

TECHNICAL ASSISTANCE COMPLETION REPORT¹

Division: CWFWM

TA 4431-KAZ: Financial Sector Governance			Amount Approved: \$800,000		
			Revised Amount: n.a.		
Executing Agency: The National Bank of Kazakhstan		Source of Funding: JSF	Amount Undisbursed: \$180,704.95	Amount Utilized: \$619,295.05	
TA Approval Date: 08 November 2004	TA Signing Date: 8 February 2006	Fielding of First Consultant: 7 April 2006	TA Completion Date Original: 30 November 2006 Actual: 31 March 2009 Account Closing Date Original: 30 November 2006 Actual: 17 July 2009		
Description					
<p>The Government of Kazakhstan established in June 2004 an interministerial commission to prepare its financial sector strategy. Simultaneously, the central bank (NBK) began quantitative inflation targeting as the basis of its proposed monetary policy. Being a new area for NBK, it needed appropriate diagnostic tools and staff training to undertake this nascent activity meaningfully. Concurrently, an International Monetary Fund and World Bank Financial Sector Assessment Program conducted in early 2004 found lacunae in financial sector supervision. In the banking sector, 6 out of 25 Basel II Core Principles were not complied with. In the capital markets and insurance supervision, compliance with the principles of the International Organization of Securities Commissions and the International Association of Insurance Supervisors remained perfunctory. A National Fund was created out of increased oil revenues, while the central bank's foreign reserves also increased. The Government recognized the necessity of their prudent management in line with international best practices. To address these issues holistically, the Government sought three TAs from ADB between 2004 and 2007. This TA was the first of these three.</p>					
Expected Impact, Outcome and Outputs					
<p>The TA's expected impact covers monetary stabilization policies and improved governance of the National Fund and the central bank's official reserves in line with international best practice. The TA's outcomes were to support the strengthening of the monetary framework by developing an inflation-targeting regime to ensure overall financial stability. The TA also sought to support strengthening governance for financial assets managed by the NBK, which include official reserves and the National Fund, by designing rules and procedures governing responsibilities and investment guidelines. The TA design is relevant as inflation targeting enables the monetary authorities to effectively implement monetary stabilization policies. Price stability will, in turn, support broad efforts of macroeconomic stabilization and create an environment conducive to stable economic growth. Moreover, transparent management and proper oversight of Kazakhstan's assets are crucial to prevent fraud, corruption, and the exploitation of the country's nonrenewable resources, and to support equitable transfer of resources to future generations to enhance the country's development. The expected outputs of the TA included (i) a monetary policy regime with inflation-targeting; (ii) asset and risk management systems of NBK established, in line with international best practices; as well as (iii) capacity building for NBK in asset management, risk management, and inflation targeting.</p>					
Delivery of Inputs and Conduct of Activities					
<p>The Government's signing of the TA Letter of Agreement was delayed by 15 months due to numerous administrative issues arising from NBK (the Executing Agency or EA) being legally independent of the Government. Nevertheless, ADB undertook preliminary activities even before the TA was signed, such as searching for possible consultants so that they could be engaged and fielded soon after the signing of the TA. Following this delay, ADB reassessed the relevance of the TA with the EA, which confirmed that the TA was still relevant and they reaffirmed their commitment to proceed with the agreed implementation arrangements.</p> <p>The international consultants were engaged under the TA while the domestic consultants were engaged by the EA as their counterpart contribution. The consultants organized a visit of NBK senior management and staff to the Czech National Bank to discuss issues of administration, economic modeling and forecasting that arise in the transition to inflation targeting. The consultants also engaged key NBK personnel in many rounds of discussions on the governance of Treasury functions pertaining to asset and risk management. Several practical coaching sessions were held pertaining to the selection of a performance and risk measurement system, risk budgeting and risk elements specific to derivative products. Through extensive interactive workshops, documentation analysis, comments and reviews, the consultants were able to elaborate a set of recommendations that are well adapted to NBK's context today. The consultants also advised NBK on monetary management in the context of the recent global financial turmoil. The consultants' performance was satisfactory overall.</p> <p>The TA supported the procurement of economic modeling software for the EA. In addition, the EA purchased additional servers and software with its own resources to allow the installation of risk management software. The EA's performance is rated satisfactory. ADB's performance is also rated satisfactory. It conducted seven review missions for the TA apart from being in constant communication with the EA and consultants. At TA Steering Committee meetings, the EA expressed its full satisfaction with TA implementation.</p>					

¹ In preparing any country program or strategy, financing any project, or by making any designation of or reference to a particular territory or geographic area in this document, the Asian Development Bank does not intend to make any judgments as to the legal or other status of any territory or area.

Evaluation of Outputs and Achievement of Outcome²

The TA performed a diagnostic assessment of NBK asset and risk management framework and gave recommendations for strengthening of such frameworks in line with internationally recognized best practices.³ Significant progress was made as several recommendations have been or are in the progress of being implemented. An investment committee and a risk management committee have been established and the risk management function has been institutionally separated from the internal audit function. The global crisis has naturally caused delays and adjustments to initial plans. The implementation of core systems (such as Temenos, Bloomberg AIM, DSTi) and interfaces linking those systems have yet to be effectively completed. Nevertheless, the consultants noted that over the last few months, while the world markets have been affected by extreme volatility and a high level of defaults, the NBK asset managers have operated in an efficient and effective manner during the crisis.

NBK's external reserves have even increased from \$17.6 billion at the end of 2007 to \$19.9 billion at present (the equivalent of slightly less than seven months of imports). In addition, the National Fund provides sufficient cushion to the Government to mitigate risks arising from the global financial crisis. Kazakhstan's ability to weather the crisis has been due in large part to considerable earnings built up in the National Fund which grew from \$14 billion in 2006 to \$28 billion in 2008. At the beginning of the TA, in May 2006, the NBK was outsourcing management of approximately 60% of its National Fund assets to 15 of the world's leading financial institutions. In view of the generally better results recorded internally, particularly for the fixed income asset class, the number of external managers has been reduced to eight as of March 2009. In addition, the fixed income asset class is now managed internally for close to 90% of the assets. There are no external managers used for the Foreign Reserves portfolio. To ensure transparency and accountability of the process, the NBK applies the approach of segregated accounts, whereby all positions are held (by the global custodian) in the name of the NBK, whether the corresponding portfolio is managed internally or externally. This is far more transparent than pooled accounts, where the NBK would own unit funds in a fund managed by the external manager, not having necessarily full disclosure as to the content of the fund.

The TA also assisted NBK in developing much of the infrastructure needed for implementing inflation targeting,⁴ although the full implementation of a forecasting system, including the formation of a permanent full-time modeling and forecasting team, has not yet been realized. Demands on staff time due to the financial crisis have slowed progress in this area although there have been significant accomplishments nonetheless. Progress has been made in the training of researchers and the development of econometric capabilities of the NBK staff. A database of critical macroeconomic data has been constructed. This database was used as input for generating quarterly reports on economic performance, and more importantly it provides the raw data for the estimation of single equation forecasting models, a small structural econometric model and a small calibrated model. All of the models were developed through the course of the TA in workshops for the staff of the Research and Statistics Department and researchers in other departments including Financial Stabilization and the Balance of Payments.

Overall Assessment and Rating

The TA was successful. Good progress has been made on developing risk management policies and procedures for the National Fund and NBK's official reserves, as well as establishing limits to be expressed in NBK's investment policy. The TA has accomplished several important tasks in the area of inflation targeting. It has helped in improving the capacity of NBK staff in using statistical packages. All equations for the modules of a comprehensive macroeconomic forecasting model have been estimated. They now have a strong foundation to re-specify and employ this model or develop new models. Although developing the tools for a monetary policy regime with inflation targeting was the impetus for the modeling, the models are useful regardless of the monetary policy regime. The TA also focused on the interaction between the modeling team and NBK's Monetary Policy Council to maximize the impact of the model results on monetary policymaking. Although TA implementation was completed 28 months after the original completion date, this is justified by the substantive delay in signing the TA letter as well as the heavy additional workload for NBK management and staff brought about by the spillover of the global financial crisis to the Kazakh economy.

Major Lesson

The core group responsible for econometric modeling under the TA's inflation targeting component, although proficient in the use of statistical software and have a reasonable knowledge of basic econometrics, faced tremendous demands on their time for numerous other purposes—from report writing to responding to requests for information by the public and other agencies in addition to modeling and forecasting. There is also concern that staff turnover may suddenly reduce the capacity to manage modeling efforts and the forecasting system. Even under the TA's asset management component, the fast deterioration of the banking industry has taken its toll in terms of time and energy of the NBK asset managers who had to dedicate most of their attention to managing the crisis. It is clear that additional highly trained personnel are needed. NBK management acknowledges the need.

Recommendation and Follow-Up Action

While inflation targeting has been introduced by law and all stakeholders were officially committed to it, NBK still pursues exchange rate management. The global financial crisis provides an opportunity to increase awareness on the importance of both areas covered by the TA, namely, asset and risk management of official reserves and the National Fund, and the introduction of inflation targeting. ADB should continue its policy dialogue with the Government on these areas, building on the TA's findings and accomplishments.

Prepared by: Lyle Raquipiso

Designation: Senior Economics Officer

² ADB Results Framework indicators are not applicable to this TA.

³ The main sources with respect to international best practice are publications issued by the Bank for International Settlements, the European Central Bank, and by the International Monetary Fund, complemented by the consultants' practical experience in North American and European financial institutions.

⁴ Jointly with the Government, NBK sets broad inflation objectives for three years ahead and publishes an inflation report. Further, NBK has put in place and increased the liquidity of the money market instruments needed to implement inflation targeting, and developed a quarterly inflation forecasting model to better understand and communicate the transmission of monetary policy signals to the real and external sectors of the economy.