR 25K), which is supposed to cover 95% of all household deposits. The existence of a deposit insurance scheme is a precondition for applying a 90% ASF (available stable funding factor) under Basel 3. However, the deposit insurance is a necessary condition, not a sufficient one. As most of the deposited money can be withdrawn any time, a factor of 80% has to be applied to a large part of household deposits and probably even this does not fully reflect the potential volatility. For corporate deposits a 50%factor is applied under Basel 3. At the same time "Required Stable Funding" is quite high in Kazakhstan because loans to clients account for more than 60% of total assets. For them, a RSF (required stable funding factor) of 85% is to be applied.

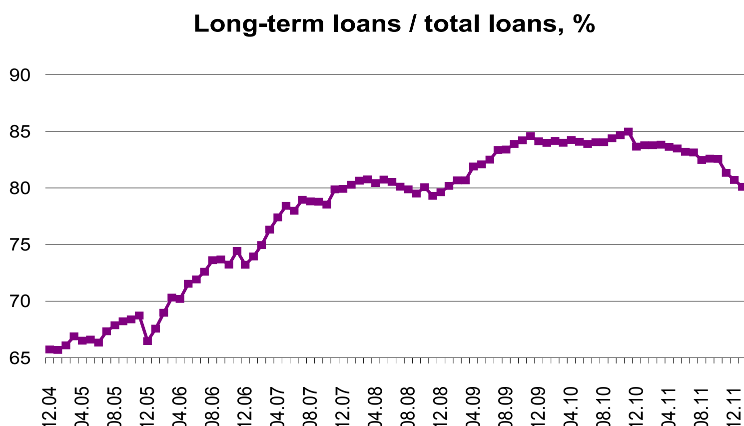
Table 4. Client deposits account for 68% of liabilities

	1.1.11		1.1.12			
	KZTbn	% of total	KZTbn	% of total	% yoy	Delta, KZT bn
Interbank deposits	215	2	106.4	0.9	-50.5	-108.6
Loans, received from other banks	548.5	5.1	491.3	4.3	-10.4	-57.2
Loans received from the government	58.4	0.5	72.2	0.6	23.6	13.8
Loans received from IFIs	77.8	0.7	54.9	0.5	-29.4	-22.9
Deposits received from legal entities	4574.4	42.7	5033.5	43.7	10	459.1
Deposits by natural persons	2250.9	21	2764.1	24	22.8	513.2
Deposits by SPVs	25.4	0.2	1.5	0	-94.1	-23.9
Securities issued	1577.2	14.7	1498.1	13	-5	-79.1
"Repo" operation with securities	577.2	5.4	497	4.3	-13.9	-80.2
Other liabilities	810.4	7.6	997.3	8.7	23.1	186.9
Total liabilities	10715.2	100	11516.3	100	7.5	801.1

Source: KFN

Measures to make funding more stable would ease the introduction of Basel 3 and, more importantly, help avoid maturity mismatches and thus make financial intermediation more efficient and cheaper. The share of long-term (maturity above 1 year) client loans has somewhat declined from its in 2010 but has remained above 80% (chart 16).

Chart 16: More than 80% of Kazakhstani client loans are long-term
(Source: NBRK, ATFBank Research)



Conclusions

Measures are needed to speed the cleaning up of the banking system as well as measure to make funding more long-term; a renewed stronger engagement of the IFIs via domestic banks is also desirable.

For reaching the government's growth and diversification targets, substantial financing is required, particularly long-term. To avoid serious maturity mismatches, there has to be a stable long-term funding base. A shift to more stable, long-term funding would reduce the need for the banks to hold low yielding highly liquid asset and free means for longer-term lending and make financial intermediation in general more efficient.

One possibility for banks to make the funding base more long-term is to issue more bonds, but the size of the Kazakhstani domestic bond market is limited.

Encouraging long-term saving probably requires:

- some regulation (legislation) changes (such as making term-deposits really term),
- possibly some new instruments (e.g. covered bonds) and related regulation,
- fixing of the remaining problems of the banking system via the Impaired Asset Fund and other initiatives.

Higher foreign funding would also have a positive impact particularly for long-term funding. Given the current international environment, there is little danger that foreign refinancing would reach again the excessive volumes seen in 2006-2007 any time soon. Bringing down the high share of non-performing assets and solving the open issues around BTA would be supportive for some revival of foreign funding.

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Funding by the International Financial Institutions has also a role to play in making the funding base more stable and long-term. Whereas lending to the government by the IFIs and bilateral lending by foreign public institutions has constantly increased since 2007, refinancing of banks has constantly fallen since 2009 in USD terms and as share of banks' liabilities (table 5).

Table 5. Banking system financing by IFIs* has halved from the 2008 peak

	2005	2006	2007	2008	2009	2010	2011
State liabilities to IFIs, USD mn	3003	1242	2662	3036	4236	7302	8711
Bank liabilities to IFIs, USD mn	198	216	707	736	665	528	370
Bank liabilities to IFIs over total bank liabilities, %	0.6	0.3	0.8	0.8	0.8	0.7	0.5
Bank liabilities to IFIs over state liabilities to IFI, %	6.6	17.4	26.6	24.2	15.7	7.2	4.2

** Includes: International Bank for Reconstruction and Development, Asian Development Bank, European Bank for Reconstruction and Development, Islamic Development Bank, Saudi Fund for Development, Kuwait Fund for Arab Economic Development, Abu-Dhabi Fund for Development, Japan International Cooperation Agency, Credit Agency of the Government of Germany*

Source: Ministry of Finance of the Republic of Kazakhstan, KFN, ATFBank Research

A stronger engagement again of the IFIs also via the banking system would be beneficial for the economy in general as well as for improving banking system efficiency via making funding more long-term and predictable and via encouraging banking lending particularly to sectors with long-term importance and potential.

Main indicators

	2008	2009	2010	2011
Macro/Monetary				
real GDP (% yoy)	3.3	1.2	7.3	7.5
CPI (avg)	17	7.3	7.1	8.3
Central Bank reference rate (eop)	10.5	7	7	7.5
Volumes				
Deposits by residents (% yoy)	19.9	26.9	17.1	14.7
Lending to residents (% yoy)	5.5	5.3	9	14.2
L/D ratio	175.6	145.7	135.6	135
Mortgages (% of GDP)	4.1	4.3	3.1	2.7
FX deposits (% of total deposits)	35.4	43.7	34.9	31.4
FX lending (% of total lending)	44.2	48.4	42.3	35.3
Profitability				
Revenues / Average Volumes				
(Loans+Deposits)	6.6	2.6	-3.4*	2.5
Net Operating Profit (% of GDP)	3.6	0.9	-3.5*	-0.04
Cost/Income	0.29	0.58	**	0.6
ROA	0.3	-19.4	-5.4*	-0.1
ROE	2.6	-***	-61.2*	-0.9
Capital, Liquidity and Funding				
CAR % (local accounting standard - K2)	12.4	-11.6	17.9	17.4
Net foreign assets (% of GDP)	-10	-3.6	2	3.6
Asset quality				
NPA (%)	10.8	28.7	32.3	34.4
Structural				
Number of operating banks	37	38	39	38
Foreign ownership (% of total assets)	13.1	16.8	17.5	22
Top 5 players (% in total assets	74.8	73.9	71.8	65.3

* net of USD 15bn in foreign debt forgiveness; ** in 2010 income was negative, net of debt restructuring; *** in 2009 the equity of the banking system was negative.

Source: NBRK, ATFBank Research

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KYRGYZSTAN

By Brett E. Coleman, Senior Financial Sector Specialist, Mairam Usupova, Senior Financial Sector Specialist, and Bujana Perolli, Financial Analyst, the World Bank[9]

Key Messages

- Due to the global economic crisis and the political events of 2010, the economy of Kyrgyzstan suffered a substantial downturn during 2009-2010. The economy has rebounded in 2011 with 5.7 percent growth, supported by political stability and growth in the major trading partners. However, Kyrgyzstan remains vulnerable to terms of trade shocks, and thus a potential regional slowdown would have negative repercussions for the Kyrgyz economy.

- The Kyrgyz financial sector remained stable throughout the 2008-2009 global financial crisis, but the political upheavals of 2010 led to substantial financial instability. The largest bank was nationalized, declared insolvent, and restructured, and supervisory action was taken against several other banks. Financial instability led to increased risk aversion by banks, limiting the role of financial intermediation in supporting private sector growth. The private sector is weak, with low levels of competitiveness, resulting mainly from inefficient market mechanisms and a poor business environment.

- Several policy priorities remain to address private and financial sector development challenges in Kyrgyzstan, including: (i) resolving problem banks and privatizing state-owned banks in line with international practices; (ii) strengthening the legal and regulatory framework in the banking sector, particularly for early intervention and resolution of problem banks; (iii) enhancing supervision, particularly of systemically important banks; (iv) undertaking policy measures that enhance access to finance, including strengthening financial infrastructure; (v) improving management of public assets and governance of state-owned enterprises (SOEs); and (vi) improving the business environment for the private sector.

Macroeconomic Overview

The Kyrgyz Republic enjoyed a period of macroeconomic stability and economic growth prior to the 2008-2009 global crisis. Between 2003 and 2008, GDP growth averaged about 6 percent a year, largely driven by an expansion in the construction and services sectors. A prudent monetary policy kept inflation stable and the external public debt burden dropped from over 80 percent of GDP in 2005 to about 45 percent of GDP in 2008 (Table 1).

The Kyrgyz Republic's economic performance deteriorated significantly during the global crisis, but a recession was avoided due to a large fiscal stimulus. The crisis affected the Kyrgyz economy mainly through trade and remittance channels. Russia and Kazakhstan are key export destinations of the Kyrgyz Republic and the main sources of remittances. With these countries in recession, the Kyrgyz economy slowed down sharply from 8.4 percent in 2008 to 2.9 percent in 2009 due to decreased demand for Kyrgyz exports and a decline in remittances by about 20 percent in 2009. The authorities responded by relaxing fiscal and monetary policies, and a recession was averted.

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[9] The World Bank supports financial sector development in the Kyrgyz Republic through policy advice, technical assistance and financial support. In 2010, the World Bank conducted a Financial Sector Vulnerability Assessment and Access to Finance Assessment that contain detailed diagnostics and recommendations. The World Bank has been providing TA over the past 2 years to improve banking sector supervision and to strengthen the deposit insurance system. The World Bank has also supported the modernization of the payment system by funding deployment of a new bulk clearing system, a real time gross settlement system, and an inter-bank card processing center. A new financial sector development project planned for implementation during 2012-2017 will become the cornerstone of the World Bank's support of financial sector development in the Kyrgyz Republic. The project has four components: (i) strengthening the legal, regulatory, and supervisory framework for banks, MFOs, and credit unions; (ii) expanding financial services via Kyrgyz Post Office network; (iii) supporting Aiyl Bank for privatization and deposit mobilization; and (iv) modernizing the moveable collateral and debt resolution regime.
The World Bank also supports private sector development in Kyrgyzstan. The main areas of engagement in private sector development include: (i) supporting reforms to reduce barriers to trade by addressing shortcomings in regulation and quality infrastructure; (ii) supporting reforms to enhance the business climate; and (iii) defining private sector-led growth strategies for various economic sectors.

However, the deep political crisis in 2010 caused an economic downturn. In the three years before April 2010, the president concentrated power in his administrative apparatus, weakened the national assembly, and circumvented ministries. In April 2010, anti-government demonstrations led to the overthrow of the government and the formation of an interim administration. In June 2010, violent clashes took place over three days, particularly in the cities of Jalalabad and Osh. It was officially reported that over 300 persons were killed, over 2500 were injured, and nearly 400,000 were temporarily displaced. The disturbances also damaged infrastructure and destroyed private and public property. Economic activity was disrupted, investment fell, trade was adversely affected, and the financial sector was severely stressed. The economy contracted by 0.5 percent in 2010. Inflation rose to about 20 percent at end of 2010 due to spikes in world food prices, the current account went from a surplus in 2009 to a 6.9 percent deficit, and fiscal pressures emerged (Table 1).

Table 1. Macroeconomic Indicators

							2010 median value for Emerging Regions			
	2007	2008	2009	2010	2011e	2012 p	ENCA	EE	East Asia	LatAm
GDP per capita (USD)	726	972	864.3	875	1070	1153	3,013	8,926	2,549	6,980
Real GDP growth (% change)	8.5	8.4	2.9	-0.5	5.7	5	6.4	1	7.7	5.3
CPI Inflation	10.2	24.5	6.9	8	5.7	4.1	7.4	2.8	4.5	4
Current Account Balance (% of GDP)	-0.2	-8.1	0.7	-6.9	-3.1	-4.9	-8.3	-4.4	2.5	-2.1
Fiscal Balance (% of GDP)	-0.3	0	-3.5	-6.3	-4.8	-6	-2.4	-3.9	-2.6	-2
Gross government debt (% of GDP)	56.8	48.5	58	62.6	55.2	-	26.6	41.4	49.4	36.3
External debt (% of GDP)	60.2	45.1	58.2	68.3	61.2	-	79.2	45.6	28.7	26.2
Population (Millions)	5.2	5.3	5.4	5.5	5.5	-	9.5	5.9	132.9	14.6

Source: World Development Indicators (World Bank), World Economic Outlook (IMF), Quarterly External Debt Statistics (IMF), Official statistics and World Bank staff calculations and estimates.

ENCA: Eastern Neighbours and Central Asia; EE: Emerging Europe; LatAm: Latin America

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

Following the economic downturn in 2010, the Kyrgyz economy has recovered. With increased political stability and a favorable external environment, the economy grew by 5.7 percent in 2011, and is projected to grow by about 5 percent in 2012. Inflation has eased due to a decline in international food prices, resumption of domestic agricultural production, and monetary tightening – from above 20 percent in July 2011 to 5.7 percent at end-2011. Fiscal performance was also strong in 2011. External trade has grown, tourism has recovered, and the current account has improved as continued growth in Russia and Kazakhstan contributed to an expansion in remittances and exports.

- Low economic performance calls for enhanced competitiveness and private sector development. While Kyrgyzstan has one of the best records among transition economies in terms of institutional change, its growth record has been one of the weakest and its vulnerability to shocks one of the highest. This contrast results largely from low levels of economic efficiency and poor competitiveness in a weak and poorly diversified private sector which now dominates the national economy.

- Weaknesses in the private sector result mainly from inefficient market mechanisms and from a poor business environment and investment climate. State-owned enterprises continue to play a key role in several important segments of the economy where they prevent

development of competitive markets. At the same time, despite numerous reforms, the investment climate still has shortcomings, with progress in some areas counterbalanced by serious weaknesses in others (Table 2). Doing Business 2012 ranks Kyrgyzstan 70th out of 183 countries. In addition, even where regulations were strengthened, progress on the ground has remained limited. Other bottlenecks include infrastructure gaps, inadequate skills availability, insufficient technology absorption to modernize the corporate sector, and obstacles to trade.

Table 2. Kyrgyzstan: Doing Business Rankings 2012

Starting a business	17
Dealing with construction permits	62
Getting electricity	181
Registering property	17
Getting credit	8
Protecting investors	13
Paying taxes	162
Trading across borders	171
Enforcing contracts	48
Resolving insolvency	150

Source: Doing Business

Financial Sector Risks and Development Challenges

The financial sector in Kyrgyzstan is dominated by the banking sector, accounting for about 77 percent of total assets (excluding microfinance organisations). There are 22 commercial banks in Kyrgyzstan, with 10 banks having more than 50 percent foreign capital. Banking sector assets amounted to 24 percent of GDP at end-2011 (Table 3). There are also 454 microfinance organizations (MFOs) and 197 credit unions, accounting for about 21 percent and 1.5 percent of total financial sector assets, respectively. MFOs and credit unions provided 31 percent of all credit provided by the financial sector as of end-2011. Pension and insurance sectors are negligible.

Table 3. Banking Sector Indicators

	2005	2006	2007	2008	2009	2010	2011	2010 median values for Emerging Regions			
								ENCA	EE	East Asia	LatAm
Number of banks	20	21	21	21	22	22	22				
Assets/GDP	21.7	24.8	30.1	29.7	34.6	27.3	24.4				
Deposits/GDP	12	13.2	13.6	15.2	16.9	13	13.5	32	53	68	31
Loans/GDP	7.6	9.9	14.9	13.8	12.8	12.4	11.4	38	49	48	31
Loans/Deposits	63.2	75.4	109.2	110.2	75.7	95.3	96.8	145	99	76	87
Foreign liabilities/GDP	16.7	13.4	12.7	13.1	18.2	10.1	7.8				
FX Loans/Loans	71.4	69.7	62.5	64.7	62.3	55.7	55.2				
Asset Concentration (top 3 banks)	n/a	38.52	39.17	45.05	48.52	39.09	41.5				
NPLs/Gross Loans	8.2	6.2	3.5	5.3	8.2	15.8	10.2	13	12	4	2
CAR	26.2	28.2	31.1	32.6	33.5	31	30.3	21	16	16	16
ROE	17.6	21.4	26.4	20.7	13.6	7.1	17.7	11	3	17	19
Loan loss provisions/NPLs	49.5	53.2	60.3	55.9	58.3	67.7	61.6	63	55	74	141

Source: Financial Soundness Indicators (IMF), International Financial Statistics (IMF), National Bank of Tajikistan, and World Bank staff calculations

ENCA: Eastern Neighbors and Central Asia; EE: Emerging Europe; LatAm: Latin America.

NPLs include substandard, doubtful, and loss loans.

The level of concentration in the banking sector is moderate. The three largest banks (RSK, Unicredit, and KICB) account for about 42 percent of the system's assets (Table 4). RSK bank is a state-owned bank, and Unicredit and KICB are majority foreign-owned.

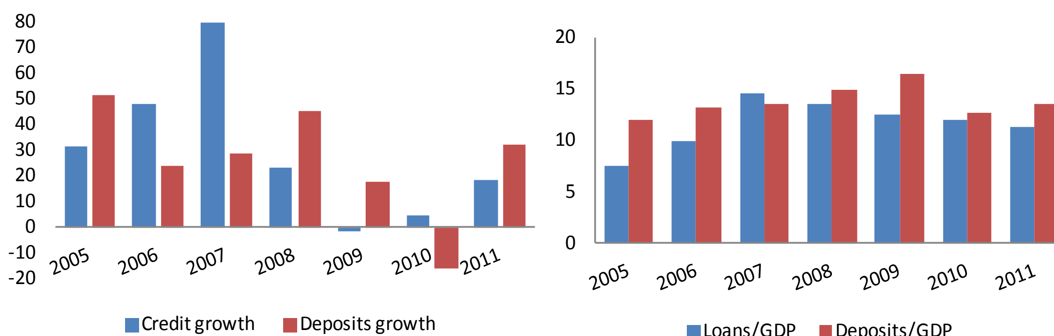
Table 4. Banking Sector Concentration

	Assets (bln.soms)	Liabilities (bln.soms)	Capital (bln. soms)
RSK Bank	10.0	8.6	1.4
UniCredit Bank	9.9	8.4	1.5
Kyrgyz Investment and Credit Bank (KICB)	7.8	6.1	1.7
Top 3 banks' share	41.5%	44.2%	32.0%
Total banking system	66.7	52.3	14.4

Source: Official statistics and websites of banks

The banking sector expanded rapidly before 2008, but the global economic crisis of 2008-2009 led to a slowdown in growth. In 2004-2007 bank credit increased on average by 55 percent per year, but slowed to 23 percent growth in 2008, and declined by 1.8 percent in 2009 due to the economic crisis that led to increased risk aversion in banks and reduced demand by clients. Deposits also increased on average by 40 percent per year in 2004-2008, slowing to 18 percent in 2009 (Figure 1).

Figure 1. Kyrgyzstan: Bank Credit and Deposit Growth



Source: NBKR

The financial sector had built up serious vulnerabilities prior to the 2008-2009 crisis, especially in terms of: (i) high credit risk resulting from rapid credit growth and a high share of foreign currency loans to non-hedged borrowers, (ii) heavy reliance on wholesale funding (especially from Kazakhstani banks), and (iii) a moderate level of concentration in the banking sector which further compounds the other vulnerabilities.

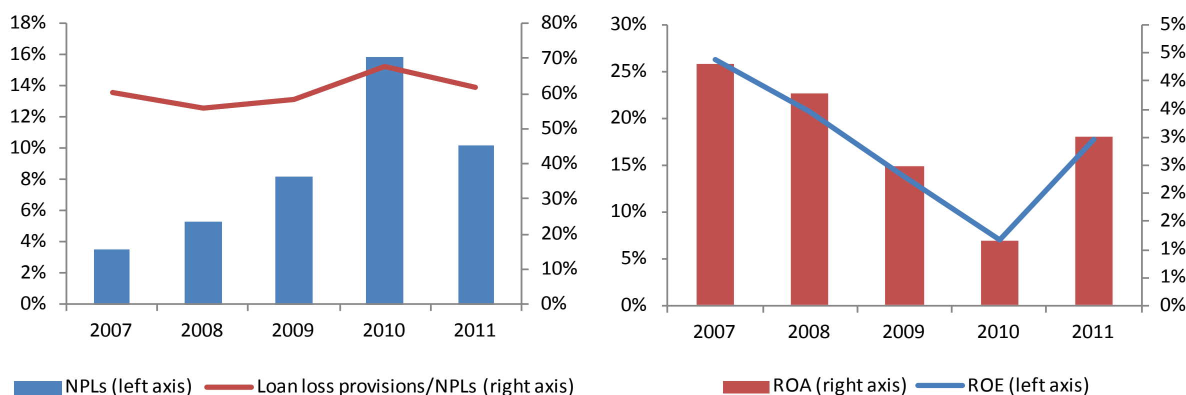
Despite these vulnerabilities, the Kyrgyz banking sector remained stable throughout 2008-2009 and withstood the effects of the global financial crisis relatively well. Capital adequacy and liquidity remained adequate, although non-performing loans (NPLs) grew from 5 percent at end-2008 to about 8 percent at end-2009, return on equity (ROE) dropped from 21 percent to 14 percent, and return on assets (ROA) from 3.8 percent at end-2008 to 2.5 percent in 2009 (**Figure 2**).

The political upheavals of 2010 caused economic turmoil and led to significant financial sector instability. The political crisis caused a large and immediate deposit outflow. Total deposits fell by 30 percent between March and April 2010, mostly due to large withdrawals from nonresident accounts. The deposit decline was mainly concentrated in AUB, the largest bank at that time with 53 percent of deposits. NPLs increased rapidly after March 2010, reaching 17 percent of total loans at end-2010 (from 8 percent in 2009). The increase in loss provisions strained bank capital buffers and profitability in 2010. Capitalization stood at about 23-24

percent for most of 2010 (compared to 34 percent at end-2009) before increasing to 31 percent at end-2010, following the split of AUB. Profitability dropped substantially after the 2010 events, and banks incurred significant losses as of end-October 2010 (in the amount of KGS 4.5 billion), with a negative ROE of 50 percent and a negative ROA of 9 percent. Financial instability increased risk aversion in banks and credit remained largely stagnant with a modest 4.8 percent growth in 2010.

The NBKR took immediate measures to restore financial stability, although the interventions stretched its capacity. Following the large deposit outflow, the NBKR took seven banks (accounting for 45 percent of the system's assets) under temporary administration, including AUB. Following a complicated legal process, AUB was nationalized and declared bankrupt at the end of 2010, and restructured, being split into a "good bank" (Zalkar Bank) and a "bad bank". The authorities are in the process of privatizing Zalkar Bank. Four other banks remain under receivership and face pending litigation.

Figure 2. NPLs, Loan loss Provisions, and Profitability



Source: NBKR

Due to the NBKR's interventions, as well as improved stability in the political and economic climate, banking sector indicators have improved. NPLs declined to 10 percent at end- 2011. Capitalization (over 30 percent at end of 2011) and the liquidity ratio[10] (over 74 percent) remain stable and comfortably above the minimum requirements. Bank profitability rebounded in 2011, with ROE at 17.7 percent and ROA at 3 percent. The loan portfolio grew by 18 percent in 2011[11] Deposits grew by 33 percent, suggesting restored levels of public confidence.

Financial intermediation in Kyrgyzstan remains limited, and became more limited due to the global economic crisis and the 2010 political events. Kyrgyzstan ranks low in credit and deposit penetration compared to other countries in the ECA region (Figure 3). In 2011, credit to the private sector and deposits as a share of GDP amounted to about 12 percent and 13.5 percent, respectively (Figure 6). In the latest round of BEEP surveys (2009), access to finance was the second highest obstacle for growth identified by firms (after access to electricity). MFOs and credit unions are filling some of the gaps in access to finance for smaller borrowers, the poor, and the agricultural and rural areas. Access to financial services is particularly limited in rural areas of the country. A number of obstacles prevent a deepening of financial services, including low outreach of deposit services and weaknesses in financial infrastructure.

[10] The liquidity ratio is defined as liquid assets as a percentage of liabilities maturing within 30 days.
[11] More than 40 percent of total loans are issued to the trade sector, about 14 percent to agriculture, and about 10 percent for mortgages.

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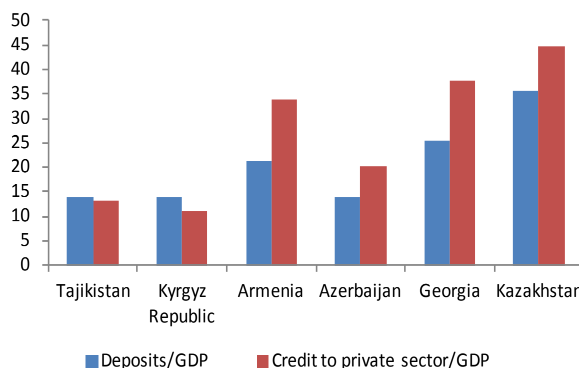
Figure 3. Credit to the private sector and deposits, November 2011 (in percent of GDP)



Source: IFS, WEO

Key policy priorities

The Kyrgyz banking sector is recovering, but continued legal, regulatory, and supervisory reforms are necessary. The crisis of 2010 highlighted weaknesses in the legal, regulatory, and supervisory framework for the banking sector. Several immediate priorities remain, especially to: (i) complete the resolution and privatization of Zalkar Bank in line with international best practices; (ii) resolve banks currently under receivership; (iii) strengthen the legal and regulatory framework in the banking sector, particularly for early intervention and resolution of problem banks; and (iv) enhance supervision, particularly of systemically important banks, to ensure that vulnerabilities are identified and addressed in a timely manner.

In addition, given the limited financial intermediation in Kyrgyzstan, the following policy priorities are needed to expand access to finance: (i) promoting greater access to deposit services in rural areas through transforming Kyrgyz Post Office (KPO) so it can provide limited financial services, privatizing Aiyl Bank and granting it a full deposit taking license, and granting deposit-taking or banking licenses to qualified MFOs; and (ii) strengthening the legal and institutional framework to improve the secured transactions framework (i.e., use of moveable collateral to secure loans), including collateral registration and execution.

Summary and Conclusions

Due to the global economic crisis and the political events of 2010, the economy of Kyrgyzstan suffered a substantial downturn during 2009-2010. The economy has rebounded in 2011 with 5.7 percent growth, supported by political stability and growth in the major trading partners. However, Kyrgyzstan remains vulnerable to terms of trade shocks, and thus a potential regional slowdown would have negative repercussions for the Kyrgyz economy.

The Kyrgyz financial sector remained stable throughout the 2008-2009 global financial crisis, but the political upheavals of 2010 led to substantial financial instability. The largest bank was nationalized, declared insolvent, and restructured, and supervisory action was taken against several other banks. Financial instability led to increased risk aversion by banks, limiting the role of financial intermediation in supporting private sector growth. The private sector is weak, with low levels of competitiveness, resulting mainly from inefficient market mechanisms and a poor business environment.

Several policy priorities remain to address private and financial sector development challenges in Kyrgyzstan, including: (i) resolving problem banks and privatizing state-owned banks in line with international practices; (ii) strengthening the legal and regulatory framework in the banking sector, particularly for early intervention and resolution of problem banks; (iii) enhancing supervision, particularly of systemically important banks; (iv) undertaking policy measures that enhance access to finance, including strengthening financial infrastructure; (v) improving management of public assets and governance of state-owned enterprises (SOEs); and (vi) improving the business environment for the private sector.

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REPUBLIC OF MOLDOVA

By Andreas Kappeler, Economist, European Investment Bank

With a population of 3.6 million and a GDP per capita of USD 2,022 in 2011 (USD 3,383 at PPP) Moldova is a lower middle-income country and one of the poorest in Europe. It has few natural resources and remains dependent on the low-productivity agriculture sector. Moldova came through the crisis in relatively good shape.

Moldova faces several macroeconomic challenges:

- Future economic prospects are dependent on structural reforms. In this context, improving the business environment (Doing Business rating 81 in 2012), tackling shortcomings in the regulatory environment, promoting the expansion of the SME sector and improving the quality of and access to education are key factors.
- The current account deficit remains high and the economy's dependence on volatile remittance inflows and foreign aid are the principal sources of macroeconomic risk.
- Transport infrastructure has to be improved. This also includes continued efforts to privatizepublic telecommunications, airline incumbents and railways.
- Moldova's dependence on energy imports highlights the need to focus on energy security.
- Settlement of the Transnistrian conflict.

Given the income level of the country, the banking sector in Moldova is comparatively sound providing a buffer to face future challenges. Compared to the income level in the countries, the size of the banking sector is adequate but needs to keep up with GDP growth. Interest rate spreads are not excessive compared to other countries in the region and profitability of banks is adequate.

Having said this, several vulnerabilities remain:

- One of the main challenges is to uphold financial stability while seeking to unblock credit. Closely monitoring banks' asset quality, lending and provisioning practices, NPLs and capital needs remains a top priority in this context. The cost of credit remains relatively high, and access to long-term credit by the corporate sector, especially SMEs, is limited.
- Unpredictability of monetary policy implementation complicates bank operations and is one reason for the high liquidity buffers held by banks.
- The institutional framework in general and transparency in the banking sector in particular should continue improving. Also, further foreign strategic investments in the banking sector can help to boost the development of the sector.
- The increasing share of foreign currency loans in total loans exposes the borrowers and banks to exchange rate and credit risks.

Macroeconomic Overview[12]

With a population of 3.6 million and a GDP per capita of USD 2,022 in 2011 (USD 3,383 at PPP) Moldova is a lower middle-income country and one of the poorest in Europe. It has few natural resources and remains dependent on the low-productivity agriculture sector. Over the past two decades, value added by agriculture declined from 50% to close to 10 percent. While value added of the industry remains very low (roughly 10%) services have evolved quickly

[12] Main references: Partners for Financial Stability (2011) Moldova High Level Financial Sector Review. USAID, October 2011; EIU (2012) Country Report Moldova, February 2012; IMF (2012) Moldova: Fourth Reviews Under the Extended Arrangement and Under the Three-Year Arrangement Under the Extended Credit Facility; WB (2011) Moldova - Country Development Agenda and Priorities.

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with their ratio of Value added being comparable to the one of the Euro Area. Having said this, Moldova is very open to international trade, with imports -- including energy and key inputs for its manufacturing industry -- accounting for some 90 percent of GDP. Moldova is one of the largest recipients of remittances in the world (roughly 22% of GDP). Besides remittances, foreign direct investment has been a main driver of growth. The UN Human Development Index ranks Moldova 111th out of 187 countries. Moldova performs poorly in international rankings of competitiveness and business environment. Infrastructure is in poor condition with rail and road networks being in urgent need of rehabilitation. Moldova is rated B3 stable by ECON in line with Moody's.

The political situation is slowly stabilising. Since independence in 1991, Moldova has maintained difficult relations with Russia (the main destination for exports and for the majority of the more than 400,000 Moldavians working abroad) due to the stalemate with the breakaway territory of Transnistria, which does not recognise the Moldovan government in Chisinau. Russia has occasionally exercised its political power by restricting access to Moldova's agricultural exports. Relations with Romania have also remained complicated, due to citizenship considerations. However, with the election of an independent judge, Nicolae Timofti, as president of Moldova on 16 March 2012 nearly three years of uncertainty came to an end and this could pave the way for further reforms.

The 2008-09 crisis resulted in a sharp contraction of economic activity. Moldova's economic performance has strengthened considerably since 2000, with GDP growth averaging 5.8% in 2000-2008. The global financial and economic crisis has, however, dealt the economy a heavy blow, mainly via weak demand by trading partners, but also through a decline in FDI. GDP contracted by 6.0% in 2009. To face this critical situation Moldova and the IMF agreed on a three-year bailout package in 2010 worth some USD 570m.

After the crisis, recovery set in quickly with an increase in real GDP by roughly 7 percent annually. Indeed, Moldova was one of the fastest growing economies in the region in 2010; fixed investment increased by 17 percent in 2010 after a decline by 31 percent in 2009. Also, remittance inflows and real wages continued to rise. However, given the difficult global environment, GDP growth is projected to only reach 3.5 percent in 2012 and roughly 5 percent in the next future. Inflation started to pick up after the crisis, but stabilised late in 2011.

Moldova's external position is characterised by large capital inflows - mainly through remittances - and a large current account deficit. As one of the largest receivers of remittances Moldova is characterised by large capital inflows. Moreover, FDI inflows accounted for 3.3% of GDP in 2011. These capital inflows support a current account deficit of more than 10%. Another consequence of these capital inflows is a relatively high level of fixed investment, particularly by the private sector.

Table 1: FDI, Remittances and Investment

	2007	2008	2009	2010	2011	2012
FDI (% of GDP)	7.8	8.7	2.9	3.0	3.3	3.5
Remittances (% of GDP)	34.0	31.3	22.3	23.6		
Gross fixed capital formation (% of GDP)	34.1	34.0	22.6	22.7	23.4	24.0

Source: IMF, WB

The fiscal adjustment is broadly on track according to the IMF. The government deficit is expected to remain below 1 percent of GDP and government debt to decline from 28 percent in 2011 to less than 20 percent in 2016.

According to the Law on National Bank of Moldova (NBM), the main objective of monetary policy is to achieve and maintain price stability. Moreover, NBM's direct lending to the government is prohibited. With the assistance of the IMF, the NBM plans to gradually switch to inflation targeting. The inflation target has been defined in terms of CPI inflation and set at of 5 percent with a variation band of ± 1 percentage point in 2010. All in all, in light of the openness of the economy and its fairly high degree of financial dollarization, giving up exchange rate management for inflation targeting is likely to prove challenging.

Several challenges remain to be resolved to maintain high and sustainable growth. As Moldova approaches middle-income status, the country needs a sustainable growth strategy - recognizing that it is unlikely that remittance flows will continue to grow very rapidly. In this context the country faces several macroeconomic challenges:

- Future economic prospects are very dependent on structural reforms. In this context, improving the business environment (Doing Business rating 81 in 2012), tackling shortcomings in the regulatory environment, promoting the expansion of the SME sector and improving the quality of and access to education are key factors.

- The current account deficit remains high and the economy's dependence on volatile remittance inflows and foreign aid is among the key sources of macroeconomic risk. In this context, the ability of the economy to participate in global trade as well as efforts to attract greater FDI inflows should be improved.

- Weak transport infrastructure has to be addressed. The country's economy is highly dependent on road transport, and developing this physical infrastructure is critical for enhancing competitiveness. This also includes a continued privatisation of the public telecommunications, airline incumbents and railways.

- Moldova's dependence on energy imports highlights the need to focus on energy security. More investment in this sector is required to integrate Moldova into the EU energy market. This should be combined with measures to increase energy efficiency.

- Settlement of the Transnistrian conflict.

Table 2: Macroeconomic Indicators

	2007	2008	2009	2010	2011	2012
GDP per capita (USD)	1,229	1,695	1,524	1,630	2,022	2,277
Real GDP growth (% change)	3.0	7.8	-6.0	6.9	7.0	4.5
CPI Inflation (% change)	12.4	12.7	0.0	7.4	7.9	7.8
Current Account Balance (% of GDP)	-15.3	-16.3	-8.5	-8.3	-9.9	-10.3
Fiscal Balance (% of GDP)	-0.2	-1.0	-6.3	-2.5	-1.9	-1.2
Gross government debt (% of GDP)	24.6	19.3	29.1	26.6	23.6	21.7
Population (Millions)	3.6	3.6	3.6	3.6	3.6	3.6

Source: IMF, WB

Banking Sector Overview[13]

As is the case in most developing and emerging countries, Moldova's financial sector is bank dominated. In fact, relative to the stage of development of the Moldovan economy, the financial sector has developed at a rapid pace, albeit from a very low base, with assets totalling 57 percent of GDP in 2011, broad money slightly more than 50 percent of GDP (up from 17 percent ten years ago) and credit to the economy amounting to less than 40 percent of GDP. In spite of this notable progress, the financial sector lacks sophistication and diversification as non-bank financial institutions and capital markets are barely developed.

The non-banking sector is relatively small and underdeveloped. There are some 400 Savings and Credit Associations in Moldova with assets equivalent to 0.8 percent of GDP. SCAs represent a very small, but growing segment of Moldova's financial system. Assets of the 32 Microfinance Institutions (MFIs) in Moldova account for 3.8 percent of GDP. The relatively high degree of operational flexibility they enjoy has favoured their development, with doubling

[13] Main references: Hunya G, Mládek J and Pöschl J (2008) Private Sector and Financial Markets Development in the Republic of Moldova, The Vienna Institute for International Economic Studies, Vienna, December 2008; IMF (2012) Moldova: Fourth Reviews Under the Extended Arrangement and Under the Three-Year Arrangement Under the Extended Credit Facility; IMF (2010) Republic of Moldova: 2010 Article IV Consultation and Staff Report for the 2010 Article IV Consultation, IMF Country Report No. 10/234; IMF (2008) Republic of Moldova: Financial System Stability Assessment—Update, IMF Country Report No. 08/274; Lalayan M, Mundy S and Suteu V (2008) Responsible Finance and Financial Education in Moldova, Microfinance Centre for Central and Eastern Europe; WB (2011) Moldova - Country Development Agenda and Priorities.

profits and assets over the last couple of years. The economic contraction induced by the global economic and financial crisis has put MFIs expansion on hold. Leasing companies only started to be active in Moldova a few years ago. They mostly operate in the vehicle leasing sector and some in real estate, due to the underdevelopment of mortgage lending in the official banking sector. The insurance sector is underdeveloped in Moldova both relative to its potential and in comparison to peers. Currently 24 licensed insurance companies operate in the country, of which only two in the life-insurance compartment. Total premia account for a mere 1.3 percent of GDP. Moldova's securities market was launched in 1992 along with the process of privatisation. It remains however very small and illiquid.

Table 3: Characteristics of the Financial System

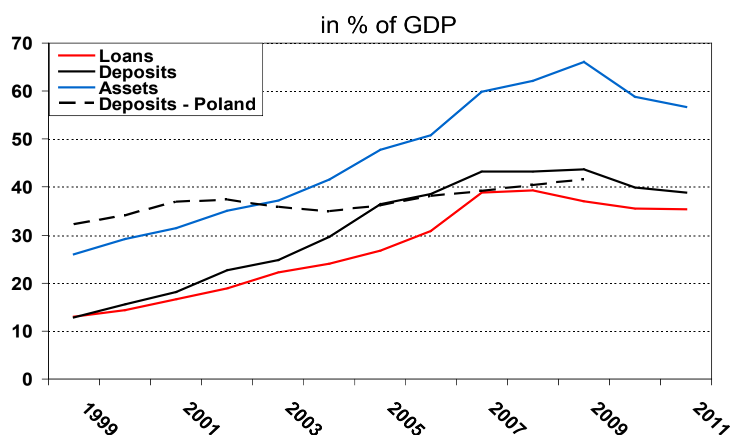
	Assets/GDP (%)	Number of Institutions
Commercial Banks	56.5	14
Micro-Finance Institutions	3.8	32
Savings and Credit Associations	0.8	400
Insurance Companies	2.5	24
Leasing companies	na	25

Sources: NBM, Lalayan et al. (2008)

Involvement of foreign investors in the banking sector is limited. The participation of foreign strategic investors, while increasing, amounts to only 18 percent of the banking sector's assets. Looking forward the participation of strategic foreign investors is likely to be further encouraged by the Moldovan authorities. Note that final beneficiaries are often unknown as the ownerships structure of banks does not have be revealed to the public.

The banking sector of Moldova compares well with its peers by size. Assets of the banking sector have grown from 26 percent of GDP 1999 to 57 percent of GDP in 2011. Both lending activity and deposits have picked up in recent years. Deposits are at 39 percent of GDP – a level comparable to Poland. Since 2009, deposits have fallen but not as much as could be expected considering that deposit rates have been halved. Note that concentration has been decreasing over the last few years with the three largest banks holding 45 percent of total banks' assets (down from 51 percent in 2003).

Moldova – size of the banking sector



Source: NBM.

Regulation and Supervision

The NBM is responsible for the supervision of the activities of banks. Key prudential requirements can be summarised as follows:

- minimum required entry capital is leu 10m;
- minimum capital adequacy ratio is 12 percent of total risk-weighted assets;
- the limit on exposure to individual creditors or group of creditors has been recently reduced from 25 to 15 percent of regulatory capital;
- the sum of the ten biggest loans cannot exceed 30 percent of total loans (previously 50 percent);
- the limit on exposure to any affiliated person or group of affiliated persons has been reduced from 20 to 10 percent of capital;
- the foreign currency open position cannot exceed 10 percent for each individual currency and 20 percent for all currencies (including off-balance sheet exposures);
- banks have to maintain liquid asset amounting to not less than 20 percent of total assets;
- the ratio between assets and liabilities with maturity of more than 2 years cannot exceed 1.

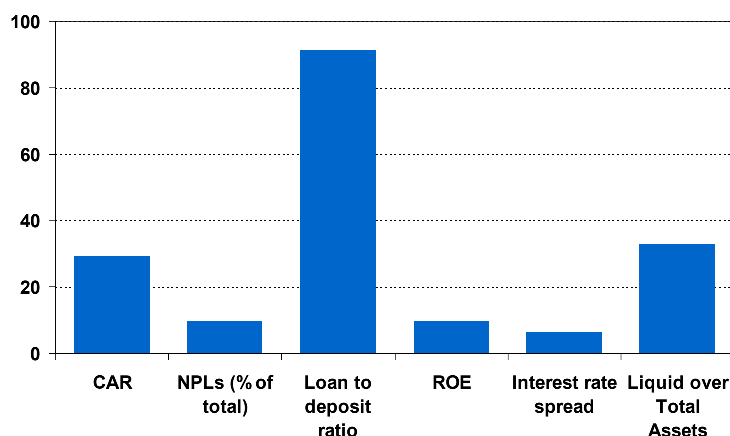
Banking regulation should continue improving.[14] Most importantly, transparency in bank ownership and cooperation with the National Commission of Financial Market should continue improving. Currently, the ownership structure of banks has to be revealed to the Central Bank, but not the public. Moreover, the availability of data on individual banks is more limited than in other countries in the region, such as Georgia.

At the same time, a series of measures were and are in the process of being adopted to strengthen financial sector supervision. Indeed, the NBM has taken steps to reinforce its ability to intervene early in problem banks and also to improve the effectiveness of the Deposit Guarantee Fund (DGF). To limit reliance on non-resident deposits, the authorities are planning to introduce a 100-percent marginal liquidity requirement on non-resident deposits in excess of 10 percent of the deposit base.

Performance and Soundness

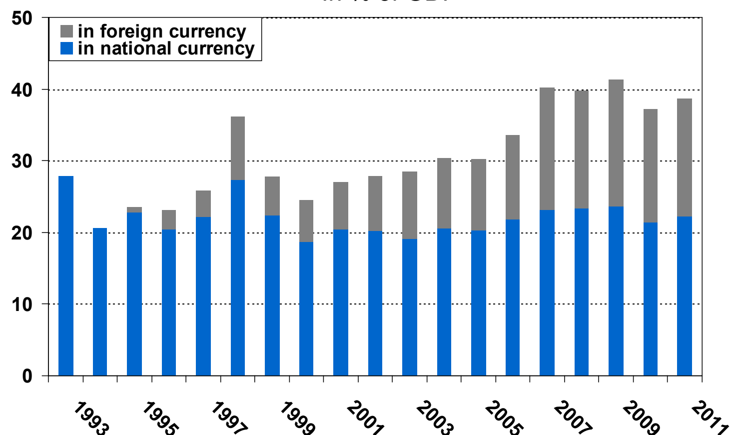
Given the income level of the country, the banking sector in Moldova is comparatively sound providing a buffer to face future challenges. The capital adequacy ratio was over 29 percent in 2011 well above the minimum regulatory requirement of 12 percent and among the highest in the region. Liquidity likewise is buoyant, with the liquidity ratio, defined as liquid assets over total deposit, at 48 percent. The high volume of banks' capital seems to suggest that banks have not yet found a way to put it to productive use in the Moldovan economy. It should also be stressed that banks' liquidity, while buoyant, is short-term whereas many companies, especially SMEs, are typically in need of medium to long term financing. This implies a maturity mismatch between the effective supply of funding and the notional demand for credit.

[14] see IMF (2012) and Hunya et al. (2008).



Source: NBM.

Moldovan banks' exposure to direct and indirect foreign exchange risk has increased recently. The chart below shows that in terms of GDP credit in domestic currency remained fairly stable. Having said this growth of total credit stems almost exclusively from credit in foreign currency implying a notable increase in loans in foreign currency from 3 percent in 1995 to 43 percent of total loans in 2011.



Source: NBM.

The banks' efforts to clean up their balance sheets are leading to a still stagnating credit stock. Indeed, the spread between lending and deposit rates has increased by more than 4.5 percentage points between 2007 and 2009. Since then the spread declined (6.4 percent in 2011). One should note however that compared to other economies in the region, the interest rate spread is not excessive.

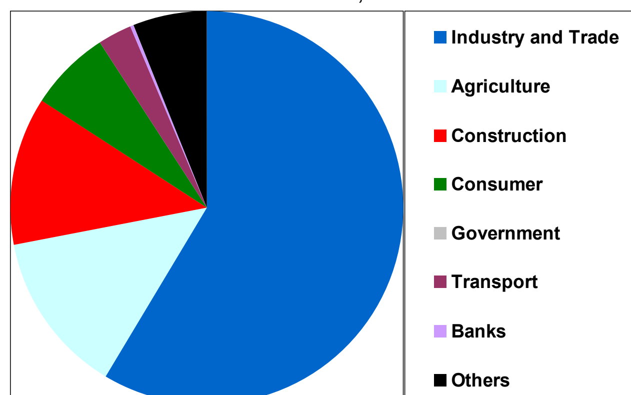
The profitability of the banking sector is declining. As a result of the crisis, returns on Equity and Assets turned negative in 2009 but since then recovered quickly and are now at comfortable levels (9.9 percent and 1.7 percent, respectively). At the same time this is well below what has been observed before the crisis (24 percent and 3.9 percent respectively). Indeed, anecdotal evidence suggests that profitability will remain lower than before the crisis, if banks owned by foreign strategic investors move beyond the "cherry-picking" phase and induce competition in the banking sectors.

NPLs have spiked during the recent financial crisis but have recently declined. During the crisis, NPLs increased from 5 percent in 2008 to 16.6 percent in 2009. With a NPL share of 9.9 percent in 2011 the ratio remains high compared to other countries in the region.

In terms of sector of activity, industry and trade as well as agriculture absorb the bulk of bank's lending, as shown in the figure below. In contrast, lending to consumers is relatively limited.

Moldova, Loan Structure

end 2011, in %



Source: NBM.

The loan to deposit ratio is currently at 91 percent and remained fairly stable during the crisis. The central bank considers that non-resident deposits can provide diversification benefits but also create new financial stability risks, owing to the potentially volatile nature of these inflows.

Main Challenges

The banking sector has developed considerably, but several challenges remain. In recent years, the authorities have addressed some critical banking challenges such as the government's role in the banking system, transparency and the absence of reputable strategic investors. Having said this, several vulnerabilities remain:

- One of the main challenges is to uphold financial stability while seeking to unblock credit. Closely monitoring banks' asset quality, lending and provisioning practices, and capital needs remains a top priority. The cost of credit remains relatively high, and access to long-term credit by the corporate sector, especially SMEs, is very limited. This need is also shown by a NPLs ratio, which though declining, remains high compared to other countries in the region.

- The institutional framework in general and transparency in the banking sector in particular should continue improving. Also, further foreign strategic investments could help to further boost the development of the banking sector.

- The increasing share of foreign currency loans in total loans exposes the borrowers and banks to exchange rate and credit risks.

- Though improvements have been made, weaknesses in the operational environment continue to undermine the efficiency of the banking sector[15]. In particular, uncertainties about policy implementations complicate banks' operations. E.g. as monetary operations by the NBM are often deemed to be unpredictable for banks, they tend to keep higher liquidity.

[15] see IMF (2010)

Table 4: Banking Sector Indicators					
	2007	**2008**	**2009**	**2010**	**2011**
Assets/GDP	59.9	62.1	66.1	58.8	56.7
Deposits/GDP	43.2	43.2	43.7	40.0	38.8
Loans/GDP	38.8	39.4	37.1	35.5	35.4
Loans/deposits	89.9	91.1	84.9	88.8	91.4
Asset concentration (top three banks)	45.8	44.2	45.8	48.6	49.7
Number of banks		16	16	15	15
NPLs/ Gross loans	3.7	5.2	16.3	13.3	9.7
CAR	27.9	29.6	32.1	31.6	29.5
Return on Equity (ROE)	24.2	19.9	-2.1	3	9.9
Loan-loss provisioning/gross loans	4.2	4.9	9.7	8.4	7.6
Capital/Assets	17.3	17.3	17.9	17.3	17.2

Sources: NBM and IMF

Analysis of the Leading Banks

Analysing the banking sector of Moldova at company level is not straightforward as data availability is rather limited. For instance no detailed data is available about the banks' loan structure and information about their ownership structure is limited.

Currently the banking sector consists of 14 banks. Agronind and VICTORIA are the largest banks in Moldova accounting together for roughly 36% of the market. Thus, market concentration is lower than in other countries such as Georgia. Moldova's Universal Bank has lost its license to provide banking services on 15 February 2012. The impossibility to adjust the financial situation of the bank is one of the main reasons which led to insolvency of the institution.

Table 5: Major banks, stylized facts	
Bank	**Some facts**
AGROIND	The Commercial Bank Moldova Agroindbank»S.A. (MAIB) is the largest bank in terms of assets. In 2011 AGROIND reported the highest Return on Assets and Equity.
VICTORIA	It holds a leading position and is ahead of many other commercial banks as regards development and innovations of banking services. Victoria bank has worked together with EBRD since 1995 to develop its SME and Microfinance business.
MOLDINDCON	MOLDINCON reached the highest ROE among the top 10 banks in Moldova in 2011. Its Capital adequacy and liquidity ratios are relatively low. MOLDINDCON has signed a EUR 11mln loan with EBRD to support SMEs in 2009. and a €3.5 million credit line in 2011.
ECONOMII	Banca de Economii S.A. is among the most powerful banks in Moldova. It is the only publicly owned bank.
EXIM	Exim has reported the lowest Return on Equity and Assets as well as a relatively low liquidity ratio. Moreover the share of its non performing loans is excessive (28% as of September 2011) questioning the viability of its business model. Exim has also the highest loan to deposit ratio among the top 10 banks in Moldova.
SOCIALA	Banka Social has the lowest liquidity ratio among the ten largest banks in Moldova. Its profitability is relatively low. The bank is not rated. The EBRD supported SME lending by Banca Sociala through a EUR 5 mln loan in 2010 and 2011.

MOBIAS	Mobias has the highest liquidity ratio and the highest regulatory capital ratio. Moreover it has the lowest ratio of non performing loans to total loans. In 2010, the EIB signed a EUR 55 mln credit line with Mobias to support SMEs.
FINCOM	With a market share of 3.5%, FinComBank is among the smaller banks in Moldova. It performs well on most of the soundness indicators.
ENERG	"ENERGBANK" provides a wide range of corporate and investment banking services to Moldovan and foreign clients. Its client base is comprised of private persons, small and medium size business and large enterprises.
CHISINAU	CHISINAU Bank is the smallest among the top 10 banks in Moldova. It is characterised by high liquidity, a high regulatory capital, a high ROE and low ratio of NPLs. The EIB approved an SME loan with CHISINAU in 2011.

Sources: banks' websites, annual reports, Internet research

As to the ownership structure, all owners with a share above a 5% stake in a bank must be disclosed to the BNM, but not to the public. This poses a risk as many investors are offshore companies and thus the final beneficiaries remain unknown in many cases. Out of 14 banks only 6 have a majority owner. Banca de Economii is the only remaining publicly owned bank with the Ministry of Economy and Trade owning 56.1% of the share capital. Mobiasbanca is owned by the Societe Generale Groupe (87.85%), and EXIMBANK is 100% owned by Veneto Banca from Italy. Banca Comerciala Româna Chişinău S.A is indirectly owned by Austria's Erste Bank through Romania's Banca Comerciala Română Bucureşti and Unibank was purchased by an Austrian venture capital fund.

Soundness indicators vary considerably across banks. AGRO IND bank has the highest loan to deposit ratio and a relatively low liquidity ratio. Mobias has the highest liquidity ratio and the highest regulatory capital ratio. Moreover it has the lowest ratio of non performing loans to total loans. Exim is the bank with the highest regulatory capital adequacy ratio.

Profitability was high for most banks. Indeed, Return on Equity was beyond 10% for seven of the ten largest banks. The largest Return on Assets was reported by AGROIND bank; the lowest Return on Equity and Assets by Exim. This is due to excessive Non performing loans (28% as of September 2011).

Table 6: Analysis of Leading Banks, September or December 2011, monetary values in mln MDL

	Market Share (Assets)	Assets	Loans	Deposits	ROA	ROE	NPLs (% of total)	Regulatory Capital Ratio (≥ 12%)	Ownership structure	liquidity ratio
AGROIND	19.29%	9201.4	6363.2	5832.6	3.30%	17.66%	6.03%	24.98%	private	30.4%
VICTORIA	16.82%	8022.2	4659.6	6493.4	2.02%	16.63%	7.51%	23.22%	foreign owned	37.7%
MOLDINDCON	14.10%	6726.6	4525.0	4953.1	2.26%	18.81%	6.59%	23.07%	private	28.4%
ECONOMII	12.24%	5841.0	2866.0	4494.2	1.28%	8.11%	4.88%	27.90%	public	31.3%
EXIM	7.98%	3807.9	2589.5	1940.5	0.85%	4.39%	28.01%	33.31%	foreign owned	24.1%
SOCIALA	6.69%	3193.2	2215.2	2171.6	1.38%	8.30%	5.76%	24.49%	private	24.1%
MOBIAS	6.11%	2917.3	1684.8	1889.2	2.40%	10.12%	3.43%	49.70%	foreign owned	41.9%
FINCOM	3.51%	1672.3	844.3	1049.0	2.54%	15.14%	7.69%	23.39%	private	35.4%
ENERG	3.32%	1585.1	979.0	1151.0	2.27%	12.11%	8.40%	38.61%	private	31.8%
CHISINAU	2.65%	1266.2	666.1	753.1	2.55%	16.21%	4.89%	44.70%	foreign owned	32.8%
Sector	100.00%	47707.9	29813.5	32632.1	2.0%	11.5%	10.7%	30.4%		33.2%

Source: NBM

Conclusions

While Moldova came through the crisis in relatively good shape, several macroeconomic challenges remain to be solved. Most importantly, Moldova remains vulnerable to external developments because of its reliance on external borrowing and remittances.

Given the income level of the country, the banking sector in Moldova is comparatively sound providing a buffer to face future challenges. Given its income level, the size of the banking sector is adequate but needs to keep up with the growth of the real economy. Also, NPLs are declining relatively quickly. At the same time, the non banking sector continues to play only a marginal role. Moldovan Banks are well capitalised and liquid. Interest rate spreads are not excessive compared to other countries in the region and profitability of banks is adequate.

Looking forward, improving the institutional framework as well as a high level of dollarisation and NPLs are among the most urging challenges to be addressed. The increasing share of foreign currency loans in total loans exposes the borrowers and banks to exchange rate and credit risks. It should also be stressed that banks' liquidity, while buoyant, is short-term whereas many companies are in need of medium to long term financing. Banks' efforts to clean up their balance sheets are leading to a still stagnating credit stock. It should also be noted that the ratio of NPLs remain high. The governance of locally-owned banks and transparency should continue improving. This is also true for the monitoring of banks' asset quality, lending and provisioning practices, and capital needs.

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RUSSIA

By Natalia Orlova, Chief Economist, Alfa Bank

Key messages

- The need to support diversified economic growth and to assure macro stability is a challenge for the Russian Cabinet's ability to stimulate growth through budget instruments, opening an opportunity for higher financial intermediation. However, even if the low level of financial intermediation in Russia promises strong upside, we see a couple structural concerns.

- The demand side of the loan growth is damaged by the unequally distributed debt burden among sectors in corporate lending, by high prices of real estate and deceleration in income growth in retail.

- The supply side is suffering from a lack of long-term savings and increased dependency on state funding. Clients' unwillingness to take currency risks limits the banking sector's ability to use foreign debt as a source of potential long-term funding.

- Our conclusion is that the increase in banking service penetration in the Russian economy should be assured by structural reforms and better prospects for economic growth.

Macroeconomics: Focus on structural issues

Although Russia was deeply hit by the 2008 crisis, the country continues its consumption-based growth: The Russian economy experienced a very sharp 7.8% GDP drop in 2008, which was deeper than in peer countries. This came as a surprise given the low state debt to GDP ratio and strong budget discipline, suggesting that the accumulated macro stability did not help to decouple from the global turmoil. This development suggested that the country's high vulnerability to oil and financial market shocks, which in fall 2008 provoked huge capital outflow and flight from ruble assets, is a risk factor which has to be addressed. At the same time, oil revenues still contribute 65% of the country's total exports and 50% of its federal budget revenues, suggesting no improvement compared to pre-crisis levels. After a brief reduction in 2008-09, corporate foreign debt has already recovered to almost $500bn, its pre-crisis peak. The sharp GDP collapse also focused more attention on the quality of economic growth, which continues to rely on consumption as opposed to investment, and still represents only 20% of GDP. The Russian banking sector, which at the moment has low penetration, can play an important role in supporting more diversified and solid economic growth.

The social focus in budget policy pushed up budget vulnerability to oil prices: Responding to the crisis, the Russian government has focused on stabilizing the economy with monetary and budget easing. The CBR made significant changes to the refinancing system, making it available to a long list of banks. The state spent around $100bn from the state oil reserve fund to assure injection to the real and financial sectors and to finance the budget deficit. Budget policy took on a social focus: 38m pensioners and 18m public sector employees, 40% of total Russian population, became the eventual target. Average pension indexation in 2008-2011 accounted for 25% a year and social expenditures increased from 24% of the consolidated budget expenditures in 2007 to 33% in 2011. The generous social indexation set an environment of strong growth of local funding for Russian banks. At the same time, this social support was financed at the expense of higher budget sensitivity to oil prices: in 2011 the federal budget breakeven to oil prices was $102/bbl versus $34/bbl in 2007. The Russian State Pension Fund now runs a deficit of 2.4% of GDP and poor demographic trends will keep it in deficit for coming years.

Post-crisis economic growth is below the 7.0% average for 2000-2008: The deeper social focus of the budget policy unfortunately did not help to assure fast economic recovery. While in 2000-2008 average GDP growth accounted to around 7% a year, in 2010-2011 GDP growth was only slightly above 4%. This growth continues to be assured by consumption, which currently exceeds the 2008 level by 4% while investments are 4% below the pre-crisis level. The consumption-focused budget policy has in fact fuelled strong import growth, which fully

absorbed household demand growth in 2010 and 2011. Another sign of weakness of the post-crisis growth structure is that more than two-thirds of annual GDP growth in 2010-2011 reflects a recovery in inventories, which is high in comparison with developed and developing countries, and reflects positive expectations over commodity prices and local demand growth as opposed to actual increase in demand.

The private sector is reacting to the new environment through capital outflow: Increased budget vulnerability combined with the obvious deterioration of the growth structure has generated a cautious stance from the Russian private sector. In 2009-2011, Russia experienced very strong private capital outflow, which in 2011 accounted to 4.4% of GDP or $81bn. The corporate implication of this higher preference for foreign investments of Russian capital is that the share of SMEs in Russia remains below 20% of GDP. In the meantime, the state corporations became active players in the Russian economy unlike during the pre-crisis period.

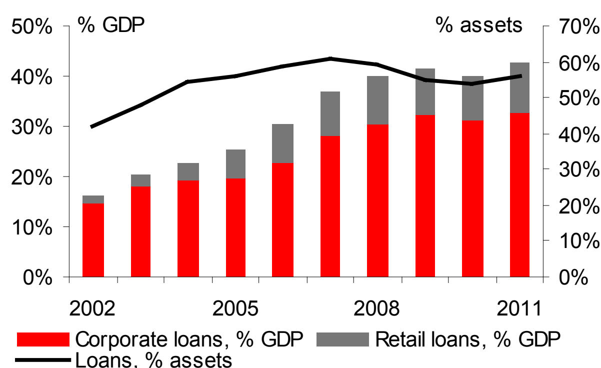
Structural reforms are prerequisite for sustainable loan growth: In coming years, Russia's newly elected president and his Cabinet will have to balance global uncertainty and the need to create a source of local growth. The recent decision to enter the WTO, signed in December 2011, confirms Russia's will to continue its economic integration with the world economy. Even if the opening of the local market will be very gradual, it will bring new risks to Russia, making the economy even more vulnerable to capital flows and global trade instability. Combined with the need to generate investment-focused growth, it is very likely to favor continuing accumulation of oil reserve funds by the Russian government while financing the possible budget deficit from market borrowing. This will offer a window of opportunity to reinforce the role of banks for economic growth in Russia, leading to an increased role in financial intermediation. In the meantime, significant improvement in the business climate, in particular increased competition and institutional reforms, will be a prerequisite to assure high quality of loan portfolios in this scenario.

Russian banking sector: Potential for growth

Assets and loan to GDP ratios are low, financial instrument risks modest: Now as well as before the 2008 crisis, the penetration of banking services in Russia is not very high. Total assets account for 76% of Russian GDP with total loans staying at only 43% of GDP, including 33% of GDP due to corporate loans and 10% of GDP in retail. The loan book represented 59% of total assets in 2008 and declined to 56% of total assets in 2011 (**Figure 1**), suggesting strong long-term upside potential. Since the crisis, Russian banks have increased exposure to financial markets with their share of securities portfolios increasing from 11% of total assets in 2007 to 15% in 2011, but the risks here are limited. The largest share of this portfolio is made up of state or quasi-state corporate bonds, making Russian banks even less vulnerable to foreign market risk than before the crisis. Derivatives were virtually absent among other financial instruments.

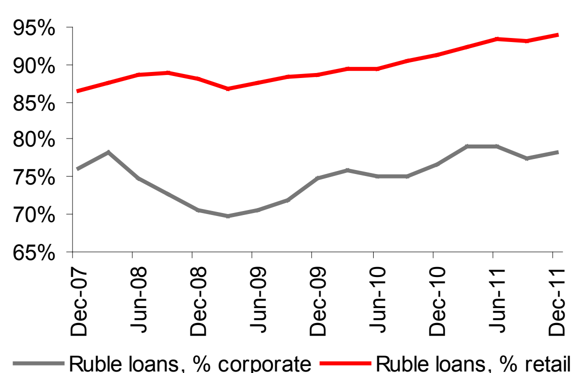
Currency risk is not an issue in Russia: Unlike the situation in a number of other markets, Russian banks have no need to worry about the currency exposure. First, the Central Bank of Russia executes control over the open currency position of banks, which should not exceed 10% of the bank's equity. Second, Russian households have increased their exposure to ruble loans, which as of end of 2011 represents 94% of the total loan book while it stood at 86% of total loans in 2007. Russian companies run a lower share of ruble-denominated loans with around 76% of their loan exposure to Russian banks and demonstrate a high preference for ruble-denominated loans as opposed to the previous period (**Figure 2**). On both retail and corporate sides, the shift reflects the expectations of ruble depreciation based on higher ruble vulnerability to oil. This puts banks in a comfortable position, as opposed to the 2008-2009 situation, because the currency structure of borrowers' revenues is better matched with the currency composition of the loan book.

Figure 1: Russian banks' loan book



Source: CBR, Rosstat Alfa Bank

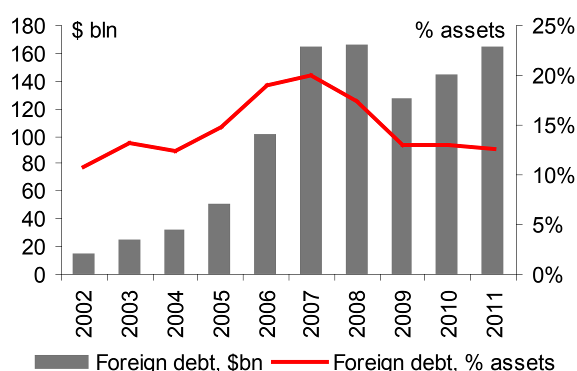
Figure 2: Share of ruble-denominated loans



Source: CBR, Alfa Bank

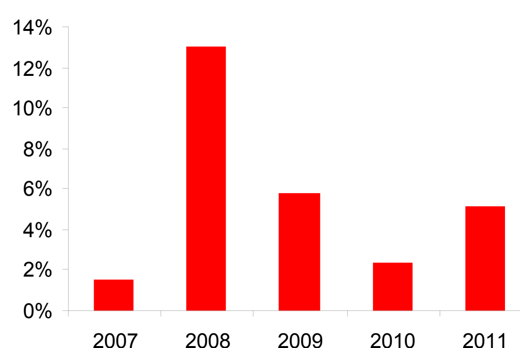
State funding has replaced foreign debt exposure on the liabilities side: On the liabilities side, Russian banks keep low exposure to foreign debt. The foreign debt of Russian banks represents $163bn as of end of 2011, or 9% of GDP, and now funds only 13% of total banking sector assets as opposed to 20% in mid-2008 (**Figure 3**). The decline in foreign debt as a funding source during the crisis was replaced by direct state funding: the position of the Finance Ministry and of the CBR in liabilities of Russian banks jumped to 13% of assets as of the end of 2008, while before 2008 it was virtually nonexistent (**Figure 4**). Even as of the end of 2011, the state funded 5% of total banking sector liabilities.

Figure 3: Banking foreign debt evolution



Source: CBR, Alfa Bank

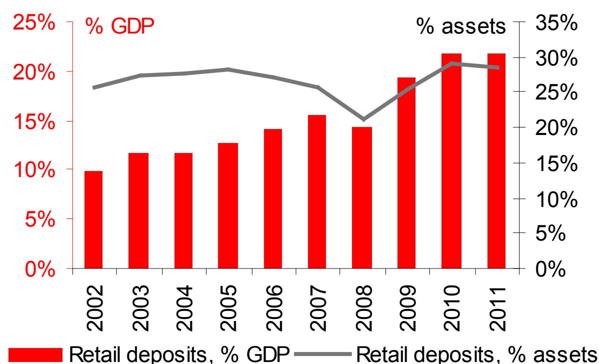
Figure 4: State funding of the banking sector



Source: CBR, Alfa Bank

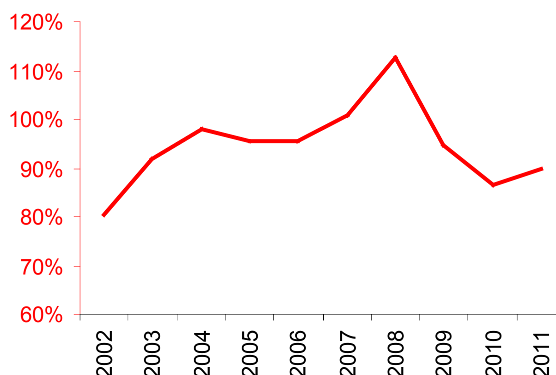
Deposit growth was supported by indexation and helped to reduce the loan to deposit ratio: The government has also initiated an active boost to social spending, mainly pensions, which assured strong inflows to retail deposits. As a result, despite the crisis, the importance of retail funding continued to rise, and by the end of 2011 it reached 22% of GDP, or 29% of assets, becoming the single most important component of bank funding (**Figure 5**). As this process was combined with a deceleration in lending activity, the loans-to-deposits ratio, after spiking to 115% in 2008, returned to the 90% level by the end of 2011 (**Figure 6**), which is very comfortable. The sector thus has room for additional loan growth; however, the economy first has to overcome the consequences of the 2008 bad loan crisis.

Figure 5: Retail deposits, % of GDP and % of assets



Source: CBR, Rosstat Alfa Bank

Figure 6: Loans to deposits ratio



Source: CBR, Alfa Bank

Russian banking sector: Obstacles to growth

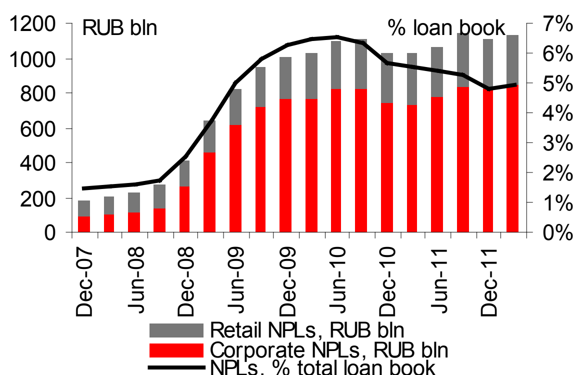
Corporate and retail loan growth of 26% and 36% y/y, respectively, in 2011 is below pre-crisis levels: The current state of the banking sector represents a completely new reality. The pre-crisis market growth was very impressive: average annual corporate loan growth accounted for 41% a year and in retail lending it was as high as 77% p.a. (**Figure 7**). Mortgage, car loans and consumer loan markets emerged from zero and became an important growth factor. Being just 12% of GDP and 1% of GDP in 2000, corporate and retail loans grew to 30% and 10% of GDP by 2008, respectively. In 2008-2009, however, the sector stagnated due to the bad loans crisis and returned to a growth trajectory only in 2010. That said, current growth rates are well below pre-crisis levels – only 26% for corporate loans and 36% for retail in 2011.

NPLs have reached a peak in nominal terms but are not declining: Despite low banking penetration and some recovery in loan growth seen in the last 2 years, the ability to come back to the pre-crisis growth rate is questionable. Some factors suggest that the recovery in lending demand will not be as easy as expected. First, the recovery is considered easier when the crisis is followed by deleveraging. This helps companies to reduce debt burdens and later to enter a new growth cycle. The countries that posted a decline in financial leverage delivered faster lending recovery following the crisis. But in Russia, deleveraging did not take place, and the loan to GDP ratio is currently staying even slightly above that of 2008. This is a reflection of the fact that Russian banks were offering companies the possibility to reschedule their loans during the crisis, which helped to avoid deeper economic contraction, but kept companies burdened with debt and banks with hidden NPLs of up to 20-30% of their loan books. This idea finds support from the fact that even the official NPL level in nominal terms stopped declining in 2010 (**Figure 8**) and still remains above the pre-crisis level relative to the loan book.

Figure 7: Retail and corporate loan growth

Source: CBR, Alfa Bank

Figure 8: Non-performing loans dynamics



Source: CBR, Alfa Bank

The oil sector has a low debt-to-GDP ratio; the non-oil sector is burdened by debt: Another obstacle to strong loan growth is the fact that the debt burden in Russia is not equally spread across the sectors. The Russian oil sector represents 15% of Russian GDP but its accumulated debt represents just $100bn, or 40% of the sector's value added. In the meantime, the non-oil sector has accumulated almost $750bn, representing as high as 90% of its GDP. This second figure is comparable with the high debt to GDP level observed in the developed countries, suggesting some limits to potential growth. The paradox is that this segmentation would suggest that additional demand for loans could come from fuel companies, but as the Russian state is taking around 3/4 of their export revenues in form of taxation, fuel sector annual output growth is around 2-3% a year, well below the GDP growth level, also limiting the demand for loans from this sector.

The lack of good borrowers is an obstacle to corporate loan growth: Given the high NPL level and unequally distributed debt burden in the economy, Russian banks obviously have a preference to provide loans to related parties or state corporations, which usually can provide implicit or explicit guarantees from the government. The share of related parties lending in Russian banks on average remains as high as 10% of loans and 50% of the bank's equity capital, however in some cases is going as high as 20-30% even for big and known institutions. Looking into sector composition, the share for state-related construction and transportation sectors increased in previous years, while the share of the trade sector, the most private-oriented, has declined (**Figure 9**). SME lending still suffers from a couple obstacles, namely the low transparency of their financials and the lack of high-value, liquid collateral assets. As a result, since the crisis Russian banks have become more focused on large borrowers as opposed to SMEs. There are no statistics available, but by our estimates the share of large borrowers has increased from 40% of the corporate loan book in the pre-crisis years to 60-70% now. The instability of global financial markets has also helped Russian banks gain exposure to this group of clients, as before the crisis large Russian corporates were usually attracting capital from abroad.

Figure 9: Corporate loans sector composition, % of total

	2006	2008	2011
Commodity extraction	5.2%	4.4%	3.7%
Manufacturing	19.5%	19.0%	19.4%
Regulated services	2.7%	2.5%	3.6%
Agriculture	4.8%	5.5%	6.3%
Construction	6.5%	8.1%	7.9%
Real estate	8.5%	10.5%	12.5%
Transport	4.9%	5.7%	6.9%
Trade	26.2%	23.0%	19.4%
Other	21.6%	21.4%	20.3%

Source: CBR, Alfa Bank

Retail lending is only 25% of total loans in Russia: The weakness of corporate lending, which represents 75% of Russian banks' loan book, cannot be offset by retail lending, which despite the recent acceleration of growth rates is also facing structural problems. After the 2008 crisis, the retail loan market became more focused on short-term loans, such as personal (cash) loans and credit cards, while the share of long-term products, i.e. mortgage and car loans has declined (**Figure 10**).

Slower income growth and expensive real estate limit retail lending prospects: The key obstacle to improved confidence in the retail lending segment is the dynamics of disposable income. If in 2000, at the beginning of the retail lending expansion, the average monthly wage in Russia was $100 compared with the average per capita consumer (non mortgage) loan of just $10, by 2011 the monthly average per capita wage of $800 corresponded to almost $900 per capita consumer loan, suggesting limited potential for growth (see **Figure 11**). While before 2008 average real disposable income growth was in the double digits, for 2007-2010 it grew 2-4% a year and slowed to just 1% in 2011 (see **Figure 12**).

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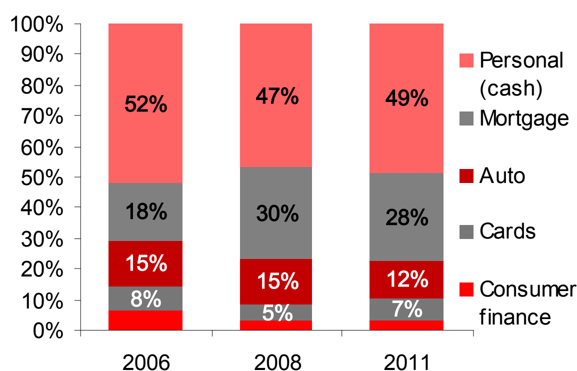
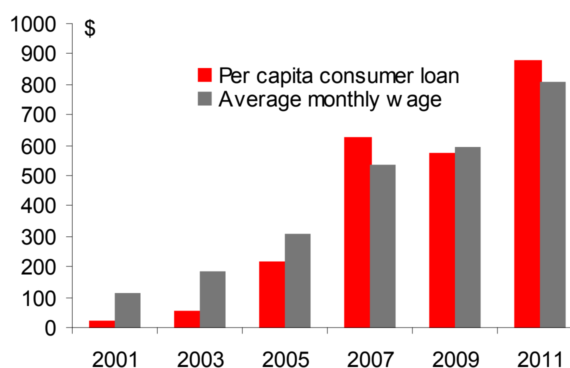
Very positive expectations regarding Russian banking market growth traditionally relied on the positive view on the mortgage segment. The largest portion of retail lending in the developed economies is related to these long-term products. However, in Russia this market slowed significantly in the post-crisis years, which happened for a couple reasons. First, real estate in Russia is very expensive, which limits the potential demand for loans. Compared with other countries, Russian cities have one of the highest costs of real estate compared to GDP per capita (**Figure 13**). Such a level implies that demand tends to decline rapidly when price growth is limited. The second issue is that as opposed to developed countries, where usually a small part of the population owns real estate, in Russia around 80% of households are owners of their property. The demand for mortgages thus reflects willingness to improve life conditions rather than just a necessity. Thirdly, labor market conditions limit the accumulation of long-term debt at the household level. In Russia employees have little legal protection against losing jobs and thus are usually trying to borrow over 2-3 years. In addition, high interest rates make mortgages too expensive.

Figure 10: Retail loan book composition



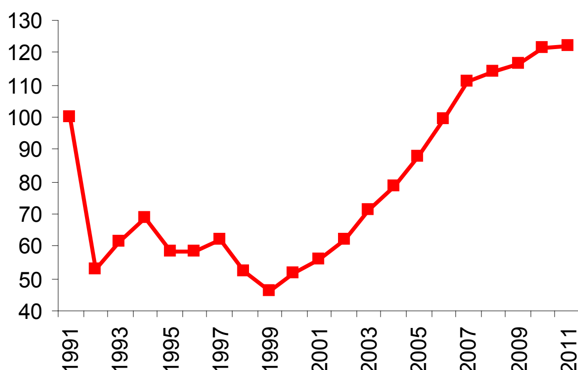
Source: CBR, Frank Research Group

Figure 11: Monthly wage and per-capita consumer loans*



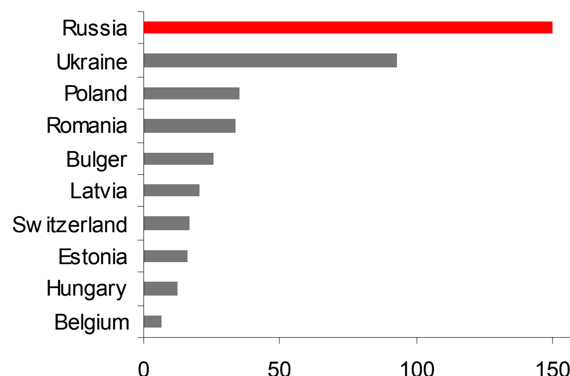
*Source: Rosstat, CBR, Alfa Bank; * - retail loans less mortgage*

Figure 12: Real disposable income index



Source: Rosstat, Alfa Bank (1991=100)

Figure 13: House price to GDP per capita*,



*Source: Global Property Guide, Alfa Bank; * - price of 100 sqm upscale residential property relative to annual per capita GDP*

Liabilities: Long-term funding is still an issue

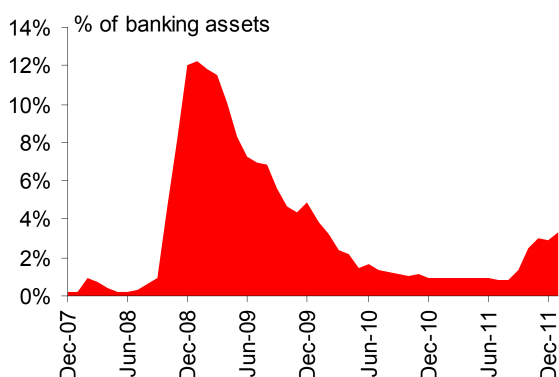
The 2008 crisis pushed the CBR to expand the list of its refinancing facilities, previously available mainly for state-owned banks: The combination of the interbank crisis and the bad loan crisis in 2008-2009 led Russian banks to increase their demand substantially for Central Bank refinancing. The CBR's most commendable achievement was its ability to thoroughly deal with the liquidity crunch. At the time, with Russia absorbed in the financial turmoil of 2008, it was equipped with a very restricted system of refinancing facilities, of which key instruments were repo operations based on the state or municipal bonds. Taking into account the decline in

Russian sovereign debt the previous year, it is clear that the size of this market was insufficient to guarantee large-scale refinancing support. Another important issue was that state bonds were mostly held on the loan books of large state-owned banks. The low return on these state bonds made them largely unattractive for private banks, and consequently, private banks had limited access to refinancing facilities.

In September/October 2008, the CBR oversaw an unprecedented series of changes in the refinancing system. After defining a list of around 120 banks which possessed appropriate risk profiles, the CBR began offering unsecured loans with a 3-6 month maturity. By the end of the fall of 2008, the CBR started providing refinancing for corporate loans to banks' large borrowers. In a record short period, the CBR supplied banks with RUB 3.5tr ($110-120bn) in liquidity support, which played an important role in stabilizing the banking sector. In addition, it offered around $10bn in support to banks on their cross-guarantees, taking the banks' loan books as collateral. While before 2007 the CBR had never had strong direct exposure to local banks, as of the end of 2008 it was funding 12% of total banking assets (**Figure 14**).

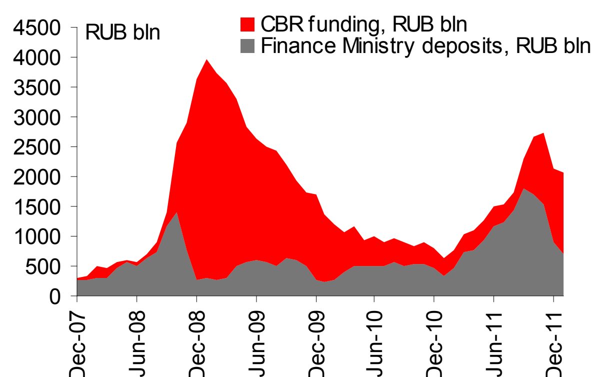
The Finance Ministry is also intervening to support banking sector funding: An important factor to take into account is that in Russia, in addition to CBR refinancing, the Finance Ministry is also actively participating in providing support to the financial sector. In fact, the Finance Ministry started to intervene at a very early stage in the crisis, in 2007, by placing its budget surplus in deposits with Russian banks. As opposed to the CBR instruments, deposit auctions are available for a more limited list of banks, containing around the 20-30 largest institutions. The Finance Ministry deposits are thus an instrument used to smooth the banking sector trend, but during financial turmoil they cannot really replace the CBR's refinancing support (**Figure 15**). In 2008, the Finance Ministry was also ready to support banking sector equity capital, allocating money from the Stabilization Fund to provide 5-10 year subordinated loans through VEB, the government's development bank, to the largest banking institutions. In fact, around $14bn was used by banks to support their equity capital through this instrument.

Figure 14: CBR funding of banking sector



Source: CBR, Alfa Bank

Figure 15: Finance Ministry and CBR support

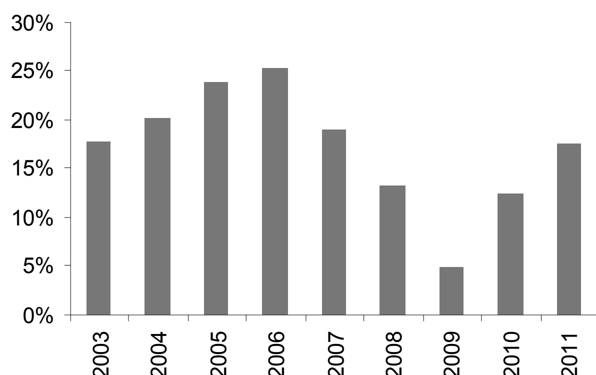


Source: CBR, Alfa Bank

ROE is now 15-20%, with the margin having contracted: With 5% of total banking assets funding from the CBR and Finance Ministry, we see Russian banks relying on the state even if loan growth stays strong. State funding support to local banks in 2011, similarly to 2007, is now largely motivated by an intention to ease pressure on margins. According to expert estimates, the net interest margins of Russian banks were down 1.0-1.5pp in the last three years, declining from a level of 6% to 4.5%-5.0%. Russian banks now run ROEs of 15-20% as opposed to the 20-25% seen in pre-crisis years (**Figure 16**).

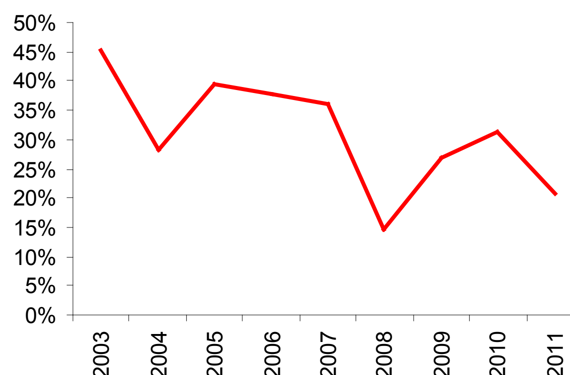
Long-term funding is still an issue for Russian banks: While the Russian authorities have successfully resolved the liquidity issue, Russian banks are definitely suffering from a lack of long-term funding. Traditionally, retail deposits have been the key source of funding, accounting for one-third of total assets with another 30% coming from corporate deposits and foreign debt being the third large contributor. Retail deposit growth, which had decelerated from 35-45% pre-crisis to 30% in 2009-2010, was still strong, supported by pension indexations (**Figure 17**). However, with tighter budgetary control, the fast pension indexation is over and this will limit the growth of retail deposits.

Figure 16: ROE, 2003 -2011



Source: CBR, Alfa Bank

Figure 17: Retail deposits growth, y/y



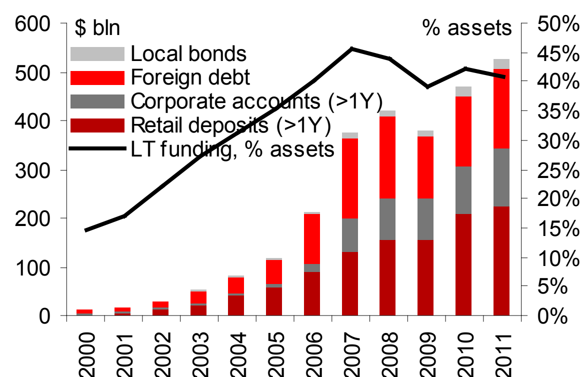
Source: CBR, Alfa Bank

Before the 2008 crisis, Russian banks were actively building their exposure to foreign debt, which by 2008 funded 20% of their assets. The global instability brought on by the Lehman Brothers collapse caused them to cut exposure to this instrument. In 4Q08, Russian banks had to redeem $30bn, or 12% of their foreign debt, leading to a severe contraction of banking liquidity and forcing banks to look for a replacement. The decline in foreign debt continued until the end of 2009, when it fell to $127bn, or 65% of its pre-crisis peak. The current instability of global markets is likely to limit banks' ability to rely on this source of funding.

Foreign debt, together with retail deposits, were the key contributors to long-term funding, which accounted to 45% of total assets in pre-crisis 2007 (**Figure 18**). However, long-term funding has now fallen to 40% of assets, becoming a potential limit for banking system growth.

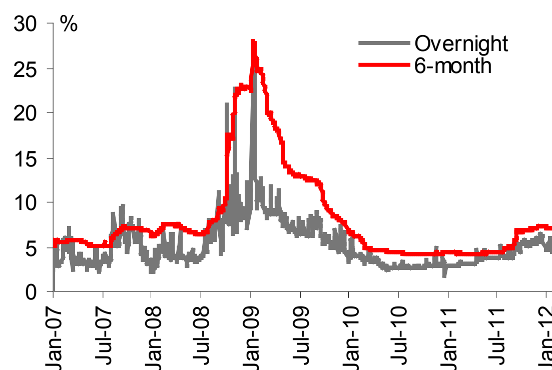
Slower growth in net savings in Russia forces interest rates to rise: Another way to look in to the funding constraint is to match the net lending position of Russian households and Russian companies. Historically, households maintained a large net savings position, which was used to finance borrowing by companies. Previously, the fast growth in household income allowed the population to increase their net savings rapidly, and in 2010 it reached almost $200bn. However, as a result of the slowdown in pension indexation last year, households failed to increase their net savings materially. Thus, with the recent recovery in demand for loans from the corporate sector, the gap between household and company positions is narrowing, which has already caused an increase in interest rates on the Russian market, and this constitutes a risk factor for continuing loan growth (**Figure 19**).

Figure 18: Long-term funding of Russian banks



Source: CBR, Alfa Bank

Figure 19: Interbank interest rates



Source: CBR, Alfa Bank

Competition is getting tougher

Foreign banks had little presence in the Russian market before the crisis and started to retreat thereafter: The crisis is causing serious structural changes in the banking sector universe. Before the crisis, the key concern was how to play the penetration of foreign banks in to the local market. Indirectly, through foreign borrowing, even in 2011 the Russian economy saw significant exposure to foreign banks, which at $494bn was equivalent to the total Russian corporate foreign debt. However, the direct presence of foreign banks is rather modest: as of 2008 the share of foreign banks represented around 13% of total assets, 16% in retail loans and 12% in corporate loans (**Figure 20**).

Figure 20: Foreign banks' direct presence in Russia

	2000	2005	2008	2011
Assets	6%	8%	13%	12%
Retail deposits	2%	3%	5%	6%
Retail loans	3%	9%	16%	14%
Corporate loans	2%	7%	12%	10%

Source: CBR, Interfax, Trust, Alfa Bank

In addition, following the global crisis, foreign banks are facing difficulties in boosting their presence on the Russian market. The halt in disposable income growth in Russia has forced a downgrade in retail segment growth prospects, which, combined with tighter prudential regulation in developed economies, resulted in a wave of retreats starting in 2010. A large number of foreign banks either sold their business or cut them significantly (**Figure 21**), reducing the presence of foreign players in most of the banking markets.

Figure 21: Retreat of foreign banks from the Russian market

June 2010	**Morgan Stanley** sells mortgage business in Russia
July 2010	**Swedbank** announces closure of retail business in Russia
Dec. 2010	**Santander** exits Russian market
Jan. 2011	**Barclay's** announces intentions to sell retail business in Russia
April 2011	**HSBC** announces exit from the Russian retail market
June 2011	**GE Money Bank** and **Handelsbanken** announce intention to quit Russia
Sep. 2011	**BNP Paribas** announces intention to close majority of branches in Russia

Source: Media, Alfa Bank

Another possible reason why foreign banks took a cautious view on the Russian market is that positive expectations for a change in Russian regulation related to Russia's WTO entry did not materialize. After joining the WTO, Russia will continue to prohibit foreign banks to open branches in Russia, and thus they will still have to register as a local banking entity applying for a local license and provisioning equity capital. This regulatory clause limits foreign banks' interest in Russian expansion.

The number of Russian banks is declining: The declining activity of foreign banks caused a deceleration in M&A activity in the Russian banking sector and is one of the reasons explaining a faster decline in the number of banks in Russia. While the number of Russian banks stayed at 1,107 until 2009, as of the end of 2011 it had declined to 922, mainly at the expense of small banks. The largest Russian banks used the crisis as an opportunity and continued to gain market share, with the top 20 Russian banks now controlling 70% of the market, while the share of the top 200 banks is now 94% (**Figure 22**).

Figure 22: Banking sector concentration, % of assets

	2000	2007	2009	2011
Top-5	41%	42%	48%	50%
Top-20	64%	64%	68%	70%
Top-50	76%	76%	80%	81%
Top-200	89%	92%	94%	94%

Source: CBR, Alfa Bank

While positive, the decline in the number of banks is still relatively slow. According to various estimates, Russia should keep between 300 to 500 banks, the range that would be optimal given the country's macro parameters. The high level of concentration also points to the need to adjust the number of banks. The context of slower loan growth, in our view, should set the case for a continuing reduction in the number of players in coming years.

State banks have been gaining market share in corporate and retail loans: Another dimension to the higher concentration of the banking business in the last year, however, was the significant reinforcement of state-owned banks. In a way, this trend is not completely new and contradicts the peer trend. The share of the three largest state-owned banks (Sberbank, Russian Agricultural Bank and VTB group) in both corporate and retail lending markets was around 30% in 2000; however, this increased during the period of the lending boom up through 2007 and continues to increase following the crisis. The figure is currently between 45-55% of the entire sector, signaling a very high level of concentration (**Figure 23**). State banks' share of the retail deposit markets had stabilized at around 55-57% of the market by 2007, when Sberbank's lost its monopolist 85% market share that the bank had in the aftermath of the 1998 crisis.

Figure 23: Market share of top 3 banks, % of respective segments

	2000	2007	2010	2011
Assets	28%	37%	43%	47%
Corporate loans	33%	45%	48%	53%
Retail loans	34%	39%	44%	46%
Retail deposits	77%	57%	55%	56%

Source: CBR, Interfax, Trust, Alfa Bank

The gap between the largest bank by assets and the second largest in Europe represents around 4% of the market, with the largest player controlling around 20% and the second largest 15% of the market. In Russia, however, Sberbank has 27% of total assets while VTB, the second largest and also a state-owned bank, holds 17% of the market (**Figure 24**) even after the purchase of Bank of Moscow, another state bank. The largest private bank in Russia has only 3% of the total assets, staying in fifth place after the state banks and making competition virtually impossible.

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Figure 24: First and second largest banks' market shares by country, 2010-2011

	1st bank share, % assets	2nd bank share, % assets
Slovakia	18	17
Bosnia	21	20
Poland	15	14
Bulgaria	15	13
Serbia	13	10
Czech Republic	21	18
Croatia	23	18
Romania	25	16
Hungary	20	9
Russia	27	17

Source: Fitch, media, Trust, Alfa Bank

State banks' presence grew through organic and non-organic growth: It should be noted that the state banks' reinforcement during the crisis was both organic and non-organic. Organic growth was first of all assured by the large size of state banks, which is a competitive advantage per se. The CBR enforces a rule under which a bank's exposure to one borrower should not exceed 25% of the bank's equity capital. As a result, state banks as the largest players have a natural advantage for organic growth, while this limits the ability of private, much smaller, banks to service the largest Russian companies and gain market share. Secondly, financial instability in Russia is usually associated with the banks' inability to pay back deposits. Despite the fact that the deposit insurance system launched in Russia in 2004 has substantially reduced the risks of runs on deposits, the crisis has still pushed depositors to transfer their savings from private banks to state-owned entities. This helped the state banks maintain their market presence on the retail deposit market in 2008-2010 despite less competitive interest rates.

Acquisition activity has been another channel to gain market share. Supporting troubled banks via state banks is not a new practice for Russia. During the 2004 banking crisis, GUTA-Bank, a troubled retail bank, was purchased by the state-owned VTB. In 2006 the bank purchased another institution in Saint-Petersburg, Promstroybank, and converted it into its VTB North-West, a regional branch. In 2010, VTB also acquired Transkredit bank, which was the pocket bank of Russian Railways. In 2011, VTB initiated an acquisition of Bank of Moscow, the largest municipal bank, which required around $10bn in support from the Central Bank of Russia. In total, VTB has consolidated banks that together accounted for 5% of the market in 2008 (Transkreditbank, Bank of Moscow). In addition to VTB, during the 2008 banking crisis the government used VEB, its development bank, to purchase two troubled institutions, Globex and KIT-Finance. The state also announced an ambitious plan to support the development of state-owned Svyazbank, a proxy to the postal savings banks in developed countries.

Key players

NPLs declined, provisions are still high: The environment of slower loan growth and accumulated bad loans has affected the financials of key Russian banks. Even though the level of NPLs (90+ day overdue interest payments) has declined from an average of 8% for the top-5 Russian publicly traded banks to the current figure of 5%, which is still rather high. The average level of provision coverage of these bad loans represent around 150%, which is still above the 130% seen in 2009, reflecting the point that banks are not yet comfortable to release provisions. We anticipate the level of provisions should stay high in coming years, reflecting global regulators' preference for tighter provisioning rules.

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The net interest margin has declined: Rather weak demand growth combined with unstable funding has put pressure on banks' net interest margins. While in 2009 the NIM for the sample of banks was around 6% on average, it has now declined to only 5%. The key reason is that the yield on loans dropped even more significantly as opposed to the cost of liabilities in the last three years.

Low cost efficiency reflects the business environment: The need to compete in the tighter economic environment has resulted in deterioration of the cost/income ratio. While staying below 40% on average in 2009, it is now close to 50%. The high administrative burden, reflecting high levels of employment in the back-office will be an obstacle to reduce this indicator in the near future.

ROE is lower than pre-crisis: Not surprisingly, banks' ROE has declined to around 20% as opposed to 25% seen before the crisis. This is also putting pressure on capital adequacy ratios. While the average indicator did not change much in 2011 as opposed to 2009, the ability of the largest banks to keep it high has differentiated substantially. This implies that if, despite constraints to generate growth, Russian banks will continue to increase their loan books, they will soon face a capital constraint.

Figure 25: Key indicators of Russian top publicly traded banks

	SBER	VTB	NMOS	VZRZ	BSPB	Average
90-day NPLs / gross loans						
2009	8.5%	9.8%	6.2%	7.2%	6.4%	7.6%
2011	6.0%	5.8%	2.1%	6.0%	4.6%	4.9%
Provisions / 90-day NPLs						
2009	124.9%	94.2%	153.2%	137.7%	142.4%	130.5%
2011	133.7%	111.8%	143.8%	153.6%	198.6%	148.3%
Net interest margin						
2009	7.4%	4.1%	6.5%	6.0%	4.7%	5.7%
2011	6.2%	4.1%	4.7%	4.1%	4.8%	4.8%
Yield on average assets						
2009	12.0%	10.2%	13.5%	12.2%	11.6%	11.9%
2011	9.2%	7.7%	8.6%	8.0%	8.9%	8.5%
Yield on average liabilities						
2009	-5.2%	-6.8%	-8.1%	-7.0%	-7.6%	-6.9%
2011	-3.3%	-4.0%	-4.5%	-4.3%	-4.6%	-4.1%
Cost / income ratio						
2009	35.4%	47.2%	25.5%	48.7%	25.1%	36.4%
2011	47.9%	44.0%	47.3%	68.8%	33.5%	48.3%
Return on equity						
2009	3.2%	-14.8%	12.2%	7.8%	3.2%	2.3%
2011	28.8%	17.6%	19.2%	9.4%	21.7%	19.3%
Tier 1 capital adequacy ratio						
2009	11.5%	14.8%	13.8%	15.5%	10.7%	13.3%
2011	12.5%	9.7%	11.7%	12.1%	9.6%	11.1%

Source: Company data, Alfa Bank

Conclusion

Accelerated loan growth may bring risks given the business environment: Even if the level of banking sector penetration in Russia is low by global standards and continuing economic recovery offers a window of opportunity for financial intermediation to expand, there are still a couple of concerns with regards to the sustainability of this trend. The structural constraints of the Russian economy are affecting banks on the assets and liabilities side. As opposed to developed countries, financial risks, including the currency composition of the loan book and exposure to financial assets, are not an issue in Russia. However, the remaining burden of bad loans and the weakness of the Russian economic growth model suggest potential poor quality of local demand for loans. In this situation, should banks continue strong loan growth without appropriate institutional and structural reforms, the risk of a new NPL crisis remains possible for the Russian banking sector in coming years.

The funding structure raises concerns: An additional reason to have concerns over the stability of the banking sector in case of continuing growth is weakness on the liabilities side. A big portion of long-term funding was previously attracted through foreign borrowing, which now is not such an obvious option. Retail deposits are likely to slow growth in coming years. While at the moment both the Central Bank and the Finance Ministry are increasing their support to banking system liabilities, this funding is of a much shorter nature, which will not help to assure long-term funding and did not prevent the recent increase in local interest rates.

State banks are replacing foreign banks: While foreign bank penetration in the local market turned out much slower than expected, the sector is dominated by state-owned banks, which reinforced their position through organic growth and acquisitions made during the crisis. The competitive environment is thus tighter for private banks. Also, this sector structure brings an additional risk of a potential bad loan crisis, generated by the state-dominated part of the banking segment.

Higher financial intermediation should be assured by structural reforms: While Russia intends to join global efforts to improve prudential regulation and is actively following the new approach proposed by Basel III, we believe that the combination of potential risks and low financial intermediation implies that higher banking penetration is more an issue of the investment climate and structure of the Russian economy. We believe that an increase in the level of competition and institutional transformation would have a strong positive impact on the banking sector, allowing financial intermediation to increase its role in financing economic growth.

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Figure 26: Key macro figures

MACRO					
	2008	**2009**	**2010**	**2011**	**2012F**
GDP per capita, $	11711	8615	10494	13080	13190
Real GDP growth, %	5.2%	-7.8%	4.3%	4.3%	3.2%
CPI growth, %	13.3%	8.8%	8.8%	6.1%	5.8%
Current account, % GDP	6.2%	4.0%	4.8%	5.5%	4.0%
Budget balance, % GDP	4.1%	-5.9%	-4.0%	0.8%	-1.0%
State debt, % GDP	6.5%	8.3%	9.4%	8.2%	8.7%
Population, mn people	141.8	141.9	141.7	141.5	141.2
BANKING SECTOR					
	2008	**2009**	**2010**	**2011**	**2012F**
Assets/GDP	68%	76%	75%	76%	84%
Deposits/GDP	36%	44%	46%	48%	52%
Loans/GDP	40%	42%	40%	43%	48%
Loans/Deposits	113%	95%	87%	90%	91%
Retail loans, % total	24%	22%	23%	24%	24%
Corporate loans, % total	76%	78%	77%	76%	76%
Retail loans, % growth	34%	-11%	14%	36%	17%
Corporate loans, % growth	35%	0%	12%	26%	15%
Top 3 banks, % assets	n/a	45%	45%	46%	n/a
Number of banks	1058	1107	955	922	n/a
NPLs, % total loan book	2.5%	6.2%	5.7%	4.8%	5.0%
CAR	16.8%	20.9%	18.1%	14.7%	n/a
ROE	13.3%	4.9.%	12.5%	17.6%	n/a
Provisions/NPLs	213%	179%	184%	175%	n/a
Capital/Assets	11%	13%	13%	12%	n/a
MEMORANDUM					
	2008	**2009**	**2010**	**2011**	**2012F**
GDP, $bn	1661	1223	1457	1850	1862
Asset, RUBbn	28022	29430	33805	41628	47144
Deposits, RUBbn	14682	17042	20945	25963	29391
Loans, RUBbn	16527	16116	18148	23270	26872
Capital, RUBbn	3 109	3 766	4 339	4 963	n/a

Source: CBR, Rosstat, Alfa Bank

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TAJIKISTAN

By Brett E. Coleman, Senior Financial Sector Specialist, and Bujana Perolli, Financial Analyst, the World Bank[16]

Key Messages

- Tajikistan has emerged from the global economic downturn of 2009, but the outlook for 2012 is uncertain. The economy grew by 6.5 percent in 2010, by an estimated 6 percent in 2011, and is projected to grow by 6 percent in 2012. However, risks from a potential global or regional slow-down have recently increased.

- The banking sector remains weak, with a large overhang of NPLs, weak profitability, and funding and liquidity constraints. The economic slowdown that followed the 2009 global crisis, the Government's interference in lending to the agriculture sector (particularly cotton) via directed lending programs, poor risk management in banks, deficiencies in the supervisory and regulatory framework, and the absence of an effective financial infrastructure, have contributed to increased stress in the banking sector.

- Structural weaknesses need to be addressed for sustainable economic growth. Priorities remain to: (i) maintain sound macroeconomic management and manage public finances more efficiently; (ii) strengthen governance of public institutions; (iii) create a sustainable mechanism for agricultural finance; (iv) foster a more conducive environment for private sector growth, and (v) address vulnerabilities in the financial sector in order to enable it to intermediate more effectively and efficiently, and thus contribute to economic growth.

Macroeconomic Overview

The Tajik economy grew rapidly prior to the 2008-09 global financial crisis. The economy grew at an average of 8 percent per year during 2000-2008. Growth was driven mainly by a favourable external environment, with rising prices of Tajik exports, especially aluminum and cotton; and growing demand for Tajik labor especially from Russia, resulting in high remittance inflows equivalent to over 45 percent of GDP in 2008.

However, macroeconomic vulnerabilities built up during the high growth period, and they were exacerbated by the global crisis. In 2007, inflation rose close to 20 percent,[17] the current account deficit to about 9 percent of GDP, and external debt to 40 percent of GDP. The fiscal position was weakened from a surplus to a deficit of over 6 percent in 2007 due to increased borrowings to finance infrastructure projects. Lower world prices of cotton and aluminum in 2007 led to a severe terms of trade shock. Increased fuel and food prices coupled with an expansionary monetary policy led to high inflation. The global crisis exacerbated these vulnerabilities and affected Tajikistan mainly through: (i) a contraction in remittance inflows by more than 30 percent in 2009 leading to a decline in incomes; and (ii) reduced exports and investment as Tajikistan's trade partners were hit hard, especially Russia. In 2009, growth of the Tajik economy slowed down to 3.9 percent. The economic downturn had a negative impact on the banking sector, as bank performance weakened, nonperforming loans (NPLs) increased sharply, and liquidity was constrained.

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[16] The World Bank supports financial sector development in Tajikistan through diagnostics, technical assistance, and financial support. The World Bank has conducted various diagnostics on the financial sector in Tajikistan, including an access to finance assessment in 2009 and a vulnerability assessment in 2010. The World Bank provides significant financial sector advisory assistance to the Tajik authorities, including on: (i) banking legislation and regulation (central bank law, banking law, deposit insurance law, payment system law, bank insolvency law, and related regulations); (ii) payment systems development; (iii) secured transactions modernization; (iv) banking supervision; and (v) contingency planning. The World Bank also assisted the authorities to prepare a medium-term financial sector strategy and action plan and mobilize donor support for its implementation. A World Bank private sector development project currently under preparation will support financial sector development by financing: (i) the establishment of a modern, online collateral registry; (ii) upgrading of the real-time gross settlement payment system in the National Bank; and (iii) further strengthening of the regulatory and supervisory framework for the banking sector.

[17] Inflation averaged 13 percent in 2007.

The Tajik economy has recovered from the global crisis, but structural weaknesses depress sustained economic growth. The economy has recovered with a 6.5 percent growth in 2010, and an estimated 6 percent growth in 2011, driven by domestic trade and services, as well as agriculture, construction, and industry. The recovery of remittances has been key in fueling growth. Real GDP growth for 2012 is projected at 6 percent, and inflation is expected to decline gradually, in line with global food and fuel prices. However, there are structural weaknesses that need to be addressed for sustainable growth including: (i) maintaining sound macroeconomic management and managing public finances more efficiently; (ii) increasing the financial viability and transparency of state-owned enterprises (SOE); (iii) creating a sustainable mechanism for agricultural finance; (iv) improving a poor investment climate; and (v) addressing weaknesses in the banking sector so it can intermediate more efficiently and support private sector growth.

Table 1: Macroeconomic Indicators

							2010 median values for Emerging Regions			
	2007	2008	2009	2010	2011e	2012p	ENCA	EE	East Asia	LatAm
GDP per capita (USD)	514.5	696.3	661.0	733.9	862.0		3,013	8,926	2,549	6,980
Real GDP growth (% change)	7.8	7.9	3.9	6.5	6.0	6.0	6.4	1	7.7	5.3
CPI Inflation (period average)	13.2	20.4	6.5	6.5	13.0	10.6	7.4	2.8	4.5	4
Current Account Balance (% of GDP)	(8.6)	(7.7)	(5.9)	2.1	(4.1)	(6.5)	-8.3	-4.4	2.5	-2.1
Fiscal Balance (% of GDP)	(6.1)	(5.5)	(5.4)	(3.7)	(5.4)	(4.1)	-2.4	-3.9	-2.6	-2
Gross government debt (% of GDP)	35.2	30.2	36.6	36.7	33.3	35.3	26.6	41.4	49.4	36.3
External debt (% of GDP)*	40.7	46.0	51.5	50.4	51.8	52.1	79.2	45.6	28.7	26.2
Population (Millions)	6.7	6.8	7.0	7.6	7.8	8.0	9.5	5.9	132.9	14.6

Source: World Development Indicators (World Bank), World Economic Outlook (IMF), Quarterly External Debt Statistics (IMF), Official statistics and World Bank staff calculations and estimates.

ENCA: Eastern Neighbours and Central Asia; EE: Emerging Europe; LatAm: Latin America

**Latest figure is for Q32011*

The private sector, the engine of economic growth, faces significant constraints due to a poor business environment. Enterprise surveys[18] show that firms face substantial constraints to growth with the top four constraints being: (1) tax complexity and inefficiencies; (ii) unreliable electricity supply; (iii) corruption; and (iv) limited access to finance. The World Bank's Doing Business 2012 indicators show that the investment climate in Tajikistan is amongst the least supportive of private sector growth in Central Asia. Tajikistan was ranked 147th of 183 countries for doing business (although this is an improvement from 2011's rank of 152nd).

Financial Sector Risks and Development Challenges

The financial sector in Tajikistan is dominated by the banking system, which accounts for about 90 percent of the system's assets. There were 15 banks operating in Tajikistan at end-2011. Banking sector assets amount to 25 percent of the country's GDP (Table 2), relatively low compared to some of its neighbors. Foreign banks account for a very small share of the banking sector's assets. The banking system is highly concentrated, with the 3 largest banks by asset size (Agroinvestbank, Orienbank, and Amonatbank) accounting for over 70 percent of the system's assets. Microfinance organizations are small but growing, and they account for 9 percent of the financial system's assets. Other segments of the financial sector are virtually nonexistent.

The Tajik financial sector grew rapidly until 2008, but growth has slowed since then.[19] Increased financial intermediation before 2008 is reflected in the overall growth of the financial system, greater diversification of the lending portfolio, and the expansion of lending to agriculture and small- and medium-sized enterprises (SMEs). Financial system

[18] Business Environment and Enterprise Performance Survey (BEEPS), 2008.

[19] Before 2008, a large portion of the financial sector was accounted for by Kredit Invest (KI), a non-bank financial institution that was channelling international credit lines (with National Bank of Tajikistan guarantees) to the cotton sector. KI's loans are included in much of the pre-2008 data and are not separable from bank loans in the aggregate data. The rapid increase in "financial sector" (not just "banking sector") lending through 2008 and the slowdown in lending growth after 2008, were significantly affected by KI's pre-2008 lending followed by cessation of its lending in 2008, and the subsequent write-off of loans. Through the end of 2009, KI's assets represented 30 percent of total financial sector assets, and its loans represented 46 percent of total financial sector lending. In February 2010, most of these loans were transferred to "other assets," and subsequently, most of them were written off in October 2010.

loans as a share of GDP almost doubled between 2005 and 2009. A large share of loans (an estimated 7% of GDP) was directed towards the cotton sector through directed lending programs. Coinciding with the global economic slowdown, credit growth to the private sector slowed down from 59 percent in 2007 to 19 percent in 2008, declined by 2 percent in 2009, and by 15 percent in 2010. The decline in 2010 is due to the writing off of Kredit Invest's nonperforming loans to the cotton sector. Preliminary estimates indicate that credit to the private sector increased by about 9 percent at end-2011. Deposits also increased in recent years, by more than 100 percent from 2005 (8 percent of GDP) to 2007 (19 percent of GDP). Following a rapid growth until 2007, bank deposits declined by 20 percent in 2008 (due to some large corporates, mainly state-owned enterprises, withdrawing their deposits), recovered with a 36 percent growth in 2009, increased by 25 percent in 2010, and by 25 percent as of November 2011 (Figure 1). Deposit growth in 2011 was driven by individuals, individuals' deposits increased by more than 45 percent and corporate deposits increased by 10 percent at end-November 2011.

Table 2: Banking Sector Indicators (%)

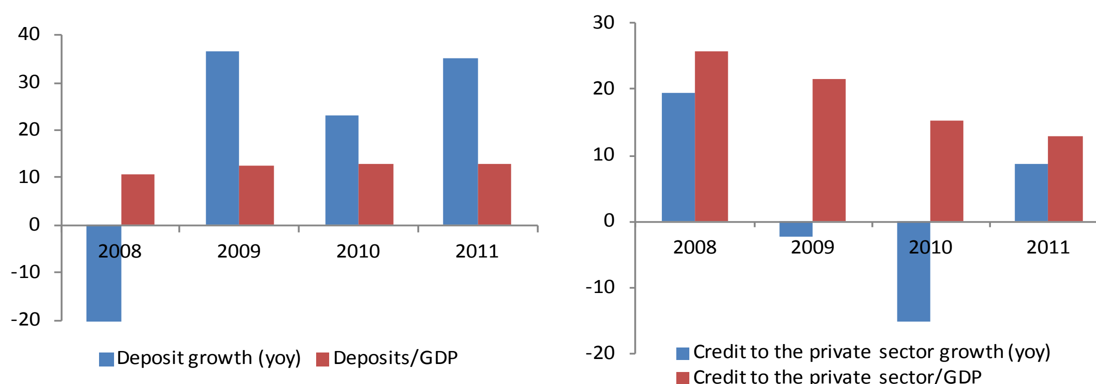
						2010 median values for Emerging Regions			
	2007	2008	2009	2010	2011	ENCA	EE	East Asia	LatAm
Number of banks	11	12	13	14	15				
Assets/GDP	28.0	22.2	23.9	25.2	25.0				
Deposits/GDP	18.8	10.9	12.6	13.2	13.0	32	53	68	31
Loans/GDP	12.9	13.7	12.2	12.5	12.4	38	49	48	31
Loans/Deposits	149.5	100.1	96.5	94.5	95.8	145	99	76	87
FX Loans/Loans	68.2	63.8	63.4	54.2	59.3				
NPLs*/Gross Loans	4.8	9.5	21.6	17.2	14.9	13	12	4	2
CAR	21.3	29.2	30.0	26.3	25.3	21	16	16	16
ROE	16.8	11.0	3.4	3.8	3.4	11	3	17	19
Loan loss provisions/NPLs	40.5	32.5	29.4	35.9	45.7	63	55	74	141
Capital/Assets	16.5	24.4	21.7	18.9	18.7	15	10	10	10

Source: Financial Soundness Indicators (IMF), International Financial Statistics (IMF), National Bank of Tajikistan, and World Bank staff calculations, data for assets, deposits, and loans as a share of GDP are as of November 2011.

ENCA: Eastern Neighbors and Central Asia; EE: Emerging Europe; LatAm: Latin America.

**Non-performing loans amount is calculated as the sum of loans, classified as doubtful 5th category, bad loans and actual provisions for homogenous loans*

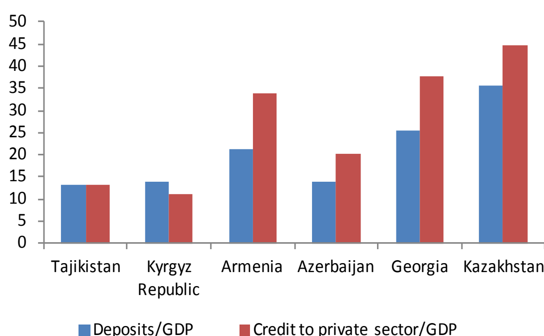
Figure 1. Tajikistan: Credit and Deposit Growth



Source: IMF, NBT

Note: Deposits data as of November 2011, credit to the private sector data for end-2011 are projections.

Figure 2. Credit to the private sector and deposits, November 2011 (in percent of GDP)



Source: IFS, WEO

Financial intermediation in Tajikistan is limited. Credit and deposit penetration in Tajikistan is low compared to other countries in the region. Credit to the private sector and deposits as a share of GDP amounted to about 13 percent in 2011 (Figure 2). According to enterprise surveys, access to finance is a top constraint for their growth. Only a third of all firms in Tajikistan had a loan or line of credit (compared to a 44 percent average in the ECA region).[20] A number of obstacles prevent increased financial sector depth, including weaknesses in the infrastructure (such as lack of a credit bureau and ineffective secured transactions framework), weak risk management and credit appraisal in financial institutions, low public confidence in banks with leads to low deposit penetration[21] and raises intermediation costs, lack of adequate financial information on firms due to weak accounting standards and practices, poor contract enforcement which raises the risk of lending, and others. Access to finance is constrained especially for SMEs.

Despite broader economic recovery, Tajikistan's banking sector continues to show signs of weakness, limiting the role that financial intermediation can play in supporting economic growth. The banking sector in Tajikistan has faced a number of vulnerabilities arising from: (i) credit risk as a result of prior rapid credit growth; (ii) indirect foreign exchange risk due to high dollarization of loans that expose unhedged borrowers to the depreciation of the local currency; and (iii) funding and liquidity risks due to reliance on wholesale funds and maturity mismatches. The economic slowdown that followed the global crisis, the government's interference in lending to the agriculture sector (particularly cotton) via directed lending programs, poor risk management in banks, deficiencies in the supervisory and regulatory framework for the banking sector, and the absence of adequate financial infrastructure, have exacerbated these vulnerabilities and have contributed to increased stress in the banking sector.

Asset quality has deteriorated substantially since 2009. Several factors have contributed to an increase in NPLs. The global downturn lowered domestic and international demand for the output and services of Tajik firms. In addition, the government's directed lending program has contributed to the deterioration of the loan portfolio by adversely impacting the risk management systems of banks and their financial positions. During 2008 and 2009, the government allocated TJS 320 million (US$73 million), and reportedly influenced banks to lend their own resources too, for financing the agriculture sector, primarily cotton.[22] The large depreciation of the somoni in 2009 also put pressure on banks, as debtors that do not generate income in foreign currency but hold foreign currency denominated loans (at about 60 percent of total loans) could not service their loans. In addition, falling remittances in 2009 made it difficult for households and small businesses to service their loans. As a result, bank balance sheets deteriorated. At end-2011, NPLs remain high at 15 percent, although they declined after a peak of 28 percent in the first quarter of 2010 (Figure 3). However, much of this decline was due to writing off NPLs. Moreover, NPLs may be overstated due to supervisory and regulatory weaknesses. The provision coverage for NPLs at end-2011 is low at around 46 percent at the system level.

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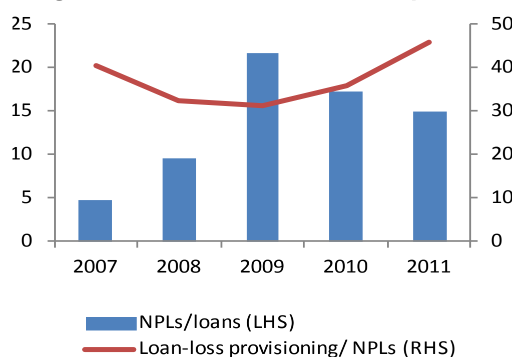
[20] BEEPS 2008.

[21] Tajikistan has the lowest deposit account penetration in ECA (31 bank accounts per 1,000 adults) compared to 146 in Kyrgyzstan, 378 in Azerbaijan, and 626 in Georgia. There is also a limited bank branch network, with 274 bank branches in 2011, about 4 branches per hundred thousand adults, and 1.19 branches per thousand km2. The penetration of ATMs is also very low. There are 3.98 ATMs per hundred thousand adults, and 1.21 ATMs per thousand km2 (Finstats 2011).

[22] Five banks were effectively required to channel these credit lines. These banks were required to borrow from the MoF at 10 percent interest, onlend at 14 percent, and bear the credit risk. With the poor repayment history of the cotton sector since the 1990s, even in years when international cotton prices were high, some banks expressly acknowledged that they would incur losses from this operation. The 2008 credit line expressly targeted cotton. After criticism from donors that such targeting was inconsistent with "freedom to farm", the 2009 credit line targeted "agriculture", but again the vast majority of lending went to cotton.

High NPLs have weakened bank capitalization and profitability. The capital adequacy ratio (CAR) of the banking system was 25 percent at end-2011, above the minimum requirement of 12 percent. Although capital adequacy may seem adequate, the misclassification and underprovisioning of NPLs may overstate capitalization and profitability (Figure 4). After turning negative in mid-2010, the reported return on equity (ROE) and return on assets (ROA) improved to 3.4 and 0.7 percent, respectively at end-2011.

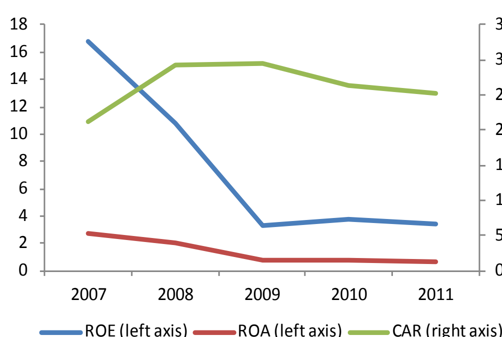
Figure 3. NPLs and Loan-loss provisions



Source: NBT

Banks face liquidity pressures due to significant maturity mismatches, and have been increasingly dependent on National Bank of Tajikistan (NBT) liquidity loans to meet their funding needs. Liquidity support from NBT rose sharply from TJS 7 million in mid-2010 to over TJS 400 million in early 2011. This reduces banks' incentives to enhance capital buffers, implement stricter risk management and accounting practices, and engage in interbank markets. In the second half of 2011, in an effort to curb inflationary pressures, NBT's liquidity support to the banking sector was reduced (at TJS 100 million at end-September 2011). The banking system's liquid assets remain below pre-crisis levels, with liquid assets accounting for 21 percent of total assets and equal to 41 percent of total deposits at end-2011.

Figure 4. Capitalization and profitability



Source: NBT

In addition, the large share of foreign currency denominated loans presents high indirect foreign exchange risk for the banking sector, as unhedged borrowers that do not generate income in foreign currency are faced with higher payments in case of a devaluation. The extent of dollarization in the banking system has remained around 60 percent during the last three years. The depreciation of the somoni in the first half of 2009 contributed to a rise in NPLs, as it affected the repayment capacity of unhedged borrowers.

NBT has undertaken a number of actions to address financial sector vulnerabilities. NBT has adopted a financial sector stability action plan for addressing weaknesses in the financial sector, such as requiring banks not meeting prudential criteria to submit time-bound action plans to become fully compliant with the criteria, increasing the capital adequacy requirement for the top 6 banks to 15 percent, and strengthening the legal and regulatory framework. Nonetheless, NBT's lack of independence subjects it to political interference which limits its ability to intervene.

Table 2: Top five banks by asset size (in percent)

	Deposits	Loans	Assets
Agroinvestbank	30.9	33.4	26.6
Orionbank	25.2	17.6	23.6
Tojiksidorat Bank	14.9	16.6	12.8
Amonat Bank	12.0	7.9	13.6
Fononbonk	4.8	4.4	3.3

Source: NBT, Sept 2010

Key Policy Priorities

The banking sector remains vulnerable to future shocks and significant reforms are needed. Several obstacles limit the sound and stable growth of the banking sector including: (i) government interference in bank lending; (ii) poor risk management in banks; (iii) absence of stable funding sources; (iv) lax enforcement of prudential standards; and (v) lack of key elements of financial sector infrastructure. Therefore, substantial reforms are needed: (i) directed lending as it is practiced today should stop as it adversely affects the health of the banking sector; (ii) the regulatory framework should be strengthened to address credit risk, liquidity risk, funding risk, and indirect foreign exchange risk; (iii) the supervisory framework should be strengthened to ensure that vulnerabilities are addressed in an effective and timely manner; (iv) supervision of systemic banks should be enhanced; (v) a contingency plan should be put in place to handle stress situations in the banking sector; and (vi) the financial infrastructure should be improved through upgrading the real-time gross settlement payment system, establishing a credit information bureau, and a collateral registry.

Summary and Conclusions

Tajikistan has emerged from the global economic downturn of 2009, but the outlook for 2012 is uncertain. The economy grew by 6.5 percent in 2010, by an estimated 6 percent in 2011, and is projected to grow by 6 percent in 2012. However, risks from a potential global or regional slow-down have recently increased.

The banking sector remains weak, with a large overhang of NPLs, weak profitability, and funding and liquidity constraints. The economic slowdown that followed the 2009 global crisis, the Government's interference in lending to the agriculture sector (particularly cotton) via directed lending programs, poor risk management in banks, deficiencies in the supervisory and regulatory framework, and the absence of an effective financial infrastructure, have contributed to increased stress in the banking sector.

Structural weaknesses need to be addressed for sustainable economic growth. Priorities remain to: (i) maintain sound macroeconomic management and manage public finances more efficiently; (ii) strengthen governance of public institutions; (iii) create a sustainable mechanism for agricultural finance; (iv) foster a more conducive environment for private sector growth, and (v) address vulnerabilities in the financial sector in order to enable it to intermediate more effectively and efficiently, and thus contribute to economic growth.

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TURKMENISTAN
By Brett E. Coleman, Senior Financial Sector Specialist, and Leyla V. Castillo, Financial Sector Specialist, the World Bank[23]

Key Messages

- The Turkmen economy has consistently experienced significant growth since late 1990s, bolstered by a boom in world prices of oil and gas. The main effect of the 2008/09 global crisis in the country was lower demand for the country's main export products. The government implemented a number of counter-cyclical measures to ameliorate the effects of the crisis. Current vulnerabilities arise from the country's high dependence on natural resources and limited economic diversification which makes the economy vulnerable to fluctuations in commodity prices.

- Financial sector development is at a very early stage in Turkmenistan, with total assets of the banking sector representing only 22 percent of GDP. The banking system is predominantly state owned, and most of the lending and services are provided to state-owned enterprises (85 percent of total lending). Key challenges for development include (i) enhancing the legal and regulatory framework by introducing international standards and best practices, (ii) enhancing access to finance and financial services, including retail payments system to a broader sector of the population and private entrepreneurs, and (iii) continue to improve the enabling environment to support private sector development and economic diversification.

Macroeconomic Context

The Turkmen economy experienced significant growth during the past decade bolstered by a boom in international prices of oil and natural gas. Turkmenistan demonstrated strong growth performance in the pre-crisis period with an average annual growth rate of 12 percent between 2004 and 2008. High growth was mainly driven by natural gas exports to Ukraine and Russia and by large-scale public investment in oil refineries, textiles, food processing, transport, telecommunication, and construction projects. The economy expanded considerably against the background of the strong fiscal position of the government and a negligible level of public debt. According to the State Statistics Committee of Turkmenistan, real income rose by 1.8 times between 2000 and 2010.

The 2008/09 global crisis affected the country mostly through the drop in global demand for gas. Disruption of gas exports to Russia[24] and the drop in global demand for gas caused a sharp contraction of the oil and gas sector in 2009 and subsequently a significant deterioration in the current account balance. The government responded swiftly to mitigate the negative impact of the crisis by implementing a number of fiscal stimulus measures as part of its countercyclical policy strategy. When the external environment appeared to be favorable during 2005-07, the government opted to increase reserves while keeping spending roughly constant in nominal dollar terms. In contrast, in 2009-10, despite the fall in hydro-carbon revenues due to lower international gas prices and interruption of exports, the government used accumulated reserves from its Stabilization and Saving Fund to execute the 2009 State Budget. The government increased public spending on infrastructure in transport, communications, and the retail sector. These countercyclical measures played a key role in mitigating the adverse impact of the crisis on the domestic economy. As a result, the country managed to continue to grow by 6.1 percent in 2009, 9.2 percent in 2010, and 9.9 percent in 2011.

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[23] The World Bank has provided analytical and advisory services on a number of issues to share lessons, best practices and international standards to contribute to align practices, laws, and regulations to support development of the financial sector: Introduction of International Accounting Standards Grant (2004); Advice on modernizing the Payment systems (2008); Accounting and Auditing module of the Reports of Standards and Codes (A&A ROSC) (2010); Legal framework for Anti-money laundering/Combating the financing of terrorism (AML/CFT); Advice on the development of capital markets (2011).

[24] Since 1992, Russia, the key export market for Turkmenistan, has exerted significant influence over export prices of gas resources charged by Turkmenistan. As a result of a pipeline explosion on the Central Asian Center export pipeline to Russia in April 2009, Turkmen gas production suffered serious declines. Gas production fell almost 50 percent. Following the pipeline repair and a new pricing agreement signed with Russia in January 2010, Turkmenistan raised production to 1.6 Tcf/y in 2010 from 1.3 Tcf/y in 2009. However, Russia agreed to accept only one third of the volumes it imported prior to the explosion and at a lower import price, resulting from its declining exports to Europe.

High dependence on natural resources and limited economic diversification make the country vulnerable to fluctuations in commodity prices. Natural gas, petroleum products, and crude oil account for 85 percent of the country's total exports. Private investment has picked up considerably since 2010, reaching 15 percent of GDP, compared to less than 7 percent during the period 2006-2008. Driven by higher food prices, inflation increased from 0.1 percent in 2009 to 4.8 percent in 2010 and accelerated further to 6.2 percent in 2011. Food price inflation reached 13 percent by end-April, 2011. The external position remained strong despite the relatively large current account deficit in previous years (16 percent of GDP in 2009, 12 percent in 2010, and 3 percent in 2011). The current account balance is largely a result of high investment-related imports.

Table 1: Macroeconomic Indicators

	2007	2008	2009	2010	2011e	2012p	2010 median values for Emerging Regions			
							ENCA	EE	East Asia	LatAm
GDP per capita (USD)	5,006	4,084	3,484	3,677	4,362	n/a	3,013	8,926	2,549	6,980
Real GDP growth (% change)	11.1	14.7	6.1	9.2	9.9	n/a	6.4	1	7.7	5.3
CPI Inflation (% change)	6.3	14.5	-2.7	4.5	6.1	7.2	7.4	2.8	4.5	4
Current Account Balance (% of GDP)	15.5	16.5	(16.0)	(11.7)	(2.9)	(2.5)	-8.3	-4.4	2.5	-2.1
Fiscal Balance (% of GDP)	2.5	-0.8	2.9	6.3	4.2	n/a	-2.4	-3.9	-2.6	-2
Gross government debt (% of GDP)	2.4	2.8	2.6	11.8	20.5	n/a	26.6	41.4	49.4	36.3
External debt (% of GDP)*	n/a	n/a	n/a	n/a	n/a	n/a	79.2	45.6	28.7	26.2
Foreign Direct Investment (% of GDP)	n/a	n/a	n/a	18.2	13.2	10.4				
Population (Millions)	5.2	5.3	5.4	5.4	5.5	n/a	9.5	5.9	132.9	14.6

Source: World Development Indicators (World Bank), World Economic Outlook (IMF), Quarterly External Debt Statistics (IMF), Official statistics and World Bank staff calculations and estimates.
ENCA: Eastern Neighbors and Central Asia; EE: Emerging Europe; LatAm: Latin America
**Latest figure is for Q32011*

Sound fiscal management remains a key policy priority and a challenge given the government's objective to maintain low inflation levels. A large share of the country's foreign exchange and fiscal revenues come from the hydrocarbon sector. Favorable conditions have contributed to raise the government's revenues in recent years, allowing for a substantial reduction in total external public debt. As a result, total public external debt fell from about 19 percent to 3 percent of GDP between 2002 and 2009. More recently, the government has increased external borrowing from China (US$4 billion) for gas exploration and development, and with the Islamic Development Bank (US$1 billion) to finance investment in the health sector, banking sector, and large infrastructure projects.

Economic diversification and sustainable inclusive development are key pillars of the country's development strategy. The government approved a comprehensive long term development plan for the period 2011-2030 establishing the policy priorities to achieve diversification. Long-term growth prospects will depend not only on traditional natural resources, but also on the successful development of the non-resource economy. The private sector accounts currently for 55 percent of the non-oil and gas GDP, although several sectors, including large manufacturing and the financial sector continue to be predominantly government owned. The government's target is to reach a share of private GDP in the total non-oil and gas economy of 70 percent by 2020. Growing foreign direct investment, large public investments and the implementation of major state construction projects, as well as the growth of natural gas exports to China are expected to contribute to the country's economic growth in the near future. The country has developed new destinations for its gas exports which include China and Iran, and signed a framework agreement in 2010 for the construction of a pipeline connecting Turkmenistan, Afghanistan, Pakistan and India.

The government initiated a number of reforms to strengthen and open up the financial sector and promote development of the private sector. A law to support SME development was approved in 2009. Following the unification of the exchange rate in 2008, the government introduced a new foreign investment law which entailed provisions for the repatriation of profits, and exemptions for duties and fees for foreign entrepreneurs, among other things. The unification of the dual exchange rate in 2008 provided additional incentives for foreign investments into non-hydrocarbon industries and the unrestricted FX access also encourages the development and growth of local export and importing businesses. A new currency was introduced in January 2010, the Manat, and a new "Law on Central Bank of Turkmenistan" and the "Law on Commercial Banks and Banking" were adopted in April 2011.[25] Following an Accounting and Auditing (A&A) Report on the Observance of Standards and Codes (ROSC) in 2009 conducted with World Bank assistance, a "Law on Accounting and Financial Reporting"

[25] No review, however, has been done of these laws to judge their quality.

was adopted in December 2010 which requires all banks to introduce International Financial Reporting Standards (IFRS) and use independent auditors starting in 2011. Although companies continue to report by local standards, they are obliged to publish results.

Financial Sector Risks and Development Challenges

The 2008/09 crisis had virtually no impact on the Turkmen banking sector as it is dominated by state owned banks that are not integrated into the global financial system. The Turkmen banking sector is a classical two tier banking system dominated by state owned banks. A total of 11 commercial banks are currently active in the country, 5 of them state owned, 2 joint stock banks, 1 joint venture bank and 2 foreign banks.[26] The banking system has experienced significant growth in recent years with an increase in total loans of 33% and 43% in 2009 and 2010, respectively. By end of 2010, 3 commercial banks had an external auditor and financial statements in line with IFRS.

Intermediation in the Turkmen economy remains low compared to international standards. Total assets of the banking system are estimated around 22 percent of GDP, total loans around 17 percent of GDP, and total deposits around 5 percent of GDP.27 Banking activity in the real economy has been limited by banks' capital base which was estimated at around US$220 million in 2010.[28] Banks show very low debt to asset ratios. State directed lending schemes provide cheap loans (e.g., 5 percent interest rate) to private businesses in certain sectors under strong qualification requirements (e.g., 120 percent collateral). The majority of loans are provided to state owned companies (85 percent of total loans in local currency as of January 2011). Financial sector development is at an early stage; for private enterprises, access to formal-sector finance remains limited at less than 10 per cent of total lending.

From a demand side perspective, access to financial services and sources of finance is very limited for the majority of the population. According to World Bank data,[29] less than 1 percent of households in Turkmenistan had a formal bank account in 2011, while around 1 percent of households confirmed borrowing from formal sources of financing. Similarly, only 1 percent of household confirmed having a mortgage loan and 2 percent having an emergency or health loan.

Key policy priorities

The enabling environment is a key pre-condition for private sector development and a sound and sustainable financial sector. In 2010, the government approved a comprehensive reform program for 2011-2030. A substantial part of the reforms outlined in the program aims at strengthening the country's financial sector and its monetary and foreign exchange policies to support competitiveness and long term growth. As a result, key pieces of the national strategy include the "State Program for the Development of the Banking System 2011-2030" and the "Program for the Development of the Securities Market".

Challenges remain to continue to improve the country's enabling environment for private and financial sector growth and to continue to introduce internationally accepted standards. The main challenge for the banking sector will be to continue to grow, aiming at further increasing current intermediation levels, and reaching out to a larger share of households and private companies. Priority areas would include i) improving the legal framework to promote competition, ii) integrating international standards and best practices, iii) expanding access and quality of financial services, and iv) improving the payments system.

[26] National Bank of Pakistan and Bank Saderat Iran.
[27] Deutsche Bank, "Financial Sector in Turkmenistan". May, 2011.
[28] Deutsche Bank, "Financial Sector in Turkmenistan". May, 2011.
[29] Global Findex, 2012

Summary and Conclusions

The Turkmen economy has consistently experienced significant growth since late 1990s, bolstered by a boom in world prices of oil and gas. The main effect of the 2008/09 global crisis in the country was lower demand for the country's main export products. The government implemented a number of counter-cyclical measures to ameliorate the effects of the crisis. Current vulnerabilities arise from the country's high dependence on natural resources and limited economic diversification which make the economy vulnerable to fluctuations in commodity prices.

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UKRAINE

By Dimitry Sologoub, Head of Research Department, Raiffeisen Bank - Aval

Ukrainian banking sector: The roller-coaster ride

- Macroeconomic environment doesn't look supportive for the dynamic growth of the banking system amid high and volatile inflation, unstable exchange rate expectations and poor business climate.
- The Ukrainian banking system has been hit hard by the latest crisis, which led to the massive deposit outflows and mounting loan defaults, prompting the banks to halt lending activity for more than two years.
- The banking system is characterized by low degree of concentration and consolidation with gradually diminishing market share of foreign-owned banks.
- Lending to corporate and retail clients is the main business for the banks on the assets' side, while the funding focus in the post-crisis years has shifted from external borrowings to the domestic deposits.
- We see several main obstacles to the dynamic development of the banking sector – unstable macroeconomic environment, inadequate legal framework, lack of stable long-term funding base, poor loan quality and weak capital position of the banking system.

Macroeconomic Overview

Ukraine is an upper-middle income country with a GDP per capita of EUR 2600 (EUR 5800 in PPP terms) as of end-2011. Country headline economic indicators are biased downwards due to the vast shadow economy – its share could be as high as 40-50%, according to some estimates. For example, Ukraine's nominal GDP level in 2011 amounted only to 30% of Poland's, despite similar economy structures and demographic characteristics. Ukraine has highly open economy – foreign trade turnover constituted 110% of GDP in 2011, the share of exports in GDP exceeded 50%. Moreover, the export structure is skewed towards low-value added commodities – steel exports comprised 33% of total export in 2011, and the share of chemicals' export stood at 10%. Ukraine is a net energy importer (share of energy imports is 35%), however the country's exposure to energy price movements is hedged by the dependence on steel exports (as steel and oil prices tend to be highly correlated). The investment share of the output is disappointingly low and shrinking – 16% at end-2011, much below the level necessary to modernise the capital stock of the economy and improve infrastructure of the country. According to EBRD, the share of the private sector in the economy stood at 60% as of end-2010. The government retains control over natural monopolies (energy, transport), as well as over certain assets in machine building, chemical and banking industries.

Ukraine's key long-term economic advantages include favorable geographic location (at the crossroads between Europe and Asia, next to the vast Russian market), abundant natural resources and high-quality human capital. In particular, the agricultural sector has enormous potential – Ukraine is ranked 8th in the world by arable land quantity, and was the 6th largest wheat exporter in 2011. Ukraine also enjoys relatively high social indicators (compared to other countries at the similar level of economic development) – adult literacy and school enrolment rates are at almost 100%, and the poverty rate is declining. Consequently, according to the United Nations, Ukraine is considered a country with high human development. On the negative side, the long-term demographic outlook is relatively bleak amid falling life expectancy, one of the lowest birth rates in Europe and an unfavourable migration pattern. Also, the country scores particularly badly in the global rankings of business climate and investment attractiveness. Ukraine is ranked 152nd (out of 183) in World Bank Doing Business 2012 survey and has the same ranking (again, out of 183 countries) in world corruption rating calculated by Transparency International. Due to the unfortunate combination of large macroeconomic vulnerabilities and structural weaknesses, Ukraine's credit is perceived as highly risky – S&P assigned B+ sovereign rating (with negative outlook) to Ukraine, which puts it into the highly speculative category, four notches below investment grade.

The country has recently lived through a period of extreme economic turbulences. In 2004-2007 real GDP grew 7.4% per annum on average benefiting from improving terms of trade, strong demand for Ukrainian machinery in Russia, artificially low gas import prices, and large capital inflows amid abundant global liquidity and the growing presence of foreign banks. This array of external factors was also combined with clearly pro-cyclical domestic economic policies. However, the robust economic growth was accompanied by clear overheating signs (skyrocketing inflation, a widening current account deficit and surging external debt), and, at the same time, masked the fundamental weaknesses of the Ukrainian economy – lack of export diversification, low energy efficiency, buoyant shadow economy, an unfavorable business climate, shallow domestic capital markets, etc. Therefore, not surprisingly, when steel prices crashed in the late summer of 2008 and capital flows reversed after the Lehman shock in September, Ukraine immediately slipped into a deep recession, becoming one of the main victims of the global economic downturn. Moreover, the adverse change in external conditions was also exacerbated by domestic factors, such as plunging confidence in the national currency, run on deposits, frozen lending activity and persistent political quarrels. As a result, GDP slumped by 15% in 2009, while the local currency value to US dollar plunged by 40%. Consequently, the country had to be bailed out by the IMF, which provided a USD 16.4 bn stand-by loan in November 2008.

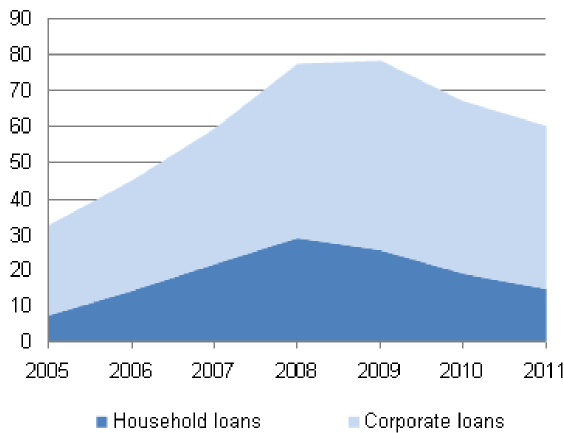
Table 1. Macroeconomic indicators

	2008	2009	2010	2011	2012
GDP per capita (EUR)	2,660	1,770	2,250	2,600	3,120
Real GDP growth (% change)	2.3	-14.8	4.1	5.2	3.5
CPI inflation (% change)	22.3	12.3	9.1	4.6	9.2
Current Account Balance (% of GDP)	-7.1	-1.5	-2.2	-5.5	-4.1
Fiscal Balance (% of GDP)	-1.5	-8.7	-7.5	-4.3	-3
Gross government debt (% of GDP)	19.9	34.6	40	36	36
Population (Millions)	46.4	46.1	46	45.8	45.6

Source: State Statistics Committee, National Bank of Ukraine, Raiffeisen RESEARCH

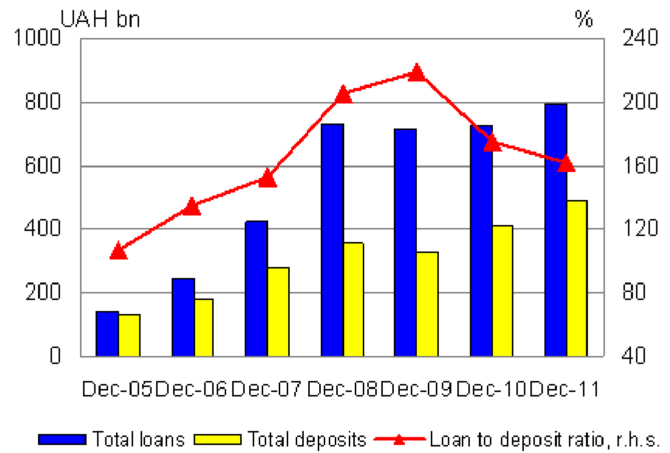
Since late 2009 a mainly export-led recovery had set in, enabled by resurging export prices. The domestic demand has embarked on the rebound path as well. As a result, country's GDP surged by 4.1% in 2010 and economic growth further accelerated to 5.2% in 2011 driven by robust agricultural output, revived bank lending and boost in the investment spending in the course of Ukraine's preparations for hosting UEFA EURO 2012 football tournament. Meanwhile, inflation has been largely under control in the post-crisis years. The consumer price index hit a 9-year low in 2011 thanks to plunging food prices – the annual CPI was up 4.6% yoy, after a 9.1% increase in 2010. The large competitiveness gain (following massive local currency depreciation) and improving terms of trade helped to repair the external accounts – the current account deficit sharply narrowed from 7.1% of GDP in 2008 to 1.6% in 2009 and only slightly widened to 2.1% in 2010. However, external vulnerabilities loomed once again last year, bringing back painful memories of the 2008 turmoil. The current account deficit jumped to 5.6% of GDP in 2011 amid rising energy import costs and robust demand for non-energy imports. The external financing conditions soured in H2 2011, amidst renewed global financial turbulences, a stalemate in the IMF programme and the weak fiscal position. At one stage, Ukraine was the worst performing credit in the CEE sovereign Eurobond universe. Not surprisingly, with the deteriorating external environment and vanishing confidence in the domestic policies, hryvnia devaluation fears re-emerged in late summer, pushing the central bank into the role of a net seller of foreign currency to defend the (politically motivated) formal currency peg at USD/UAH 8. Headline fiscal indicators registered notable improvement – general government deficit shrank to 4.3% of GDP in 2011 (from 8.7% and 7.5% in 2009 and 2010 respectively), while public debt to GDP ratio fell to 36% at end-2011 (from the peak of 40% a year before). At the same time, the fiscal position is damaged by the disastrous financial stance of state-owned gas monopoly Naftogas.

1. Total loans, % of GDP



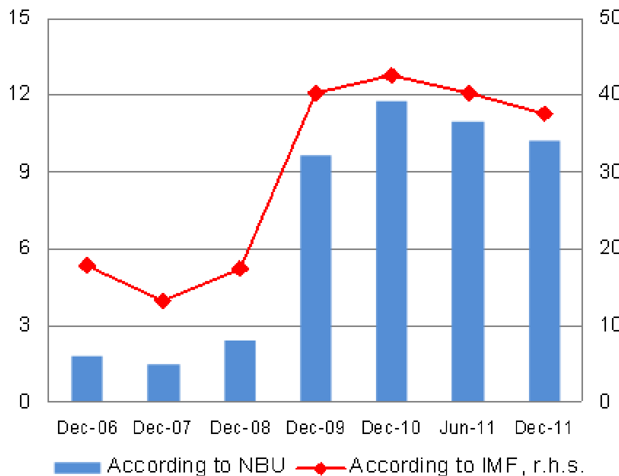
Source: National Bank of Ukraine, Raiffeisen RESEARCH

2. Bank loans and deposits



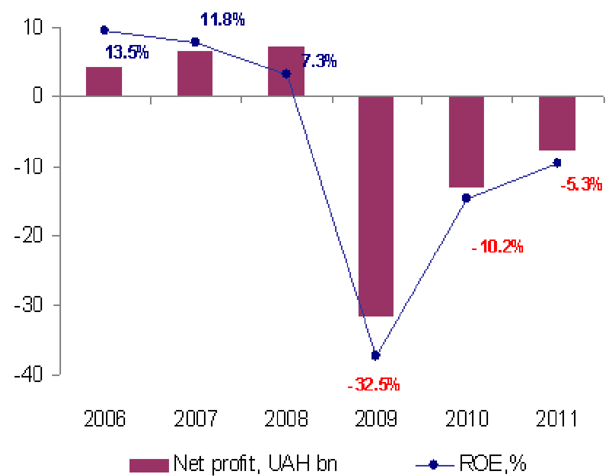
Source: National Bank of Ukraine

3. Non-performing loans ratio, %



Source: National Bank of Ukraine, IMF

4. Financial indicators

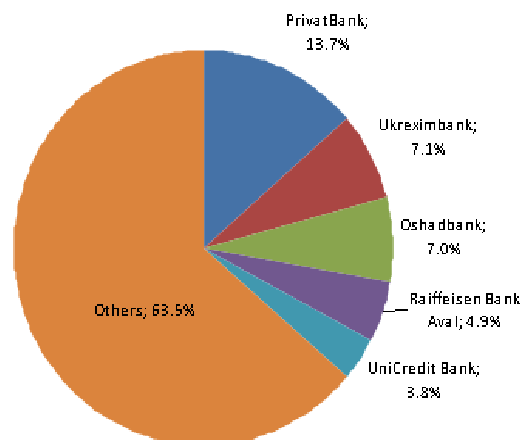


Source: National Bank of Ukraine

5. Market structure by ownership

Source: National Bank of Ukraine

6. Market share, % of total assets (at end-2011)



Source: National Bank of Ukraine, Raiffeisen RESEARCH

Hence, more than three years after the crisis, the Ukrainian economy is facing strong headwinds once again. The immediate point of concern is the fragile external position against the background of surging gas import price, large external debt repayments (short-term external debt constituted USD 52 bn as of end-September 2011), widening C/A deficit and blocked access to the global capital markets. In general, the country is still plagued by the same structural problems as back in 2008, while the volatile political situation did nothing to help the authorities in finding long term solutions to resolve these problems. Therefore, we argue that without radical changes in the economic and institutional environment, the country will be unable to tap its long-term competitive advantages and risks falling into the vicious devaluation-inflation cycle accompanied by subpar growth performance and deteriorating living standards.

Banking Sector Overview

Few sectors of the Ukrainian economy have experienced the same dramatic turns of fortune in recent years as the domestic banking system. **The sector embarked on a robust growth path in 2005 amid improved economic prospects and booming capital inflows.** Total loan portfolio grew 70% yoy on average in 2005-2007 with the most striking expansion having taken place in the retail lending (the retail loan volume hiked by more than 10 times in the period from end-2004 to end-2007). As a result, the loan-to-GDP ratio surged to 77% as of end-2008 – one of the highest in CEE region, while Ukraine was lagging far behind the neighboring countries in terms of GDP per capita. The enormous credit expansion has been primarily financed by the international borrowings, while the domestic funding base remained largely undeveloped due to the high degree of dollarization (promoted by fixed exchange rate regime, vast shadow economy and high and volatile inflation) and the lack of institutional investors. Consequently, loan-to-deposit ratio took off in 2005 (from the level of 109%) and reached 190% in mid-2008. The Ukrainian banking sector has been one of the major recipients of FDI since 2004. The share of foreign capital in the banking system has quickly jumped up from 13% in 2004 to 40% in 2008 - incited by the spectacular political changes, foreign investors rushed in to explore deep domestic market with huge catch-up potential and bright long-term growth perspectives. However, the breakneck credit expansion also contributed to the build-up of systemic risks in the banking industry, stemming from a large share of FX lending to unhedged borrowers (80% of mortgage loans were FX-denominated due to the wide interest rate differential), inadequate risk supervision practices (i.e. dangerously high loan-to-value (up to 90-100%) and debt-to-income (exceeding 50%) ratios), poorly developed loan market infrastructure, in particular, the absence of fully-functioning credit bureau system, weak capital base, overreliance on global capital markets and the lack of long-term domestic funding.

The success story turned into a spectacular bust following drastic, adverse changes in the domestic and external economic conditions in the third quarter of 2008. Specifically, the banks got the first hit on the funding side as sharp hryvnia depreciation and problems at one of the largest banks provoked a massive run on deposits (causing the outflow of nearly 25% of the total deposit base in the last quarter of 2008), while external financing conditions were damaged by the global credit crunch in the aftermath of the Lehman Brothers bankruptcy. The default risk surged as well - 40% devaluation of the local currency, coupled with falling real incomes, eroded borrowers' ability to repay their FX loans. Moreover, the sharp economic downturn has also dramatically affected loan quality in the corporate segment. In addition, loan foreclosure and recovery procedures have been hampered by weak legal practices (burdensome and lengthy legal procedures on loan foreclosure, non-transparent bankruptcy regulation, corruption in the courts) and disastrous performance of the property market (housing real estate prices have plunged by 30-40% from their peak in the first two years after the crisis). As a result, the NPL ratio has gone through the roof – according to IMF, the share of non-performing loans reached 40% in 2009. Following massive deposit outflows and mounting loan defaults, a number of banks fell into insolvency – since end-2008 the National bank put 27 banks under receivership, 20 of which were subsequently put for the liquidation.

To preserve the stability of the banking system, the central bank and other authorities employed a number of emergency measures, such as a moratorium on the early withdrawal of deposits, an increase in the maximum deposit insurance coverage, the relaxation of banks' capital requirements, ban on FX lending, provision of large-scale liquidity support by the National Bank. Also, the NBU required the banks to pass the stress test and replenish the capital according to its results. In addition, the government (under the guidance of IMF and

World Bank) has developed a recapitalization mechanism in which the state acquired the majority stake in the ailing systemic banks. Five banks have been recapitalized by the state under this mechanism, albeit the process turned to be rather messy amidst vested political interests and powerful lobbying efforts of particular business groups. Total bank recapitalization costs amounted to 4% of GDP for 2009-2011.

Table 2. Banking sector indicators

	2008	2009	2010	2011	2012
Assets/GDP	97.7	96.2	87	80.6	75.6
Deposits/GDP	37.7	35.8	38.3	37	36.8
Loans/GDP	77.4	78.4	66.9	60.4	55.1
Loans/Deposits	205.1	218.9	174.9	162.9	149.6
Corporate loans (% of total)	62.7	67.2	71.8	75.3	77
Corporate loans (% year-on-year growth)	69.6	4.8	7.9	14.8	8
Household loans (% of total)	37.3	32.8	28.2	24.7	23
Household loans (% year-on-year growth)	76.1	-14.1	-13.1	-4	-1.6
Asset Concentration (top 3 banks)	22	23.1	26.1	27.9	n/a
Number of banks	184	182	176	176	n/a
NPLs*/Gross loans	17.4	40.5	42.5	37.7	n/a
CAR	14	18.1	20.8	18.9	n/a
ROE	8.5	-32.5	-10.2	-5.3	n/a
Loan loss provisions/NPLs	n/a	n/a	n/a	n/a	n/a
Capital / Assets	12.9	13.1	14.9	15.2	15.7

*NPL definition is according to IMF

Source: National Bank of Ukraine, Raiffeisen RESEARCH

Banks' responses to the crisis included a number of measures. Specifically, liquidity erosion and extremely high macroeconomic uncertainty prompted the banks to freeze lending activity. Second, facing severe liquidity squeeze the banks have hiked the interest rates to lure the depositors back. Third, to mitigate loan quality problems the bankers launched large-scale loan restructuring processes trying to lower borrowers' repayment burden. Several instruments have been used – lowering interest rate on loans for some period, increasing the loan tenor, converting the loan from the foreign currency to hryvnia at preferential rate. Also, following the sharp deterioration in the financial indicators, bank shareholders had to replenish the capital in the vast amounts. For example, according to our estimates, the capital injections by foreign banking groups operating in Ukraine amounted to nearly USD 4 bn in 2008-2010. Finally, the banks stepped up cost saving efforts, including the reduction in headcount, the optimization of branch network etc.

The crisis tensions in the banking system have first started to ease on the funding side amid gradual return of deposits. In the light of certain economic stabilization and attractive interest rates, the volume of private deposits returned to the pre-crisis level in mid-2010. It has been followed by the lending recovery – the banks drastically cut the loan interest rates, while the demand for credit resources has also resurged on the back of reviving aggregate demand in the economy. The loan quality problem has been alleviated recently, as NPL ratio apparently reached its peak in the 1st half of 2011. Following the recovery in lending activity and loan quality stabilization, banks' financial indicators improved as well.

Lending to corporate and retail clients remains the dominating business for the banks on the asset side. The share of loans in total assets stood at 60% at end-2011. Corporate loans (including lending to SME) comprise 75% of banks' loan books. Across the sectors of the economy, the trade industry is the main recipient of loan resources (36% of total), followed by manufacturing (20%). SME sub-segment of the loan market remains much less developed than the lending to large enterprises, mostly concentrating in working capital loans to the entities in trade and agricultural sectors. The main reasons for this are low transparency of SME sector, poor business climate and high tax and regulatory burden on the enterprises. Specifically, it's quite difficult and burdensome for the banks to assess SME's risks, given inadequate financial reporting standards in this segment. Therefore, the lending conditions for SMEs have visibly deteriorated in the post-crisis years amid economic turbulences and the adoption of new Tax Code, which substantially increased regulatory burden on the small and medium enterprises. At the same time, according to WB Enterprise Survey, the access to finance is only of the modest relevance for the Ukrainian SMEs, while the major concern lies with tax rate level and corruption. In the recent years there have been a number of initiatives from the foreign donors

(IFC, USAID, EBRD) aimed at facilitating SME lending – risk-sharing and credit guarantee schemes, SME lending programs (via banks) for specific purposes (for example improving energy efficiency). On the other side, the government largely stays away from supporting lending to SME, except specific projects in agriculture (i.e. providing interest rates subsidies, facilitating the purchase and lease of agricultural machinery). Retail lending has been strongly on the rise in the pre-crisis years, led by residential mortgages. However, the crisis changed the picture completely as most of the retail lending business is currently concentrated in short-term unsecured consumer lending. The mortgage lending remains largely frozen amid the ban on FX lending, high interest rates in the local currency, unaffordable housing prices and much tighter loan conditions.

After two consecutive years of decrease in the loan volume, loan portfolio of the banking system increased by 9.6% in 2011 driven by resurging corporate lending and strong restart in consumer lending business. However, the post-crisis deleveraging process continues – the loan-to-GDP ratio descended from 77.4% at end-2008 to 60.4% at the moment, thus gradually realigning with Ukraine's per capita income level. However, this figure is likely to be distorted by the buoyant shadow economy, while the de-facto level of penetration of loan services is lower than headline figures suggest. In particular, according to the official data, only 15% of capital investment is currently financed by bank loans. The halt in FX lending (except lending to exporters) stimulated the visible loan dedollarization - the share of FX loans in total loans fell from 46.6% to 40.7% in 2011, returning to the level of early 2006.

The banks in the last few years heavily invested in securities, lured by attractively high interest rates on government bonds. The share of securities in total assets increased from 4% to 8% in 2010 and then remained unchanged in 2011 amid sharp fall in bond yields and restart of lending. We currently see the potential for banks' future significant investment in securities as rather limited due to the shallowness and illiquidity of domestic debt market. In fact, local government bonds are the only available instrument for the banks at the moment, but given Ukraine's high sovereign risk the banks are reluctant to increase the holdings of government securities further. Municipal and corporate segments of the bond market remain largely dead. Specifically, municipal bond issuance is constrained by inadequate regulations and weakness of Ukrainian fiscal system in general. The corporate bond segment was hit hard by the latest crisis, as nearly 90% of issues have gone into technical default. Therefore, the revival of this segment is conditional on the resolution of outstanding issues and appropriate legal changes.

On the funding side, the role of domestic deposits became much more prominent in the post-crisis years, while external deleveraging is still far from over. In the last three years the local banking system underwent through impressive external deleveraging process – the total external debt of the Ukrainian banks fell by 40% in the period from October 2008 to December 2011 (from USD 42 bn to 25 bn), while the share of non-resident liabilities in total liabilities shrank from 32% to 22% during this time period. The deleveraging has been first caused by the dry-up in the foreign funding in aftermath of Lehman crisis. The banks regained access to the international debt markets in early 2011, albeit the demand for FX funding remains feeble given the limited opportunities for the foreign currency lending. Thus, we expect the banks to continue to reduce the share of FX funding. Under these circumstances, domestic deposits again (as before 2006) emerged as the main funding source. Deposits' share in total liabilities (including capital) increased from 44% at end-2008 to 54% as of end-2011. At the same time, the increasing reliance on domestic deposits and external deleveraging made the problem of long-term funding for the banks even more acute. The domestic deposit base can be hardly considered stable long-term funding source. Given high inflation and unstable currency expectations, the households prefer shorter-term deposits, thus the share of long-term retail deposits (more than 1-year) stood at 44% at end-2011. Moreover, all retail deposits are de-facto callable, since the Civil Code requires the bank to return money on the first call of the depositor. Therefore, the banks are facing maturity mismatch problem (when long-term loans are financed by short-term deposits). In the recent years, however, there has been the certain improvement in this respect stemming from rising average maturity of deposits (at end-2009 long-term retail deposits comprised less than 30% of total) and shortening average loan maturity, especially in the retail segment. The combination of subdued loan growth, external deleveraging and strong rebound in deposits also helped to reduce loan-to-deposit ratio to more healthy levels. It fell to 162% as of end-2011 (which is, however, still much higher than in most of the neighboring countries).

The headline capital position of the banking system looks strong at the moment – the capital adequacy ratio stood at solid 19% as of end-2011 (the minimum required ratio is 10%), improving from 13% at end-2008. However, the capital positions of individual banks might be much weaker as the anecdotal evidence suggests that not all banks have fully disclosed the loan losses in the financial accounts.

Banks' financial results in the recent years have visibly deteriorated amid disastrous loan quality, albeit operational efficiency even improved on the back of massive cost saving exercises. Following the massive build-up in provisions, the banking system posted huge losses in 2009 and 2010 – average ROE turned from 8.5% in 2008 to -32.5% in 2009 and then improved to -10.2% in 2010. In 2011 most of the banks returned to the profitability, although the system as whole still posted a loss (40% smaller than a year before) due to the disastrous financial performance of a few banks. The wide divergence in banks' financial results should be mostly traced back to the different provisioning approach (as the local accounting standards are rather lax in this respect). Some banks look fully provisioned as they built up large provisions consistent with (poor) loan quality (and, consequently, showed massive losses). On the other hand, several banks, aiming at limiting capital replenishment, did not fully recognize loan losses (and, thus, did not make adequate provisions). There have also been banks, which employed a mixed approach - recognizing the loan loss not in the years when it primarily occurred (i.e. 2008-2009), but extending loss booking process to 2010-2011 (as it apparently became easier for bank shareholders to replenish capital when the economy started to recover). The operating earnings of the Ukrainian banks are showing encouraging resilience. Net interest margin firmly holds above 5% level. However, this figure should be interpreted with caution, as a substantial part of interest income has been accrued but not received in cash – the local accounting standards do not allow to stop interest income accrual on non-performing loans. The share of non-interest income in total earnings has been historically rather small in the Ukrainian banking system (around 25-30%) as the bank services were mostly limited to the standard credit and deposit operations. Now, given the slump in the traditional lending business, the banks put more focus on commission income, actively proposing payment, factoring and other fee-based services to the clients.

Poor asset quality remains the major risk for the banking system, despite some improvement in this respect last year. According to the official data of the central bank, the NPL ratio fell from 11.2% at end-2010 to 9.6% as of end-2011. IMF estimates also suggest that the NPL peak was reached in the first half of 2011 and NPL ratio started to level off afterwards. Several reasons should be cited for this. The first reason is merely statistical – loan growth recovery reduced the ratio of non-performing loans to total loan volume. Second, the improvement in economic indicators has positively affected borrowers' repayment ability. Another reason for improvement was the activation of loan write-off and sales processes last year following the relevant amendments in the regulatory framework. Finally, according to anecdotal evidence, the performance of new loan portfolio (i.e. the loans originated in 2010-2011) has been extremely good so far with NPL levels staying in low single digits. However, despite this improvement, we see no easy way out of this situation and the banks will continue to be plagued by asset quality problem for quite some time.

Another major concern for the banking system at the moment is foreign exchange risk. Contrary to three years ago, this risk right now stems not from FX lending to unhedged borrowers, but from large open short FX position of the banks. The roots of the problem lie in the regulatory amendments, introduced by the central bank in 2009. Faced with severe devaluation pressure, the NBU excluded the loan loss reserves in the foreign currency from the calculation of open FX position, thus forcing the banks to sell foreign exchange. Consequently, as the banks continued to form the reserves on FX loans, their short FX position was getting larger and larger (according to IFRS reporting). Eventually, the total open FX position of the Ukrainian banking system is estimated at EUR 3-4 bn at the moment, which means that 10% local currency depreciation will immediately result in additional bank losses of EUR 300-400 mn. Under the IMF stand-by arrangement the National Bank was required to abolish this regulation, but have not done it yet, fearing that the corresponding increase in FX demand would gravely damage the (fragile) currency peg.

Bank supervision and regulation is mainly performed by the National Bank of Ukraine. The latest legislative amendments, adopted in February 2012, increased the role of the Deposit Guarantee Fund with respect to the resolution of insolvent banks. Specifically, in line with the US and European regulations, the Ukrainian Deposit Guarantee Fund will be responsible for

supervising receivership, rehabilitation and liquidation procedures for problem institutions, while the NBU retains its role as the main supervisory authority. The new law also envisages the introduction of risk-based supervision, the move, which has been long advocated by the international organizations. The Ukrainian deposit insurance system is in place since 1998. It covers all private deposits with the amount up to UAH 150 000 (EUR 15 000), thus the guarantee extends to nearly 95% of total retail deposits. The system has been tested several times during the crisis and substantial defects were detected. In particular, due to the lengthy and non-transparent resolution procedures, the rights of depositors have been repeatedly violated.

Ukraine's banking system is fragmented, characterized by a vast number of banks, low market concentration and smaller share of foreign-owned banks compared to most of other countries in the region. In particular, 175 banks are operating at the moment (compared to 184 as of end-December 2008). The market share of top the 10 banks in total assets is just slightly above 50%, much lower than in other CEE countries, where the top 10 banks usually control up to 80-90% of the market. The highest concentration is observed in mortgage loan segment – here 10 leading banks had combined market share of 61% at end-2011. In general, the domestic banking system appears to be rather diverse with several groups of banks could be identified. The first group comprises large universal banks with more or less transparent balance sheets and ownership structures. The second group consists of mid- and small-sized niche banks focusing on particular market segments or regions - for example, the banks specialized in consumer lending or SME business; and foreign-owned banks, which follow multinational corporate customers. The third, and probably the largest group (up to 100 institutions), includes small pocket banks, which operate as treasuries for particular business groups. Such banks are characterized by opaque ownership structures and the large extent of related lending activities. The drive for higher consolidation and concentration of the Ukrainian banking system has been long expected by the market players but did not occur yet. In our view, there are several reasons for that. First, the lax requirements on banks' registration and operation entail the presence of large number of weakly capitalized, non-transparent banks. Second, the consolidation of the banking system via mergers and acquisitions is hampered by burdensome legal procedures. Also, the sector looks overbanked in terms of branches and offices, so the banks normally do not see much sense in extending the branch network via acquisitions.

In terms of ownership structure, the domestic banking system is pretty balanced compared to CEE peers, where either foreign-owned or state-owned banks dominate the sector. As of end-2011, the leading group was domestic private banks, which controlled nearly 45% of total assets, followed by foreign-owned institutions (37%) and state-owned banks (17%). In the aftermath of the crisis the foreign-owned banks switched to more cautious approach, based on moderate loan growth and conservative pricing policy. Consequently, most of the banks are aiming at downsizing their Ukrainian operations as the opportunities for outright exit are limited due to the severe lack of legitimate buyers. For example, several banks have announced the closure of their retail operations in Ukraine, intending to concentrate on the more profitable (and less risky) corporate segment. At the same time, Russian banks exhibited the opposite dynamics in the post-crisis period. Most of these banks have been the latecomers into the sector, and thus suffered less during the crisis. Moreover, their market expansion has been apparently based not only on purely economic considerations (especially given the fact that Russian state-owned banks have been the most aggressive). As a result of robust loan growth, backed by large-scale parent funding and aggressive pricing policies in the deposit market, the share of Russian banks in total assets of foreign-owned banks went from one-fifth to one-third during the last three years. In total, the market share of foreign-owned banks shrank from 43% of total assets at end-2010 to 37% as of end-2011, while several private domestic banks emerged as the major winners in terms of market share amid aggressive growth strategies. State-owned banks have doubled the market share (in total assets) in the last few years that is partially explained by nationalization of ailing systemic banks. Plus, incumbent state-owned banks (Ukreximbank and Oschadbank) have been strongly expanding their balance sheets in the last few years amid the buoyancy of directed lending activities – Oschadbank lending of last resort to ailing state-owned gas monopoly Naftogas, project financing of state-owned companies on the request of the government etc. Government's future plans for its investments in the banking sector look unclear for now. On the one hand, it officially announced the plans to privatize newly state-turned banks as soon as they return to the normal operations. On the other hand, we see the temptation of authorities to maintain the state presence in the banking sector

by transforming these recently nationalized banks into specialized lending institutions (i.e. agricultural bank, development bank etc).

While the Ukrainian banking system emerged largely unscathed from the latest crisis, the prospects for the sustainable development do not look particularly bright. More than three years since the onset of the crisis it is safe to say that the local banking system has survived the shock. At the same time, the future ahead remains in vain. Based on our analysis above, we see several main obstacles to the dynamic development of the banking sector – unstable macroeconomic environment (which negatively affects both supply and demand sides of the banking market), inadequate legal framework, lack of stable long-term funding base, poor loan quality and weak capital position of the banking system. Unless these problems are resolved, banks' intermediation capacity is not likely to improve. We expect loan growth to remain subdued in the next few years (it will lag behind nominal GDP change), thus the banks will face the hard task to sustain profitability in unfriendly growth environment. On the funding side, the loan-to-deposit ratio is set to slide further, albeit domestic deposit base will remain volatile. To sum up, we have rather cautious outlook for the Ukrainian banking sector, although there is also clear upside potential. In the best-case scenario (which implies the implementation of structural reforms, elimination of corruption, and de-shadowing of the economy), the level of financial intermediation in the economy might significantly rise on a sustainable basis.

Analysis of the Leading Banks

Privatbank: Privatbank is Ukraine's largest bank, with 13.8% market share in total assets and 22.8% in retail deposits as of end-2011. Despite the hostile market environment, the bank has been on a strong expansion path in the last few years managing to boost the balance sheet by 80% and double the volume of retail deposits in the period from 2009 to 2011. The robust loan growth reflects an extensive corporate client-base (including affiliated companies) and strong presence in the consumer lending segment. The bank is owned by local businessmen and considered part of the large business group, which also controls a number of industrial assets in Ukraine and abroad.

On the asset side the bank is focused on traditional lending business – loan books comprised 67% of total assets as of end-2011. Corporate lending has been expanding much stronger than retail lending in the post-crisis years. The share of corporate loans in total loans increased from 65% at end-2008 to almost 80% as of end-2011, while PrivatBank market share in this sub-segment surged from 10% to 16% in the last three years. The bank is primarily funded by the domestic deposits – its share in total liabilities (including capital) constituted 67% as of end-2011. As a result, the bank's loan-to-deposit ratio currently stands at 122% - much lower than that of the main peers and sector average. Privatbank also returned to the global capital markets in 2010 with Eurobond placement. The proceeds have been used to finance the bank's still viable FX lending business.

Privatbank's financials look solid on the back of a moderately positive loan quality picture. The bank apparently escaped excesses of retail FX lending in the pre-crisis years, and their loan restructuring and work-out procedures are considered the best in the Ukrainian banking sector. The reported (IFRS) NPL ratio is in single digits, which is much better than the sector average. Operating efficiency looks impressive as well with net interest margin of 5.5% as of end-September 2011 and cost-income ratio of 40% (which is good for a bank with 3000 branches and over 30000 employees).

Ukreximbank: Ukreximbank is the Ukrainian successor of Vnesheconombank, the former export-import bank, and the country's second-largest bank. It is entirely state-owned. As of end-2011 the bank had a 7.1% market share in total assets, 4.3% market share in retail deposits and controlled 8.4% of the market in the corporate loan segment. Ukreximbank is mainly corporate focused, with a strong emphasis on servicing the country's foreign trade (trade finance in particular). The retail franchise is used for deposit gathering, while active operations are aimed at cross-selling to the employees of key corporate customers.

The bank's assets increased by almost 60% in the period from 2009 to 2011 on the back of strong growth in corporate lending. The corporate loan portfolio of Ukreximbank expanded by 25% in 2009, while the total corporate loan growth rate of the banking system was just slightly above zero. Given the bank's strong links to the exporters, the share of FX loans to corporates

comprised 50% of the total corporate loan portfolio as of end-2011. Together with other state-owned banks Ukreximbank has also been a heavy buyer of government securities, in particular participating in the capitalization and refinancing schemes of ailing gas monopoly Naftogas. As of end-2011 the bank was the largest investor in government bonds, which comprised more than 13% of bank's total assets.

On the funding side, the bank has rather a balanced strategy with strong presence in corporate and retail deposit segments, as well as regularly tapping the global debt markets. The bank's structural liquidity position improved remarkably with the loan-to-deposit ratio descending from over 200% at end-2009 to 130% at the moment. In the last few years the bank got huge capital injections from the government, which was necessary given the robust expansion of the loan book and state securities portfolio. Consequently, the bank reported an extremely high capital adequacy ratio – 25% for Tier 1 capital as of end-June 2011.

Loan quality is significantly better than average for the system – 25% at end-2010, according to IFRS accounts. Net profit was around "black zero" for 2009-2011 and the net interest margin was below 5%. The strong capital and liquidity positions (stemming from government support) are undoubtedly the main strengths of Ukreximbank. The bank also has a history of good corporate governance and there has been no adverse interference in decision-making in recent years.

Conclusions

The developments in the Ukrainian banking sector during the last 10 years reflect the situation in the economy as a whole. Buoyant growth has been replaced by spectacular collapse, followed by slow and painful recovery. While the banking system emerged largely unscathed from the latest crisis, the prospects for sustainable development do not look particularly bright in view of the following factors. First, the macroeconomic environment is clearly not supportive for the dynamic development of the banking industry taking into account high and volatile inflation, widening external imbalances and the poor business climate. Under these circumstances, we expect the demand for loans from the corporate sector to remain subdued in the next few years. Second, the banks are suffering from a weak legal environment and low transparency of the corporate sector. Consequently, lending activity is hampered (especially to SMEs). Third, in the last few years the baking sector has undergone a process of severe external deleveraging putting more and more focus on domestic deposits. However, given looming economic uncertainty, lack of institutional investors and low depositors' confidence in the banking system, domestic deposits could be hardly considered a stable, long-term funding source. Finally, the banks are plagued with asset quality problems, as some estimates currently put the NPL ratio at 30-35%.

On a more positive note, the recovery of most of the banks from the crisis is reflected in resumed loan growth, tapering off of the NPL ratio and improved financial indicators and capital positions. There have also been certain improvements in the legislative framework in the post-crisis years, which, hopefully, will increase the stability of the banking system and raise depositors' confidence. Also, the banking system looks very competitive with a lot of banks fighting for market share, while the role of the state is limited. To sum up, we have a rather cautious outlook for the Ukrainian banking sector, although there is also a clear upside potential. In the best-case scenario (which implies the implementation of structural reforms, elimination of corruption, and de-shadowing of the economy), the level of financial intermediation in the economy might significantly rise on a sustainable basis.

Table 3. Analysis of the leading banks (as of end-2011)

	Assets, UAH bn	Market share in assets	Total Loans, UAH bn	Corporate loans, % of total assets	Retail loans, % of total assets	Retail deposits, UAH bn	Retail deposits, % of total liabilities	Market share in retail deposits	Ownership	Return on equity*
Privatbank	145.1	96.2	87	80.6	75.6	75.6	75.6	75.6	75.6	75.6
Ukreximbank	75.1	35.8	38.3	37	36.8	36.8	36.8	36.8	36.8	36.8
Oschadbank	74	78.4	66.9	60.4	55.1	55.1	55.1	55.1	55.1	55.1
Raiffeisen Bank Aval	51.3	218.9	174.9	162.9	149.6	149.6	149.6	149.6	149.6	149.6
Ukrsotsbank	40.2	67.2	71.8	75.3	77	77	77	77	77	77
Prominvestbank	38.2	4.8	7.9	14.8	8	8	8	8	8	8
VTB Ukraine	37.1	32.8	28.2	24.7	23	23	23	23	23	23
FUIB	34.9	-14.1	-13.1	-4	-1.6	-1.6	-1.6	-1.6	-1.6	-1.6
Ukrsibbank	32.9	23.1	26.1	27.9	n/a	n/a	n/a	n/a	n/a	n/a
Alfa Bank	28	182	176	176	n/a	n/a	n/a	n/a	n/a	n/a
TOTAL BANKING SYSTEM	1054.2	n/a	764	55.9	16.6	308.8	29.3	n/a	n/a	-5.3

*According to local accounting standards

Source: National Bank of Ukraine, Raiffeisen RESEARCH

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UZBEKISTAN

By Brett E. Coleman, Senior Financial Sector Specialist, and Valeriya Goffe, Financial Sector Specialist, the World Bank

Key Messages

- Uzbekistan has enjoyed robust gross domestic product (GDP) growth since the mid-2000s, averaging 8 percent annually, according to official data. Overall growth is projected to continue around 7-8 percent annually during 2011-14, supported by net exports and a large capital investment program. The government's medium-term growth and development strategy embodies four cross-cutting development policy goals and priorities: (i) to increase the efficiency of infrastructure, especially of energy, transport, and irrigation; (ii) to enhance the competitiveness of specific industries, such as agro-processing, petrochemicals, and textiles; (iii) to diversify the economy and thereby reduce its reliance on commodity exports; and (iv) to improve access to and the quality and outcomes of education, health and other social services.

- The central government, the economy and the banking sector of Uzbekistan are highly integrated. The state owns approximately two thirds of the economy and almost 80 percent of the banking system. Due to multiple injections of capital by the government into the banking system since the beginning of the international financial crisis, the state ownership of the banking system increased during the recent years, and is expected to go up even more, as the government plans to boost the capital of banks by 2.5 times during 2011-2015.

- The state has also instituted tight controls over the use of cash and foreign exchange (FX) in the country. Controls on the availability of cash, which are mainly set up in order to reduce inflation, have resulted in a premium of 10-20 percent on cash over non-cash. While deposits in the banking system have been growing, this is primarily a result of the government's cash controls. Many individuals do not open a bank account because they do not trust banks. FX is allocated to companies based on the government's priorities for various sectors of the economy. The exchange rate premium on the curb market has been approximately 50 percent in 2010-11.

- The government also plays an important role in the allocation of resources available for lending in the country through its directed lending program, which facilitates channeling of resources to priority areas of the economy. Market participants report that very limited analysis of borrower creditworthiness is performed by the banks in Uzbekistan, and no due diligence is performed in the cases of directed lending. Macroeconomic conditions are currently favorable for Uzbekistan's economy, and as a result borrowers are able to repay the loans. If conditions were to change, however, significant deterioration of the loan portfolios of Uzbek banks could occur.

- Main policy priorities in the financial sector of Uzbekistan should include eliminating de-facto government controls over FX and cash; undertaking measures to further deepen financial sector intermediation; introducing an appropriate degree of risk perspective in the regulatory and supervisory frameworks in Uzbekistan to promote risk management culture in banks; improving the quality of credit portfolios of commercial banks by moving away from directed lending, improving underwriting and risk-management standards, and reducing concentration of credit portfolios and volumes of related party lending; reducing the state share in the banking system; increasing liquidity of banks; and improving the quality and consistency of banks' disclosures. Over a sustained period of implementing such reforms, public confidence in the banking system could gradually improve.

Macroeconomic Overview

Uzbekistan has enjoyed robust GDP growth since the mid-2000s, averaging 8 percent annually, according to official data.[30] Such high growth was due mainly to three factors: (i) favorable terms of trade, in particular the continued high world market prices of the country's

[30] At 8.5 percent on average over the last five years, Uzbekistan's growth has been higher than the average growth in Central Asia

key export commodities- copper, gold, natural gas and, since 2010, cotton;[31] (ii) the government's macroeconomic management, including its end-2008 stimulus;[32] and (iii) limited exposure to the turmoil in international financial markets. In 2010, real GDP increased by 8.5 percent. Main macroeconomic indicators for Uzbekistan are presented in Table 1. Overall growth[33] is projected to continue at around 7-8 percent annually during 2011-14, supported by net exports and a large capital investment program. Uzbekistan's external debt was low in 2010 (15.2 percent), compared to the regional average of 79.2 percent. Poverty declined from 25 percent of the population in 2005 to about 19.5 percent in 2010. Prudent macroeconomic management, selective price controls, and the soum's de facto peg to the US dollar all helped to lower inflation, which fell from double digits through the early 2000s to less than 10 percent during 2004-10. The 2010 consumer price index (CPI) in Uzbekistan (7.2 percent) was in line with the Central Asian median value.

Table 1: Macroeconomic Indicators

	2008	2009	2010	2011	2010 median values for Emerging Regions			
					ENCA	EE	East Asia	Lat Am
GDP per capita (USD)	1,038.2	1,198.8	1,380.2	1,529.4	3,013	8,926	2,549	6,980
Real GDP growth (% change)	9.0	8.1	8.5	7.1	6.4	1.0	7.7	5.3
CPI Inflation (% change)	7.2	7.8	7.2	7.7	7.4	2.8	4.5	4.0
Current Account Balance (% of GDP)	8.7	2.2	6.7	8.0	-8.3	-4.4	2.5	-2.1
Fiscal Balance (% of GDP)	10.7	3.2	2.2	2.9	-2.4	-3.9	-2.6	-2.0
Gross government debt (% of GDP)	12.7	11.0	10.0	12.6	26.6	41.4	49.4	36.3
External debt (% of GDP)*	14.3	15.3	15.2	17.4	79.2	45.6	28.7	26.2
Population (Millions)	27.3	27.8	28.2	28.5	9.5	5.9	132.9	14.6

Source: World Development Indicators (World Bank), World Economic Outlook (IMF), Quarterly External Debt Statistics (IMF), Official statistics and World Bank staff calculations and estimates.

*Latest figure is for Q32011

While the country's economic, political and social environment is currently stable, a combination of regional and domestic risk factors may affect this stability. Regional factors include deteriorating security conditions due to the situation in Afghanistan and increasing tensions between Uzbekistan and its neighbors over regional issues, especially the management and use of trans-boundary energy and water resources.[34] International risk factors include the economy's vulnerability to possible external shocks affecting commodity prices and the anticipated inflow of foreign direct investment and external loans to finance the large public investment program. Because the state controls the export of strategic commodities, international trade proceeds underpin the government's financial flexibility. Despite high reserve levels, the government's fiscal flexibility remains exposed to commodity prices and the economic cycles of major trade partners, such as China, the Commonwealth of Independent States (CIS), and Europe. Any tightening of the government's investment programs, or any substantial changes in other economic policies, would quickly translate into weakened performance for all other segments of the economy, as dependence on state financing is widespread. Given the authorities' plans to finance up to two-thirds of their investment program from external sources, including loans, external debt is expected to increase gradually.

[31] The Uzbek economy is export-driven and the country's positive trade balance totaled $4.2 billion (or 11 percent of GDP) in 2010.

[32] This stimulus is equivalent to 4 percent of GDP, financed partly by the Fund for Reconstruction and Development (FRD)—a sovereign wealth fund established in 2006 to collect windfall gains from commodity-based revenues. The 2010 consolidated balance, including FRD resources totalling $4.9 billion, posted a surplus equivalent to 2.2 percent of GDP.

[33] Uzbekistan's growth is expected to be the fastest and most persistent among CIS countries, along with Azerbaijan.

[34] Uzbekistan opposes to the construction of two large hydropower projects in the Kyrgyz Republic and Tajikistan that could affect the flow of water it requires for irrigation.

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Uzbekistan aims at becoming an industrialized high-income country by the middle of this century. This implies that Uzbekistan's per capita income, which is presently estimated at USD 1,380, should increase almost ten-fold by 2050.[35] The government's medium-term growth and development strategy is reflected in its USD 47.3 billion five-year Industrial Modernization and Infrastructure Development Program (2011-15) and in recently issued presidential decrees. These documents embody four cross-cutting development policy goals and priorities: (i) to increase the efficiency of infrastructure; (ii) to enhance the competitiveness of specific industries, such as agro-processing, petrochemicals, and textiles; (iii) to diversify the economy and thereby reduce its reliance on commodity exports; and (iv) to improve access to and the quality and outcomes of education, health and other social services. A large number of infrastructure and plant renovation projects launched by the government are expected to spur the development of other segments of the economy, including small and midsize enterprise (SME) and household consumption.

While the government expects to finance up to two-thirds of its five-year development program with foreign direct investment and/or external loans, Uzbekistan's poor investment climate might make it difficult to achieve this goal. The unfavorable investment climate has been a major challenge for Uzbekistan for years, and there is scant evidence of any real improvement in the country's overall business environment since 2008. Uzbekistan's relative country ranking in Doing Business fell in 2012 compared to 2011 from an already low 164 to 166, despite implementing a reform in starting a business.[36] Uzbekistan ranks particularly low on getting electricity (170), getting credit (159), paying taxes (157) and trading across borders (183) indicators.

Financial Sector Risks and Development Challenges

Financial intermediation in Uzbekistan, measured by credit to GDP, has experienced a steady increase during the last four years, from 11.4 percent in 2008 to 15.4 percent in 2011, but it remains low for a country at this income level.[37] Excessive government controls over FX and cash create a major obstacle for Uzbekistan financial sector development and result in an inefficient resource allocation. Government controls on the availability of cash, which are mainly set up in order to reduce inflation, have resulted in a premium of 10-20 percent on cash over non-cash. There are currently no legal restrictions on FX availability, but market participants report that such controls exist in practice: FX is allocated to companies based on the government's priorities for various sectors of the economy. The exchange rate premium on the curb market did not exceed 5 percent during 2004-08, but this premium increased to 40 percent in 2009 and to 50 percent in 2010-11. Until cash and FX controls have been mitigated or removed, it may be difficult for the government to attract the levels of investment required for the financing of its USD 47.3 billion development program.[38]

The Uzbek banking system, comprised of 31 banks, dominates the financial sector with over 95 percent of financial sector assets. Of the 31 commercial banks, 3 are state-owned, 12 are joint stock banks in most of which the state has a varying proportion of shareholding, 11 are private, and 5 have foreign capital participation.[39] The state-owned banks continue to dominate the banking system. The largest bank, the National Bank for Foreign Economic Activity of the Republic of Uzbekistan (NBU), a state-owned bank, accounts for about 30 percent of the market. According to S&P estimates, the state owns almost 80 percent of the banking sector. Major banking sector indicators are presented in Table 2 below. In addition to performing standard bank functions, the government of Uzbekistan also requires banks to perform many non-bank functions, including control over accounts receivable and accounts payable of bank clients; registration and control over export and import operations; calculation and distribution of wages and salaries; control over payments by clients of tax and customs duties; and control and provision of information on transactions exceeding 4000 times the minimum wage.

[35] To reach this level of per capita income in 2050, the economy of Uzbekistan would need to grow at an average of 6 percent per annum.
[36] Uzbekistan made starting a business easier by reducing the minimum capital requirement, eliminating one procedure and reducing the cost of registration.
[37] In Kazakhstan and Georgia, credit as percentage of GDP is over 40 and 30 percent, respectively.
[38] Uzbekistan FY12-15 Country Partnership Strategy, World Bank.
[39] International financial institutions with shares in Uzbek banks include EBRD, KDB, IFC, Aussenhandels GMBH-Germany , Ziraat Bank International AG- Germany, and Ziraat Bankasi A.S - Turkey.

Table 2: Banking Sector Indicators								
	2008	2009	2010	2011	2010 median values for Emerging Regions			
					ENCA	EE	East Asia	Lat Am
Assets/GDP	41.0	40.7	46.9	49.3				
Deposits/GDP	9.3	9.4	11.2	11.8	32.0	53.0	68.0	31.0
Loans/GDP	11.4	11.5	14.1	15.4	38.0	49.0	48.0	31.0
Loans/Deposits	122.5	122.6	126.0	130.2	145.0	99.0	76.0	87.0
Foreign Liabilities/GDP					11.0	20.0	6.0	3.0
FX Loans/Loans	40.1	34.9	40.3	40.9				
Asset Concentration (top 3 banks)	90.5	88.5	91.9					
Number of banks	30	30	31					
NPLs*/Gross Loans	21.2	8.0	9.6	7.1	12.5	11.9	3.6	2.4
CAR	23.2	23.4	23.4	24.2	20.5	15.8	16.0	16.4
ROE†	12.0	9.5	12.7	14.4	10.7	3.3	16.7	18.7
Loan loss provisions/NPLs					63.2	54.6	74.2	140.8
Capital/Assets	9.8	10.5	9.1	8.5	14.6	10.2	9.6	10.1

Source: Financial Soundness Indicators (IMF), International Financial Statistics (IMF), CBU and World Bank staff calculations.

* Official NPL rates in Uzbekistan can be confusing because the lowest level of classification per CBU guidelines is called "nonperforming (hopeless)" and refers to loans that other jurisdictions would typically call "bad". NPLs in most jurisdictions would include all loans that are substandard or worse (typically more than 90 days overdue, although qualitative criteria might also be applied). Loan classifications in Uzbekistan include both qualitative criteria as well as the number of days overdue. A summary of the classifications and their definitions includes: (i) good (fully current and repayment "cannot be doubted"); (ii) standard (1-30 days overdue, financial position of borrower is stable, good collateral); (iii) substandard (loans without collateral, more than 30 days overdue; loans with collateral, more than 90 days overdue); (iv) doubtful ("high probability to incur losses"); and (v) "nonperforming (hopeless)" (more than 180 days overdue). NPL rates quoted in the table include all loans that are classified as substandard, doubtful, or "nonperforming (hopeless)". By comparison, official NPLs were 2.8 percent, 3.0 percent, 1.2 percent, and 0.97 percent in 2007-10, respectively.

Central Bank of Uzbekistan (CBU) is fully-owned by the government of Uzbekistan. According to the Law "About the Central Bank of Uzbekistan", CBU is an economically independent institution which finances its expenses with the funds received from its revenues. However, CBU effectively lacks independence in practice, despite laws to the contrary.

In practice, CBU is requested by the government to implement reforms in the financial sector, as opposed to making changes based on CBU's own views. For example, the President's Decree from November 26, 2010 on "The Priority Directions of Further Reforming and Enhancement of Financial and Banking System Stability of the Republic for the Period of 2011-2015 and Achieving High International Rating Indicators" calls for the revision of the bank regulatory and supervisory framework and other tasks. Further, based on President's Decree from August 24, 2011, "About Additional Measures on the Establishment of Favorable Business Environment for the Further Development of Small and Private Business", CBU was requested to attract technical assistance and cooperate with international financial institutions and foreign banks to make recommendations to the Cabinet of Ministers on the mechanism of creation of the partial credit guarantee fund for business development. While many of these activities are useful for the development of the financial system of Uzbekistan, it is the government which instructs CBU to perform them. In practice, government interference in the banking system is significant, and CBU's ability to intervene when appropriate to ensure a sound, healthy, competitive banking sector is limited due to its lack of independence from the government.

The CBU supervisory approach at present is more compliance oriented than risk oriented. The supervisory rating framework is based on CAMELS[40] methodology, whereby each of the six parameters are rated individually and then aggregated into a composite rating. Although banks seem to have received fairly good CAMELS ratings, major banks that have been rated by external rating agencies[41] all have below investment grade rating, some of which are lower by at least two notches. This divergence reflects the weaknesses in the CAMELS rating methodology and the risks inherent in the banking system. Risk management systems in banks are underdeveloped and offer scope for improvement. The disclosure requirements on banks appear to be minimal and will need to improve considerably in terms of frequency and granularity of banks' disclosures and their accessibility to market participants, to be seen as adequate for the fast growing and evolving Uzbek banking system.

The regulatory framework for banks in Uzbekistan needs to improve to be in alignment with international norms. The prudential framework currently includes regulations on the main areas of capital adequacy, loan classification and provisioning, liquidity requirements, related party exposure and FOREX positions. Banks are implementing Basel I norms as administered by CBU, and are maintaining capital for credit risk. CBU has not yet required banks to maintain capital for market risk. While banks are required to comply with certain liquidity stock ratios, they are yet to be required to implement sophisticated asset-liability management systems that better address maturity mismatches and funding liquidity risks. The regulatory framework does not include the latest Basel iterations on capital adequacy, management of various risks, corporate governance, compliance functions, internal control, outsourcing, business continuity planning and disaster recovery management, stress testing, and contingency planning. An appropriate degree of risk perspective needs to be adopted in the regulatory and supervisory frameworks in Uzbekistan to promote risk management culture in banks.

Since the beginning of the global crisis, the Uzbek government has injected large doses of capital into the banking system, which resulted in a significant increase of the state share in the banking system.[42] Similar to previous several years, in the first nine months of 2011, the Central Bank of Uzbekistan (CBU) performed significant work on further strengthening of the banking system. Figure 1 shows that the aggregate capital of the Uzbek banks grew from UZS 4.1 trillion (USD 2.3 billion)[43] on January 1, 2011, to UZS 4.6 trillion (USD 2.6 billion) on October 1, 2011 (14 percent increase). Further increases in bank capital are expected in the future: capital of banks will be increased by 2.5 times during 2011-2015 in accordance with the President's Decree on "The Priority Directions of Further Reforming and Increasing the Sustainability of the Financial and Banking System of the Country in 2011-2015 and Achievement of High International Rating Figures".[44] Some international observers have expressed the view that substantial increases in bank capitalization contributed to the stability of the banking sector and are facilitating the authorities' development programs. However, others have argued that the government's injection of capital was unnecessary since capital levels were already well over 20 percent at the time when capital injections started, and the banks were insulated from international financial markets. It is clear, however, that the capital injections have increased government control and ownership of banks, reversing a trend to more private ownership before the global financial crisis.

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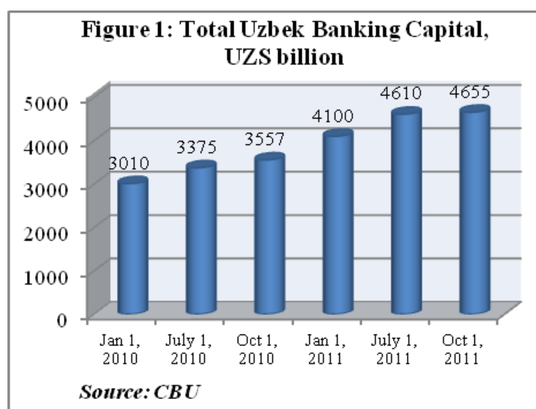
[40] The six factors examined in the CAMELS rating system used by supervisory authorities include capital adequacy, asset quality, management quality, earnings, liquidity, and sensitivity to market risk.

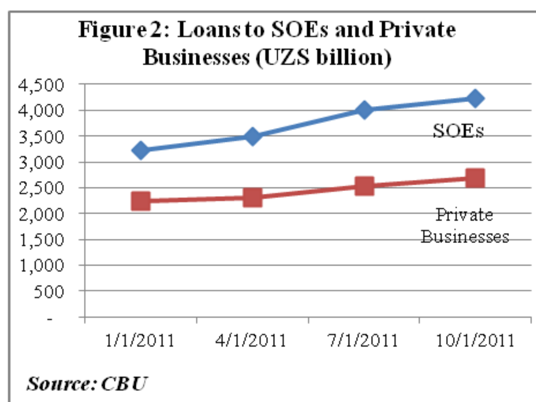
[41] At present, 18 out of 31 Uzbek commercial banks have been rated by international rating agencies. Some rating withdrawals, downgrades, and changes in outlook on several banks in Uzbekistan have occurred in the recent past. Moody's has recently withdrawn its rating for Turonbank and downgraded Agrobank. Moody's has also placed on review for downgrade the local currency deposit ratings of five Uzbek banks, which have historically received a higher deposit rating due to the high level of government support they would be expected to receive if they had financial difficulties. The review for downgrade is due to Moody's view that the state support for these banks has not always been timely.

[42] In the fall of 2008, to support local banks in a difficult macroeconomic environment, CBU and the Finance Ministry took measures to inject money into the banking system. Injections into the country's banking system continued in the following years.

[43] Exchange rate used for calculations of all 2011 amounts in this note is from December, 2011 (1 USD = UZS1,784)

[44] According to the forecasts of Uzbekistan's rating agency Ahbor-Rating, the state will increase the capital (and the state share) in the following banks during 2012: Asaka, Uzpromstrojbank, Agrobank, People's Bank, Microcreditbank, and Kishlok-Kurilish bank.





The capital boost fueled a rapid increase in bank loans during the last several years. Bank assets climbed from UZS 30.9 trillion (USD 17.3 billion) in the beginning of 2011 to UZS 37 trillion (US$ 20.7 billion) on October 1, 2011, which represented a 20 percent increase. NBU assets also increased rapidly during the last several years, and from January 2010 to June 2011 went up by 59 percent. Loans to state-owned enterprises (SOEs), largely in the form of directed lending, increased by 32 percent from January to October 2011, as compared to a 20 percent increase in loans to private partnerships and corporations, as shown in Figure 2. Furthermore, volumes of loans to SOEs were significantly above volumes of loans to private businesses throughout the year. Prior to 2009, lending to SOEs was fairly equal to lending to private businesses; however, in 2009, a gap emerged, and lending to SOEs dominated since. The volume of loans to SMEs during the nine months of 2011, compared to the same period in 2010, increased by 1.5 times and reached UZS 3.1 trillion (USD 1.7 billion), due to measures taken in accordance with the government program "The Year of Small Business and Entrepreneurship".

Asset quality of the banking system in Uzbekistan is a source of concern due to large volumes of directed and related party lending, high concentration among industries and individual borrowers, and low underwriting standards. Loans of the majority of banks continue to be concentrated in a particular sector, a legacy from the prior years when Uzbek banks used to specialize in particular sectors of the economy. A large number of banks have loan portfolios with a high concentration in loans to several large borrowers. For example, as of Dec 31, 2010, NBU had a concentration of loans due from the ten largest borrowers representing 61 percent of its gross loan portfolio, compared to 51 percent in 2009. Loans were primarily granted to production industry and transportation and communication (83 percent of the portfolio in 2010, up from 78 percent in 2009). Table 3 below presents a detailed breakdown of NBU's portfolio.

Table 3: NBU Concentration of Loans to Customers (Source: NBU Annual Report)

Industry	2010		2009	
	Amount (UZS million)	%	Amount (UZS million)	%
Production industry	2,511,387	60%	1,656,289	59%
Transportation and communication	986,415	23%	538,097	19%
Trading and catering	224,213	5%	114,964	4%
Agriculture	184,411	4%	219,125	8%
Individuals	90,038	2%	90,132	3%
Housing and utilities	53,927	1%	73,113	3%
Construction	44,934	1%	33,768	1%
Education	35,958	1%	25,557	1%
Other	71,299	2%	75,926	3%
Loans to customers, gross	4,202,582		2,826,971	
Less- allowance for impairment	(229,577)		(261,005)	
Loans to customers, net	3,973,005		2,565,966	

Related party lending, which is an important driver behind the high level of problem loans in CIS banks, has also experienced an increase in Uzbekistan during the last several years. For instance, NBU experienced an increase in related party exposure in recent years: in 2010, outstanding loans to related parties were UZS 130,960 million (USD 73.4 million), up from UZS 98,680 million (USD 55.3 million) in 2009. Funds received by NBU from CBU to help finance NBU's directed lending have been declining during the recent years, which is a positive sign. In 2008, these funds amounted to UZS 461,467 million (USD 337 million), representing 18 percent of NBU's total gross loans portfolio, compared to UZS 26,707 million (USD 15 million), or 1 percent, in 2010. At the same time, amounts due to the Ministry of Finance, the purpose of which is not described in NBU's annual report, have been increasing over the last several years and reached UZS 220,736 million (USD 124 million) in 2010.

At present, demand for Uzbekistan's export commodities and growing internal consumption may be able to support the financial condition of many borrowers, but if macroeconomic conditions were to change for certain sectors, banks could suffer significant losses due to highly concentrated portfolios. Moreover, market participants report that very limited analysis of borrower creditworthiness is performed by the banks in Uzbekistan, and no due diligence is performed in the cases of directed lending. Given low underwriting standards and the widespread use of directed lending, such a rapid increase in lending during the last several years may result in a high percentage of problem loans in banks' portfolios in future. It is not clear whether banks would receive government support in time if the loans they extended to government enterprises did not get repaid. While the government has provided both liquidity and capital to banks with state ownership, the support has not always been sufficient, timely, and transparent.

The level of non-performing loans (NPLs) held by Uzbek banks is difficult to evaluate, as local banks' practices and disclosures are not fully consistent.[45] Official CBU figures show NPLs significantly below the average levels in the countries of Central Asia and Eastern Europe. The reported NPL percentage appears extremely low when assessed in relation to credit risks taken on by the banks, low underwriting standards, and a wide-spread practice at Uzbek banks to restructure doubtful exposures without reporting them as problem loans. As noted by Moody's, according to the rated banks'[46] reports based on IFRS, the aggregate level of impaired loans at Uzbek banks was 12.4 percent as of year-end 2010, and the accumulated loan-loss reserve (5.5 percent of gross loans) was not sufficient to cover potential losses. Moreover, the level of NPLs reported by banks in Uzbekistan appears to be understated, as banks often restructure some doubtful exposures without reporting them as problem loans.

According to the official figures, Basel I capital-adequacy ratio (CAR) in the banking system of Uzbekistan was 23.4 percent in 2009 and 2010, which is significantly above regional averages and CBU's requirement of 10 percent, but this level may be overstated. Some analytics have questioned whether the loans of NBU, the largest bank in the country with a 30 percent market share, are assigned an adequate risk level. Most of these loans are guaranteed by the state and therefore are assigned no risk weighting. If these loans were regarded as entirely commercial credits, the total amount of risky assets in the system would significantly increase, and the level of CAR would be significantly lower for NBU[47] and the overall banking system. Moody's has reported that, as of August, 2011, the sector's total aggregated CAR was approximately 13 percent. While this is above the 10 percent requirement of CBU, the level of CAR may drop below the requirement if further increases in bank lending and risk-taking are not supported by adequate increases in capital.

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[45] Quoted "NPL" rates in Uzbekistan can be confusing because the lowest level of classification per CBU guidelines is called "nonperforming (hopeless)" and refers to loans that other jurisdictions would typically call "bad". NPLs in most jurisdictions would include all loans that are substandard or worse (typically more than 90 days overdue, although qualitative criteria might also be applied). Loan classifications in Uzbekistan include both qualitative criteria as well as the number of days overdue. A summary of the classifications and their definitions includes: : (i) good (fully current and repayment "cannot be doubted"); (ii) standard (1-30 days overdue, financial position of borrower is stable, good collateral); (iii) substandard (loans without collateral, more than 30 days overdue; loans with collateral, more than 90 days overdue); (iv) doubtful ("high probability to incur losses"); and (v) "nonperforming (hopeless)" (more than 180 days overdue).

[46] At present, only 18 out of 31 Uzbek commercial banks have been rated by international rating agencies. 11 commercial banks of the country hold stable ratings from international ratings agencies. Fitch rated 7 banks, S&P rated 5 banks, and Moody's rated 10 banks. NBU, Asaka bank, Uzpromstroybank and Agrobank have ratings from 2 international rating agencies.

[47] NBU reported CAR of 16 percent in Dec 2009 and 13 percent in Dec 2010.

According to official data, the profitability of the Uzbek banking system was high during the last several years, compared to other countries in the region.[48] High profitability reported for Uzbek banks is primarily due high commissions which account for 40 percent of all operating revenues and a substantial interest margin of 400-500 basis points. NBU reported a record net profit of UZS 31.6 billion (USD 17.7 million) at Q2, 2011. This represents a 182 percent increase over the net profit of UZS 11.2 billion (USD 6.3 million) at Q2, 2010. NBU's profit as of Q2, 2011 significantly increased compared to Q2, 2010 due to significantly higher net interest income and higher net fees and commissions. Provision for losses was higher in 2011, but it was offset by much higher revenues.

The liquidity of banks has been relatively low during the recent years. Specifically, the liquid assets to short-term liabilities ratio in 2010 was 67.3 percent, only slightly higher than 66.6 percent in 2009.

Banks' loan-to-deposit ratio (LDR) has experienced a steady increase over the 2008-2011 period, from 122.5 percent to 130.2 percent, which increased funding constraints for the banking system. Although deposits in the banking system have been increasing and deposits to GDP went up during the last several years (from 9.3 percent in 2008 to 11.8 percent in 2011), deposit growth was unable to catch up with a more rapid growth in lending. Furthermore, the deposit base of most banks is predominantly short-term and highly concentrated, which makes banks vulnerable if depositors were to withdraw their funds.

For example, the majority of deposits at NBU in 2010 and 2009 were current accounts (89 percent and 80 percent, respectively) as opposed to term deposits (11 percent and 20 percent, respectively). Moreover, they were predominantly held by state and budgetary organizations, as shown in Table 4 below. Private enterprises' deposits decreased dramatically in 2009 and rebounded in 2010, but their share in the overall deposit base declined in 2010 compared to 2008 due to a large increase in deposits of state and budgetary organizations. Deposits of individuals slightly increased in 2010 compared to 2008, but their growth was very low compared to the growth of state and budgetary organizations deposits. At December 31, 2010, deposits in the amount of UZS 1,613,040 million (USD 904 million), or 59 percent, were held by the ten largest NBU customers. This represents a significant increase from 2009 when only UZS 459,266 million (USD 257 million), or 31 percent, were held by the ten largest customers.

Table 4: NBU Deposits Distribution by Customer Type (2008-2010)

Type of Customer	2010		2009		2008	
	Amount (UZS billion)	%	Amount (UZS billion)	%	Amount (UZS billion)	%
State and budgetary organizations	1,682,242	54%	1,145,716	61%	382,439	24%
Private enterprises	991,606	32%	349,909	19%	872,954	54%
Individuals	367,934	12%	308,239	17%	327,355	20%
Other	45,602	1%	59,158	3%	21,946	1%
Total	**3,087,384**		**1,863,022**		**1,604,694**	

Source: NBU Annual Report

Although deposits in the banking system of Uzbekistan have been growing, the population's trust in banks has not been improving, and government's cash controls are largely responsible for increases in deposits. Banks still have to perform as fiscal agents of the Government. This entails lack of a trustful relationship between the banks and their clients, and, as a result, a large portion of trade turnover and cash proceeds from it stays beyond the banks. Because more individuals and entities have been forced to use banks for their transactions in the last several years and are not able to take their money out of banks or ATMs in cash, volumes of deposits have been increasing in the recent years.

[48] Reported ROE in the Uzbek banking system was 12.7 and 14.4 percent in 2010 and 2011, respectively, while 2010 median ROE in ENCA and EE were 11 percent and 3 percent, respectively. ROE for Kazakhstan's banking system was negative on both 2009 and 2010. Tajikistan's ROE was only 3.8 and 3.4 percent, respectively, in 2010 and 2011.

Key policy priorities

Excessive government controls over FX and cash need to be phased out to improve Uzbekistan's business environment and investment climate. Specifically, it is important for the government to move away from its current methods of stimulation of non-cash transactions and instead focus on increasing the trust of the population in order to channel more money into the banking system on a voluntary basis.

The government's role in the banking system of Uzbekistan needs to diminish in a phased but deliberate manner. The CBU needs to be more independent from the government to ensure that its ability to intervene when appropriate to ensure a sound, healthy, competitive banking sector is not limited. The state share in the banking system needs to decline rather than increase in the future years. Because further increases in bank capital no longer provide benefits, other measures need to be used to promote soundness and stability of the banking system. Specifically, an appropriate degree of risk perspective needs to be adopted in the regulatory and supervisory frameworks in Uzbekistan to promote a risk management culture in banks. The regulatory framework for banks in Uzbekistan should be improved to be in alignment with international norms. The supervisory approach needs to become more risk-oriented as opposed to the current compliance-oriented approach. Finally, the banking system needs to become more open and attractive for foreign banks, as their entrance would help introduce modern practices and skilled specialists into the operation of banks.

Improvement of the quality of credit portfolios of commercial banks should be one of the top priorities of the government. A large increase in lending during recent years, and specifically directed lending and lending to related parties, will likely result in high NPLs in the future. The level of NPLs in the banking system has to be evaluated based on a consistent methodology, and provision levels at banks have to be increased to be sufficient to cover potential losses. As noted above, most of the banks have large exposures to only a few borrowers and/or certain industries, and underwriting standards at Uzbek banks are weak. The soundness of the banking system may, therefore, be threatened in the future. Underwriting standards need to be improved, and more advanced methodologies need to be applied to assess creditworthiness of borrowers. Concentration of credit portfolios at banks has to be significantly reduced and modern diversification methods have to be applied. Moreover, the government needs to move away from directed lending. While this might not be possible in the short-term and will be a gradual process, at the minimum, the government needs to re-evaluate its approach to providing support to state-owned banks and make it more transparent.

It is also important to increase liquidity of banks in Uzbekistan to ensure the stability of the banking system. As noted above, banks' liquidity has been low compared to other countries in the region, and liquidity problems might threaten the stability of the banking system in future.

Summary and Conclusions

Uzbekistan has enjoyed robust gross domestic product (GDP) growth since the mid-2000s, averaging 8 percent annually, according to official data. Overall growth is projected to continue around 7-8 percent annually during 2011-14, supported by net exports and a large capital investment program. The government's medium-term growth and development strategy embodies four cross-cutting development policy goals and priorities: (i) to increase the efficiency of infrastructure, especially of energy, transport, and irrigation; (ii) to enhance the competitiveness of specific industries, such as agro-processing, petrochemicals, and textiles; (iii) to diversify the economy and thereby reduce its reliance on commodity exports; and (iv) to improve access to and the quality and outcomes of education, health and other social services.

The central government, the economy and the banking sector of Uzbekistan are highly integrated. The state owns approximately two thirds of the economy and almost 80 percent of the banking system. Due to multiple injections of capital by the government into the banking system since the beginning of the international financial crisis, the state ownership of the banking system increased during the recent years, and is expected to go up even more, as the government plans to boost the capital of banks by 2.5 times during 2011-2015.

The state has also instituted tight controls over the use of cash and foreign exchange (FX) in the country. Controls on the availability of cash, which are mainly set up in order to reduce inflation, have resulted in a premium of 10-20 percent on cash over non-cash. While deposits in the banking system have been growing, this is primarily a result of the government's cash controls. Many individuals do not open a bank account because they do not trust banks. FX is allocated to companies based on the government's priorities for various sectors of the economy. The exchange rate premium on the curb market has been approximately 50 percent in 2010-11.

The government also plays an important role in the allocation of resources available for lending in the country through its directed lending program, which facilitates channelling of resources to priority areas of the economy. Market participants report that very limited analysis of borrower creditworthiness is performed by the banks in Uzbekistan, and no due diligence is performed in the cases of directed lending. Macroeconomic conditions are currently favourable for Uzbekistan's economy, and as a result borrowers are able to repay the loans. If conditions were to change, however, significant deterioration of the loan portfolios of Uzbek banks could occur.

Main policy priorities in the financial sector of Uzbekistan should include eliminating de-facto government controls over FX and cash; undertaking measures to further deepen financial sector intermediation; introducing an appropriate degree of risk perspective in the regulatory and supervisory frameworks in Uzbekistan to promote risk management culture in banks; improving the quality of credit portfolios of commercial banks by moving away from directed lending, improving underwriting and risk-management standards, and reducing concentration of credit portfolios and volumes of related party lending; reducing the state share in the banking system; increasing liquidity of banks; and improving the quality and consistency of banks' disclosures. Over a sustained period of implementing such reforms, public confidence in the banking system could gradually improve.

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THE EIB IN THE EASTERN NEIGHBOURS AND CENTRAL ASIA

The EIB supports the EU Neighbourhood Policy in the Eastern Partner Countries (Armenia, Azerbaijan, Georgia, Moldova, Russia, Ukraine) and Central Asia (Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, Uzbekistan).

EIB lending to date

The Bank's lending operations in ENCA expanded over the years, with a notable increase since 2010 to reach a record level in 2011 of EUR 782m, bringing EIB financing in the Eastern Neighbourhood and Central Asia to a total of EUR 2.1bn to date. Loans signed in 2011 include the first ever Bank loan under the EPF, namely the EUR 100m Bank loan to support the Mondi Syktivkar mill modernisation in Russia, an EU FDI, as well as the largest loan ever extended by the Bank in ENCA (namely the EUR 450m loan to support the European Roads II project in Ukraine).

The Framework for EIB operations in 2012-13

The Mid-Term Review of the Mandate, which was finalised in October 2011, resulted in significant changes for the Bank's remit in the ENCA region, which have the potential to affect significantly Bank lending in ENCA during the 2012-13 period.

The overall ceiling for bank lending in Eastern Neighbours was increased to EUR 3.85bn for the period 2007-2013, and there was a significant broadening of the Bank's sectoral remit to include:

a) local private sector development, in particular support to SMEs,
b) development of social and economic infrastructure, and
c) climate change mitigation and adaptation.

The decision also states that the EIB shall consider increasing its activity in support of health and education infrastructure when there is clear added value in doing so.

The decision provides that the EIB should be able to support the EU presence in partner countries through Foreign Direct Investment (FDI) that contributes to promoting technology and knowledge transfer either under the EU guarantee for investments within the three aforementioned areas or at its own risk (under the Eastern Partners Facility).

The decision also provides that regional integration among partner countries, including economic integration between pre-accession countries, Neighbourhood countries and the Union, shall be an underlying objective for EIB financing operations within areas covered by the aforementioned general objectives.

In addition to this general mandate, the Mid-Term Review provides for a EUR 2bn Climate Change Mandate, which can be used in all regions; the Neighbourhood regions (East and South) are expected to use up to 50% of this amount. (The Bank can support climate action projects in ENCA under the EUR 4.5 bn Energy Sustainability Facility)

In geographical terms, the scope of the Mandate remained unchanged (Belarus remains only "potentially eligible"), and the Decision provides that, within this ceiling, the EIB should progressively ensure a balanced country distribution.

The Mandate also states that the EIB should continue to enhance cooperation with the other European financial institutions, such as the tripartite memorandum of understanding between the Commission, the EIB Group and the EBRD.

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The EU Bank

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Its shareholders are the 27 Member States of the Union, which have jointly subscribed its capital. Outside the EU, the EIB is active in over 150 countries (the pre-accession countries of South-East Europe, the Mediterranean partner countries, the African, Caribbean and Pacific countries, Asia and Latin America, Central Asia, Russia and other neighbours to the East), working to implement the financial pillar of EU external cooperation and development policies (private sector development, infrastructure development, security of energy supply, and environmental sustainability).

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