FINANCE SECTOR BACKGROUND BRIEF

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Finance Sector Background Brief
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Executive Summary

Key Opportunities

- Strategic investments in banks to strengthen the capitalization and lending capacity of the region's banking systems
- Portfolio investment in privatized SOEs, although the pipeline of finance sector IPOs hinges largely on the revival of reform agendas
- Investing in Non-Banking Financial Institutions and through investment funds to participate in capital markets development

Critical Issues

- Finance sectors in the CARs are underdeveloped and rudimentary, and are unable to mobilize and efficiently intermediate funds on a scale necessary to underwrite growth in the real sectors
- The commercial banking systems are fragile and prone to systemic risk, and low confidence in the banking system has undermined growth of deposits
- Securities markets are either practically non-existent or insignificant and have little prospect for growth unless the private corporate sector develops further to generate investment opportunities
- The finance sectors in the CARs are characterized by inadequate accounting, auditing, financial reporting, and corporate governance standards, which undermine investors' confidence
- There is a need for many CAR governments to make a more concerted effort at finance sector policy and strategy formulation and implementation if their potential economic development is to be realized

Major Impediments

- The small size of CAR economies and their finance sectors involves tying up expensive management time on small deals with limited scalability
- Governments of many CARs adhere to a paradigm of state control over strategic economic activities, including the major financial institutions
- CARs' finance sectors' regulators lack capacity for supervision and risk management
- ICT infrastructure is generally underdeveloped and challenged by the geography
- Payments systems are often inefficient and CARS' banking systems suffer from a range of problems including inadequate legal systems and weak governance
- Capital markets are underdeveloped and important NBFI services such as leasing are often lacking

Possible Recommendations

- Since opportunities are closely linked to reform programs, potential investors should maintain liaison with IFIs for key information on reform implementation
- Investors should be open to partnership opportunities with the IFIs

I. Sector Overview

The finance sectors in the Central Asian countries covered in this background brief – Afghanistan, Azerbaijan, Kazakhstan, Kyrgyz Republic, Tajikistan, Uzbekistan, Mongolia and the Chinese province of Xinjiang – remain in their infancy and thus far provide few services other than banking (the term CAR is used to describe all or most of these economies). However, a sound and efficient financial system is essential for achieving broad-based economic growth and socioeconomic objectives, including poverty reduction.

The Banking Sector

Although all of the banking sectors still have a great deal of participation from the government, the banking sectors in Uzbekistan and Tajikistan are more government-controlled than those in Kazakhstan and the Kyrgyz Republic. Demand for credit and other forms of finance tend to exceed the available supply in most Central Asian countries, but Kazakhstan's financial services are more developed than the others. Most companies in Central Asia rely on reinvested earnings for any significant investment activities.

Kazakhstan has 35 commercial banks as of early 2005, 15 of which have foreign capital. It is essentially a private-sector banking industry, as only two of the commercial banks are state-owned. Foreign banks face restrictions in that the aggregate charter capital of all banks with foreign capital must not exceed 50% of the aggregate charter capital of all banks in Kazakhstan. Other restrictions apply as well. In addition to banks, Kazakhstan has several insurance firms. Stricter legislation has led to a decline in the number of insurance firms since the late 1990s, but at the same time strengthened the sector.

The banking sector in the Kyrgyz Republic has 18 commercial banks as of 2005, 11 of which have foreign participation. Only three commercial banks are government-owned. Several companies also provide insurance services.

Tajikistan has a small banking sector, and all but one of the banks have been privatized. In spite of privatization, the government retains a minority shareholding in the banks. Banking services are mainly for the cotton industry and state-owned enterprises.

Uzbekistan has three groups of banks: (i) government-controlled banks; (ii) banks with foreign investment; and (iii) small and medium sized private banks. The state-owned National Bank of Uzbekistan is the largest bank and controls most of the commercial banking loans in the country, including those for government enterprises and agencies. The six major banks are all state-owned and controlled 95% of the bank assets in 2003.

The financial sector in Afghanistan is small and just beginning to develop, consisting of commercial banks, microfinance institutions, foreign exchange dealers, money service providers, and one insurance company. The banking sector represents over 95% of the assets of the formal finance market. State-owned banks control an estimated 35% of the total deposits in the commercial banking system and an estimated 68% of the assets. The Afghan National Insurance Company, a state-owned company, has a monopoly on the small insurance sector. Capital markets are non-existent, as is the venture capital and leasing industry.

Azerbaijan's finance sector is relatively weak and presents a significant risk to economic prospects in the medium term. Outside of the two large state-owned banks, the banking sector is small and under-capitalized. These capital constraints limit the ability of privately owned banks to provide medium-sized financing (US$ 0.5-2.0mn) to growth segments of the credit market, particularly to emerging domestic corporations.

The growth of the Mongolian economy will depend on the efficiency of the financial sector, on how effectively savings and investment are channeled into its most productive sectors. Following the two major banking crises of 1996 and 1999, the finance sector has since grown rapidly, a result of the increase in deposits, mostly in savings accounts. The growth of the finance sector has gone hand in hand with the expansion of the trade, construction, and services sectors, which are the largest recipients of bank loans.

The banking sector in China has been under reform since the 1990s. The government owns directly or indirectly nearly all of the important banks. Four large state-owned banks dominate China's banking sector, accounting for some 60% of the banking system's assets. Their primary focus, however, has been on serving the needs of large state-owned enterprises. Foreign banks have taken strategic stakes in some of them and by the end of 2006, three out of four will have had IPOs. The second tier government-owned commercial banks also largely serve SOEs. Consumers' and the private sector's demands for capital are currently not being satisfied. China's WTO agreement requires opening up of the domestic banking market for participation by foreign banks by the end of 2006.

The financial sector in China's western provinces is far less developed than in the eastern region and needs more and stronger financial institutions. Xi'an City Commercial Bank is the largest bank in western China.

The Securities Markets

The securities markets in Central Asia have received assistance from international financial institutions, which have enabled their young markets to have relatively sophisticated electronic trading systems and central depository systems, except in Tajikistan.

Uzbekistan in particular operates an electronic over-the-counter trading system for small investors. Securities markets in Central Asia have served primarily as a means for privatization of SOEs. Also, short-term government bonds tend to be the main product compared to equity and corporate bonds.

The Stock Markets

Stock market capitalization throughout Central Asia is low, and not all of the markets are active. The Kazakhstan Stock Exchange (KASE) was initially set up to focus on foreign investors and blue chip stocks, but the exchange was subsequently re-focused towards domestic institutional investors. Currently, there are 61 companies listed on the KASE. The corporate bond market in Kazakhstan is young but growing, and this demonstrates the increasing sophistication of the country's financial services.

The Kyrgyz Republic has a small stock exchange with 16 companies listed. A few small investment funds are operating with stock exchange securities.

Uzbekistan's Tashkent Republican Stock Exchange started in 1994 and previously had hundreds of companies listed at a time. At present, it has 158 listed companies.

Tajikistan established a securities market, but it is not operational yet. Capital markets are not established in China's western provinces. The country's two securities markets are located in the eastern part of China.

Although the financial systems of Central Asia are underdeveloped, there is nonetheless a significant range of development levels among them. While the region would benefit from cross-border standardization in many finance sector practices and regulations, and many reform requirements are common to all, it is important that reform agenda is carefully tailored to the individual needs of countries in the region.

Table 1: Financial Market Development Indicators – Selected CAREC Countries

	1999	2000	2001	2002	2003
AZERBAIJAN					
No of banks (foreign)	70(5)	59(5)	53(5)	46(4)	na
Asset share of state-owned banks (%)	82.5	60.4	na	62.0	na
Non-performing loans (%of total loans)	37.2	na	na	19.7	na
Domestic credit to private sector (% of GDP)	na	na	na	na	na
Stock market capitalization (% of GDP)	na	0.1	0.1	na	na
EBRD index of banking sector reform	2.0	2.0	2.3	2.3	2.3
EBRD index of reform of NBFIs	1.7	1.7	1.7	1.7	1.7
KAZAKHSTAN					
No of banks (foreign)	55(18)	48(16)	44(15)	na	na
Asset share of state-owned banks (%)	19.9	1.9	3.5	na	na
Non-performing loans (%of total loans)	na	na	na	na	na
Domestic credit to private sector (% of GDP)	7.4	10.6	15.1	na	na
Stock market capitalization (% of GDP)	15.5	7.5	5.6	5.6	na
EBRD index of banking sector reform	2.3	2.3	2.7	2.7	3.0
EBRD index of reform of NBFIs	2.0	2.3	2.3	2.3	2.3
KYRGYZSTAN					
No of banks (foreign)	23(5)	22(6)	20(5)	20(6)	na
Asset share of state-owned banks (%)	25.8	15.8	16.6	9.7	na
Non-performing loans (%of total loans)	6.4	16.4	13.8	13.3	na
Domestic credit to private sector (% of GDP)	3.0	2.2	2.0	2.6	na
Stock market capitalization (% of GDP)	0.4	0.3	0.3	0.5	na
EBRD index of banking sector reform	2.3	2.3	2.3	2.3	2.3
EBRD index of reform of NBFIs	2.0	2.0	2.0	2.0	2.0
TAJIKISTAN					
No of banks (foreign)	20(3)	17(4)	17(3)	17(2)	na
Asset share of state-owned banks (%)	6.9	6.8	4.8	4.5	na
Non-performing loans (%of total loans)	15.8	10.8	12.5	na	na
Domestic credit to private sector (% of GDP)	10.0	11.3	13.6	11.5	na
Stock market capitalization (% of GDP)	na	na	na	na	na
EBRD index of banking sector reform	1.0	1.0	1.0	1.7	1.7
EBRD index of reform of NBFIs	1.0	1.0	1.0	1.0	1.0
UZBEKISTAN					
No of banks (foreign)	35(5)	34(6)	na	na	na
Asset share of state-owned banks (%)	65.8	77.5	na	na	na
Non-performing loans (%of total loans)	0.1	0.0	na	na	na
Domestic credit to private sector (% of GDP)	na	na	na	na	na
Stock market capitalization (% of GDP)	1.9	1.0	0.6	0.4	na
EBRD index of banking sector reform	1.7	1.7	1.7	1.7	1.7
EBRD index of reform of NBFIs	2.0	2.0	2.0	2.0	2.0

Index of reform: from 1 (low) to 4 (high).
Source: EBRD Transition Report 2003

Table 2: Summary Statistics for Selected Transition Economies[a]

Country	No. of Banks	Interest Spread[b]	NPLs[c] (% of total loans)	No. of Credit Unions	Broad Money	Bank Assets	Bank Dep-osits	Insurance Premium	Equity Market Capitali-zation[d]
					% of GDP				
Kyrgyz Republic	19	22.6	7.0	306	18	19	8.6	0.2	1.5
Azerbaijan	42	8.9	8.2	28	18	18	12.0	0.8	0.1
Kazakhstan	35	9.0	13.1	52	21	49	30.0	0.7	7.5
Mongolia	17	11.2	11.0	570	47	61	39.0	0.5	1.4
Uzbekistan	33	3.5	1.5	—	9.3	37.8	2.1	0.3	4.4

GDP = gross domestic product, No. = number, NPL = nonperforming loan.

[a] Data are for 2003 or 2004, depending on availability.

[b] Difference between average lending rate and average deposit rate, as published in International Financial Statistics.

[c] Official figures provided by national banking sector supervisory bodies. Independent estimates for Uzbekistan are much higher.

[d] Calculated as the total capitalization of the most actively traded companies listed at the stock exchange.

Sources: National Authorities, International Monetary Fund (IMF) International Financial Statistics, Financial Sector Stability Assessments, Article IV Consultation Reports, and European Bank for Reconstruction and Development (EBRD) Transition Report 2004.

II. Sector Features and Endowments

Given the small size of the economies of Central Asia, there is a good case for building an integrated financial sector for the region as a whole. However, the regional structure of independent nation-states and feelings of local nationalism make this a distant goal. There has only been a small amount of cross-border systemic finance sector investment and operations. The region's financial systems are dominated by banking systems organized along national lines. In addition, the microfinance sector, the insurance sector and pension system, the insurance sector, non-banking financial institutions (NBFIs), the money market, and the capital market are part of CARs' finance sectors.

The Banking Sector

Afghanistan

The private sector has historically played a significant role in the banking sector, with the first private commercial bank (Bank Millie Afghan) established in 1933, followed by the Bank Pashtany Terjaraty in 1955. Three other banks were set up by the government for specific developmental purposes (The Agricultural Development Bank, Mortgage and Construction Bank and Export Promotion Bank). The second fully private bank, Industrial Development Bank, was established in 1973. By 1978, the government had taken over control of all of the banks through the Daoud government's nationalization program.

By December 2001, decades of war and Taliban rule had reduced the banking sector to a virtual shell. Their principal assets consisted of foreign accounts frozen during the Taliban era and real estate assets, and most loans were unrecoverable. An IMF program led to a series of reforms designed to strengthen and revitalize the sector. The DAB Law and Banking Law in September 2003 established a new regulatory and licensing regime leading to the immediate issuance of eight new banking licenses. The sector is now composed of three state-owned banks and eight private banks, all of whom have full service banking licenses, allowing them to take deposits and provide foreign exchange, funds transfer, and to engage in consumer and corporate lending. These new banks are located in Kabul, although Afghan International Bank plans to open a branch in Mazar-i-Sharif, and the National Bank of Pakistan plans to open a branch in Jalalabad in the near future.

A key characteristic of the commercial banking sector today is the virtual absence of any lending activity. Total credit outstanding as of September 2004 was estimated at 1.5 billion Afghanis (US$33mn), or 9.81% of total assets and 0.67% of GDP, one of the lowest ratios in the developing world. While new commercial banks are collecting deposits, most of their revenue is being generated with service fees for trade finance and fund transfers. The state-owned banks are particularly inactive, collecting most of their revenue from foreign deposits and rents on real estate investments. The perceived high risk of lending keeps working capital interest rates at levels that are uneconomic for most Afghan businesses.

The low level of activity of the state-owned banks reduces their competitive effect on the market. While they still represent approximately 35% of the total deposits in the commercial banking sector, they are forced to provide higher interest rates on deposits to offset their generally inferior service. The new commercial banks are growing their deposit base at a much faster rate than the state-owned banks, gaining a 65% market share in just 14 months of operation. These banks are interested in placing additional ATMs in Afghanistan (in addition to the few that already exist) to further attract customers.

While the introduction of new commercial banks are critical to reviving the banking sector, in the near to medium term, these banks will likely limit their operations to the larger cities, and to certain type of customers, namely international organizations, NGOs, the diplomatic corps, and the largest corporations, leaving small and medium-size enterprises and rural areas without services. While some commercial banks are planning to expand operations outside of Kabul within the next year, there remains an important role for DAB, micro-finance institutions, and the hawala dealers to deliver financial services outside of Kabul and to a client base not served by the commercial banks.

Azerbaijan

The banking sector in Azerbaijan has traditionally played only a marginal role, with foreign direct investment as the main source of capital investment. However, a deeper deposit base is allowing banks to increase their lending, resulting to strong growth in domestic credit. According to the National Bank of Azerbaijan, total finance sector deposits rose by 41% in the year to end-June 2006, to Manat 1.6bn. Although the maturity of deposits is shortening, the dominance of foreign currency deposits is weakening. Foreign currency made up just over 53% of the deposit base in June 2006, compared with 65% in the previous year, while outstanding domestic credit was Manat1.66bn, up by almost 54%. The share of total lending denominated in hard currency was almost unchanged year on year, at around 60%, as was the proportion of short-term hard-currency loans in total short-term loans, also at around 60%. This indicates that borrowers still remain reluctant to trust the local currency. The risk of the boom in lending is that the quality of the new credit will be poor, owing to inadequate credit control mechanisms.

Kazakhstan

Kazakhstan has one of the most developed banking sectors in the CIS, with domestic credit to the private sector reaching 23% of GDP at the end of 2003. Credit to the private sector continues to grow strongly at 64.3 per cent in July 2004 from a year earlier. The majority of outstanding loans are long-term, and banks provide more diversified products such as consumer credit, mortgage loans and lease finance. A key challenge ahead for both banks and the regulatory authority is to further improve the risk management functions, as the share of classified loans remains relatively high and has been increasing despite high real growth.

The banking sector consolidated rapidly in the aftermath of the 1998 crisis, through the enforcement of effective regulation. At present there are 35 commercial banks (33 of them are members of the deposit insurance system), down from 71 at end-1998 and almost 200 at the peak in 1993. Of the commercial banks, 16 banks were foreign-owned. Of the three state-owned banks EximBank was sold in February 2004 to a group of local investors. The Kazakhstan Development Bank (KDB) and Zhilstroibank (a mortgage bank set up in April 2004 to provide housing loans) remain state owned with defined roles and do not compete directly with the commercial banks. Although these specialist state-owned banks may help serve market segments that are currently not sufficiently addressed by commercial banks, their eventual privatization should be considered when commercial banks are able to service these market segments adequately. The regulatory quality of the sector has also improved in recent years with the introduction of group level consolidated supervision, international accounting standards and a deposit insurance system.

Kyrgyz Republic

The Kyrgyz banking sector is dominated by private banks, which accounted for 96% of banking sector assets at end-2004. The sector has significant investment by foreign investors (particularly from Kazakhstan), which hold majority shares in ten banks. At end-2004, 57% of the capital and 60% of the assets of the system were foreign-owned. The sector is not overly concentrated – at end-2004, the five largest banks accounted for about 50% of the capital, 60% of the deposits, and 66% of the loans. (A list of commercial banks is in Table 3.)

The total capital of commercial banks increased from the equivalent of 1.3% of GDP at end-1999 to 2.6% of GDP in December 2004 (US$ 56mn), mainly due to higher capital requirements and increasing FDI. Banking sector assets increased from 8.6% of GDP at end-1999 to 19% of GDP at end-2004. This compares to banking sector assets equivalent to 48.5% of GDP in Kazakhstan. The share of non-performing loans in the Kyrgyz banking sector declined from 24.9% in October 1999 to 7.0% in June 2005 due to bank closures and successful bank restructuring, combined with more prudent lending practices. Recent rapid growth in lending, however, needs to be monitored to avoid deteriorating loan quality. Private sector credit growth accelerated from 11% in 2002 to 27% in 2003 and 70% in 2004, mainly due to a more conducive macroeconomic environment, introduction of new lending products, and growing competition.

There is still scope to enhance public confidence in banks given the low level of deposits relative to GDP (just 8.6% in 2004). Further, the differential between deposit and lending rates remains very high. The range and quality of banking services, such as simple deposit and payment services are below customers' expectations. Cash in circulation is still significantly greater than money in commercial bank accounts. Checks are scarcely used and credit and bank cards are just being introduced.

In terms of access to and outreach of banks, three commercial banks have a well-developed countrywide branch network and six other banks have five to seven branches each. Based on the number of bank branches, it is estimated that there is one branch per 32,000 people. However, only 1 in 40 Kyrgyz residents actually has a bank account. Half of these accounts are with the state-owned Settlement and Savings Company, which mainly provides payment, transfer, and savings services, but also will begin micro-credit lending in 2006.

Table 3: List of Kyrgyz Republic's Commercial Banks

Bank	Branches	Assets	Loans	Deposits	Paid-in Capital		Foreign owned	
	Number	% of Total	% of Total	% of Total	Som million	% of Total	%	Origin
Asia Universal Bank	2	37.0	10.1	24.3	300	12.4	79.0	RUS, US
Inleximbank	4	9.7	17.3	8.8	230	9.5	71.0	KAZ, EBRD, IFC
Bank Kyrgyzstan	28	7.1	13.1	6.9	121	5.0	0.0	
Demir Kyrgyz International Bank	1	6.3	1.8	11.4	133	5.5	100.0	TUR, EBRD, IFC
Kazkommertsbank Kyrgyzstan	3	6.0	14.7	2.6	100	4.1	74.0	KAZ (EBRD)
Energobank	7	5.9	9.5	8.9	109	4.5	34.0	KAZ, ITA, LUX
Kyrgyz Credit Investment Bank	1	5.1	10.5	3.9	291	12.0	90.0	EBRD, IFC, KfW, Agha Khan F.
Kyrgyzpromstroybank	29	4.4	6.2	6.9	100	4.1	0.0	
Savings and Settlement Company	48	4.1	0.0	5.2	100	4.1	0.0	
Branch of Pakistan National Bank	1	2.8	0.0	4.3	105	4.3	100.0	PAK
Bakay Bank	4	2.4	3.2	4.1	60	2.5	0.0	
Ekobank	7	2.2	3.8	2.7	100	4.1	6.0	KAZ, EBRD, IFC
Khalik Bank Kyrgyzstan (former Kairat Bank)	5	1.8	0.0	3.2	170	7.0	100.0	KAZ
Tolubay	1	1.2	2.5	1.7	36	1.5	2.0	RUS
Amanbank	5	0.9	1.4	1.0	55	2.3	24.0	RUS
Bank of Asia	0	0.9	1.5	0.9	63	2.6	100.0	KOR
Dos Credobank	7	0.8	1.6	1.2	77	3.2	0.0	
Issyk-kul	6	0.8	1.2	1.2	35	1.4	14.0	KOR
Kyrgyzkredit	0	0.8	1.6	0.9	40	1.6	89.0	ITA
AK Bank (licence revoked)	0				200	8.2	44.0	CAN RUS (KAZ)
Total	159	100.0	100.0	100.0	2425	91.8	57.4	
Memorandum Item:								
Kyrgyz Agricultural Finance Corporation	11	9.9	26.3	0.0	300	12.4	0.0	

CAN = Canada, EBRD = European Bank for Reconstruction and Development, IFC = International Finance Corporation, ITA = Italy, KAZ = Kazakhstan, KfW = Kreditanstalt für Wiederaufbau, KOR = Korea, LUX = Luxemburg, PAK = Pakistan, RUS = Russia, TUR = Turkey, US= United States of America.

[a] Indirect shareholding through Kazkommertsbank (Kazakhstan).

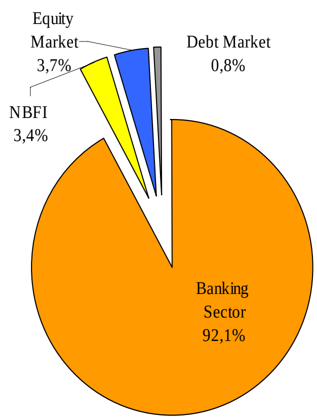
Sources: National Bank of the Kyrgyz Republic and Asian Development Bank.

Mongolia

The banking sector has strengthened considerably since the 1990s' crises**.** With total assets of MNT1.1 trillion or 61% of GDP, the banking system dominates the financial sector. Of the 17 commercial banks, 1 is state-owned (Savings Bank), and 4 have foreign ownership. Except for one Russian bank branch, no foreign banks are licensed to operate in Mongolia. The banking sector is highly concentrated, with the four largest banks accounting for 61% of total banking assets, and 69% of deposits. During 2006, the Bank of Mongolia (BOM) will increase minimum capital requirements of banks from the current MNT4 billion to MNT8 billion. This will drive consolidation within the sector as only three banks have capital levels exceeding MNT8 billion. Deposits and loans as a share of GDP grew from 14% and 8% in 1999 to 39% and 35% in 2004. Bank deposits and loans are mostly short-term, with maturities of less than 1 year.

Despite a downward trend, interest rates remain high. The high interest spreads – deposit and lending rates of 14% and 25% in 2004 – are symptomatic of high credit risk, high operating costs of banks, strong demand for bank loans because of a lack of other funding sources, and the lack of effective competition among banks. The ratio of total capital to assets of the banking sector increased from below 4% in 1998 to 15% in 2004, and the entire banking sector was profitable during 2000–2004. The NPL ratio declined from 54% in 1999 to 8% in 2001 and then stayed at 7–11% until 2004. The loan loss reserves are provisioned in line with the BOM guidelines, and stand at a high level. While the rapid increase in bank loans during 2001–2003 raised concerns, credit expansion slowed down in 2004. Credit expanded by 88% annually during 2001–2003 and grew by 44% in 2004. However, the NPL ratio increased from 7% in 2002 to 8% in 2003 and to 11% in 2004, reflecting poor performance of the loans recently extended and weak internal control and risk assessment capacities in banks.

Graph 1. Mongolia's Financial Sector



The following institutions are engaging in the financial sector:

a. *Banks*
b. *Other financial institutions*
   - Insurance companies and pension fund - Insurance Companies (23)
   - Other financial intermediaries – Non-bank Financial Institutions (110), Saving and Credit Unions (about 570, of which around 205 are engaged in activity)
   - Financial auxiliaries – securities companies (25), exchange bureaus (above 41)

Tajikistan

The government has made considerable progress in reforming the banking sector in recent years. The share of non-performing loans to total lending declined from 32% in 2000 to about 10% by 2005. The number of commercial banks has fallen from 33 to 12 over the same period, and most banks are now profitable. Measures such as an increase in the capital requirement to US$ 5mn as of January 2006, and the opening up of the sector to foreign banks (approved by the government in late 2005), are likely to strengthen the sector further. Reforms in 2006 concentrate on measures to enhance supervisory capacity and improve the transparency of lending activities, including the development of credit-rating agencies and the publication of banks' balance sheets.

There is some progress in the consolidation of the banking sector. The number of commercial banks decreased from 28 in 1998 to 14 in 2000. All banks except one (Amonatbank) are formally privatized but the state retains control through minority shareholdings. Existing banks are susceptible to shocks due to the low level of capital, high credit concentration, and low levels of liquidity. Lending is constrained by liquidity requirements. There is a large proportion of problem loans in large banks. Although small banks are increasing in importance, the main barriers to entry are: high level of capital required to establish a bank; variable application of prudential standards; and a lengthy registration process. Banking supervision is weak, and restructuring of large banks is slow. Many banks are pocket banks for certain branches of the economy, which limits competition.

Lending rates remain high in both nominal and real terms, at 26% in March 2006. Deposit rates are barely positive in real terms, at just 9% in March 2006, offering little incentive for savers to place money in banks. Raising the capital requirement has worsened access to credit in the short term, as banks have focused on low-risk lending and on recovering loans. Banking penetration remains uneven geographically: the province of Badakhshan and direct rule districts (located around Dushanbe) accounted for 87% of all loans, while Khatlon and Soghd provinces (the most populated regions) accounted for a mere 6% and 7% of all loans, respectively.

The country's small and underdeveloped banking sector is oriented toward cotton and state-owned enterprises. Bank deposits account for only 4% of GDP, with the bulk of sector liabilities in the form of foreign loans. Domestic credit accounts for only 18.6% of GDP, lower than that of other transition economies. The banking system remains fragile, with low levels of deposits as a result of low confidence and recent political turmoil. 60% of household savings are outside the banking system, and there is extensive and increasing reliance on barter transactions. Apart from banking, financial services are almost non-existent.

Uzbekistan

The level of financial intermediation, excluding state-sponsored lending, in Uzbekistan is low and compares unfavourably with other transition countries. Mobilization of household deposits is low at 2.2% of GDP (2002). Banks still operate as an arm of the government. Uzbekistan has six major domestic banks, all of which are majority state-owned. Foreign ownership of banks is minimal, with six small banks that are majority foreign-owned. State-owned banks control 95% of total assets in the sector, with the remaining 5% distributed among private banks and credit associations.

The banking system suffers from the effects of the culture of state 'directed' lending to underperforming state owned companies. If Uzbekistan is to move decisively towards market liberalization and structural reforms, the banking system needs to undergo a significant adjustment process that would involve dealing with the large portfolio of state-guaranteed and possibly doubtful loans and re-orientating lending policies towards the private sector. There is a need to promote competition in the banking sector through increasing the number of participating banks under various IFI projects which aim to support the strengthening of the sector, and institution building in the sector to improve the banks' credit assessment and monitoring processes, auditing, management information systems, the development of new products such as trade financing, etc.

Microfinance

In the CARs the banking sectors are only reaching a minority of the people. Two problems are evident. First, individuals and SMEs may only require small loans and services which would not be economic for the banks to provide. Second, although a significant proportion of the population in the region live in a handful of cities there is a bank outreach problem for provincial towns and also the need to develop a rural finance system. Although donors are active in the area of establishing microfinance projects there is great scope in the region to establish new projects and extend existing ones.

The region has a large informal sector, and micro-credit is the norm, where shopkeepers, traders, moneylenders, family, and friends are the principal creditors.

Afghanistan

In Afghanistan, the NGOs operating in the sector have traditionally treated microcredit as a charitable undertaking, with limited emphasis on cost recovery and outreach. In mid-2002, a total of 25 NGOs were operating in the country, serving less than 20,000 people. Since that period, however, the international aid community has moved quickly to establish formal microfinance networks to serve the significant demand in the rural areas.

Kyrgyz Republic

The Kyrgyz Republic is an example of where some of the microfinance potential has been realized, with the total microfinance credit extended equivalent to two-thirds of the conventional bank credit outstanding, in sharp contrast to the usual situation of microfinance amounting to only a small portion of formal credit in the economy. In part this is due to the nascent state of bank development, but it is in part also due to efforts to stimulate rapid growth in microfinance. Many of the credit unions and microfinance organizations are very small, and a shakeout or consolidation is inevitable, as these organizations will have to grow to more sustainable sizes, or wither when financial incentives and technical assistance are reduced.

The Insurance Sector and Pension System

CARs have only very rudimentary insurance sectors and pension systems. This increases the risks of local firms – as well as international ones – of conducting business in the region.

Afghanistan

An example of an acutely underinsured society is Afghanistan. The underdevelopment of insurance coverage and the inefficiency of the insurance industry inhibit the participation of Afghan truckers in transit trade to other countries. The Afghan National Insurance Company (ANIC), the only insurance company operating in the country, currently enjoys a monopoly on all insurance functions. It derives most of its revenue from the mandatory sales of automobile collision and casualty insurance. It does not actively solicit business. The ANIC suffers from a lack of trained staff, no opportunities for investing its premiums in fixed-income investment instruments and a poor track record in paying out on legitimate claims. An obvious and speedy remedy to this gap would be to open the insurance sector selectively or entirely to private competition including through the participation of foreign insurance companies with diverse experience in transport insurance. Afghanistan has no life insurance or pension system, and no insurance law. While performance bonds are currently used in construction projects throughout the country, they are being underwritten regionally.

Kyrgyz Republic

The Kyrgyz Republic's situation is typical of countries in the region. Its insurance sector is at an early stage of development, with premium collected equivalent to 0.2% of GDP. Companies are undercapitalized, and most of the risk is reinsured abroad. The only life insurer went bankrupt in 2003. The State Social Insurance Fund is the only government-owned pension fund and covers contributions to both pension payments and other social security benefits. The sole private pension fund services about 600 individuals.

Mongolia

Mongolia has restructured its insurance sector, and the number of insurance companies has increased from 10 to 23 from 1999 to March 2005. Following the privatization of the largest insurance company, Mongol Daatgal, in February 2004, all insurance companies are now privately owned. In 2003, total insurance premiums were MNT6.3 billion, about 0.5% of GDP. Aircraft-related insurance (hull and liability) comprises the largest category and accounts for 40% of the industry. The only class of mandatory insurance is motor vehicle liability, accounting for 8% of total industry premium. The sector is highly concentrated, with Mongol Daatgal accounting for 74% of total insurance sector premiums in 2003. The recent bankruptcies of two insurance companies have raised concerns about the solvency of the smaller companies. The insurance payout ratio (claims paid as a percentage of total premiums collected) is low at 20%.

Non-bank Financial Institutions (NBFIs)

NBFIs are enterprises engaged in lending, factoring, leasing, issuing guarantees, issuing payment instruments, electronic payments and remittance services, foreign exchange services, trust services, investment in short-term financial instruments, and advisory services. NBFIs are not usually allowed to take deposits. While most of the smaller NBFIs are financed by equity, some large ones have significant loan financing and accrued interests. NBFIs broaden and deepen a country's financial services sector, as many of them support the development of money and capital markets. However, they do require development of a more sophisticated regulatory environment.

In Mongolia, the number, loans, and total assets of NBFIs have grown rapidly since 2000, when Mongol Credit was established as the first licensed NBFI. Of the 114 NBFIs registered in 2004, nine were foreign-owned or joint ventures. Most NBFIs provide small consumer loans, or short-term loans to small- and medium-sized enterprises (SMEs), and a handful are engaged in other activities such as leasing and foreign exchange trading. NBFIs are incorporated as limited liability companies, and are typically owned by an individual, a family, or a small group of related individuals. With total assets of MNT28.7 billion, NBFIs as a group account for about 2.6% of banking sector assets. NBFIs' NPLs are 4.5% of total loans.

Lease financing provided by NBFIs is important for private sector development. Its absence constrains SMEs from acquiring needed equipment to grow their businesses. In many CARs, banks do not provide lease financing, forcing most companies to purchase machinery, automobiles and heavy equipment on a cash or credit basis.

Throughout South and Central Asia, the Middle East and some countries in Africa there is a long tradition of money dealers. In Afghanistan they are referred to as hawaladars and there are an estimated 800-2000 of them operating throughout the country, with 300 of them registered and licensed and organized into a professional association. They provide a range of financial services such as foreign exchange, fund transfers, microfinance, trade finance and some deposit taking. Hawaladars also provide international money transfers: the hawala money transfer system is highly efficient and cost effective, with transfers to Kabul from Dubai or London taking just 6-12 hours, and transfers within the country taking only 24 hours. The cost of fund transfers averages 1-2%. Donors, international aid agencies and NGOs regularly use the hawala system to move funds around the country.

Interbank/Money Markets

Interbank and money market development usually matches the development of the banking and non-banking sectors. A foundation for a market in short-term unsecured interbank lending is needed to provide a foundation for money markets (including treasury bills), based on a Negotiable Instruments Law. Interbank markets can then be strengthened by establishing regulations for diverse money market instruments, such as negotiable certificates of deposit and repurchase agreements, as well as by regularizing the issuance of treasury bills with the development of a primary dealer system. After that, money markets can be broadened with a regulatory framework for non-financial issuers of money market instruments, such as commercial paper.

Kazakhstan

Kazakhstan has one of the more developed financial sectors in the region and hence leads in its development of interbank and money markets. The interest rate market has 3 types of government securities: T-bills, T-bonds and inflation-linked bonds and variable bonds. There is presently only one outstanding T-bill, 19 outstanding T-bonds, which are typically 3-5 year debt, with the longest fixed-rate bond maturing in May 2010. The amount outstanding currently stands at KZT 56bn, or US$ 430mn. There are 5 CPI-linked bonds amounting to KZT 15bn (US$ 115mn). The latest CPI-linked bond was issued in April 2005, and has the largest outstanding amount (KZT 14bn, or US$ 110mn), and matures in 2015. Due to the high oil revenues and a cautious fiscal stance, the government does not need to borrow in the local debt market. Due to growth of the pension fund system in Kazakhstan, there is a serious shortage of good domestic long-term investment assets for these funds. The bond market is therefore very illiquid in Kazakhstan, as most of the outstanding issues are held by the local pension funds.

Capital Markets

Since the enabling environment for a capital market requires the adoption of detailed regulations and procedures only a handful of the CARs have capital markets, and even these are not particularly active.

Kyrgyz Republic

Over the period 1990–2004, 1,596 companies issued corporate stocks and/or bonds in the Kyrgyz Republic, amounting to Som31.9 billion (US$ 4.6bn). However, most issues do not represent capital raised by enterprises, as they were allocated to individuals as a result of privatization of state-owned enterprises (SOEs). Given that large enterprises were initially privatized to their workforce and the population overall, ownership in most joint stock companies (JSCs) is fragmented. There are currently about 1,200 JSCs in the Kyrgyz Republic, of which about 300 have more than 500 shareholders.

Shares of about 400 JSCs are traded at the Stock Exchange Trading System (SETS) with various exchanges, although only sixteen JSCs are actually listed. 85% of trading volume at the Kyrgyz Stock Exchange (KSE) is in the securities of unlisted companies. Trading volume averaged only US$ 22mn equivalent in 2000–2003, but increased to US$59mn equivalent in 2004, mainly due to the privatization of three SOEs through the KSE. Most securities transactions are negotiated and closed outside the exchanges and merely registered on them. Market price quotations are mostly absent and the market is highly fragmented since broker-dealers are not allowed to operate on different exchanges simultaneously. Consequently, shares of the same JSC change ownership at greatly diverging prices at different exchanges, or even at the same exchange. One major issuer defaulted in 2003, undermining public confidence in securities markets and their regulatory oversight. The number of investors affected was significant and included the more vulnerable groups of the population.

While a market for government securities exists, primary issues remain small. Because budget deficits have been largely financed by external funding agencies, there has been little issuance of government debt. Participation in the market is limited mainly to commercial banks who hold about 95% of total government securities outstanding. The secondary market is negligible.

Mongolia

There are 395 companies listed on the Mongolian Stock Exchange (MSE). Market capitalization in 2004 was MNT29.8 billion (1.4% of GDP) and annual trading value was MNT654 million. The trading value at the MSE has been declining since a large part of corporate shares have been traded outside MSE and concentrated into a small number of shareholders. In 2004, only 1,300 companies and individuals owned 96% of the shares of all listed companies. Private companies and financial institutions currently do not use the MSE to raise new equity capital.

The total trade value of bonds in 2004 was MNT15.3 billion, 81.8% in government bonds and 18.2% in corporate bonds. Nearly all the government and corporate bonds are bought by banks and held to maturity, and there is virtually no secondary market trading. As a result of the rapid decline in trading activity and the increase in minimum capital requirement (from MNT10 million to MNT50 million in January 2003), the number of licensed securities broker/dealer companies declined from 42 in 2000 to 25 in 2004. Of the 25 securities companies, only two have foreign participation. There is no licensed underwriter, and there are no collective investment funds.

In 2003, the trading and listing functions of MSE were separated from its securities clearing and depository systems to improve transparency and accountability. The MSE is a 100% government-owned profit-making joint stock company, listed on the stock exchange (but with no shares traded), continuing to operate as a traditional state-owned enterprise with six government representatives on the board, including the Mongolian Securities Exchange Commission (MSEC), and only one private sector representative from a broker/dealer company.

Tajikistan

Tajikistan has established a securities market but it is presently non-operational. Access to international debt and equity markets by Tajikistan enterprises remains almost impossible. The country is essentially dependent on official finance from donors and IFIs for most public investments. Although FDI has been increasing, it remains below the level of official flows and is unlikely to replace such flows anytime soon.

Uzbekistan

The Tashkent Republican Stock Exchange, established in 1994, presently has 158 listed companies. The exchange was established primarily for the privatization of SOEs, only a few of which have taken place.

III. Legal and Regulatory Environment

The legal and regulatory framework is a key enabling factor for finance sector development. There is the issue of drafting the appropriate rules and regulations and laws to govern the banking sector and the various other components of the financial system. These should not be unnecessarily complicated, contradictory or ambiguous (allowing excessive discretionary powers for officials' interpretation), but they need to be appropriate to the country's finance sector's level of development and flexible enough not to need constant revision. Plentiful advice is on-hand from the IFIs, and the EBRD is particularly active in Central Asia in this area.

There is also the issue of enforcement of the rules and regulations and laws. This is undertaken by the ministries of the executive branch of government and by the judiciary. This raises issues of state capacity, such as that appropriate institutions are in place, that they are adequately staffed, that there are sufficient levels of technical expertise and training and that public sector remuneration is satisfactory. Again, the IFIs can assist with carefully targeted programs. The usual principles of good governance apply: predictability, transparency and accountability.

In CARs, in common with other developing countries there is a bureaucratic tendency to add rules and regulations, but not to repeal them, so that private sector participants are faced with a bewildering array of rules, often contradictory, that enhances rent seeking opportunities for officials who can use their discretionary powers to grant necessary licenses and exemptions in return for discreet payment. Unfortunately, the CARs have something of a reputation for corruption and weak governance and this is again considered in the section on impediments to investments and conducting business.

Weaknesses in governance, and the overall condition of the legal and regulatory system, is a function of how much progress the country concerned has made with reform. There is thus considerable divergence in the situation in one country to another, depending on the political commitment to reform of the host government and the level of engagement that the IFIs have hence achieved, although of course there are many other factors involved.

Because of the U.S. war on terror, there is considerable IFI commitment to improving Afghanistan's level of economic development. Capacity building in financial supervision at the central bank has been ongoing since late 2002. The Law on Da Afghanistan Bank (Central Banking Law) of September 2003 provides the basis for a two-tiered banking structure, with Da Afghanistan Bank (DAB, the Central Bank) regulating and supervising the sector. DAB licenses, regulates, and supervises banks, foreign exchange dealers, and money service providers, as well as microfinance depository institutions, . but However, it does not yet have the authority to regulate microfinance institutions that obtain their funds from donors.

In contrast, Azerbaijan, has not had much IFI contact. While the government's poverty reduction program considers microfinance as an effective instrument in reducing poverty and creating economic opportunities, a comprehensive microfinance development strategy remains to be developed. Policy is restrictive and not conducive to the development of the sector, particularly to deposit taking by MFIs and Credit Unions (CUs). The legal and regulatory framework is inadequate to support the development of a financially viable system and effective local rural financial intermediation does not exist.

While IFIs provide valuable technical assistance their role should not be overstated. The government of Kyrgyz Republic has made considerable progress with the legal framework for banking supervision. While problems remain, significant strides have been taken, most notably with the introduction of a specialized bank insolvency law, revisions to the law on banking, non-judicial dispute resolution, and new or improved regulations on risk management. But the remaining inconsistencies and overlaps in the banking legal and regulatory framework present uncertainty regarding the enforcement authority of the central bank, which prevents it from effectively enforcing legislation and regulation over sector participants. As a result, problems in banks are frequently addressed too late and weak banks continue to operate. This poses significant risks to financial sector stability and dampens depositors' confidence, thus impeding development of the banking sector. Also, concerns remain about the quality and integrity of the judicial system, which will take time to remedy.

Some of the other CARs have made little attempt to improve the legal and regulatory environment for their financial systems, instead preferring to rely on executive orders which are sometimes arbitrary, and neglecting the reform agenda in general.

IV. Government Policies and Strategies

So it is the case that the finance sectors in the CARs are underdeveloped and rudimentary, and are unable to mobilise and efficiently intermediate funds on a scale necessary to underwrite growth in the real sectors. The commercial banking systems are fragile and prone to systemic risk, and low confidence in the banking system has undermined growth of deposits. Securities markets are either practically non-existent or insignificant and have little prospect for growth unless the private corporate sector develops further to generate investment opportunities. The financial sectors in the CARs are also characterised by inadequate accounting, auditing, financial reporting and corporate governance standards, which undermine investors' confidence. Clearly there is a need for many CAR governments to make a more concerted effort at finance sector policy and strategy formulation and implementation if their potential economic development is to be realized.

Reformers in the CARs will have to decide whether to advocate reforms of existing entities, which may confront strong sectional interests, such as powerful Soviet era bosses opposing privatization of their SOEs, or else put their effort into advocating a space for new institutions that can grow to surpass existing ones.

There is clearly a need to strengthen the commercial banking systems in the region through improved banking technology in areas such as credit policies, asset-liability management, financial controls, risk management, compliance with prudential standards, disclosures, corporate governance, etc., which could enhance performance and depositors' confidence. But while these generic efforts to strengthen the commercial banking system are essential to financial market stability and development, the extent to which they can and will lead to appreciably higher levels of lending to private sector firms, and to SMEs in particular, would be limited without corresponding and complementary initiatives to improve the credit worthiness of firms, including changes to laws and regulations to facilitate the use of a broader range of types of collateral and other assets for securitised lending and the establishment of SME credit guarantee companies. Specialised credit lines and facilities established to target support to SMEs should be backed by efforts to improve the capacity of firms to borrow. In addition to the traditional SME financing facilities, considerations could also be given to the creation of facilities earmarked at supporting export-oriented activities.

These initiatives in the financial sector to support SMEs and private sector development are standard and are already being undertaken in most CARs. But many of these initiatives tend to focus on the supply side by increasing the availability of credit for SMEs without complementary efforts on the demand side to enhance the ability of firms to borrow. Another issue here is the sustainability and impact of these targeted initiatives to increase the access by SMEs and private sector firms to finance if the overall policy environment remains fundamentally unfriendly to private sector development, as they appear to be in Tajikistan, Turkmenistan and Uzbekistan. They may be warranted as a second best solution to provide SMEs and private sector firms with some form of lifeline amidst a highly unfavourable policy environment. But it is debatable whether such initiatives should constitute a priority in the CARs aside from Kazakhstan and Kyrgyzstan, and whether significant resources should be deployed for these initiatives.

In a number of countries, such as Uzbekistan, the privatisation of state banks is an imperative. But the near-term prospects of success of such initiatives are doubtful given the adherence of these governments to a paradigm of state control over strategic economic activities, including the major financial institutions. Given this policy and political constraint, an important initiative would be to introduce or enhance competition among state banks as a means initially for improving performance and eventually as a pathway to privatisation. Consideration could therefore be given to initiatives to assist in the creation of new, *de novo*, private banks rather than seeking to privatize existing state banks. If this option were feasible then this approach would have the advantage of avoiding the need to address the weak balance sheets and non-performing assets, which will be carried forward in privatised state banks.

In private sector policy friendly countries such as Kazakhstan and the Kyrgyz Republic where there are already sizeable private sectors, financial market development initiatives could aim to develop capital markets, and in particular the creation of NBFIs targeted at facilitating the growth of SMEs and private sector firms. The options here include the formation of specialised investment funds, relying on subscriptions from private domestic and foreign investors that could participate in the divestiture of large strategic enterprises as well as investments in SMEs. Some of these risk capital or venture capital funds could be earmarked for investment in firms in selected industries to promote the development of specific sectors. These investment funds, if appropriately structured and managed and through their ownership, governance and control rights and responsibilities over invested firms, could perform an essential role in the improved corporate governance of firms. Obviously, the development of these funds would also accelerate the development of the securities market and provide a pathway for the development of pension funds and the insurance industry.

It may be somewhat paradoxical but the development of capital markets through the creation of asset management companies, investment funds and NBFIs is also an option that could be considered for the less private sector friendly CARs. A second best solution to the reform of large enterprises and strategic industries where their full privatisation is not an immediately feasible option is to improve the performance of this sector by moving the exercise of ownership, governance and control functions away from government ministries and placing them under corporatized, commercially based state holding companies. The activities of the state holding companies would involve (state) asset management and the raising of external finance for restructuring and recapitalization; these and other activities could provide opportunities for various instruments and modalities of public-private financing which would contribute towards the development of capital markets. A precedent here is the Chinese experience with the formation of numerous state holding companies, which then played an important role in the development of the financial market once they sought to raise funds on the market.

V. Infrastructure Development

While roads, railways and bridges are not of direct relevance to finance sector development, telecommunications infrastructure is. Banks and NBFIs are normally substantial investors in ICT and they are dependent on conventional cable and fiber optic networks for their ability to transfer information and conduct transactions over intranets and the internet. Kazakhstan is similar to Mongolia in that its relatively small population is spread across a vast territory, which makes hard infrastructure such as telephone lines uneconomical. There are other solutions such as local wireless and microwave but clearly the geography presents challenges. The Kyrgyz Republic has modernized much of its telecommunications network whilst Tajikistan has developed wireless because of problems with fixed lines. Uzbekistan's telecommunications sector is still predominantly state-owned. China's Xinjiang Province has a well developed telecommunications network.

Related to ICT is the importance of developing a financial information system for overall finance sector development. This can be considered "soft" infrastructure. It is crucial to cultivate a credit and repayment culture in the early stages of financial development. CAR governments have to facilitate development in financial market information systems via banker-led arrangements for sharing credit information, and later to expand the scope of the arrangements to NBFIs and eventually the financial market information system will be further diversified by introducing a credit rating industry.

Another important part of "soft" infrastructure for the finance sector is the accounting and auditing system. CARs are in varying stages regarding the establishment of accounting and auditing standards and a system for their enforcement through promulgation of a law on corporate accounts, their audit and the accounting profession; adoption of International Accounting Standards/International Standards on Auditing; and establishment of an accounting professional body and an accounting standards board. The accounting association should strengthen the enforcement of accounting and auditing standards, and promote competition in the accounting industry to reduce the accounting and auditing compliance costs of the private sector. Over time enforcement of accounting standards and expansion of International Accounting Standards to more firms will occur.

VI. Impediments to Investments and Conducting Business

The private sector seeking opportunities in the finance sectors of CARS needs to be aware of a number of impediments to investment and conducting business in the region. The constraints can be classified as the size constraint, the policy constraint, legal and regulatory problems, institutional capacity issues, ICT infrastructure, the payments system and other banking limitations, and underdeveloped capital markets and other NBFI limitations.

The Size Constraint

The single most important constraint on financial sector development in the transition economies in Central Asia is the small size of the economies. To overcome this constraint, the CARs must integrate their financial markets with each other or larger countries. Although this goal is not achievable in the near future, progress can be made towards integration by harmonizing standards and regulations according to international best practices. To that end, IFIs are providing technical assistance (TA) designed to assist Azerbaijan, Kazakhstan, Kyrgyz Republic, Tajikistan and Uzbekistan to harmonize and strengthen (i) banking sector regulation with regards to risk management, (ii) financial disclosure standards, and (iii) the regulatory framework for corporate governance. But presently the lack of cross-border agreements hinders supervision of risk management and as cross-border banking increases, particularly the expansion of Kazakh banks into neighboring countries, it is important that there be agreements between the regional regulators in order for effective supervision.

But there will be limitations to the feasible degree of integration amongst the countries' economies in the region, let alone the present situation, so potential foreign investors will find that management time is tied up on small deals and that the scope for scaling up may be limited.

The Policy Constraint

The governments of a number of CARs adhere to a paradigm of state control over strategic economic activities, including the major financial institutions. Opportunities for investors in privatization are therefore correspondingly more remote. Reformers within these countries may hope that space can be created for new banks and NBFIs to at least enhance competition among state banks as a means initially for improving their performance and eventually as a pathway to privatisation. However, the policy decision makers and other officials who resist privatization may also have strong instincts against the introduction of new sources of competing interests. With the policy constraint on reform, not only are there less likely to be specific opportunities for investors but also the overall environment will be less attractive, not least because there will be lower sectoral and overall economic growth.

Legal and Regulatory Problems

We have already discussed the important role that the legal and regulatory framework has in finance sector development in Section III. Here are just a few additional legal and regulatory factors confronting investors. The security of property rights and the effectiveness of the legal framework for protecting investments are a primary determinant of the level of FDI and availability of local bank credit and equity capital within a country. Many CARs offer inadequate legal protection of property rights. This increases risks for potential investors.

The pledge and bankruptcy laws provide the framework for the provision of credit that is supported by collateral. A pledge is the most efficient means of supporting loan finance, but it must be registered for the creditor to establish the priority of their rights to the asset relative to third parties. And the bankruptcy law plays a critical role in enforcing collateral. Many CARs have not legally incorporated the former and the latter suffers from a range of problems such as insufficient prioritization of creditor rights that has made it difficult to enforce.

The adoption of a legal framework that promotes effective corporate governance is a key mechanism for facilitating access to equity investment, especially in the context of banks, greenfield foreign JVs, and privatization of large companies. Without effective corporate governance laws and procedures, majority shareholders and insiders can expropriate company property through mechanisms such as asset stripping, below cost transfer pricing arrangements, installing unqualified family members of friends in managerial positions, and overpaying executives.

Institutional Capacity Issues

There are a number of capacity shortcomings in the CARs' finance sectors' regulators that include: (i) under-staffing, with not sufficient number of staff to effectively inspect the banks; (ii) supervision staff lack knowledge of risk management; (iii) limited job rotation and career development resulting in loss of staff; (iv) low salary scales that limit hiring of staff with banking experience; and (v) limited training budgets resulting in on-the-job training.

Considering the area of risk management, with specific and systemic risk that applies to potential investors in the region's banks and NBFIs, the following observations can be made: (i) supervision departments of regional regulators are not in sufficient condition to efficiently oversee risk management in the banking system (ii) on-site supervision of risk management is often nonexistent (iii) off-site supervision mechanisms are not focused on risk management (iv) ownership structures of commercial banks are opaque (v) anti-money laundering efforts remain weak in all CARs, creating operational and reputation risks for banks (vi) commercial banks have weak risk management systems.

ICT Infrastructure

The generally underdeveloped condition of ICT infrastructure will be an impediment to investment and conducting business in the CARs for most potential investors in the finance sector.

Payments Systems and Other Banking Sector Limitations

Many firms in the region experience problems with making payments, one of the most rudimentary functions of the banking system. The main deficiencies of payments systems in CARs are (i) heavy reliance on paper documents; (ii) lack of affordable, convenient payment services; (iii) inconsistencies in the legal framework that may be confusing to banks and the judiciary; and (iv) lack of documented plans and backup facilities for either system. Some CARs, such as Kyrgyz Republic, have made progress towards purely electronic clearing but many have not. And card payment services are only in their infancy.

Many CARs continue to suffer from the following structural problems in the banking sector: (i) banks are small and operationally not economical; (ii) corporate governance in the banking industry is poor; (iii) regulation of the banking sector is weak due to capacity limitations and outside interference; (iv) public confidence in financial sector institutions is low; (v) the adjudication process pertaining to the banking sector is unpredictable.

Underdeveloped Capital Markets and other NBFI Limitations

There are only a handful of capital markets in the region and these are somewhat underdeveloped, suffering from weak securities market regulation and supervision and securities laws that do not provide adequate entry standards for market intermediaries and contain very few rules governing the conduct of market participants. There are also significant weaknesses related to the institutional framework of sector supervision and policy issues, particularly in the area of taxation and privatization. Regarding listings (and applying equally to lending), accurate and reliable company financial statements are scarce, not least because many firms in CARs continue to rely upon Soviet accounting and asset valuation practices that are oriented to record physical rather than financial performance.

NBFIs in CARs are often subject to (i) a fragmented regulatory structure and weak institutional capacity; (ii) gaps and anomalies in the legal framework; (iii) weak governance, disclosure, and investor confidence; and (iv) tax impediments. It is unsurprising that under such conditions NBFIs remain undeveloped in CARs, although this is really a function of the broader finance sector's level of development and of the country, and indeed of the region, as a whole.

VII. Investment Opportunities

Given the above description of the impediments to investments and conducting business in the finance sectors of the countries of Central Asia it would seem that investment opportunities for foreigners are comparatively few. Whilst this is probably true it is also unsurprising. In the extractive industries of energy and mining, the feasibility of investment often hinges on the natural resource endowment and the ability to get at it. Mining and oil companies can negotiate a concession with host governments within internationally acceptable norms of regulation and the projects can to a large extent be ring-fenced from other factors in the economy. However, investments in the finance sector are right at the core of the country's economic system. The finance sector can be a constraint on, or a facilitator of, overall economic development but it is also a reflection of it. Therefore such factors as the legal and regulatory environment cannot be leapfrogged with "sweetheart deals" and investors have to be particularly careful that their proposed investment can survive the governance environment, that it is not over-sophisticated and that it is properly scaled. Finance sector investment opportunities are intrinsically linked to the reform program.

In private sector policy friendly countries such as Kazakhstan and the Kyrgyz Republic where there are already sizeable private sectors, financial market development initiatives could aim to develop capital markets, and in particular the creation of NBFIs targeted at facilitating the growth of SMEs and private sector firms. The options here include the formation of specialised investment funds, relying on subscriptions from private domestic and foreign investors that could participate in the divestiture of large strategic enterprises as well as investments in SMEs. Some of these risk capital or venture capital funds could be earmarked for investment in firms in selected industries to promote the development of specific sectors. These investment funds, if appropriately structured and managed and through their ownership, governance and control rights and responsibilities over invested firms, could perform an essential role in the improved corporate governance of firms. Obviously, the development of these funds would also accelerate the development of the securities market and provide a pathway for the development of pension funds and the insurance industry.

It may be somewhat paradoxical but the development of capital markets through the creation of asset management companies, investment funds and NBFIs is also an option that could be considered for the less private sector friendly CAR countries. As discussed earlier (in Section IV), a second best solution to the reform of large enterprises and strategic industries where their full privatisation is not an immediately feasible option is to improve the performance of this sector by moving the exercise of ownership, governance and control functions away from government ministries and administrative and placing them under corporatized, commercially based state holding companies. The activities of the state holding companies would involve (state) asset management and the raising of external finance for restructuring and recapitalisation; these and other activities could provide opportunities for various instruments and modalities of public-private financing which would contribute towards the development of capital markets. A precedent here is the Chinese experience with the formation of numerous state holding companies, which then played an important role in the development of the financial market once they sought to raise funds on the market.

There are some investment opportunities in the banking sectors of the Kyrgyz Republic and Tajikistan. In the former, sector consolidation is recommended by IFIs and should be supported both by entry of stronger banks and continuing increases in minimum capital requirements. In the latter, IFIs are advocating increased capitalization and will remain ready to support the entry of new private investors, i.e. reputable local investors and regional and international foreign investors including Russia and Kazakhstan, and will seek further opportunities for equity participation, in order to strengthen the banking sector's institutional capacity.

For some countries in the region investment opportunities are about potential rather than actual and the timing now is premature. Investment in Uzbekistan's finance sector, for example, is not feasible until the government there addresses its policy challenges which include the following: (i) to discontinue directed lending; (ii) to improve the corporate governance and management capacity of commercial banks; (iii) to upgrade the supervisory capabilities of the Central Bank; (iv) to solve the large potential portfolio of non-performing loans; (v) to privatize state-owned banks possibly with foreign strategic investors; (vi) to develop non-banking financial institutions; and (vii) to increase competition in the financial system and improve efficiency of financial intermediation.

VIII. Recommendations

Given that the investment opportunities in the finance sectors of CARs are incontrovertibly linked to the reform programs that these countries are undertaking the key recommendation is that private investors should maintain close liaison with the IFIs so that they can be aware of the policy advocacy and formulation that is taking place in the CARs, along with the proposed sequencing and timetables for implementation, so that they are in a position to identify the investment opportunities as and when they arise and be in a position to participate in partnerships with the IFIs if appropriate.