



# Technical Assistance Report

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Project Number: 37319  
November 2005

## Technical Assistance Republic of Kazakhstan: Financial Sector Governance Phase II (Financed by the Japan Special Fund)

Asian Development Bank

## CURRENCY EQUIVALENTS

(as of 31 October 2005)

Currency Unit	–	tenge (T)
T1.00	=	\$0.0075
\$1.00	=	T134

## ABBREVIATIONS

ADB	–	Asian Development Bank
AMC	–	asset management company
APF	–	accumulation pension fund
FSAK	–	Agency of the Republic of Kazakhstan on Regulation and Supervision of Financial Markets and Financial Organizations
GDP	–	gross domestic product
NBK	–	National Bank of Kazakhstan
TA	–	technical assistance

## TECHNICAL ASSISTANCE CLASSIFICATION

<b>Targeting Classification</b>	–	General intervention
<b>Sector</b>	–	Finance
<b>Subsectors</b>	–	Banking systems; pensions, insurance, social security, and contractual savings; finance sector development
<b>Themes</b>	–	Governance, sustainable economic growth, capacity development
<b>Subthemes</b>	–	Promoting macroeconomic stability, financial and economic governance, institutional development

## NOTE

In this report, "\$" refers to US dollars.

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## I. INTRODUCTION

1. As part of the Country Strategy and Program Update for 2005–2007,<sup>1</sup> technical assistance (TA) for the second phase of improving financial sector governance in Kazakhstan was included in the nonlending pipeline for 2005. The TA is part of an envisaged series of three financial sector governance TAs over 2004–2006. A Fact-Finding Mission from the Asian Development Bank (ADB) visited Almaty and Astana during 18-22 July 2005 and met with the Agency of the Republic of Kazakhstan on Regulation and Supervision of Financial Markets and Financial Organizations (FSAK); National Bank of Kazakhstan (NBK); Ministry of Economy, Budget, and Planning; Ministry of Finance; Ministry of Labor and Social Protection; financial institutions; and bilateral/multilateral organizations. The Government and the Mission reached an understanding on the objectives, scope, cost estimates, financing, and implementation arrangements for the TA. The TA design and monitoring framework is in Appendix 1.<sup>2</sup>

## II. ISSUES

2. Kazakhstan's financial sector has grown rapidly and, in recent years, has been the fastest-growing sector outside the oil industry. This development has occurred against the backdrop of favorable macroeconomic prospects, an ambitious program of structural reforms, and a cautious fiscal stance supported by increasing oil revenues. The financial sector remains bank-dominated, with banking system assets accounting for almost 50% of gross domestic product (GDP); and the rest (insurance companies, pension funds, equities, and nonbanks), for only about 14% of GDP.

3. Financial supervision is the responsibility of FSAK, an independent agency which was spun off from NBK in January 2004. FSAK is accountable to the President of the Republic and has clear responsibilities and objectives. It has a detailed cooperation agreement with NBK and obtains its funding from the latter. The 2004 update of the joint Financial Sector Stability Assessment by the International Monetary Fund and the World Bank<sup>3</sup> concluded that a suitable legal framework exists for banking supervision, and that compliance with the Basle Core Principles has substantially improved since 2000, with respect to not only the legal foundations but also practical application. However, because FSAK and the legal framework were established only recently, it would be critical to focus on implementation in key areas, including completing the launch phase of FSAK (e.g., adequate staffing and training), achieving effective consolidated supervision, and implementing risk management requirements introduced in December 2003.

4. The banking sector has seen the following recent developments:

- (i) Overall bank loan growth has been rapid and credit risk has grown. Loans grew by 42% in 2004, with the share of "classified" loans (doubtful and bad) rising from 39% in 2003 to 44%, and loan losses rising from 2% of total loans in 2003 to 3% in 2004. Although the banking system's capital adequacy ratio currently seems comfortable (about 16% at end-2004), the rapid credit expansion and the rise in the share of "classified" loans (despite strong real growth) call for closer attention to credit evaluation and risk management capacities and practices in banks.
- (ii) Household deposits have not grown as fast as credit. Hence, banks have tended to rely on wholesale funding (e.g., syndicated loans, Eurobonds, or medium-term

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<sup>1</sup> ADB. 2004. *Country Strategy and Program Update (2005–2007): Kazakhstan*. Manila.

<sup>2</sup> The TA first appeared in *ADB Business Opportunities* (internet edition) on 13 August 2005.

<sup>3</sup> IMF. 2004. *Republic of Kazakhstan—Financial System Stability Assessment—Update*. Washington DC.

notes). Consequently, net external liabilities have risen sharply since 2000. Moreover, the share of foreign currency lending in total bank credit, though declining, remains high at more than 50% of total credit. The situation raises concerns about banks' capacity to manage the foreign exchange and interest rate risks associated with reliance on foreign borrowing.

- (iii) Concentration in certain sectors (e.g., real estate and consumer lending) and large business groups remains an issue. Real estate lending jumped from 15% of total loans in 2003 to 19% in 2004. Also, the emergence of interlinked financial-industrial groups raises the need for strengthening the supervision of related party lending, aggregated large exposures, and bank's risk management practices.
- (iv) In general, the quality of financial and risk management varies greatly among the banks, with smaller banks facing serious challenges in maintaining their viability.

5. As previously noted, legislation and regulations on risk management in banks and consolidated supervision were issued in 2004 and provide a framework for addressing the above concerns. However, for this recently established framework to sufficiently contribute to promoting financial stability, the capacity of on-site inspectors to ensure that banks rigorously apply the regulations needs to be bolstered.

6. Meanwhile, the key to fostering the growth of the nonbank sector is to strengthen its largest component, the pension system. Since the establishment in 1998 of the defined contribution pension system modeled after Chile's, the Kazakhstani private pension system has grown steadily. Employees are required to contribute 10% of their salaries to an accumulation pension fund (APF) of their choice; these funds then delegate the investment to at least one asset management company (AMC). The invested funds are guaranteed to grow by at least the rate of inflation until the contributor retires. In addition, all citizens, including those receiving disability allowances, receive a base pension irrespective of their pension contributions. As of mid-2005, total assets amounted to about \$4.4 billion (10% of GDP). There are about 7 million accounts administered by 15 APFs, of which the largest is the Halyk Bank Accumulation Pension Fund, with 25% of total assets. Coverage is not universal, with most of the rural population and the self-employed not participating; participation in the voluntary (i.e., supplementary) contribution system is also minimal.

7. The funds' investment opportunities are limited by the lack of domestic financial instruments. Consequently, at end-2004, about 54% of their assets were held as government securities (including NBK notes), well above the 25% minimum required holding. Conversely, other holdings are well below the regulatory ceilings; for example, foreign government securities, 0.1% (vs 40%), and Kazakhstani non-state securities, 32% (vs 50%). In turn, the lack of financial instruments is due to the relative underdevelopment of the Kazakhstani financial sector, despite its recent rapid growth. Although, theoretically, diversification into foreign assets could help alleviate this problem, this is not feasible in practice due to the lack of hedging instruments. The funds have recently been allowed to engage in trading derivatives, but this is not likely to help the situation because (i) the regulations still need to be clarified (e.g., the distinction between speculation and hedging); and (ii) derivatives instruments do not exist. In fact, the lack of hedging instruments contributed to the negative returns that the system

experienced in the past 2 years, due to losses from dollar-denominated securities as the tenge appreciated.<sup>4</sup>

8. The limited capacity of APFs and AMCs, combined with their significant fiduciary responsibilities, implies that closer attention to their regulation is also warranted. FSAK has set regulations on investment portfolio, accounting rules, disclosure and announcement requirements, performance evaluation systems, and additional capital contribution requirements for underperforming APFs. However, there are concerns about whether these regulations provide adequate incentives for APFs to improve their financial viability and long-term sustainability. As with banks, the risk management practices of APFs and AMCs require close scrutiny.

9. To assist FSAK in addressing these concerns, the TA will focus on two areas: (i) strengthening on-site banking supervision, and (ii) strengthening the regulation of APFs and AMCs. The TA will build on FSAK's achievements in establishing a sound legislative framework for financial supervision, as well as support the Government's plans to promote Almaty as a regional financial center. The TA will complement, but will be different from TA 4431-KAZ<sup>5</sup> and TA 6137-REG.<sup>6</sup> The former deals with improving NBK's asset management and establishing an inflation targeting framework, and was formulated when FSAK had not yet been fully established. The latter focused on reviewing existing risk management regulations in several countries, rather than on implementation aspects. A sequence of measures is envisaged to promote financial sector development: TA 4431-KAZ will help promote a sound macroeconomic environment, TA 6137-REG will provide the initial inputs for a risk management framework, and the present TA will assist the newly established FSAK in implementing the already well-defined regulatory framework, with focus on the banking sector, as it remains the dominant player in the financial sector. The third financial sector TA planned for 2007 would then focus on developing the nonbank sector.

10. The TA will also complement assistance currently being provided by other sources. First, the European Bank for Reconstruction and Development (EBRD), through due diligence of its participant banks and moral suasion, has helped these entities improve their risk management capacity; these efforts would dovetail well with strengthening the supervisory side of risk management. Second, the United States Agency for International Development's Financial Sector Initiative, which will be completed in late 2005, has (i) provided software to help FSAK monitor APFs' and AMCs' performance and asset allocations; (ii) provided assistance in drafting regulations on consolidated supervision (but not the implementation aspect); (iii) performed analytical studies of the finances and projections of the State Accumulation Pension Fund; (iv) provided training for actuaries, which can become the foundation for future training of pension specialists; and (v) provided expert legal advice on the securitization law and the creation of infrastructure bonds as potential investment vehicles for AMCs.

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<sup>4</sup> The lack of financial instruments is ultimately a matter for financial development policy. Due to the projected high oil revenues and cautious fiscal stance, the stock of Government securities cannot be expected to increase, although there have been recent issues of long-term inflation-indexed Government securities specially marketed to pension funds, and there are plans to issue bonds linked to infrastructure projects. Corporate securities could also fill the gap, but fostering the non-state securities market will require an adequate financial infrastructure, including effective regulation of nonbank financial institutions, good corporate governance, a favorable atmosphere for enterprise listings of equities and bonds, and a sound framework for credit rating and evaluation. In this regard, the Government has established an interministerial working group to study measures to foster financial development, including efforts to promote Almaty as a regional financial center.

<sup>5</sup> ADB. 2004. *Technical Assistance for Financial Sector Governance (Phase I)*. Manila (approved on 08 November 2004 for \$800,000, financed by the Japan Special Fund, ongoing).

<sup>6</sup> ADB. 2003. *Regional Technical Assistance for Regional Financial Sector Development*. Manila (approved on 13 November 2003 for \$800,000).

### III. THE TECHNICAL ASSISTANCE

#### A. Impact and Outcome

11. The overall objective of the TA is to foster a sound, efficient, and broad financial system by strengthening the supervision of banks, APFs, and AMCs. The outputs of the TA will include (i) on-site inspection manuals for evaluating risk management systems and practices of banks, APFs, and AMCs; (ii) a training program for on-site banking inspectors of FSAK; (iii) draft regulations and legislation to improve the effectiveness of on-site banking supervision; (iv) draft regulations and legislation to improve the framework for regulating operating practices, investment allocation, risk management, capital requirements, disclosure and announcement requirements, accounting, and derivatives activities of APFs and AMCs; and (v) recommendations on methods of calculating minimum required returns on pension funds' assets.

#### B. Methodology and Key Activities

12. The TA will undertake the following activities under the two main components:

- (i) Upgrading FSAK's capacity for on-site banking supervision
  - (a) Review the existing framework for on-site supervision of banks and banking groups, with specific focus on the evaluation of banks' risk management systems.
  - (b) Develop and upgrade the on-site banking supervision framework, including risk management regulations, supervisory rating system, on-site inspection manuals, supervisory information system, follow-up mechanisms after inspections, inspection strategies, and corrective action program.
  - (c) Strengthen supervision of banking groups on a consolidated basis.
  - (d) Draft new or amended regulations, guidelines, and manuals to implement the recommendations in (b) and (c).
- (ii) Strengthening the regulation of APFs and AMCs
  - (a) Review existing regulations on risk management, investment allocation, performance evaluation and capital contribution requirements, disclosure and announcement requirements, accounting rules, and derivatives activities.
  - (b) Given (a), draft new or amended regulations to ensure financial viability, long-term sustainability, and competition in the pension system.
  - (c) Recommend measures to improve the tracking and monitoring of individual pension accounts.
  - (d) Recommend methods of calculating minimum required returns on pension assets.
  - (e) Design and implement training programs for the management and key staffs of FSAK, APFs, and AMCs; and on-site inspectors of FSAK.

### **C. Cost and Financing**

13. The total cost of the TA is estimated at \$830,000 equivalent, of which \$470,000 is in foreign exchange and \$360,000 equivalent is in local currency. The Government has requested ADB to finance \$500,000 equivalent, covering the entire foreign exchange cost and \$30,000 equivalent of the local currency cost. The TA will be financed on a grant basis from the Japan Special Fund, funded by the Government of Japan. The Government of Kazakhstan will finance the balance of the local currency cost, equivalent to \$330,000, through the provision of counterpart staff, office space and workshop facilities, remuneration and per-diem of domestic consultants, equipment, and contingencies. The cost estimates and financing plan are in Appendix 2.

### **D. Implementation Arrangements**

14. FSAK will be the Executing Agency for the TA. It is expected to provide the necessary office space, counterpart staff, transportation, and other services for the consultants; and arrange their appointments with relevant organizations. FSAK will coordinate with other government agencies and financial institutions to provide the consultants with necessary data and information and support them in arranging workshops and training programs for the regulators and financial institutions.

15. The TA will require 30 person-months of consulting services: 12 from two international consultants, and 18 from three domestic. The international consultants will be an on-site banking supervision specialist/team leader and a pension fund regulatory specialist. Domestic consultants will include a banking regulatory specialist, a pension fund specialist, and an information technology specialist. Appendix 3 outlines the terms of reference. Consultants will be recruited individually in accordance with ADB's *Guidelines on the Use of Consultants* and other arrangements satisfactory to ADB for engaging domestic consultants.

16. The consultants will submit (i) an inception report within 3 weeks after beginning their services, (ii) two interim reports 3 and 5 months after the start of their services, (iii) draft final reports before the conclusion of the contract, and (iv) final reports after incorporating FSAK's and ADB's comments. All reports must be submitted in both English and Russian. The TA will begin in January 2006 and will be completed in December 2006. A dissemination workshop will be organized near the end of the implementation period to invite comments from international and domestic experts, and disseminate the project findings. The TA will also support training programs for the management and staffs of FSAK, banks, APFs, and AMCs on, among other things, on-site inspections, risk management, and investment policies of APFs and AMCs. Consultants will arrange the dissemination workshop and training programs in close coordination with FSAK and in accordance with arrangements acceptable to ADB.

## **IV. THE PRESIDENT'S DECISION**

17. The President, acting under the authority delegated by the Board, has approved the provision of technical assistance not exceeding the equivalent of \$500,000 on a grant basis to the Government of Kazakhstan for Financial Sector Governance Phase II, and hereby reports this action to the Board.

## DESIGN AND MONITORING FRAMEWORK

Design Summary	Performance Targets/Indicators	Data Sources/ Reporting Mechanisms	Assumptions and Risks
<p><b>Impact</b> Sound financial system with increased efficiency and outreach</p>	<p>Broad money increases from 29% of GDP in 2004 to 32% by 2007</p> <p>Credit to the economy increases from 30% of GDP in 2004 to 32% by 2007</p> <p>Strengthened regulation and supervision of banks, accumulation pension funds (APFs), and asset management companies (AMCs)</p> <p>Stronger institutional capacity of the Agency of the Republic of Kazakhstan on Regulation and Supervision of Financial Markets and Financial Organizations (FSAK)</p>	<p>Economic reports and official statistics from FSAK, National Bank of Kazakhstan (NBK), International Monetary Fund (IMF), and World Bank</p> <p>Asian Development Bank (ADB) review missions</p>	<p><b>Assumptions</b></p> <ul style="list-style-type: none"> <li>• Macroeconomic and political stability</li> <li>• Continuing Government commitment to structural reforms</li> </ul> <p><b>Risks</b></p> <ul style="list-style-type: none"> <li>• Large negative external shock to the economy</li> <li>• Weakened political commitment to structural reforms</li> </ul>
<p><b>Outcome</b> Improved supervision of banks (in the areas of risk management and consolidated supervision) and APFs, and AMCs (in the areas of portfolio allocation, accounting, disclosure and announcement practices, performance evaluation, and additional capital adequacy, etc.)</p>	<p>Decrease in classified loan ratio of the banking system (from 44% of the loan portfolio in 2004 to 30% by 2007)</p> <p>Exposure to foreign exchange risk and market risk in banks properly measured and controlled</p>	<p>Economic reports and official statistics from FSAK, NBK, IMF, and World Bank</p> <p>ADB review missions</p>	<p><b>Assumptions</b></p> <ul style="list-style-type: none"> <li>• Continuing Government commitment to promote financial stability</li> <li>• FSAK maintains operational independence and support of the Government</li> </ul> <p><b>Risk</b></p> <ul style="list-style-type: none"> <li>• Strong economic growth leading to complacency and neglect of proper risk management by banks, APFs, and AMCs</li> </ul>

<b>Design Summary</b>	<b>Performance Targets/Indicators</b>	<b>Data Sources/ Reporting Mechanisms</b>	<b>Assumptions and Risks</b>
<p><b>Outputs</b></p> <p>1. On-site inspection manuals including mechanism for evaluating risk management systems in banks</p> <p>2. A supervisory information system that guides on-site inspectors in evaluating banks</p> <p>3. Strategies to effectively utilize the results of on-site supervision in the next round of supervisory activities</p> <p>4. On-site inspectors able to assess and evaluate risk management systems in banks and banking groups</p> <p>5. New or amended regulations on APFs and AMCs that ensure sound management and long-term sustainability of pension funds</p> <p>6. Strategies to improve identification of pension accumulation of each contributor</p> <p>7. FSAK, APFs, and AMCs able to implement the new and amended regulations</p>	<p>On-site inspection manuals developed by September 2006 and issued by December 2006</p> <p>Supervisory information system developed by September 2006 and put in practice by December 2006</p> <p>Recommendations for follow-up activities and streamlining of on-site inspections prepared by August 2006</p> <p>The majority of on-site inspectors take the training programs</p> <p>Draft new or amended regulations prepared by October 2006 and approved and issued by March 2007</p> <p>Strategies developed by August 2006 and implemented by March 2007</p> <p>Most of supervisory staff and representatives from APFs and AMCs taking the training programs</p>	<p>Official copies of on-site inspection manuals</p> <p>Reports of NBK, FSAK, banks, APFs, and AMCs</p> <p>Training materials and list of participants</p> <p>Feedback from participants and stakeholders</p> <p>ADB review missions</p>	<p><b>Assumptions</b></p> <ul style="list-style-type: none"> <li>• Institutional capacity to implement regulations and manuals</li> <li>• High quality of consulting services</li> </ul> <p><b>Risks</b></p> <ul style="list-style-type: none"> <li>• Loss of qualified and trained staff</li> <li>• Significant delay in drafting and passing regulations</li> </ul>

Activities with Milestones	Inputs
<p>1.1 Review the current policies and practices in on-site inspections of banks and banking groups (by May 2006).</p>	<p>JSF \$500,000</p>
<p>1.2 Develop a mechanism (rating system) to evaluate the risk management systems of banks through on-site inspections (by July 2006).</p>	<ul style="list-style-type: none"> <li>• Consulting services \$400,000</li> </ul>
<p>1.3 Draft an on-site inspection manual incorporating the evaluation mechanism (by September 2006).</p>	<ul style="list-style-type: none"> <li>• Training and workshops \$20,000</li> </ul>
<p>2.1 Develop a supervisory information system which guides on-site inspectors in evaluating banks (by September 2006).</p>	<ul style="list-style-type: none"> <li>• Miscellaneous administration and support costs \$20,000</li> </ul>
<p>3.1 Prepare recommendations to streamline supervisory activities, based on the evaluation of banks (by August 2006).</p>	<ul style="list-style-type: none"> <li>• Contingencies \$60,000</li> </ul>
<p>3.2 Prepare recommendations to improve follow-up activities after on-site inspections (by August 2006).</p>	<p>Government \$330,000</p>
<p>4.1 Draft amendments to regulations to support the upgrading of an on-site inspection framework (by October 2006).</p>	<ul style="list-style-type: none"> <li>• Domestic consultants \$50,000</li> </ul>
<p>4.2 Prepare recommendations to improve on-site supervision on a consolidated basis (by September 2006).</p>	<ul style="list-style-type: none"> <li>• Equipment \$125,000</li> </ul>
<p>4.3 Provide training on the upgraded on-site inspection framework (by November 2006).</p>	<ul style="list-style-type: none"> <li>• Office accommodation and transport \$60,000</li> <li>• Counterpart staff \$60,000</li> <li>• Contingencies \$35,000</li> </ul>
<p>5.1 Review existing regulations on investment portfolios, risk management, performance evaluation, disclosure, accounting, and derivatives activities, and identify issues that need to be addressed (by June 2006).</p>	
<p>5.2 Assess the current investment and risk management practices and performance of APFs and AMCs and identify issues that need to be addressed (by June 2006).</p>	
<p>5.3 Prepare recommendations to introduce new regulations or revise existing regulations to address the issues identified in activity 2.1 (by August 2006).</p>	
<p>5.4 Draft new or amended regulations and guidelines (by October 2006).</p>	
<p>6.1 Review the existing system of tracking and monitoring pension accounts and recommend measures to ensure accurate identification of each contributor's pension accumulation (by August 2006).</p>	
<p>7.1 Conduct training on the upgraded regulations and guidelines for staff of FSAK, APFs, and AMCs (by November 2006).</p>	

**COST ESTIMATES AND FINANCING PLAN**  
(\$'000)

Item	Foreign Exchange	Local Currency	Total Cost
<b>A. Japan Special Fund<sup>a</sup></b>			
1. International Consultants			
a. Remuneration and Per Diem	340.0	0.0	340.0
b. International and Local Travel	30.0	5.0	35.0
2. Reports, Communications, and Translation	20.0	5.0	25.0
3. Training and Dissemination Workshops (workshop materials, translators, and resource persons)	15.0	5.0	20.0
4. Miscellaneous Administration and Support Costs	15.0	5.0	20.0
5. Contingencies	50.0	10.0	60.0
<b>Subtotal (A)</b>	<b>470.0</b>	<b>30.0</b>	<b>500.0</b>
<b>B. Government Financing</b>			
1. Domestic Consultants			
a. Remuneration and Per Diem	0.0	45.0	45.0
b. Local Travel	0.0	5.0	5.0
2. Equipment <sup>b</sup>	0.0	125.0	125.0
3. Office Accommodation and Workshop Facilities	0.0	60.0	60.0
4. Remuneration, Per Diem, and Local Travel of Counterpart Staff		60.0	60.0
5. Contingencies	0.0	35.0	35.0
<b>Subtotal (B)</b>	<b>0.0</b>	<b>330.0</b>	<b>330.0</b>
<b>Total</b>	<b>470.0</b>	<b>360.0</b>	<b>830.0</b>

<sup>a</sup> Administered by the Asian Development Bank (ADB).

<sup>b</sup> Equipment consists of information technology hardware and software necessary for strengthening supervision of banks, accumulation pension funds, and asset management companies. Equipment will be financed from the 2006 budget of the Agency of the Republic of Kazakhstan on Regulation and Supervision of Financial Markets and Financial Organizations' budget for 2006 and purchased in accordance with domestic procurement guidelines.

Source: ADB estimates.

## OUTLINE TERMS OF REFERENCE FOR CONSULTANTS

### A. International Consultants

1. Two international consultants will be engaged. One will also serve as team leader.

#### 1. Team Leader/On-site Banking Supervision Specialist (6 person-months)

2. As team leader, the consultant will be responsible for overall management and implementation of the technical assistance (TA), and timely delivery of these outputs: interim and final reports, management of other consultants, and recruitment and management of resource persons. As on-site banking supervision specialist, the consultant will be responsible for tasks related to the supervision of banks and banking groups. The consultant must have sufficient knowledge and practical experience (over 10 years) in on-site supervision of banks and banking groups. Specifically, the consultant will

- (i) review current practices in on-site inspections on banks and banking groups, and identify areas that need strengthening;
- (ii) review and recommend changes, if necessary, on the regulations for risk management of banks for various types of risks: credit risk, market risk, foreign exchange risk, liquidity risk, and operational risk;
- (iii) develop a mechanism (rating system) for evaluating the risk management systems of banks through on-site inspection which identifies things that need to be looked at during inspections, information to be gathered, ways to derive ratings for each subcomponent, and ways to derive the composite rating for the entire bank;
- (iv) develop an on-site inspection manual including (a) pre-inspection questionnaires, (b) guidance for evaluating management systems for various risks and internal control and compliance assurance mechanisms in banks, (c) ways to derive ratings for each subcomponent and for the entire bank, and (d) the formats of the inspection completion reports submitted to the management of the Agency of the Republic of Kazakhstan on Regulation and Supervision of Financial Markets and Financial Organizations (FSAK) and the management of banks;
- (v) recommend the establishment of a supervisory information system which will guide on-site inspectors in conducting bank evaluation by compiling information from the findings of on-site inspections and other sources such as regular reports and off-site analysis; and advise and supervise the domestic information technology specialist in developing the information system;
- (vi) develop a summarized version of the upgraded on-site inspection manual that can be publicized by distributing to banks or posting on the FSAK website;
- (vii) review the effectiveness of current practices of follow-up after on-site inspections through complementary inspections, reporting requirements, and off-site monitoring; and recommend measures to strengthen the follow-up activities;
- (viii) develop strategies to streamline supervisory activities by effectively linking the supervisory rating of banks with the frequency and focus of inspections in the next round;
- (ix) review and, if necessary, recommend changes to the regulations and practices of supervisory corrective actions under the Banking Law so as to effectively correct the weaknesses of banks at an appropriate stage;

- (x) recommend necessary adjustments to the above-mentioned supervisory frameworks (risk management regulations, rating system, inspection manual, and corrective action program) in the supervision of banking groups on a consolidated basis; recommend additional measures, if necessary, to effectively supervise the activities of banking groups and to prevent the transactions within the groups from undermining the soundness of banks;
- (xi) in consultation with the pension fund regulatory specialist, establish procedures for information exchange and joint or coordinated inspections on banks and subsidiary or affiliated pension funds to strengthen the supervision of banking groups on a consolidated basis;
- (xii) draft new or amended regulations, guidelines, and manuals to realize the above recommendations;
- (xiii) recommend methods of calculating minimum required returns on pension assets; and
- (xiv) design and implement training programs for on-site inspectors on, among other things, (a) the conduct of on-site inspections to assess the risk management systems of banks, (b) evaluation mechanisms for risk management systems of banks and ways to derive ratings for each subcomponent and for the entire bank, (c) follow-up activities after on-site inspections, (d) supervisory strategies with effective use of the rating systems, and (e) other areas identified in the TA.

**2. Pension Fund Regulatory Specialist (6 person-months)**

3. The consultant must have sufficient knowledge and practical experience in regulating pension funds or in advising regulators of pension funds and have deep understanding of the issues of risk management in pension funds. Among other things, the consultant specifically will

- (i) review investment policies, risk management systems and practices in pension funds with a view to ensuring sound financial management activities and long-term perspectives suitable for pension funds; and identify areas that need strengthening;
- (ii) review FSAK regulations on risk management of accumulation pension funds (APFs) and asset management companies (AMCs) for various types of risks, and identify areas that need strengthening;
- (iii) review FSAK regulations on the investment portfolios of APFs with a view to ensuring the soundness and long-term sustainability of APFs and to effectively channeling the long-term financial resources in APFs to productive investment; and recommend changes if necessary;
- (iv) examine the effects of the current performance evaluation system and capital contribution requirement for underperforming APFs from the viewpoint of soundness and long-term sustainability of these funds, and recommend measures including suitable benchmarks to provide adequate incentive for pension funds;
- (v) examine the effects of requirements (including formats) on the announcement and disclosure of pension funds' performance to contributors and the public, and recommend adequate measures to provide proper incentive for sound investment activities, healthy competition, and long-term sustainability of pension funds;

- (vi) review accounting standards and related regulations including the classification of medium- and long-term bonds with a view to ensuring sound investment activities, profitability, and long-term perspectives of pension funds; and recommend adequate accounting rules for the areas under discussion;
- (vii) review the existing system (including information technology system) of tracking and managing pension contributions, administrative capacities of pension funds and the State Center for Pension Payments, and restrictions and punishments on moving pension contributions or creating multiple pension accounts; and recommend measures to ensure accurate identification of each contributor's pension accumulation;
- (viii) review the regulations on derivatives activities of pension funds and the situation of derivatives markets, and recommend adequate regulations to enable pension funds to hedge their foreign exchange risk without exposing themselves to excessive risk related to derivatives;
- (ix) in consultation with the on-site banking supervision specialist, establish procedures for information exchange between departments of FSAK and joint or coordinated inspections on banks and the affiliated pension funds to strengthen FSAK's supervision of financial groups on a consolidated basis;
- (x) draft new or amended regulations, guidelines, and manuals to realize the above recommendations;
- (xi) recommend methods of calculating minimum required returns on pension assets; and
- (xii) design and organize training programs for FSAK management and on-site inspectors, APFs, and AMCs on investment policies, risk management, and other areas identified in the TA.

## **B. Domestic Consultants**

4. To familiarize the international consultants with their tasks, the domestic consultants will translate various documents between English and Russian; research and compile the set of government policies, regulations, and procedures adopted; and ensure that the output of the international consultants is appropriate to the situation in Kazakhstan. The domestic consultants must possess in-depth country and sector knowledge, good contacts with the Government, and excellent command of the Russian and English languages.

### **1. Banking Regulatory Specialist (7 person-months)**

5. The consultant must have sufficient knowledge of banking legislation and regulations and strong analytical and communication skills. The consultant will work closely with the international on-site banking supervision specialist and coordinate closely with FSAK to ensure that the outputs of the consultants are useful to FSAK. The work plan for the consultant will be detailed during inception of the TA, in close coordination with FSAK, and will be within the scope of the TA.

### **2. Pension Fund Specialist (7 person-months)**

6. The consultant must have practical experience in several aspects of the operations of pension funds and strong analytical and communication skills. The consultant will work closely with the international pension fund regulatory specialist and coordinate closely with FSAK to ensure that the outputs of the consultants are useful to FSAK. The work plan for the

consultant will be detailed during inception of the TA, in close coordination with FSAK, and will be within the scope of the TA.

### **3. Information Technology Specialist (4 person-months)**

7. The consultant must be highly skilled in developing information systems and have a good understanding of banking operations. The consultant will work closely with the international on-site banking supervision specialist and coordinate closely with FSAK to ensure that the outputs are useful to FSAK. Specifically, the consultant will develop a supervisory information system to guide on-site inspectors in evaluating banks by compiling information from the findings of on-site inspections and other sources such as regular reports and off-site analysis. The work plan for the consultant will be detailed during the inception of the TA, in close coordination with FSAK.

### **C. Reporting Requirements**

8. The consultants will submit the following reports in both English and Russian:

- (i) an inception report summarizing initial findings of the consultants and detailed work plans for each consultant, within 3 weeks after inception of the TA;
- (ii) first interim report summarizing the activities and interim findings of the consultants, within 3 months after TA inception;
- (iii) second interim report summarizing the activities and interim findings after the first interim report, and proposing options for policy measures based on the findings of the consultants, within 5 months after TA inception;
- (iv) draft final reports 2 months before the conclusion of the contract; and
- (v) final reports after incorporating FSAK's and ADB's comments.