



# Technical Assistance Consultant's Report

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## RETA 6137-REG: Risk Management Component

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For the Asian Development Bank

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**Asian Development Bank**

## I. REGIONAL SUMMARY

1. This document is addressed to the senior management of the respective banking sector regulators in Azerbaijan, Kyrgyz Republic, Kazakhstan and Tajikistan. It is intended to disseminate the key findings of the risk-management (RM) component of ADB's regional technical assistance (RETA) 6137. As such, attached to this document as Appendices A-C, are summaries of the major Findings and Recommendations for KYR, KAZ and TAJ, respectively<sup>1</sup> (AZB chose not to participate in implementation of the risk-management component of the RETA apart from participation in regional workshops). If interest is expressed by the banking sector regulators participating in the RETA, these findings can be presented and discussed as part of a one-day regional seminar, with financial support from ADB.

2. Although most outputs generated under RETA-6137 are country specific, the RETA project was structured as a regional project rather than individual technical assistance projects to AZB, KYR, KAZ and TAJ. It was intended that the results from each country would be shared among all four countries to facilitate regional knowledge sharing. During the project, the consultant observed some similarities in the regulation and supervision of risk management in the participating countries. These similarities (and in some cases, differences) provide an opportunity to share knowledge and improve oversight of risk management in their respective banking systems. These opportunities for cooperation are described in the section below.

## II. REGIONAL THEMES AND HARMONIZATION OPPORTUNITIES

### A. Risk management regulation has not been a priority for banking sector regulators in the region.

3. Kazakhstan was the first country to implement a RM Instruction (December 2003). KYR followed in December 2004. AZB and TAJ do not have any RM Instruction/Regulation for banks, and at this time nothing is planned. However, oversight of RM in the banking system is a key issue to ensure financial stability and a sustainable development of the system and the whole economy. Therefore, AZB and TAJ may want to learn from the experiences of KAZ and KYR in this area.

4. **Regional Opportunity:** NBA and NBT may review the FSAK and NBKR Instruction/Regulation. FSAK and NBKR staff may want to provide guidance to NBA and NBT on the development process, approach to drafting RM regulation, content, comment process, implementation, and response from banks, etc. NBA and NBT can then decide on what is the appropriate approach for them to take in implementing a RM regulation in their country.

### B. The approach to risk management regulation differs in each country.

5. FSAK has taken a minimalist approach, with a basic RM instruction. It has very general requirements for banks to follow. NBKR has taken the opposite approach, developing a RM regulation that is extremely detailed in content, and that defines the minimum standards for banks. NBKR also intends to provide more detailed guidelines on each of the risk areas, which will assist the banks in implementing the regulation. Adoption of such detailed guidelines is being called for under the ongoing IMF program for the Kyrgyz Republic, and a proposed ADB

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<sup>1</sup> These findings do not yet reflect the comments of the national banks.

financial sector program. Technical assistance is being provided by ADB. At this time, neither NBA nor NBT has implemented a RM regulation.

6. Based on the consultant's experience on this project and results of surveys undertaken under the RETA, banks in the project countries do not generally take a proactive approach towards regulations. They follow the minimum requirements of law at best. So, they will need to be pushed by the regulator to strengthen their risk management systems. The NBKR regulation forces commercial banks to take significant steps to identify, measure, control and monitor risks in their banks. As such, the approach of NBKR seems more appropriate for the project countries.

**C. Regulators need to develop, implement and enforce a risk management regulation.**

7. As discussed in the comment above, the KAZ Instruction is very basic. As such, banks in KAZ have not been given the tools to develop a comprehensive risk management system for their banks. Banks have not implemented the spirit of the Instruction. In addition, FSAK cannot enforce the Instruction due to: (a) inadequate detail in the Instruction, and (b) lack of RM knowledge on the part of Supervision staff. As such, based on survey results and interviews with banks, the Kazakh RM Instruction has not had the desired effect.

8. This is a good case where the regulator has taken the first steps, but additional work needs to be done. The appropriate route is to develop a detailed regulation, assist the banks in implementing it by providing training, and then enforcing the regulation during the on-site inspections.

9. **Regional Opportunity:** (i) FSAK should take steps to better implement the RM Instruction by developing guidelines and providing training, (ii) NBKR can observe the steps taken by FSAK to ensure better implementation of their RM Instruction and use that knowledge when implementing its own RM Regulation, and (iii) NBA and NBT should review the different approaches taken by FSAK and NBKR in order to ensure that they implement the RM Regulation appropriately (in the event that they develop one).

**D. Supervision departments of regional regulators are not in sufficient condition to efficiently oversee Risk Management in the banking system.**

10. The following findings apply to all the regulators. These 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

11. Training is a particularly weak area. Due to shortage of funds, regulators rely on donor support for training needs. As a result, the training is often based on what the donor offers rather than what the regulator needs. New staff are not put in a training program and have to rely on on-the-job training. This slows down the work of regular staff and is inefficient; plus, once trained, the employee often leaves the national bank to join a commercial institution. RETA-6137 offered some, although necessarily limited, training opportunities for regulators in the form of seminars (two in KGZ, and one proposed in KAZ) and financial support to NBKR for on-line training from the Financial Stability Institute of the BIS/Basel Committee.

12. *Regional Opportunity*: All four regulators have an incentive to attract and retain qualified staff. The exchange of ideas among regulators on how to attract qualified staff, how to make the national bank a preferred employment choice, how to retain staff by offering job rotation, etc. can benefit all banks.

13. Training of supervision staff is an area that can benefit immensely from regional cooperation. It may not be financially feasible for individual regulators to set up training schools, but a regional training center that will offer courses to all project countries will benefit from economies of scale as well as serve as a forum for the exchange of ideas. Project countries should explore this idea under the auspices of a regional group such as Transcaucasia and Central Asia Regional Group ("TCARG"). In addition, regulators should also set up meetings with donors to determine the annual training needs of staff.

#### **E. On-site supervision of risk management is nonexistent.**

14. All three regulators have focused on compliance with normatives during the inspection process. The commercial banks themselves have mainly restricted themselves to complying with normatives rather than developing a holistic approach to risk management. Regulator staffs also lack knowledge of risk management.

15. Adding the Sensitivity to Market Risks to the CAMEL criteria is one step in improving supervision of risk management. FSAK has added this component (in theory but not in practice) and NBKR will consider it in the future once its RM Regulation is adequately implemented. However, commercial banks will need guidance on the new criteria, and Supervision staff will need to be trained to be able to supervise compliance with risk-management requirements. All three regulators also need to update their supervision manuals to reflect the updated regulations.

16. *Regional Opportunity*: (a) NBKR, NBT and NBA should observe the efforts of FSAK to implement the new CAMELS rating and also the capacity building in NBKR. Once implemented, FSAK should share information on developing the new criteria, revising the Supervision Manual, training of Supervision staff, guidance to banks, etc. The other regulators can then decide on the timing for introducing such changes to their own supervision process based on the experiences in KAZ and the development of their own banking systems.

#### **F. Off-site supervision mechanisms are not focused on risk management.**

17. Staff only monitors compliance with normatives. Data collected from banks is not analyzed sufficiently or in a timely manner. Reports are not sufficient, timely, nor integrated into the supervisory process. Ideally, the information received from Off-site Supervision should be discussed with On-site Supervision and used as a basis for determining the inspection schedule. USAID has provided support to some project countries to enhance the quality of information available through the off-site process.

18. None of the regulators have developed a comprehensive system whereby bank data is analyzed in a timely manner in order to prevent problems at individual banks from affecting the banking system (some rudimentary models have been built, but the have not been adapted to reflect changes in the banking system and not systematically applied). Off-site supervision needs to develop a more comprehensive approach to systemic analysis. The analysis needs to focus on identifying and anticipating risks (such as foreign exchange exposures, sectoral

concentration, etc.), quantify their impact on the banking system, and alert the supervisor with warning signals.

19. *Regional Opportunity:* Regional regulators can discuss ideas on the types of information needed from banks, frequency of reporting, etc. Regulators need to continue to get USAID support to develop off-site reporting mechanisms.

**G. Lack of cross-border agreements hinders supervision of risk management.**

20. 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. Host country regulators may require the permission of the home country supervisor prior to allowing establishment of a branch/subsidiary, but that is not itself sufficient. Regulators should have an agreement that allows the home country regulator to request the inspection report from the host country regulator, and even conduct its own inspection of the foreign branch/subsidiary. The home country regulator should also provide information on the parent company that could assist the host country regulator. FSAK and NBKR are working on agreements with some countries.

21. *Regional Opportunity:* This is one area which can particularly benefit from regional cooperation. Rather than developing individual agreements between countries, regional regulators can work towards developing standard agreements. This can also be done under the auspices of TCARG.

**H. Ownership structures of commercial banks are opaque.**

22. In all the project countries, market rumors abounded concerning the beneficial ownership of shares in commercial banks. Significant political persons are rumored to control banks. It is a weakness in the licensing and supervision process that the regulator cannot or will not determine the true owners of shares. It affects the international image and reputation of the country.

23. *Regional Opportunity:* Regional regulators can meet to discuss ways to improve transparency in ownership. For example: how to enable and enforce disclosure of ownership, how to overcome efforts to hide ownership, etc.

**I. Anti-money laundering efforts remain weak in all project countries, creating operational and reputation risks for banks.**

24. Project countries are in a region with a flourishing drug trade, and these illicit funds enter the banking system. Countries should have an effective regulatory system that prevents these funds from entering the legitimate banking system. However, none of the project countries have anti-money laundering regulations. NBKR has identified anti-money laundering as a priority issue for 2005.

25. *Regional Opportunity:* Regional regulators must introduce anti-money laundering legislation and "Know Your Customer" regulations that will protect the integrity of the banking system. Regulators can share knowledge on components of the legislation, reporting standards, difficulties in implementation, burden on banks, etc.

**J. Commercial banks have weak risk management systems.**

26. As part of the RETA, the consultant surveyed banks in the three countries, as well as conducted interviews with major banks. Banks have only focused on complying with normatives, and have not developed holistic risk management systems. They have not developed internal loan rating systems and only follow the central bank's classification system for creating reserves. Their Boards of Directors do not effectively oversee risk management. Operational risk is particularly weak. Some KAZ banks have better developed RM systems than banks in other CAR countries but there is still work to be done. (Additional survey findings are discussed in the country-specific sections in the appendices).

27. *Regional Opportunity:* It is in the interest of all regional regulators that the banks in their countries, as well as neighboring countries, are strong. This could prevent crises and contagion. It would therefore be beneficial if the regulators encouraged and facilitated interaction among the banks in the region through hosting seminars and disseminating knowledge-sharing documents.

28. As is discussed above, there are significant opportunities for regional cooperation among regulators to improve the state of risk management regulation and supervision in their banking systems. If requested by the central banks, ADB can facilitate a one-day seminar for senior management of national banks to discuss the findings of this project and the opportunities for regional cooperation.

## KYRGYZ REPUBLIC

### A. FINDINGS

- 1. There is clear legal basis for supervision of risk management.** Current legislation contains two articles in the Law “*On Banks and Banking Activity*” that refer to the responsibility of the Board of Directors and the Management Board for risk management. Though the Banking law specifically mentions the presence of risk management system in banks, at this stage most of the banks do not comply with it due to lack of expertise in this area. At the same time the NBKR, as the supervisory authority, does not have clear regulations, guidelines and procedures in place to enforce bank’s compliance with these requirements of the banking law, nor adequately trained staff to examine the condition of risk management in banks.
- 2. Risk management has not been a focus for NBKR (although this has started to change), KGZ banks or their Boards of Directors. There was a clear need for a comprehensive risk management regulation to bring this issue into focus and improve the level of risk management practice and compliance in the KYR banking system.** ADB projects TA4069 and RETA6137 developed a draft regulation, which was approved by the NBKR Board on December 29, 2004, and will become effective on July 1, 2005. The goal of the regulation is to ensure that each bank can effectively identify, measure, monitor and control risk with due regard to the types and volumes of transactions conducted by them.
- 3. NBKR has not focused on oversight of risk management.** It has only used normatives, such as restrictions on the amount of open foreign currency positions and limits on maximum exposure per borrower, in lieu of a robust risk management framework. The new RM regulation will now be used by NBKR as the basis for compliance.
- 4. NBKR staff and KYR banks’ knowledge of risk management is weak.** Staff are not exposed to current global risk management practices. ADB has financially supported twelve subscriptions to the Financial Stability Institute’s on-line risk management training program for staff of NBKR. In addition, the consultant conducted seminars on risk management for NBKR staff and senior management at KYR banks on November 10, 2004 and April 5, 2005. The focus was on explaining the new RM regulation, its impact, the requirements for banks, and the role of Boards of Directors.
- 5. NBKR’s off-site supervision of risk management is non-existent.** Staff only monitor compliance with normatives. There is also no methodology for determining and assessing the nature, importance and scope of the risks to which individual banks are exposed. The off-site staff also lack knowledge of risk management.
- 6. NBKR’s on-site supervision of risk management is non-existent.** When inspecting banks, NBKR inspectors do not focus on risk management, since it is not part of the current inspection process. Once the new RM regulation is in practice, the NBKR inspectors will review it. However, NBKR’s on-site staff lacks knowledge of risk management. The Financial Stability Institute training tool and RETA seminars will raise the level of RM knowledge, but additional training is also necessary to keep staff knowledgeable and current on supervision issues

7. **Risk management practice at KYR commercial banks needs to be improved.** NBKR has exercised oversight only through normatives, and as a result banks have focused only on compliance with normatives rather than developing a broad view of risk management. The new risk management regulation lays out a comprehensive risk management framework that the banks will need to adopt.
8. **Boards of Directors are not complying with their responsibilities in the area of risk management.** The Banking law specifically requires the Board of Directors of banks to identify major risks to which the bank is exposed, but this is not being done in practice. A majority of surveyed banks do not have adequate committee structures, have not developed adequate Conflict of Interest policies, and do not provide adequate risk management information to the Boards of Directors. The new risk management regulation more clearly defines the role of directors in the area of risk management.
9. **Risk management practice at banks, if any, is not segregated.** It is crucial that risk management be undertaken independent from the operating areas. The survey results indicated that some banks use their Internal Audit department to perform risk management tasks. The new regulation requires that a bank institute an independent Risk Management Structural Unit or appoint a Risk Manager that directly reports to the Board of Directors of the bank.
10. **Credit risk management is the most developed area of risk management practice, but still has weaknesses.** Surveyed banks generally had a credit strategy. However, it was not reviewed on an annual basis. The strategy lacked information such as target markets, and maturity or profitability preferences. Stress testing of the credit portfolio is generally not performed. At half of the surveyed banks, members of the management team and council can override credit decisions.
11. **Operational risk management is very weak and needs to be immediately addressed.** Many banks have no operational risk policy. Banks generally do not perform disaster scenario analysis and planning, nor do they have a secured backup system in a location away from the bank. Many banks stated that they have lax controls with regard to subcontractors that could lead to leaking of information, fraud, or other problems. Most banks have no insurance to protect against loss from natural or other disasters

## **B. RECOMMENDATIONS**

The following is a compilation of recommendations made throughout the report. For additional details and the background behind each recommendation, please review the concerned section in the main body of the report.

### **1. Legislation and Regulation**

- (i) Develop guidelines for each of the risk areas in order for the banks to better implement the regulation. Focus initially on the priority areas of credit risk, operational risk, market risk, country risk, followed by the other risk categories.

- (ii) Provide training sessions for the banks to explain the regulation and guidelines. In particular, the role of the Board of Directors should be stressed during the training. The consultant has conducted two such sessions on November 10, 2004 and April 5, 2005.
- (iii) The draft Law “*On Combating Financing of Terrorism and Anti-Money Laundering*” was adopted in the first reading by the Legislative Assembly of the KR Parliament on December 9, 2004. It is recommended that the NBKR ensures compliance with this law by the commercial banks and develops necessary implementing guidelines once the draft law is approved by the Parliament, and provides trainings for employees of commercial banks and NBKR staff members.
- (iv) After 1-2 years, NBKR should consider factoring in market risk in capital calculations. The time lag is necessary in order for banks to digest and comply with the new risk management regulation.
- (v) NBKR should ensure that the proposed draft Regulation on Lending developed by the NBKR is consistent with the new Risk Management Regulation. NBKR should adopt the draft regulation on lending as soon as possible.
- (vi) Once the risk management regulation has been adopted by banks and their understanding of risk management improves, NBKR should require banks to develop internal loan grading systems for better management of credit risk.
- (vii) NBKR should sign a MOU with FSAK, and initiate discussions with them on issues pertaining to supervision of Kazakh-owned banks operating in the Kyrgyz Republic.
- (viii) It is recommended that the NBKR adopts the recommendations made by ADB TA4069-KGZ to promptly adopt, and thereafter vigorously utilize the proposed new Regulation on Enforcement Measures, institute more rigorous follow-up action and make more vigorous use of management removals. Upon adoption of the new Regulation on Enforcement Measures all the normative documents of the NBKR, in particular Bank Supervision Manual should be brought into consistency with it.

## **2. Supervision**

- (i) NBKR inspectors need training on risk management in order for them to better determine whether banks and their BoDs are fulfilling their risk management responsibilities as required by the law. The consultant has already provided two training sessions. In addition, the ADB has subsidized the cost of remote learning programs on risk management for NBKR staff from the BIS’s Financial Stability Institute. Both these efforts will improve the level of risk management knowledge within the supervision areas of NBKR.

- (i) NBKR should develop a methodology for determining and assessing the nature, importance and scope of the risks to which individual banks are exposed, and use it to develop the inspection cycle for banks. Bank Supervision employees will then need to be trained in conducting such analysis.
- (ii) After a suitable period of the adoption of the Risk Management regulation, NBKR must make appropriate amendments to the Bank Supervision Manual.
- (iii) NBKR needs to improve off-site monitoring of banks by fully utilizing the FinA tool. Bank supervision staff needs more extensive training on FinA, particularly with respect to extensive trend analysis and training on creating various modules for stress testing. It is advisable to use data received and processed by Off-site Division for overseeing risk management and developing early warning signals. NBKR needs assistance in developing a Stress Testing Manual together with the training on how to use stress testing tool in the supervisory process.
- (iv) Consider creation of a central supervision database for the use by both on-site inspectors and off-site analysts.
- (v) Address issues of high staff turnover in the Supervision area (in particular, issues related with current salary levels for on-site staff and other incentives targeted to maintain highly qualified personnel).
- (vi) Develop a methodology to inspect implementation and compliance with risk management regulation by banks.
- (vii) Training should be extended to commercial banks on how to implement the Risk Management Regulation and the procedures or guidelines on individual areas of risk.
- (viii) NBKR should provide funds for international training of staff in order for them to be current with international risk management practices. Donor assistance should also be requested in order to provide additional funds for international training. NBKR should provide formal training to supervision staff, rather than relying on on-the-job training. It is crucial to have a system of on-going training for supervision staff in view of high level of staff turnover.
- (ix) NBKR should set up clear requirements for capital restoration plans in cases where a bank falls below the required capital levels.
- (x) NBKR should establish ongoing contact and information exchange with home country supervisors whose banks perform active banking operations in the Kyrgyz market.

## KAZAKHSTAN

### A. FINDINGS

1. **The Risk Management Instruction is inadequate.** It is very general in nature and does not go in to specifics. As such, the onus is on the banks to develop a comprehensive risk management structure. However, it is unlikely that Kazakh banks will take the necessary steps without further direction from FSAK (the “Agency”). In practice, the banks have not done much to comply with the spirit of the Instruction.
2. **FSAK has not focused on oversight of risk management and is not implementing the Risk Management Instruction.** The Agency has only used normatives, such as restrictions on the amount of open foreign currency positions and limits on maximum exposure per borrower, in lieu of a robust risk management framework. The Instruction should have moved the Agency towards a more risk-based supervision methodology. However, banks have not been given implementing guidelines and lack the knowledge to fully follow the Instruction. In addition, Supervision staff lack understanding of the Instruction and cannot enforce it during the inspections.
3. **FSAK is short of funds, which is affecting its ability to supervise risk management.** It lacks funds for necessary training needs, as well as for essential supplies and computers. Salaries of supervision staff are low compared to the market and it has affected the quality of staff hired by the Agency. The On-site supervision department has twelve inspectors whereas about twenty five are needed.
4. **FSAK relies on using normatives as the criterion on which safety and soundness is judged.** While this is the practice inherited from the Soviet days, it severely lags international standards. The Inspection Cycle does not factor in the risk of the bank. The Agency determines the inspection cycle without assessing the nature, importance and scope of the risks to which individual banks are exposed. The Agency is moving towards factoring in Sensitivity to Market Risks in the inspection process, but inspectors lack knowledge in implementing these factors.
5. **FSAK staff lack risk management and banking experience.** They are hired without significant banking experience and do not receive sufficient training. They are not up to date with international risk management practices and are less well-informed than the staff at banks they inspect. This affects the quality and rigor of their inspections.
6. **FSAK’s on-site supervision of risk management is non-existent.** When inspecting banks, inspectors do not focus on risk management, since it is not part of the current inspection process. This should have changes with the new Instruction, but Agency on-site staff lack knowledge of risk management.
7. **FSAK’s off-site supervision system is not sufficient to capture risk management information.** It is mainly monitoring compliance with normatives rather than tracking indicators that could highlight deterioration in financial conditions. Currently, the information received by the Division of Analysis of Financial Market and Financial Organizations from banks is filed, but is not properly used to actively track deterioration in the condition of a particular bank or to assess any trends in the banking system.

8. **FSAK lacks a formal regulatory response policy.** As a result, corrective action is not taken in a timely or consistent manner. Banks also lack a clear timetable for remedying problems.
9. **FSAK does not share information with the concerned foreign regulators.** As a result, foreign banks operating in Kazakhstan and the foreign operations of Kazakh banks are not subject to an appropriate level of supervision.
10. **Risk Management practice at Kazakh banks is mixed.** Banks have focused on compliance with normatives rather than developing a broad view of risk management. Kazakh banks that have foreign investment from overseas banks generally have better risk management systems. Such market and peer pressure may result in local banks taking steps to improve their RM systems.
11. **The role of the Board of Directors is particularly weak in the oversight of risk management.** Most bank boards do not set limits on the amount of risk that their banks take, and do not have appropriate committee structures (except for foreign-owned banks). Monitoring of lending to insiders is weak.
12. **Credit risk management remains weak at Kazakh banks.** This is worrying in view of the rapid growth in loan portfolios. A majority of banks do not set limits based on geography, economic sectors or internal risk ratings. Over twenty banks do not have a MIS system that can alert them when exposures approach limits and their systems can not consolidate exposures from on- and off-balance sheet transactions.
13. **Operational risk management is particularly weak at Kazakh banks.** A majority of banks do not have operational risk policies. Most banks don't have proper disaster scenario and planning.

## B. Recommendations

The following is a compilation of major recommendations made throughout the report. For additional details and the background behind each recommendation, please refer to the main body of the report.

### 1. Legislation and Regulation

- (i) The new RM Instruction is inadequate in detail for the banks. The Agency should develop detailed guidelines for each of the risk areas contained in the Instruction in order for the banks to better implement the Instruction
- (ii) The Agency needs to ensure that banks develop guidelines to address each of the risk areas, so the banks can begin to identify, quantify, monitor and control these risks. The focus of the guidelines should initially be on the priority areas of credit risk, operational risk, market risk, country risk, followed by the other risk categories.
- (iii) Foreign banks in Kazakhstan, currently exempt from following the Instruction, should be required to follow the Risk Management Instruction

in order to ensure that all banks operating in Kazakhstan have minimum risk management standards.

- (iv) The Agency should define by regulation or instruction the role of the Board of Directors in overseeing risk management. They should increase the requirements on the Board of directors' activity, their monitoring functions, skills of members of a Board and establishment of necessary committees under the Board (Audit committee and Risk Management committee).
- (v) The inspection area has a regulation that provides good conceptual guidance to the inspectors work. But the current inspection process is more focused on compliance with laws and normatives and verification of information than in making an overall assessment of how the bank manages its risk. A more comprehensive regulation, which focuses on bank risk management processes, should be developed on the basis of "*Recommendations for Bank Rating System (CAMELS)*". Report comments should include recommendations on how the bank can improve the effectiveness of their processes. The conclusions on bank management should be largely influenced by the effectiveness of bank risk management processes.
- (vi) The analysis prior to licensing needs to be more rigorous. The Agency needs a better way to determine the beneficial owners of stock in Kazakh banks, in order to diffuse the controversy regarding political control of banks. The licensing analysis should include an analysis of the proposed bank in light of the scope and sophistication of its projected business. This should be supported with the Agency's analysis that provides conclusions as to the risks in the institution and how those risks are mitigated through proposed policies, procedures, systems and controls. Proposed policies should be submitted for analysis prior to the bank opening in order to review these policies in light of the proposed institutional risk.
- (vii) Banks should be required to factor in the financial condition of the borrower in the classification criteria (rather than only past-due status or collateral valuation).
- (viii) The Agency should consider having banks develop an internal loan rating system.
- (ix) The requirements that banks should have procedures in place to prevent persons benefiting from the loan being part of the preparation of the loan assessment or of the decision itself are related only to executive officials of a bank. It should be modified to include all staff involved in the loan approval process.
- (x) The Agency should establish a framework for consolidated supervision, allowing it to gather any relevant information from banks as well as from the related companies, irrespective of their activities, which the supervisor believes is material to the financial situation of the bank or the

assessment of the risk of the bank. The legal framework may require amendment to ensure the Agency has sufficient authority to properly supervise all related entities.

- (xi) The assessment of the risk management supervision indicates the need to develop a significant number of regulations, policies and procedures on risk management. In light of this work, consideration should be given to establishing a special methodology division on risk-management within bank supervision.

## **2. Supervision**

- (i) The Agency should move away from the current system of using normatives as the criterion on which safety and soundness is judged. More effective supervision can be ensured by using more holistic measures such as a complete assessment of corporate governance, risk management and internal controls.
- (ii) The Agency should develop a methodology for determining and assessing the nature, importance and scope of the risks to which individual banks are exposed, and using it to develop the inspection cycle for banks. Bank Supervision employees will then need to be trained in conducting such analysis
- (iii) The Agency should provide formal training to supervision staff, rather than relying on on-the-job training. The Agency should provide funds for international training of staff in order for them to be current with international risk management practices. Donor assistance should also be requested in order to provide additional funds for international training. Agency staff needs training on risk management in order to inspect banks' compliance with the Instruction. The consultant will provide a three-day training session for Agency staff, but the Agency should consider additional training such as the Financial Stability Institute's on-line training program, or seek assistance from donors such as USAID that have provided supervision assistance in the past.
- (iv) Off-site supervision needs to focus on the development of the new off-site surveillance system that considerably enhances data quality and provides tools such as Uniform Bank Performance Report to improve analyses of financial condition of individual banks. In addition, off-site supervision needs to develop, on a basis of newly implemented tools, a more comprehensive approach to systemic analysis. The analysis needs to focus on identifying and anticipating risks (such as interest rate, foreign exchange, economic sectors, geographic location, operational, etc) and on quantifying their impact on the banking system. In order to develop integrated supervisory approach, the supervisor needs to formalize a process of close cooperation between on-site, licensing and off-site. Off-site analysts need to make a formal presentation to the inspection team about the financial condition of the bank and issues identified during the off-site supervision process. This necessitates lengthening of the preparatory period, especially for complex inspections and developing the

inspection planning process. After completing the inspection, the on-site inspection teams should be required to present their findings to the management of the supervision department and to the staff of the off-site unit.

- (v) The On-site supervision process needs to be enhanced. It should move away from only verifying compliance with normatives, and should better provide a more complete assessment of corporate governance, risk management and internal controls. The Agency needs to add staff in On-site supervision. There is a shortage of staff, which is affecting the inspection cycles and quality.
- (vi) The Inspection manual needs to be updated to reflect the Risk Management Instruction and other developments.
- (vii) Banks should be required to produce reports on lending to connected parties, and should monitor them through an independent credit administration process.
- (viii) The Agency should ensure that banks provide them with timely information on large borrowers. Banks are not making this data available to inspectors during the On-site inspection.
- (ix) The Agency must implement a formal regulatory response policy. The current practice is inconsistent. Once a formal policy is defined and implemented, it will show the banks the steps that will be taken in case of their weakening situation.
- (x) The Agency should share information with the concerned foreign regulators. It needs to sign bilateral agreements with the regulators in countries where Kazakh banks have operations and whose banks operate in Kazakhstan. These agreements should include exchange of inspection reports and eventually permission to inspect.

## TAJKISTAN

### A. FINDINGS

1. **Kreditinvest, a non-bank financial organization and the largest participant in the TAJ credit system, is not adequately supervised and could represent a risk to the TAJ banking system.** It holds a portfolio of agricultural loans, and comprises 65% of the liabilities of the entire banking system. Asset quality is assumed to be very poor and this institution represents a large risk area in the financial system. It is not supervised by the National Bank.
2. **There is a clear legal basis for regulation of risk management.** The law, “*About Normative Legal Acts of RT*”, issued in 2003, gives the NBT the right to issue rules and instructions for use in the banking system. However, NBT has not issued any specific risk management regulations.
3. **NBT has not focused on oversight of risk management.** It has basically used normatives, such as restrictions on the amount of open foreign currency positions, in lieu of a robust risk management framework.
4. **NBT has limited resources, which has constrained its ability to supervise banks and restrains the development of supervision of risk management.** There is a shortage of staff, and knowledge of a particular bank can disappear if the staff person in charge of that bank leaves NBT. There is very limited electronic storage of supervision data. There is a shortage of office equipment and materials. There is limited communication among the various divisions in Bank Supervision. As a result, supervision is not quite coordinated effectively and efficiently.
5. **NBT’s on-site supervision of risk management is non-existent.** NBT’s on-site supervision basically focuses on compliance with normatives. There is very limited qualitative assessment of the bank. When inspecting banks, NBT inspectors do not focus on risk management, since it is not part of the current inspection process. NBT’s on-site staff also lacks knowledge of risk management, as they are not exposed to current global risk management practices.
6. **NBT’s off-site supervision of risk management is non-existent.** Staff only monitor compliance with normatives. There is also no methodology for determining and assessing the nature, importance and scope of the risks to which individual banks are exposed. Off-site supervision comprises of collecting statistical data that is of limited value. However, NBT is currently introducing a new off-site reporting system (FinA), which should improve the quality of information available to the banking supervision area. Once completed, NBT should have ready access to information that it can use for efficient oversight of banks, and further develop into an early warning tool.
7. **NBT’s supervision manual is inadequate.** It has no connection with the existing legislative and normative base of TAJ and NBT and particularly with the structure of the Department of Banking Supervision and the duties of its employees. USAID is currently providing some technical assistance for updating the supervision manual.

8. **NBT's regulatory response policy is unclear.** The law "*About NBT*" specifies general steps that NBT can take, but NBT does not have any internal policies about the specific steps to be taken when the condition of banks deteriorate. NBT does not consistently enforce its regulatory response policy. While the law "*About NBT*" specifies steps that NBT can take, in practice there are concessions and waivers.
9. **Risk management practice at TAJ commercial banks is very weak.** NBT has exercised oversight basically through normatives, and as a result banks have focused only on compliance with normatives rather than developing a broad view of risk management. The responses to the survey indicate that some banks have moderately developed risk management systems. These responses are inconsistent with the face-to-face meetings conducted by the consultant. As such, the questionnaire responses should not be viewed as providing a definitive view of the risk management practices of TAJ banks.
10. **Credit risk management is the most developed risk area, but weaknesses remain.** Half the banks surveyed have not set individual nor aggregate limits on industries, economic sectors, geographic areas, etc. MIS systems are weak, with a majority of bank systems not able to identify either individual or consolidated concentrations of risk, nor consolidate exposures from on- and off-balance sheet transactions.

## B. RECOMMENDATIONS

The following is a compilation of recommendations made throughout the report. For additional details and the background behind each recommendation, please review the concerned section in the main body of the report.

### 1. Legislation and Regulation

1. NBT should consider developing a separate regulation focusing on risk management.
2. NBT should amend the law "*About the National Bank of Tajikistan*" to provide NBT the right to receive unimpeded the information necessary for regulation and supervising functions from state, commercial, public organizations of TAJ and abroad.
3. *Add in to the law "About Banks and Banking", in regard to the release by banks of confidential client information:*  
 "... d) NBT and investigating agencies on cases of clients falling under definite suspicion for possible illegal usage of bank (financial) system, including money laundering, financing of illegal activity....";
4. Make changes to the Instruction №100 regarding procedure of opening of foreign representative offices, branches, joint ventures and subsidiary enterprises of resident banks:
  - (i) include requirement to submit agreement of the authorized body of other state (host country) on opening of representative office, branch, joint venture and subsidiary enterprise;

- (ii) include as a condition for opening of branch, presence of agreement between NBT and supervision bodies of the home country regarding consolidated supervision and exchange of information;
5. Include changes and additions to Instruction “*On Work with Credits*” in the section regarding decisions to issue credits to insiders, including shareholders. Procedures of decision-making should block interested persons from influencing the credit decision.
  6. Bind banks to submit complete package of documents regarding credits issued to insiders; set monthly reporting on loans to insiders. Normative acts of NBT should underline the responsibility of the bank for inaccurate and/or unreliable information on credits.
  7. Based on analysis of banks activity in TAJ and international accounting practices, determine and include into regulations:
    - (i) relative (to capital of a bank) size of investments at which a bank is obliged to inform NBT about such investments;
    - (ii) relative (to capital of a bank) size of investments at which a bank has to receive NBT consent;
    - (iii) list activities that can not be carried out by legal entities where a bank participates directly or indirectly;
    - (iv) classification of risk level for investments into activities carried out by legal entities where a bank participates;
    - (v) and make corresponding add-ins to the laws (on first three points above);

## 2. Supervision

1. Ensure that Kreditinvest and non-bank financial organizations are subject to oversight by NBT and Department of Banking Supervision;
2. Conclude agreements for exchange of supervisory information with supervision bodies of other countries, first of all with Bahrain, Russia, Kazakhstan, Turkey and Iran;
3. Department of Licensing should analyze statutory documents of banks in order to identify:
  - extent of significant influence of founders - legal entities on decisions of credit institutions;
  - risks specified by activity of founders - legal entities having significant influence on decisions of banks;
4. Make the inspection cycles sensitive to the risk profile of the bank. Use data received by the Off-site area in adjusting the timing and scope of inspections of banks. Use Off-site data as a basis for developing a comprehensive Early Warning System that can alert NBT to emerging risks in the banking system.
5. Introduce standards of data-processing systems (MIS) and condition of their availability along with a building compliant to the requirements set by NBT in order to reduce operational risk.

6. Begin practice of scheduling periodic meetings with a senior management of banks in order to discuss condition of the bank and emerging risks.
7. NBT should move beyond the current CAMEL system and introduce some risk component to the inspection rating. However, it needs to set the stage for this change by educating the commercial banks about risk management.
8. NBT should enforce its regulatory response policy. Application of sanctions does not happen in all cases. In some cases, NBT reaches an agreement with the violating commercial bank about terms for elimination of the deficiencies, and normally, banks try to follow the directions. Nevertheless, the practice of concession and waivers is dangerous since it opens the gates for connivance, and sends an undesirable signal to the banking sector.
9. In order to prevent loss of information and provide easier access to information, organize acquisition and storage of the documentation in Department of Banking Supervision not by type (correspondence separately, legal business separately etc.), but rather for each credit institution, including to the file all information related to it including correspondence, information on candidates for the managing positions that were not approved by NBT, internal information regarding the bank, etc.;
10. NBT's supervision employees need training on risk management. NBT should solicit donor funding for appropriate training.
11. Hold training seminars on introduction of USAID FinA Project for employees of Inspection and Licensing Divisions.