



Technical Assistance Consultant's Report

Project Number: 36027
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Regional Financial Sector Development Completion Report

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Asian Development Bank

ABBREVIATIONS

ADB	–	Asian Development Bank
FCCU	–	Financial Company for the Support and Development of Credit Unions
NBKR	–	National Bank of the Kyrgyz Republic

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APPENDIX 1: TERMS OF REFERENCE FOR CONTRACT NO. S06388

I. INTRODUCTION

1. This report provides an overview of the work undertaken since the September 12 progress report and summarizes the deliverables submitted to fulfill the terms of reference for the consultant's assignment under TA-6137 (REG) Regional Financial Sector Development. The original terms of reference are included as Appendix 1. Table 1 summarizes the key deliverables under the contact.

Table 1. Deliverables Under Contract S06388.

Deliverable	Original date	Revised	Actual
Draft Report on supervisory strategy and recommendations for FCCU	July 29	September 8	September 8
Summary report of targeted loan inspections	July 29	No change	June 30
Final draft prudential guidelines	September 30	November 18	November 20
Final report on supervisory strategy and recommendations for FCCU	October 14	November 18	November 14

FCCU = Financial Company for the Support and Development of Credit Unions.

2. As detailed in the September 12 progress report, security concerns at the time of the July 2005 Presidential elections resulted in an unavoidable delay in the completion of the field work, which necessitated a re-phasing of the deliverable dates. Each of the tasks outlined in the terms of reference has now been substantially completed in accordance with the revised schedule.

3. Copies of the deliverables have already been provided to Asian Development Bank (ADB). Also provided together with this final report are: (i) additional copies of the final report on supervisory strategy and recommendations for the Financial Company for the Support and Development of Credit Unions (FCCU), both in English and Russian; (ii) a draft regulatory guideline for operational risk, and (ii) a summary note on supervision and regulation of credit unions.

II. NEW PRUDENTIAL GUIDELINES

4. One major objective of the project was to introduce two new prudential guidelines for commercial banks, one on credit risk management and one on operational risk management. The former has been formally adopted, and the latter is expected to be introduced before end-2005.

5. The National Bank of the Kyrgyz Republic (NBKR) introduced on April 27 a regulation "on Lending in Commercial Banks and Other Financial and Credit Institutions". While this regulation did not reflect all the comments provided by the consultant on March 31, 2005, the regulation as adopted is adequate as measured against international best practices and does not contain any fatal flaws. Thus, while it could be further strengthened, it is a better use of scarce NBKR resources to accept this regulation as meeting the required minimum standards set by the Basel Committee on Banking Supervision rather than introduce a revised regulation. Accordingly, the consultant recommended, and ADB concurred, that this regulation be accepted.

6. The NBKR has prepared an operational risk guideline which is consistent with international best practices. The final draft is to be considered by the NBKR Board in December 2005, with banks required to comply with the new regulation beginning in 2006. This regulation

was the result of a sound process, which could be repeated for the planned introduction of regulations on transfer, country, and market risk by the NBKR in 2006.

- (i) The consultant provided the NBKR with an initial draft regulation in advance of the first field visit. This draft was consistent with the Kyrgyz Law on Banks and Banking Activity (2003) and other relevant regulations (bylaws), specifically the Regulation on Minimum Risk Management Standards for Commercial Banks (2004), while also meeting the requirements of international best practice.
- (ii) The NBKR reviewed the draft, and proposed revisions which were discussed during the first field visit. As a result of the discussions, the NBKR prepared a revised version, which also reflected comments provided by the NBKR's peripatetic IMF bank supervision advisor.
- (iii) The revised draft was circulated to the banking industry for comment. While only two banks commented, both had obviously taken the consultation process seriously, and provided meaningful comments.
- (iv) The industry comments were reviewed by the NBKR and the consultant during the second field visit. Some of the specific comments were incorporated into the revised draft guideline to be considered by the NBKR Board. The consultant assisted the NBKR with suggestions on responses to the banks explaining why specific comments had not been reflected in revisions to the guideline.
- (v) The final version of the guideline prepared by the NBKR's supervision and methodology department is largely based on the original draft provided by the consultant, but has been substantially improved through the interaction with NBKR staff and input from the banking industry and other advisors to the NBKR.

III. SUMMARY REPORT ON CREDIT INSPECTIONS

7. The consultant provided written comments on August 24, in advance of the first field visit, on the summary report prepared by the NBKR on credit inspections completed during the first half of 2005. This was followed up by two technical discussions during the field visit, and the provision of additional data by the NBKR in response to the comments provided. Based on the review of this additional data, the consultant provided on September 30 a number of specific recommendations for inspectors, both with respect to the individual banks included in the summary report, and more generally for credit inspections. The NBKR advised that these comments have been taken into consideration in the ongoing supervision of the banks concerned.

IV. ADDITIONAL ADVICE

8. As part of the ongoing dialogue with the NBKR, the consultant provided written advice on a number of issues not contemplated in the original terms of reference. These were accommodated with ADB concurrence within the resource envelope of the original contract:

- (i) The consultant reviewed the existing regulation on corporate governance and provided comment on August 27.
- (ii) The consultant assisted the Methodology division with a technical discussion on September 5 of the principles of anti-trust legislation as applied to the banking sector, and followed this up on September 7 with a memo outlining key concerns with the current approach in the Kyrgyz Republic, and recommending that the enforcement of anti-trust legislation, even in the banking sector, is more appropriately left to the State Anti-Monopoly Body

- (iii) The consultant reviewed the current "Instructions on Inspections," providing a written response on November 7 and following up with a technical discussion on November 9. At the request of the NBKR, the consultant will review additional NBKR internal guidelines for inspectors, and provide written comments by e-mail.

9. The consultant also completed a number of specific tasks as requested by the ADB, including:

- (i) Provision of initial suggestions for a common basket (standard set) of banking products and services to be regularly published by NBKR to increase market transparency. The basket was revised by the NBKR to reflect the results of three technical meetings, two during the first field visit and one in the second field visit.
- (ii) Follow-up on a range of outstanding documentation and clarification issues during both field missions.

V. TRAINING

10. The NBKR requested that a portion of the technical assistance provided for the development of prudential guidelines include some training for supervision staff. As a result, the consultant prepared and delivered on November 14 a one-day training seminar on operational risk attended by 21 NBKR staff. The morning was devoted to two presentations by the consultant introducing operational risk and the international experience with the regulation and supervision of operational risk. The afternoon session comprised a case study (Barings Bank), intended to bring to like to conceptual material provided in the morning session. Preparation and delivery of the seminar, including translation, was accommodated within the original resource envelope for the contract.

VI. SUPERVISORY STRATEGY AND ACTION PLAN FOR RURAL FINANCE

11. As originally envisaged, the bulk of the work on this aspect of the project was completed during the first field visit. A first draft of the report was delivered to the ADB on September 8. Following comments from Kyrgyz stakeholders and the ADB, a revised draft was delivered on October 12, with the Russian translation following on November 3. The draft was further discussed with stakeholders during the second field visit, and additional comments were received. The final report was completed during the second field mission, with the English version provided to the ADB on November 14, and the Russian translation provided on November 15.

12. The draft report provided the basis for discussion of the exit strategy for the Rural Finance Program during the review mission undertaken by the KYRM November 7-11. At the request of the KYRM, the consultant participated in the review mission.

13. The National Bank of the Kyrgyz Republic has prepared a response to each of the recommendations for the supervision and regulation of credit unions in the October 2005 draft report "Credit Unions and Sustainable Rural Finance: Recommendations for Supervision and Development." This response, which in most cases indicates how the NBKR intends to implement the recommendation, has been incorporated into the NBKR's ongoing planning process. If well implemented, the NBKR plans will address the current absence of effective supervision of credit unions, and the proposed regulatory changes will better position credit unions for development without introducing undue prudential risks.

14. Following further discussion with the NBKR and KYRM during the second field mission, the consultant prepared a short summary of the recommendations on regulation and supervision. An original draft was provided to the ADB on November 13, with a final version provided on November 15.

TERMS OF REFERENCE
Contract S06388
TA 6137-REG: Regional Financial Sector Development

A. Background

1. The National Bank of Kyrgyz Republic (NBKR) approved the Resolution on Minimum Risk Management Requirements on 29 December 2004 as a basic regulatory guideline for risk management. The resolution was drafted under the RETA in light of similar resolutions adopted in other RETA countries such as Kazakhstan, and includes broad provisions for risk management, and references to credit risk, country risk, market risks, and other risks. In each case, however, there is a need for more detailed prudential guidance to indicate to banks the minimum standard to meet the prudential requirements for each individual risk. Credit risk and operational risks need to be addressed first, considering that recent sharp growth in loans outstanding raises concerns about the possibility of poor lending practices.

2. NBKR regulates microfinance organizations and credit unions. However, the day-to-day supervision of savings and credit unions (SCUs) are carried out by the Financial Company for the Development and Support of Credit Unions (FCCU). FCCU has consistently failed in establishing effective supervision of CUs on behalf of NBKR. An effective supervisory strategy and action plan is warranted to mitigate risks in the growing rural financial system.

3. While the RETA outputs are country specific, the RETA foresees regional dissemination of such outputs. As such, the regulatory guidelines on various aspects of risk management drafted under the RETA will be made available to other RETA countries.

B. Scope of Work:

4. The expert will work with the Supervision Methodology Department of the NBKR in the preparation of two prudential guidelines, one addressing credit risk and the second covering operational risk, to assist banks in implementing the broad provisions of the Regulation on Minimum Risk Management Requirements for Banks, adopted in December 2004.

5. The expert will also assist in reviewing the summary report aggregating the findings of the targeted credit inspections conducted by NBKR in May-June 2005. The results of these inspections could be useful in identifying systematic weaknesses that would need to be addressed as part of the new credit risk management guidelines.

6. The expert will also review the action plan for the establishment of a unit in NBKR for supervision of credit unions and provide recommendations on an effective supervisory strategy in light of recent developments in the sector.

7. The expert is expected to have extensive experience in banking sector regulation and supervision, and in particular a sound knowledge of international best practices in prudential requirements for risk management as codified in the Basel Core Principles for Effective Banking Supervision, and specific Basel Committee publications including "Principles for the Management of Credit Risk," "Sound Practices for the Management and Supervision of Operational Risk," and "Framework for Internal Control Systems in Banking Organizations." Prior experience with the implementation of prudential regulation in transition economies, and in particular the Central Asia region, is highly desirable.

C. Detailed Tasks:

8. The expert's tasks will include, but not be limited to, the following:
- (i) review the legal framework for banking supervision in the Kyrgyz Republic, including but not limited to the Law on Banks and Banking Activity, NBKR instructions on internal audit and control reports, and corporate governance requirements as well as the Regulation on Minimum Risk Management Requirements for Banks, to ensure that the proposed guidelines on credit and operational risk management are fully consistent with existing legal framework while also incorporating international best practices;
 - (ii) in conjunction with the NBKR, review existing prudential standards and guidelines for credit and operational risk management in neighboring jurisdictions, including Kazakhstan and Russia. To the extent that the approaches in neighboring jurisdictions are consistent with international best practices, the expert will advise the NBKR on options to ensure that the Kyrgyz standards do not conflict with specific provisions of risk-management practices that apply to the parent companies of Kyrgyz subsidiaries;
 - (iii) working closely with the Supervision Methodology Department of the NBKR, and legal and other departments as required, prepare an initial draft of guidelines on credit risk management and operational risk, to be circulated to the banking industry for review and comment;
 - (iv) following a suitable period (not less than 45 days) for consultation with the industry, the expert will assist the NBKR in reviewing the comments and suggestions provided by the industry, and preparation of final draft guidelines for implementation;
 - (v) assist in reviewing the summary report aggregating the findings of NBKR's targeted credit inspections;
 - (vi) review the regulatory and supervisory framework for supervision of credit unions and the action plan to establish a unit for supervision of credit unions in NBKR;
 - (vii) based on (vi) develop a supervisory strategy to promote a sustainable rural financial system;
 - (viii) undertake an analysis of FCCU and its role in the Kyrgyz financial system; and
 - (ix) based on (viii) assess different options for the future development of FCCU and make a recommendation with regard to a suitable strategy for FCCU resolution.

D. Output/Reporting Requirements:

9. In addition to the final draft prudential guidelines addressing credit risk management and operational risk management and the summary report of the targeted loan inspections, the expert will provide a brief inception report outlining the workplan and timetable agreed with the NBKR for completion of the key tasks:

- (i) Review of broad legal framework
- (ii) Review of credit and operational risk prudential standards and guidelines in neighboring jurisdictions
- (iii) Completion of draft credit risk and operational risk guidelines for circulation to the banking industry for comment
- (iv) Preparation of final draft guidelines following review of comments and suggestions received during the consultation period
- (v) Review of the summary report of the results of NBKR inspections

- (vi) Development of a supervisory strategy and action plan to promote a sustainable rural financial system