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WP/98/96

INTERNATIONAL MONETARY FUND

European II Department

**Banking System Restructuring in Kazakhstan**

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June 1998

**Abstract**

This paper reviews financial restructuring in Kazakhstan, and the condition of the financial system in the period following independence. The authorities' efforts to redress financial sector weaknesses fall into two phases: The first phase addressed the immediate crises in the banking system by slowing bank licensing, tightening prudential regulations, and dealing with large nonperforming loans. The next phase saw reforms to regulatory and institutional structures. The paper shows that, by the end of 1997, substantial reforms in the structure of the financial system had been accomplished and a major financial collapse avoided. However, the banking system had not begun to play an active role in financial intermediation.

JEL Classification Numbers: E44, E58, G28

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<sup>1</sup>The author would like to thank Lorenzo Figliuoli, Leif Hansen, Oleh Havrylyshyn, Sanjaya Panth, Jan-Willem van der Vossen, and Thomas Wolf for comments on an earlier draft. The author is responsible for remaining errors.

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## SUMMARY

Kazakhstan began restructuring its financial system immediately following independence in 1992. The government's first concern was to restructure the large state banks and tighten entry requirements for new banks. Once a degree of stability was achieved, the government sought to modernize banking operations and the legal and regulatory environment. Between 1995 and 1997, wide-ranging regulatory and accounting changes were introduced, and the prudential and supervisory capabilities of the National Bank of Kazakhstan (NBK) were improved. By the end of 1997, an internationally acceptable regulatory and prudential environment was largely in place.

The experience of Kazakhstan offers a number of lessons. First, the phased implementation of the restructuring permitted many undercapitalized and nonviable banks to continue to operate, posing some threat to the stability of the banking system. While arguably unavoidable, an earlier commitment to restructuring and enforcement of prudential norms could have led to a more streamlined banking sector and improved private sector confidence. Second, banking and enterprise sector reform should be closely coordinated to strengthen both activities and boost the banking system's role in financial intermediation. Third, the weak information base and poor accounting standards led to a considerable period of supervisory forbearance. The Kazakh experience suggests that such forbearance is viable when combined with enhanced monitoring and adequate enforcement rules. Fourth, the asset management companies (AMCs), formed to manage the stock of nonperforming loans removed from the state banks, gave priority to restructuring enterprises rather than rapid closure and liquidation of nonviable enterprises. Finally, the NBK succeeded in preventing a generalized collapse of the banking system, since it followed consistent and coherent restructuring policies.

## **I. INTRODUCTION**

1. Bank failures and banking system failures have become increasingly common as countries liberalize their economies and eliminate government subsidies. Since 1980, more than 130 countries—including industrialized countries, developing countries and countries in transition—have experienced significant banking system problems. These problems often resulted in large financial losses to the government, as public funds were used to restore confidence and solvency, and had a negative impact on economic growth.

2. Three broad conclusions can be drawn from these crises. First, governments must strengthen competition among banks. To do so, regulations must be applied uniformly and consistently to all banks. Second, supervision and prudential regulations must be modernized and enforced. In particular, capital requirements must be brought to or above international standards and loan provisioning for nonperforming loans must be established. Third, governments must modernize accounting and disclosure regulations. Failed banks have frequently shown healthy balance sheets just prior to the emergence of serious financial problems. Inaccurate reporting limits the ability of supervisory authorities to address deteriorating financial conditions in a timely fashion and impedes the ability of market forces to discipline bank management.

3. Following independence in 1992, the countries of the former Soviet Union had to deal with weak financial systems but were hampered by the magnitude and complexity of the other problems they faced. Government institutions had to be restructured, the financial imbalances existing when the Soviet Union was dissolved had to be eliminated, and complex sectoral reforms had to be implemented. As conditions in each country differed, governments gave different priorities to reform measures.

4. Kazakhstan was one of the countries of the former Soviet Union where banking sector reform was given a relatively high priority by the government. This paper describes the reform measures adopted during the first five years following independence. Section II provides a brief discussion of the best practices of banking system restructuring. Section III gives a description of the overall strategy followed in Kazakhstan, and Sections IV and V, respectively, describe the first phase of the restructuring process which ran through 1995 and the second phase which ran through 1997. Section VI describes policies toward banks “too big to fail”, Section VII describes the economic impact of the restructuring program, focusing first on the microeconomic effects and then on the macroeconomic effects. Some brief lessons are provided in the last section.

## **II. BEST PRACTICES OF BANKING SYSTEM RESTRUCTURING**

5. Banking system restructuring is a complex endeavor. The insolvency and poor profitability of individual banks must be reversed, the regulatory environment must be modernized, and supervisory institutions must be restructured. These steps are designed to ensure that remaining banks are strong and any subsequent banking failure does not jeopardize

the stability of the banking system. Important lessons have been learned from the successful restructuring efforts that have been implemented by both industrial and developing countries.<sup>1</sup>

### **A. Program Design and Implementation**

6. Successful restructuring programs have typically been based on a detailed diagnosis of the causes of the crisis and the development of a comprehensive restructuring strategy. This strategy generally includes steps to address individual bank insolvency and shortcomings in the accounting, legal, and regulatory framework. Factors impeding banking operations, such as interest rate controls, high reserve requirements and distortions in the tax system are also identified and their elimination planned. Restructuring programs that address only some of these problems are often ineffective. Successful programs, on the other hand, have tended to address simultaneously both problems of individual banks and problems in the banking environment.

7. The implementation of a comprehensive restructuring strategy involves coordination among a variety of government institutions including the tax authorities, the ministry of finance, and the central bank. Rather than invest any one institution with the responsibility of implementing the restructuring program, many countries established specialized institutions for that purpose. These institutions were often temporary and drew staff from other government institutions or from the private sector. By establishing a specialized institution, other government agencies are able to continue to focus on their traditional responsibilities.

### **B. Individual Bank Restructuring**

8. Problem banks may be insolvent and/or unprofitable. Bank insolvency is a stock problem, reflected in negative net worth, which is dealt with by financial restructuring.<sup>2</sup> Poor profitability is a flow problem caused by some combination of nonperforming loans and high operating costs. These conditions arise when bank management is weak and when risk and credit analyses are inadequate. Flow problems are dealt with through the operational restructuring of the bank.

#### **Financial Restructuring**

9. Financial restructuring improves a bank's balance sheet and increases bank net worth. Instruments for financial restructuring include: (i) improving the management of

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<sup>1</sup>Dziobek, Claudia and Ceyla Pazarbasioglu, 1997, *Lessons from Systemic Bank Restructuring: A Survey of 24 Countries*, IMF Working Paper No. 161, December (Washington: International Monetary Fund).

<sup>2</sup>Bank insolvency, however, may be disguised when nonperforming loans are not adequately provisioned.

nonperforming loans, (ii) transferring nonperforming loans to a special agency, (iii) injecting new capital, and (iv) shrinking bank liabilities. Improved management of nonperforming loans involves working with debtors to develop a loan repayment schedule. A specialized workout unit may be established in the bank to manage these loans. A workout unit has the advantage of bringing together specialized personnel who understand the financial conditions and prospects of the debtors. On the other hand, such a unit may divert scarce human resources and capital from the main business of the bank.

10. A second instrument is the transfer of nonperforming loans from the bank to an asset management company (AMC). Either the bank's nonperforming loans could be replaced by interest-bearing securities of the AMC or the entire balance sheet could be shrunk. The AMC, in turn, manages the nonperforming loans and is responsible for loan collection. The AMC may seek to rehabilitate the enterprise or simply manage the liquidation of the enterprise. If rehabilitation is the objective, the AMC needs both highly technical staff and sufficient capital. If enterprise liquidation is the principal objective, there needs to be clear bankruptcy legislation and a legal staff well versed in the procedures of the bankruptcy process.

11. Injection of new capital is a third instrument for the financial restructuring of banks. Cash injections can come from existing owners, from new investors, or from the government. In the first instance, the owners of the banks should bear the costs by writing down nonperforming loans and then recapitalizing the bank with their own sources. When such recapitalization is not possible, new owners, domestic or foreign, may be sought.

12. A fourth instrument of financial restructuring is the writing down of liabilities or the conversion of debt into equity. Both activities will increase a bank's net worth and lower interest costs. Liabilities may be reduced through negotiation with creditors or by government decree. While reduction in bank liabilities may reduce a bank's costs, it does not provide additional resources to the bank.

### **Operational Restructuring**

13. An adequate framework of strong governance, internal controls, and risk management must be established for a bank to remain solvent and profitable. Strengthening such a framework can require changes in bank management, improvements in internal evaluation procedures, changes in loan recovery procedures, and cost-reducing measures. Operational restructuring frequently begins with a reevaluation of a bank's business plan. Problem banks often must curtail their activities and refocus on core business, eliminate unprofitable activities and narrow their product mix. The improved focus is usually combined with cost-reducing measures such as branch closures and staff reductions. Internal procedures for risk pricing, credit assessment and internal control must also be modernized. When bank management is unable to make such adjustments, the supervisory authorities must have the option of replacing management.

14. Operational restructuring is difficult to design and time consuming to implement. There may be a lack of adequate information on internal procedures and difficulties in changing entrenched operational procedures. Furthermore, changes in bank operations rarely improve profitability in the short run. Nevertheless, financial restructuring in the absence of operational restructuring is usually unsuccessful and incomplete bank restructuring often results in successive rounds of bank restructuring.<sup>3</sup>

### **C. Banking System Restructuring**

15. If the overall financial system is to remain sound, the environment within which banks operate must be improved. Rules must be established governing the exit and entry of banks and both competition and market discipline must be strengthened. Entry requirements are often lax, leading to a proliferation of inadequately capitalized financial institutions. Regulations requiring fit and proper management and sufficient capitalization of new banks must be adopted and enforced. Equally important are the procedures for the exit of banks. Market discipline requires that banks be able to exit the market in an orderly fashion. Bankruptcy procedures must be clear and enforceable; their implementation must be relatively efficient. Legal procedures must also be established for the orderly distribution of the remaining assets of a liquidated bank among creditors.

16. An appropriate legal framework is also necessary, including adequate and enforceable corporate, contract, and accounting laws. A modern and enforceable system of bank regulation and supervision is also necessary. Prudential rules must take into account the evolution of capital markets, inter-bank relationships and the development of modern banking services. The supervisory authorities must have the authority to obtain required information and enforce prudential regulations. While the objective is not to control banking activity, clear limits to risk taking are appropriate.

17. The allocation of the costs of restructuring and the losses derived from the banking crisis must be made explicit by the authorities. This allocation often involves difficult political decisions and the allocation criteria should be made as transparent and as equitable as possible. As described above, financial resources for the recapitalization of the viable but insolvent banks should come from private sources. If recapitalization efforts fail, the best option is to close and liquidate the bank. However, if the bank plays a significant role in the interbank market (is "too big to fail") or if the banking system is in the midst of a generalized banking crisis, the government may find it advisable to recapitalize one or more banks using public resources. Such support is usually carried explicitly in the budget; the central bank generally does not provide long-term financial support to banks.

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<sup>3</sup>Lindgren, Garcia and Saal, 1996, p.93.

### III. SEQUENCING OF BANKING SYSTEM RESTRUCTURING IN KAZAKHSTAN

18. The strategy for restructuring the financial system in Kazakhstan emerged over a period of several years. Upon independence, the government's primary concern was to avert a generalized collapse of the banking system. It focused immediately on the financial restructuring of the large state banks and tightened the entry requirements for new banks. Only when some degree of stability had been achieved in the banking system did the government turn to the more complex task of modernizing banking operations and the legal and regulatory environment. Adoption of this phased approach required significant supervisory forbearance. The most seriously undercapitalized and nonviable banks were closed and liquidated but the National Bank of Kazakhstan (NBK) did not require all banks to meet all prudential requirements and did not penalize banks for noncompliance with prudential norms.

19. The NBK was charged with the development and implementation of the restructuring program.<sup>4</sup> This decision reflected the belief that specialized knowledge of banking issues was necessary and only NBK staff had such expertise. Furthermore, the staff of the NBK was already stretched, as it sought to cope with the demands of managing an increasingly open and liberalized economy, and NBK management was unwilling to second scarce staff resources to another institution. Finally, the government was in the process of rationalizing and shrinking the public sector and did therefore not wish to create a new public sector institution.

20. For a period immediately following independence, a lax licensing policy had been followed, leading to a large increase in the number of undercapitalized and possibly nonviable banks. The first step in bank restructuring was taken in 1993, when the NBK tightened the existing, albeit inadequate, licensing regulations. Another immediate concern of the NBK was the poor profitability of the state banks, caused by the large stock of nonperforming loans accumulated during the Soviet era. The options available to the NBK were limited. The state banks were unable to manage such loans, in part because the borrowers were severely handicapped by deteriorating economic conditions and in part because the banks lacked the experience of operating in a market economy. Furthermore, neither the NBK nor the government was able to recapitalize the entire banking system. The government opted, therefore, to transfer the stock of nonperforming loans to newly created asset management companies and required the state banks to resolve any remaining financial problems themselves. The only resources provided by the public sector came from the NBK's short-term lender-of-last-resort facility.

21. By 1995, sufficient progress had been achieved to permit the NBK to turn to improvements in the broader banking environment. Between 1995 and 1997, wide-ranging

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<sup>4</sup>These efforts were supported by both the IMF and the World Bank. The IMF provided specialized technical assistance in banking supervision beginning in 1993. The World Bank provided technical assistance beginning at the same time.



regulatory and accounting changes were introduced. At the same time, prudential and supervisory capabilities of the NBK were improved. By the end of 1997, the regulatory and prudential environment was largely in place.

22. In this phased approach to restructuring, several factors stand out. First, financial restructuring of state banks was given priority over improvements in bank management and bank operations. This emphasis reflected a number of factors, including the urgency of financial restructuring, the lack of information on bank operations, and a lack of experience in bank restructuring. Second, little emphasis was given to improving or enforcing prudential regulations in the early phase of the restructuring program. Although existing prudential standards were marginally tightened, the NBK did not systematically modernize supervisory and prudential norms. Banks unable to comply with prudential requirements were permitted to operate, albeit under tightened monitoring by the supervisory authorities. The NBK began to close and liquidate nonviable banks only in the second phase of the restructuring process. Finally, the restructuring plan for the banking system was developed in isolation from the restructuring plan for the enterprise sector. Enterprise restructuring focused on privatization of state assets. Issues concerning the emergence and development of a viable private sector, including improvements in the investment climate, lagged significantly behind banking system restructuring. As discussed below, the slow development of the enterprise sector would limit the development of the banking system.

#### **IV. FIRST PHASE: FINANCIAL RESTRUCTURING, 1992-95**

##### **A. Initial Conditions**

23. Prior to 1992, the central bank of the Soviet Union, the Gosbank, was responsible for the allocation of all financial resources to the economy. Enterprises did not have control over their own deposits; enterprise credit resembled budget transfers because amortization was not enforced. The banking system was structured to facilitate this arrangement. In addition to the Gosbank, there were five specialized state banks: the Savings Bank (renamed People's Bank following independence), the Bank for Foreign Trade (Vneshekonombank), the Agricultural Bank (Agroprom Bank), the Industry and Construction Bank (Promstroï Bank) and the Social Investment Bank (Zhilsots Bank). The Gosbank directed credit to these specialized banks, requiring them to on-lend the resources to specified enterprises. After 1988, enterprises were permitted to establish their own commercial banks to mobilize additional resources and a period of rapid expansion in the number of banks followed. The Gosbank, however, continued to be responsible for ensuring that enterprises had sufficient liquidity to meet the central production plan.

24. At the time of independence in 1992, the banking system of Kazakhstan consisted of the National Bank of Kazakhstan (NBK), which had been a branch of the Gosbank, and the five specialized banks. In addition, enterprises had established 72 commercial banks. There then followed a period of rapid expansion of the banking system. Immediately, four of the five specialized banks (all except People's Bank) were reestablished as joint-stock companies and

112 new commercial banks were licensed, increasing the number of financial institutions to 184 by end-1993.<sup>5</sup>

25. Between 1992 and mid-1993, Kazakhstan remained within the ruble area and monetary policy was largely conducted as before. The Central Bank of Russia provided the bulk of financial resources to the NBK, which, in turn, transferred the resources to the specialized banks for on-lending.<sup>6</sup> Following the collapse of the ruble area in mid-1993, however, the conduct of monetary policy fundamentally changed. Resource transfers from Russia ended and, in November, Kazakhstan introduced its own national currency, the tenge. The NBK was made fully independent and more strictly focused on central bank operations, in particular the control of monetary aggregates. Directed credit of the NBK was halted and was replaced by net lending from the budget to enterprises.

26. The rapid growth of the banking system in 1992 and 1993 did not increase financial intermediation. Accelerating inflation and falling real output led to severe financial disintermediation as the private sector shifted its money holdings from rubles into foreign currency held outside the banking system. The deposit base fell from 96 percent of GDP at end-1991 to only 20 percent at the end of 1993. This collapse threatened the viability of the state banks, where the majority of the deposits were held, and the NBK feared that the collapse of one of them could result in a generalized collapse of the banking system. At the same time, the NBK was concerned that many of the new banks had insufficient capital and were not viable.<sup>7</sup> In its move to address these weaknesses of the banking system, the NBK gave priority to tightening its bank licensing policy, improving state bank profitability, and tightening, but not fully enforcing, prudential requirements.

### **B. Bank Licensing**

27. At the end of 1993, 184 banks operated in Kazakhstan, including 177 private commercial and joint stock banks.<sup>8</sup> The government exercised full or partial control of the remaining seven banks: Agroprom Bank, Alem Bank (previously Vneshekonombank),

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<sup>5</sup>People's Bank became a joint-stock company in 1994.

<sup>6</sup>See Balino, Tomas J.T., David S. Hoelscher, and Jakob Horder, 1997, *Evolution of Monetary Policy Instruments in Russia*, IMF Working Paper 97/180, (Washington: International Monetary Fund).

<sup>7</sup>The true extent of undercapitalization, however, was unknown. The size of nonperforming loans was not reported and loans to state enterprises were regularly rolled over (the "evergreening" of the loan portfolios of banks).

<sup>8</sup>Two specialized banks had been privatized: the Industry Bank became Turan Bank and the Industry and Construction Bank became Kredsoz Bank.

People's Bank (previously the Savings Bank), and four newly established state banks, including the Housing Construction Bank, the Rehabilitation Bank (RB), Exim Bank, and the Development Bank.<sup>9</sup> Two of these new banks, the RB and Exim Bank, were established as part of the financial restructuring of the banking system (see below).

28. Most of the 177 commercial banks were established by state enterprises in order to obtain subsidized credit available from the NBK. These banks, however, did not play a significant role in mobilizing domestic deposits but merely channeled NBK credits to the parent enterprises. A large portion of their total credits reflected insider lending to shareholders. Many of these banks did not meet even the relatively lax prudential standards inherited from the former Soviet Union.

29. The NBK's first step was to increase minimum capital required for establishing a new bank. In 1993, the minimum legal capital requirement for banks was increased from rub 5 million for all banks to rub 200 million (approximately US\$200,000 in 1993) for joint stock banks and to the ruble equivalent of US\$1 million for joint venture banks. Then in 1994, the NBK slowed sharply the authorization of new banks, increasing the total number of banks by only 7, to 191, and began a systematic evaluation of the banking system. Although the accounting and disclosure standards were deficient, the banking supervision staff closed obviously nonviable banks and began liquidation proceedings. Initially, the NBK had difficulties in liquidating banks because of the unclear legal framework and uncertain stockholder rights. The NBK responded by creating a special liquidation unit in the banking supervision department (which was later made independent). The powers of that unit were strengthened by a 1995 Presidential decree. In 1995, some 60 banks were liquidated, reducing the total number of banks in the system to just 130 (Table 1). The majority of the banks liquidated by the NBK were small and had low or negative reported capital. The NBK estimated that all these banks would have had negative capital had appropriate loan provisioning been applied.

Table 1. Kazakhstan: Number of Commercial Banks and Branches

	State	Joint-venture 1/	Other	Total	Branches 2/
1991	...	...	...	72	...
1992	...	...	...	158	890
1993	...	...	...	184	952
1994	3	10	178	191	1,022
1995	3	7	120	130	1,036
1996	4	8	89	101	949
1997	4	8	71	83	...

Source: NBK

1/ Foreign participation greater than 50 percent.

2/ Excluding the 4,480 offices of People's Bank.

<sup>9</sup>By end-1995, these seven state banks represented about 35 percent of total commercial banking assets.

### C. Nonperforming Loans

30. The portfolios of the state banks contained a significant portion of nonperforming loans, most of which had been awarded during the previous regime. These loans were not classified and, therefore, overstated the banks' net worth. Consideration was given to providing blanket loan forgiveness, with the government accepting the cost of the loan write-down. However, the NBK was concerned about the moral hazard of such a measure and the possibility that subsequent loan forgiveness would be difficult to avoid.<sup>10</sup> In addition, loan forgiveness would have given an unfair advantage to defaulters. Rather, the authorities opted to establish several AMC's to manage the bad debt.

31. In 1994, a portion of the bad loans was shifted to one of three newly created debt resolution institutions: the Rehabilitation Bank (RB), the Agricultural Support Fund (ASF) and Exim Bank. The RB took over the nonperforming loans of 45 of the largest insolvent debtors, most of which were very large mining and metallurgical enterprises located in company towns. Banks that had on-lent the directed credits to enterprises removed both the nonperforming loans to the enterprise and the liabilities owed to the government, thus, in effect, shrinking their portfolios. The RB gave priority to enterprise rehabilitation rather than liquidation, developing comprehensive downsizing and restructuring plans for each enterprise. The RB provided resources to finance downsizing activities such as severance pay and social asset disposal. By December 1996, 28 enterprises out of a total of 42 had been either privatized (22) or liquidated (6). The revenue from the liquidation of the enterprises was used to reimburse the RB for its liquidity injection.

32. The difficulties faced by the ASF were, if anything, more complex. The ASF was established to finance certain agricultural activities with budget resources, and to take over agricultural loans extended by Agroprom and other banks to some 4,000 insolvent farms. The ASF, however, did not have the technical or organizational capacity either to rehabilitate or to liquidate such a large number of farms. As a result, loans were rescheduled indiscriminately at negative real interest rates. The ASF did require that the farms submit a restructuring plan but was unable to evaluate such plans or to require improvements in them. The ASF was also unable to foreclose on farms. Instead, farms made only minimum or token payments. While farms unable to make even the token payment were excluded from any financial support from the ASF, the debt remained unpaid.

33. Exim Bank took over from Alem Bank most of the outstanding loans funded by foreign export credit agencies which carried government guarantees. From the beginning, however, the bank was plagued with difficulties in managing the nonperforming loans. Much of the debt carried government guarantees and Exim Bank regularly was forced to pass on

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<sup>10</sup>In Eastern and Central Europe, many governments were forced to go through a series of loan forgiveness exercises and stability in the financial system was harder than expected to achieve.

debt service obligations to the Ministry of Finance. In an effort to strengthen the performance of the bank, the government put the accumulated loans on an agency basis, with a collection bonus paid when Exim Bank was successful in collecting principal.

34. Overall, loans totaling 11 percent of GDP were shifted from the original banks to specialized institutions (the RB received loans equal to 1 percent of GDP, the ASF received loans corresponding to 4 percent of GDP and Exim Bank took over loans of some 6 percent of GDP). The nonperforming loans made to small- and medium-sized enterprises, other than farms, remained in the portfolios of the lending banks, and commercial banks were urged to establish internal workout units to deal with them.

#### **D. Prudential Regulations**

35. Prudential regulations in force during the Soviet era covered capital, liquidity, lending limits, and reserve requirements. Capital-liability ratios were specified for banks (1:20 for commercial banks and 1:12 for cooperative banks) and both the size of a single loan to an individual and total household deposits were limited to 100 percent of capital. There were no limits on the aggregate exposure to an individual or group of individuals, nor were there requirements for the provisioning of nonperforming loans. Accounting and reporting standards were inadequate and often did not reflect the true financial conditions of the banks. Enforcement of these prudential regulations was weak.

36. The NBK recognized that modern prudential standards would take time to develop and implement. Some immediate changes, however, were made to bring such standards more in line with international practice. In 1994, the NBK instituted two western-style capital adequacy requirements: a minimum capital requirement of US\$500,000 (US\$1.5 million for banks taking household deposits) and a risk-weighted capital/asset ratio of 8 percent. The NBK also lowered the limits on loans to an individual shareholder to 20 percent of the bank's assets and to 40 percent for any single borrower.

37. The NBK recognized that these tightened prudential regulations could not be met by a large portion of the banking system. Resources for recapitalization could not be raised in the local capital markets and few international investors were interested in investing in bank shares. In addition, most banks exceeded the maximum legal exposure to shareholders and to individual borrowers. However, in the absence of an active interbank market where loans could be sold, banks were unable to diversify quickly their portfolios. If the NBK closed and liquidated all banks in noncompliance with prudential regulations, the banking system would collapse and market confidence could rapidly deteriorate. Therefore, the NBK had little choice but to permit a significant degree of supervisory forbearance, allowing banks sufficient time to meet prudential requirements. Although there were few alternatives to this approach, the NBK recognized the dangers of allowing a large number of banks to be in noncompliance. At the end of 1995, therefore, the NBK initiated a program of enhanced surveillance (see below).

### **E. Financial Conditions of the Banking System**

38. The NBK's initial concern about the imminent collapse of the banking system did not materialize. None of the state-run banks had to be closed and the smaller banks posed little threat to the solvency of the system. In addition, some preliminary steps had been taken to improve the financial position of the larger banks. Notwithstanding these developments, the size of the banking system sharply contracted throughout 1993–95. Prolonged financial disintermediation had reduced broad money from 21 percent of GDP at the end of 1993 to 11 percent at the end of 1995. This reduction reflected a sharp drop in banking system deposits, as currency in circulation remained relatively unchanged at about 4½ percent of GDP. This disintermediation reflected the impact of accelerating inflation and growing concerns about the soundness of the banking system.

39. Total assets of the banking system, before loan provisioning, showed a similar tendency, falling from 23 percent of GDP to only 3½ percent over the same period, almost fully reflecting the slowdown in economic activity.<sup>11</sup> Firm estimates of the size of nonperforming loans during the period were unavailable, but when such information first became available at the end of 1995, classified loans amounted to 32 percent of the banking system's portfolio and the NBK believed that nonperforming loans could amount to as much as 55 percent of all commercial loans.

### **V. SECOND PHASE: OPERATIONAL RESTRUCTURING, 1995–97**

40. Once the immediate crisis had been averted and the rapid expansion of the banking system had halted, the NBK turned to deficiencies in the operating environment of the banking system.<sup>12</sup> The objective of this phase was to put in place an appropriate regulatory and institutional framework. The NBK focused on establishing appropriate legal reforms, implementing accounting reforms and strengthening prudential regulation.

#### **A. Legal Reform**

41. In market economies, laws have at least four functions: defining and protecting property rights, setting rules for exchanging those rights, establishing rules for entry and exit,

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<sup>11</sup>The nonperforming loans of the commercial banks were shifted to AMCs which were included in the monetary survey.

<sup>12</sup>The World Bank assisted the NBK in the development of a financial sector restructuring program through the design of the Financial Sector Adjustment Loan (FSAL). Initial discussions on the components of the program began in 1994. The Board of the Executive Directors approved the loan on June 25, 1996.

and promoting competition by overseeing market structure and behavior.<sup>13</sup> The legal structures inherited from the Soviet era were designed for different purposes, namely facilitating state control over production and distribution. Therefore, a series of reforms needed to be introduced to underpin and strengthen the government's restructuring efforts.

42. The first steps were taken early in the restructuring process. Both the Law on the National Bank of Kazakhstan and a law on foreign exchange operations were passed by Parliament in 1993. Those laws were followed in quick succession by the Law on Banking in April 1993 which eliminated many restrictions on the establishment and activities of banks, including those with foreign participation. By 1995, however, it had become clear that additional amendments were required both to strengthen the legal foundations for lending and to remove regulatory barriers to competition. Rather than return to Parliament, the government opted to pass a series of Presidential regulations implementing the laws. Included in those implementing regulations were clauses that modernized the laws and brought them further in line with international practices. In 1995, Part One of the Civil Code, which clarified property rights, was approved by Parliament. In April 1995, a Presidential Decree on Bankruptcy was issued, introducing both norms for enterprise reorganization and out-of-court settlement procedures and establishing creditor rights. In addition, a Presidential Decree with Force of Law on Mortgages was issued in December 1995. These laws and decrees made judicial procedures speedier and more transparent. Finally, during the same period, Presidential decrees on the operations of the NBK and on the operations of commercial banks were approved and promulgated.

43. A new bankruptcy law, which clarified the legal definition of bankruptcy and defined the reorganization and liquidation process, was adopted in early 1997. The law permits the appointment of a liquidator by the court. Such a liquidator has a wide range of powers. The bankruptcy law governs both financial and nonfinancial institutions.

## **B. Accounting Reform**

44. Accounting and audit practices in the former Soviet Union were primarily concerned with providing information on the implementation of the credit plan and the cash plan. The objectives of accounting in this system were threefold.<sup>14</sup> First, accounting systems were designed to provide financial records of revenues and expenses. Second, they provided an elaborate system for recording aggregate economic data, such as the volume of production, costs of production, and capacity utilization. Third, accounting records were required in some commercial entities to monitor the stocks of material and inventories. No accounting was

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<sup>13</sup>World Development Report, 1966, p. 88.

<sup>14</sup>A. Premchand, 1995, Effective Government Accounting, (Washington: International Monetary Fund), p.47-48.

made of portfolio risk or of the status of loan repayments. These reports, typically, did not provide an accurate measure of the financial status of the banks.

45. Following independence, the poor quality of accounting and financial disclosure limited the ability of the NBK to analyze and monitor the financial conditions of the banking system. Furthermore, the lack of a standardized reporting format limited the ability of the NBK to compare the performance of an individual bank against the standards of the banking system as a whole. To address these problems, the NBK began development of an updated chart of accounts and modern accounting standards. In 1995, a new chart of accounts for commercial banks was designed. New accounting instructions and manuals were drafted to assist in the training of accountants in modern practices. Once the new chart was developed, an intensive program of training in accounting was begun. By 1997, all commercial banks began to run both the new and the old charts in parallel and, by late-1997, all banks shifted to the new chart.

46. The new chart of accounts was not compatible with the existing accounting practices. Accordingly, a Presidential decree established an Accounting Commission in November 1996. The Commission was charged with the development and implementation of accounting standards that are in line with Internationally Accepted Accounting Practices (IAAP). By December 1996, 20 new accounting standards had been approved and will be implemented together with the new chart of accounts.<sup>15</sup>

### **C. Prudential Standards**

47. In 1995, the NBK began the comprehensive modernization of prudential norms and regulations. Regulations were established on liquidity, lending limits, insider transactions, and reserve requirements. In 1996, requirements for loan classification and loan loss reserves were introduced and regulations were issued that more carefully defined a number of the prudential ratios, including limitations on connected borrowers and capital adequacy.<sup>16</sup>

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<sup>15</sup>The accounting standards included: (1) accounting policy and disclosure, (2) financial statement disclosures, (3) statement of operations, (4) cash flow statements, (5) revenues, (6) accounting for fixed assets, (7) accounting for inventories, (8) accounting for financial investments, (9) foreign currency transactions, (10) related party disclosures, (11) accounting for taxes on income, (12) accounting for construction contracts, (13) consolidated financial statements, (14) associated partnerships, (15) financial reporting under joint ventures, (16) accounting for retirement costs, (17) leases, (18) accounting for investment funds, (19) accounting for pension funds, and (20) reporting by oil and gas companies.

<sup>16</sup>For example, when the capital requirement was introduced, no differentiation was made between tier 1 and tier 2 capital. Tier 1 capital is considered the bank's core capital and consists of permanent equity capital and retained earnings; tier 2 capital is comprised of less  
(continued...)



48. While these improvements in prudential regulations brought regulations closer to international standards, their effectiveness was limited. First, the deficiencies in accounting and reporting, described above, made it difficult to monitor the true financial conditions of the banks. Second, most banks were unable to raise capital or to diversify their loans to meet portfolio concentration limitations within the required time period. Furthermore, if full compliance with the capital requirement and the loan loss provisions had been required, the majority of the banks in the banking system would have had to be closed.

49. The NBK recognized that a prolonged period of supervisory forbearance was needed before prudential standards could be fully enforced. At the same time, however, the safety of the banking system required that this supervisory forbearance be combined with heightened monitoring. Accordingly, the banks were required to develop a plan showing how the new requirements would be met within a five-year period. Full and accurate classification of loans was required immediately but the NBK agreed with each bank on a plan to phase in full compliance with the remaining prudential regulations. Each plan was to have monitorable benchmarks and failure to meet any benchmark resulted in supervisory action against the bank (see below).

#### **D. Bank Supervision**

50. Banking supervision in early 1995 suffered from a number of weaknesses. The NBK conducted no regular off-site analysis, instead relying on periodic reports by the banks themselves. Furthermore, the NBK had only 16 staff members conducting on-site analysis, compared with a total of 191 banks with 1,022 branches throughout the country. Finally, a set of progressively stringent enforcement measures were not available; the NBK's only enforcement tool was the revocation of a bank's license. Given the difficulties of the banks in implementing and enforcing prudential requirements, the NBK had to strengthen its ability to supervise the banking system.

#### **Strengthening Supervision Staff**

51. In 1995, the size of the staff of the Banking Supervision Department was increased to 112 and an intensive training program was begun. In 1996, the Supervision Department was reorganized. The staff located at the branches of the NBK in oblasts was moved to headquarters in order to ensure greater control and coherence in supervisory practices. The Supervision Department was reorganized into teams in charge of clusters of banks. As part of the restructuring, the Supervision Department created a special division to conduct off-site analysis. Finally, an autonomous department in the NBK, separate from the Banking Supervision Department, was established in February 1996 to supervise the liquidation of

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<sup>16</sup>(...continued)

permanent capital such as subordinated debt.

commercial banks. This department maintained close contact with the liquidation committees for each bank in liquidation, ensuring that all legal and supervisory requirements were met.

### **Supervision Practices**

52. Beginning in 1995, on-site inspections were intensified; 46 on-site inspections were conducted during the year compared with almost none in previous years. On-site inspections focused on the bank's financial position, the quality of management, risk management capability and the compliance with prudential regulations. Off-site inspections were enhanced by the introduction of a standardized reporting form which made financial reports more informative and allowed the results of the off-site analysis to be linked with the results of the on-site examinations. As accounting standards had not been fully introduced, the revised reporting form offered a short-hand method for evaluating the financial condition of the banks.

53. The NBK used information obtained from the off-site and on-site inspections to identify unsafe and unsound practices. At first, enforcement actions to correct these practices were ad hoc in nature, with the NBK informally communicating required changes to the bank in question. Enforcement actions were taken against 37 banks in 1995 and 33 banks were liquidated, most of them having paid-in capital of less than T5 billion before loan loss provisioning. The NBK also actively encouraged the mergers of weak banks with stronger ones. By 1996, the NBK had developed a full range of enforcement measures. Banks that did not meet required prudential ratios or whose on-site inspection report identified operational deficiencies were first required to sign a letter of commitment citing measures to be taken to resolve the deficiencies. The next enforcement step was the issuance of a written warning by the NBK. If the bank continued to engage in unsafe or unsound banking practices, a written prescription was issued, identifying specific measures to be taken. This written prescription could also prohibit specific operations such as the maintenance of open currency positions or the acceptance of additional deposits. If these measures were unsuccessful, the NBK could withdraw the bank's license and begin liquidation procedures.

54. In May 1996, the NBK announced a program for further strengthening the banking system. Each bank was required to resubmit its business plan, detailing the present financial conditions of the bank, its compliance with prudential standards, and its program for meeting all prudential requirements within five years. The Supervision Department reviewed these plans, requiring revisions where necessary. Liquidation proceedings were initiated against those banks unable to develop a satisfactory plan. The NBK also announced incentives to shorten the transition period from five to three years.<sup>17</sup> Banks able to present a satisfactory plan to meet all prudential standards within three years were allowed (1) to own stock in investment companies, (2) to participate in NBK credit auctions, (3) to conduct international

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<sup>17</sup>A bank meeting the requirement of the program was classified as an "International Standards Bank" and was permitted greater operating freedom. This program was included as part of the World Bank's Financial Structural Adjustment Loan.

operations, (4) to issue bonds, certificates of deposit, and checks, and (5) to act as a custodian of corporate securities.

## **VI. BANKS "TOO BIG TO FAIL"**

55. Throughout the period, the banking system in Kazakhstan was extremely concentrated. In 1992, over 80 percent of total assets were held by the five largest banks. The entrance of new banks reduced the concentration somewhat but, in 1996 and 1997, the largest five banks still represented about 60 percent of total banking system assets. The NBK believed that the failure of any one of these large banks would jeopardize the banking system.

56. In the event, four of the five major banks faced serious financial difficulties during the period 1993–97. The NBK provided required emergency credit to them but also required the adoption of a comprehensive restructuring program. The restructuring plans differed from case to case but had similar components. Owners were required to provision for nonperforming loans and develop a recapitalization plan. During restructuring, most activities of the banks were curtailed. Banks were not permitted to participate in NBK credit auctions and faced restrictions on deposit mobilization. Operating costs were reduced through downsizing and internal credit and risk analysis procedures were improved. Three former state banks were of particular concern to the authorities: Agroprom Bank, Alem Bank, and Turan Bank. Problems in a fourth bank, Kramds Bank, emerged in 1996.

### **Agroprom Bank**

57. During the Soviet period, Agroprom Bank was the principal source of rural finance. At the end of 1993, Agroprom Bank held assets equivalent to some US\$2 billion, the majority of which were loans to farms. However, most farms were unable to make debt service payments because of losses arising from inefficient operations, from the agricultural pricing policies of the government, and from the inefficient distribution system. While the financial position of the bank was strengthened when the nonperforming loans to farms were transferred to the ASF (see above), the profitability of the bank did not improve. A number of nonperforming loans to the agro-industrial sector remained on the books and the financial conditions of the bank's client base was weak. The resource base of the bank also deteriorated, in part because the core clientele of the bank ceased holding deposits at the bank and, in part, because the government stopped channeling agricultural credit through the bank. As a result, the bank severely curtailed its lending activities and, by 1996, the loan portfolio of the bank had fallen to the equivalent of US\$45 million.

58. The owners developed a restructuring program that included a sharp reduction in both staff and the branch network. Branches that could not be sold were closed. At the same time, the bank owners increased paid-in capital. During this period, the NBK suspended the need to meet prudential requirements. The government did not provide resources for the recapitalization of the bank or for the operating expenses of the bank. By late 1996, the bank was completely privatized and operating costs had been sharply reduced.

## **Alem Bank and Turan Bank**

59. Alem Bank and Turan Bank were, respectively, the second and third largest banks in the banking system. The portfolio of Alem Bank, the successor to the Soviet Union's foreign trade bank, was dominated by foreign-currency denominated loans with government guarantees. The portfolio of Turan Bank was dominated by loans to key heavy industries of the former Soviet Union.

60. In 1994, Alem Bank's portfolio was improved by the transfer of government-guaranteed loans to Exim Bank. However, its portfolio remained dominated by nonperforming loans, some of which represented directed credits from the government. The bank's risk management procedures were weak and the quality of the portfolio continued to deteriorate. In mid-1995, Alem Bank faced a severe liquidity crisis. The NBK provided emergency lender-of-last-resort credit and put the bank into conservatorship. Conservatorship was short-lived—lasting only two weeks—during which new management was appointed by the NBK. The new managers agreed to downsize the bank, reduce the bank's large branch network, foreclose on overdue debtors, and tighten both internal credit evaluation and risk management controls.

61. In 1994, Turan Bank's portfolio was strengthened when nonperforming loans to the mining and metallurgical industries were transferred to the RB. However, the bank continued to be plagued by weak credit assessment and risk management procedures. In 1995, the NBK and bank management agreed to rationalize its branch network (the bank had some 85 branches, the largest branch network outside of People's Bank) and its staff. Central control was established over the previously semi-autonomous branches of the bank and a special workout unit was established to manage loans to the largest defaulters. Access to NBK credit auctions was curtailed and limits were put on the bank's ability to mobilize deposits. Finally, the bank was prohibited from paying dividends or royalties to bank shareholders during the restructuring process.

62. Notwithstanding these steps, both Alem Bank and Turan Bank continued to be plagued by financial difficulties in 1995 and 1996. In early 1996 and again in September 1996, Turan Bank required injections of emergency credit from the NBK and was put under conservatorship in September 1996. Alem Bank required further liquidity support in October 1996 and was put under intensive monitoring by the supervisory staff. By late 1996, it became evident that both Alem Bank and Turan Bank required either substantial restructuring or liquidation. Rather than close both the second and third largest banks in the financial system, the NBK opted to merge the two banks and then privatize the merged institution.

63. On January 8, 1997, the Turan-Alem Bank (TAB) was established. The NBK rescheduled its loans to the TAB and the government provided US\$90 million in new capital. The government eased its policy of not recapitalizing banks because of the size and strategic importance of TAB, together with the fact that most of the problem loans carried government guarantees. The new bank faced the combined problems of the old banks. The branch network

inherited from Turan Bank was extensive and unprofitable. The portfolio was dominated by nonperforming loans inherited from Alem Bank. The owners began an extensive restructuring plan, including a complete audit based on international accounting standards, specialized technical assistance to improve the bank's operating procedures, and closure of unprofitable branches.

### **Kramds Bank**

64. In early 1996, Kramds Bank, the fourth largest bank in the financial system, faced a serious liquidity crisis. Kramds Bank was a private bank, unrelated to any previously state-owned bank. Initially, the NBK provided lender-of-last resort financing, requiring in return substantial restructuring measures. Internal credit procedures were revised, the bank was prohibited from using NBK financing facilities, and the bank management was required to develop a plan to resolve the underlying financial difficulties. Notwithstanding these remedial steps, liquidity problems reemerged at midyear. Some emergency financing was again provided. However, when financial difficulties reappeared in October 1996, the NBK refused further liquidity support. Notwithstanding the bank's large size and importance in the banking system, its license was withdrawn and the bank was closed. Following liquidation proceedings, all household depositors were fully reimbursed from the sale of the assets of the bank. Other creditors absorbed some losses. Throughout the process, the NBK refused to recapitalize the bank, stating that the bank had not evolved from any of the state-owned banks and that the bank's financial difficulties resulted from the unsafe and unsound policies of the private owners.

## **VII. IMPACT OF THE RESTRUCTURING PROGRAM**

65. The objective of the NBK's bank restructuring program was to forestall a generalized banking system collapse and to establish a viable banking system. The financial and operational restructuring policies strengthened the microeconomic foundations of the banking system. However, commercial banks have been slow to mobilize deposits or play a significant role in financial intermediation. In this sense, the banking system restructuring process, initiated in the mid-1990s, remains only partially complete.

### **A. Microeconomic Impact**

66. The restructuring policies resulted in a streamlined and more efficient banking system. After allowing a more than doubling in the number of banks between 1992 and 1993 (from 72 to 184), the NBK tightened licensing requirements and began the systematic elimination of unsafe and unsound banks. As a result, the number of banks fell to 83 by 1997 (see Table 1). The banking system, however, remained highly concentrated throughout the period and the composition of the top five banks remained largely unchanged. In 1992, the top five banks had consisted of the formerly specialized banks of the Soviet Union. By December 1996, only one newly established commercial bank had moved into the top five banks. In part, this continuing

concentration of banks reflects the fact that the former specialized banks retained close ties to existing enterprises, while new banks had difficulties attracting established clients.

67. The reported quality of the banking system's portfolio was poor and, in fact, deteriorated during the period for which data are available. At end-1995, banks classified 33 percent of their portfolios, of which almost 15 percent of all loans were classified as bad.<sup>18</sup> International practice suggests that a banking system is considered seriously impaired when 5 percent of the portfolio is classified.<sup>19</sup> As described earlier, the requirements for loan provisioning were tightened and, as a result, the percentage of the classified loan portfolio increased to 41 percent by end-1996. This increase reflected some combination of an underlying deterioration in the loan portfolio and more accurate loan classification. Total provisioning, however, was initially very low, amounting to only 5 percent of the classified loan portfolio in 1995. Under pressure from the supervisory authorities, provisioning increased sharply during 1996, reaching 26 percent of the classified loan portfolio by the end of the year (Table 2).

Table 2. Kazakhstan: Loan Classification and Provisioning: 1995-96

	December 1995		December 1996	
	Total in million tenge	Percent 1/ 100.0	Total in million tenge	Percent 1/ 100.0
<b>Total portfolio</b>	<b>70,423</b>	<b>100.0</b>	<b>64,250</b>	<b>100.0</b>
Standard	47,330	67.2	37,722	58.7
Non-standard	23,093	32.8	26,528	41.3
Doubtful	13,563	19.3	14,909	23.2
Bad	9,530	13.5	11,619	18.1
<b>Provisions</b>	<b>1,199</b>	<b>5.2 2/</b>	<b>6,829</b>	<b>25.7 2/</b>

Source: NBK

1/ Percent of the total portfolio, unless otherwise indicated.

2/ Percent of classified portfolio.

68. In several BRO countries (Baltics, Russia and other countries of the former Soviet Union), protracted shrinkage of the banking system or the failure of one of the larger banks provoked widespread uncertainty within the private sector and, in some cases, a system-wide banking crisis. In Kazakhstan, such a system-wide collapse did not occur in spite of the growth in nonperforming loans, the large-scale liquidation of small banks, and the somewhat unexpected failure of several large banks in 1996. This resilience may be attributable to a

<sup>18</sup>Given the changes in accounting regulations and reporting requirements, there is no comparable information for the period before December 1995.

<sup>19</sup>Lindgren, Garcia and Saal, 1996.

number of factors. First, as discussed below, the deposit base in the banking system remained small and concentrated in People's Bank, widely perceived as having an implicit government guarantee. Deposits of an enterprise, on the other hand, were generally held in a bank with close financial ties to it (for example, with common shareholders). Such deposits were less likely to be withdrawn when financial problems developed in other banks. As a result, the possibility of contagion of banking problems was limited.<sup>20</sup> A second reason for the relative resilience of the banking system was that banks did not have large exposures in the interbank market and a failure in one bank was not likely to provoke the failure of others. While a small interbank market had emerged briefly in mid-1996, the volume of transactions virtually disappeared when the principal creditor in that market, People's Bank, withdrew from the market in an effort to limit commercial risk. While the interbank market continued to exist, turnover remained small and no bank carried a large exposure. Under such circumstances, the unexpected collapse of one bank had a limited impact on the financial conditions of others.

## **B. Macroeconomic Impact**

69. Following independence, Kazakhstan underwent a period of severe macroeconomic instability. The combined impact of the collapse of the inter-state trading system and the adoption of expansionary demand management policies resulted in accelerating inflation and falling economic activity. Inflation peaked at 1,160 percent in 1994 and cumulative GDP fell by over 25 percent between 1992 and 1994. Beginning in 1995, a tightening of fiscal and monetary policies reversed the deteriorating economic conditions. The first positive GDP growth was registered in 1996 and, by 1997, annual inflation (end-period) had fallen to 11 percent. Notwithstanding the success in stabilizing economic conditions and the advances in bank restructuring, the role of the banking system in financial intermediation remained small.

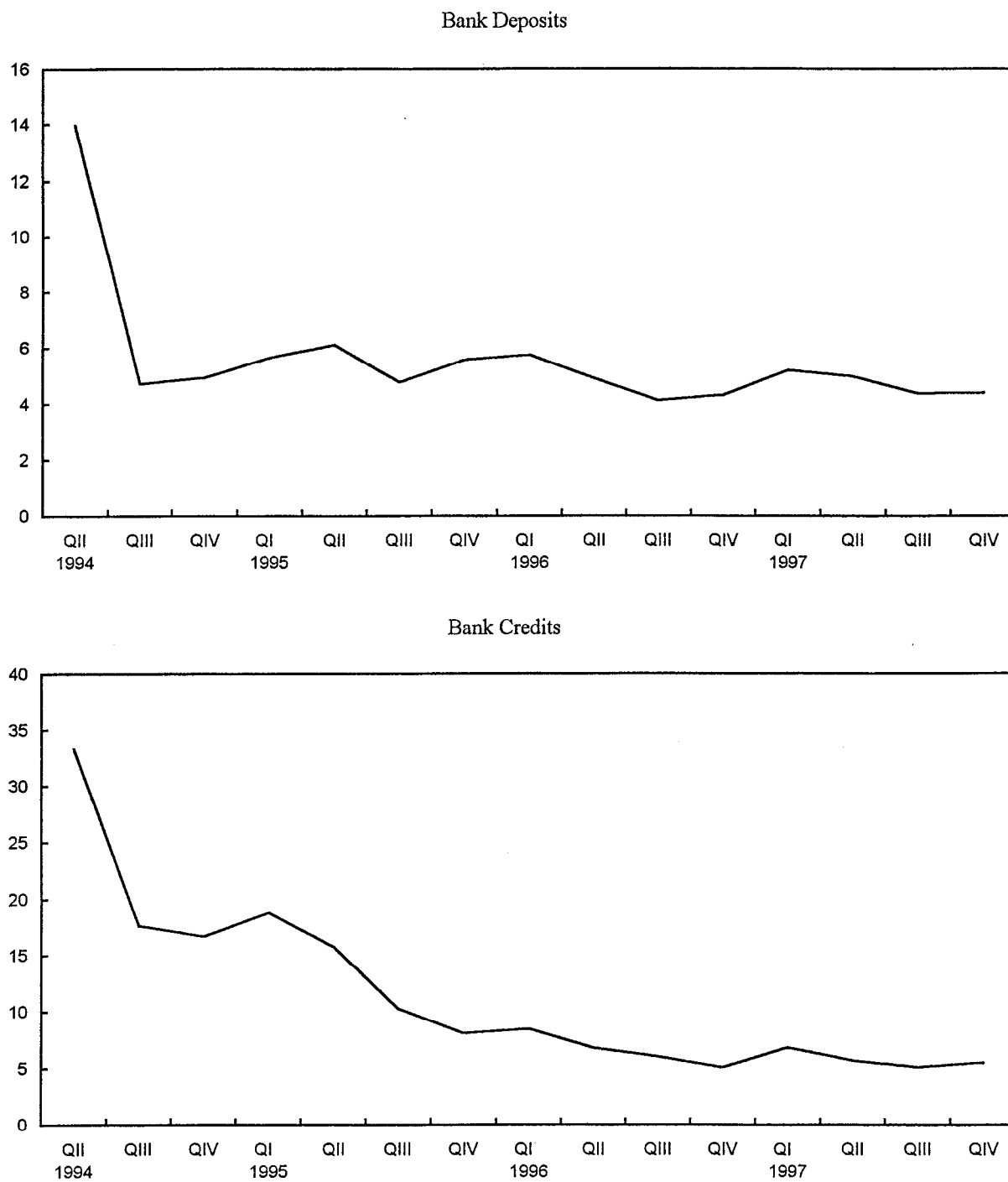
70. Financial intermediation fell sharply between 1992 and 1994 and as yet has not recovered. Two indicators of the scale of intermediation—deposits and commercial bank credit in relation to GDP—show similar trends (Figure 1). Deposits in relation to GDP fell from 72 percent in the first quarter of 1994 to less than 5 percent by the end of 1996 and have remained virtually unchanged since then. The initial decline in this ratio through 1994 could reflect, in part, the elimination of the monetary overhang in the economy. This period was also characterized by rapid inflation in the country. However, the ratio of deposits to GDP has since stabilized, but at a much lower level than was seen either in the countries of Eastern Europe (an average of 45 percent of GDP in 1995) or in the Baltics (between 12 and 14 percent of GDP).<sup>21</sup> Although the ratio has exhibited some seasonal fluctuations, there has

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<sup>20</sup>Similar conditions in other BRO countries may have prevented or limited the contagion effect of banking crises.

<sup>21</sup>For a description of financial sector reforms in Eastern Europe, see Borish, Ding and Noel,  
(continued...)

Figure 1. Kazakhstan: Bank Deposits and Credits, 1994-97  
(In percent of GDP)



Source: National Bank of Kazakhstan.



been no sustained improvement. A second indicator of the scale of financial intermediation is the level of banking system credit in relation to GDP. As above, this indicator fell from 65 percent in the first quarter of 1994 to 4 percent by the end of 1996, and it has remained in the range 4–5 percent of GDP throughout 1997. These levels are also below the averages in Eastern Europe (25–67 percent) and the Baltics (10–32 percent).

71. The low levels of financial intermediation reflected, in part, the lack of private sector confidence in the banking system. The continued existence of nonviable banks together with the lack of transparency in financial statements made households reluctant to hold resources in the banking system. One indicator of this lack of private sector confidence was the steady increase in the currency ratio between 1994 and 1997. The currency ratio was extremely low in late 1993 and early 1994, but increased sharply thereafter. According to the experiences of the Baltic and Eastern European countries, the currency ratio would be expected to stabilize as private sector confidence in the banking sector improved. In the Baltics, the currency ratio stabilized at between 50 percent and 60 percent.<sup>22</sup> In Kazakhstan, however, the currency ratio did not stabilize but rose steadily to over 100 percent by the end of 1997 (Figure 2).

72. Another indication of weak private sector confidence in the banking system is the continued high levels of velocity.<sup>23</sup> Following independence, velocity increased sharply as domestic prices and markets were liberalized and as expansionary demand management policies were followed. Although subsequent stabilization programs resulted in price stability, velocity continued to increase in 1995 and 1996, albeit at a declining pace, before declining somewhat during 1997 (Figure 2).

73. The low levels of financial intermediation cannot be fully explained by the lack of private sector confidence in the banking system. Commercial banks had little incentive to mobilize deposits to lend to private ventures when the risks of such lending were unclear and they could concentrate their portfolios in relatively risk-free assets such as treasury bills and short-term trade financing.<sup>24</sup> As the scope for increasing their holdings of such assets was limited, banks did not want to increase significantly their deposit base. Commercial banks had difficulties identifying creditworthy clients because of the weak accounting practices and the

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<sup>21</sup>(...continued)

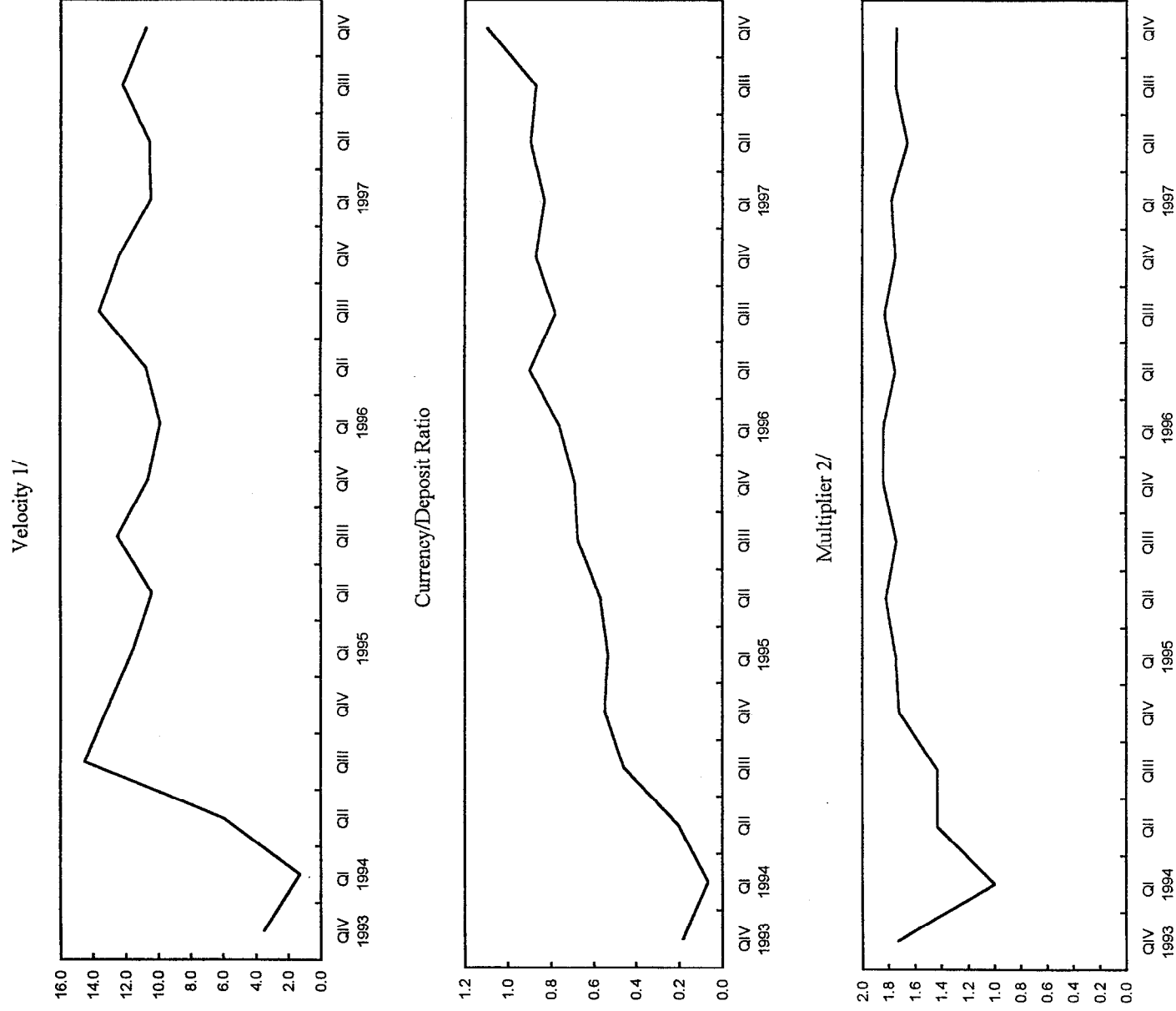
On the Road to EU Access, World Bank 1996. For the case of the Baltics, see Castello-Branco, Kammer and Psalida, Financial Sector Reforms and Banking Crises in the Baltic Countries, IMF 1997.

<sup>22</sup>See Castello-Branco, et al, page 25.

<sup>23</sup>Velocity is defined as annualized quarterly GDP divided by end-period broad money (including foreign currency deposits of the banking system).

<sup>24</sup>Some banks even charged a fee for accepting deposits.

Figure 2. Kazakhstan: Selected Monetary Indicators, 1993-97



Source: National Bank of Kazakhstan.

1/ Annualized quarterly GDP/end-period broad money.

2/ Broad money/base money (end-period).

poor state of financial information provided by enterprises. After making important strides in strengthening their portfolio, bank managers had little incentive to jeopardize their success by lending to clients of unknown creditworthiness. In 1997, some banks began to provide some longer-term loans to special clients. In those cases, however, the banks sought long-term liabilities, such as the placement of a bond in the Euromarket, rather than meet the demand for long-term credit through the maturity transformation of short-term deposits.

74. Following periods of successful stabilization and banking system restructuring, the multiplier is expected to steadily increase, as cash holdings are substituted for deposits.<sup>25</sup> Some increase in the multiplier occurred in Kazakhstan in 1994 but the lack of significant improvement in private sector confidence in the banking system limited further improvements between 1995 and 1997 (Figure 2). During the period, the observed reserve-to-deposit ratio declined for a variety of reasons. First, improvements in the payments system reduced the need to hold excess reserves in the NBK. Second, higher interest rates in the interbank market increased the opportunity cost of holding excess reserves. Finally, the reserve-to deposit ratio fell as the NBK gradually reduced the obligatory reserve requirements applied to bank deposits. However, this gradual reduction in the reserve-to-deposit ratio was offset by a steady increase in the currency-to-deposit ratio, as discussed above.

75. In countries undergoing bank restructuring, it is not unusual for interest rates to be high in real terms and increase sharply during periods of banking sector instability. High real interest rates reflect the perception of higher risks in the banking system. As private sector confidence returns, such rates are expected to fall. In Kazakhstan, real interest rates did fall from a peak in early 1996, stabilizing in mid-1996 through the end of 1997 (Figure 3).<sup>26</sup> The principal exception occurred in late 1996 when real lending rates jumped briefly in response to the collapse of Kramds Bank. However, this pattern of stable real interest rates was not incompatible with low private sector confidence in the banking sector, reflecting instead the generally low levels of financial intermediation, discussed above. Banks had little wish to expand their credit portfolios and had few incentives to mobilize domestic resources.

### **VIII. LESSONS FROM KAZAKHSTAN'S RESTRUCTURING PROGRAM**

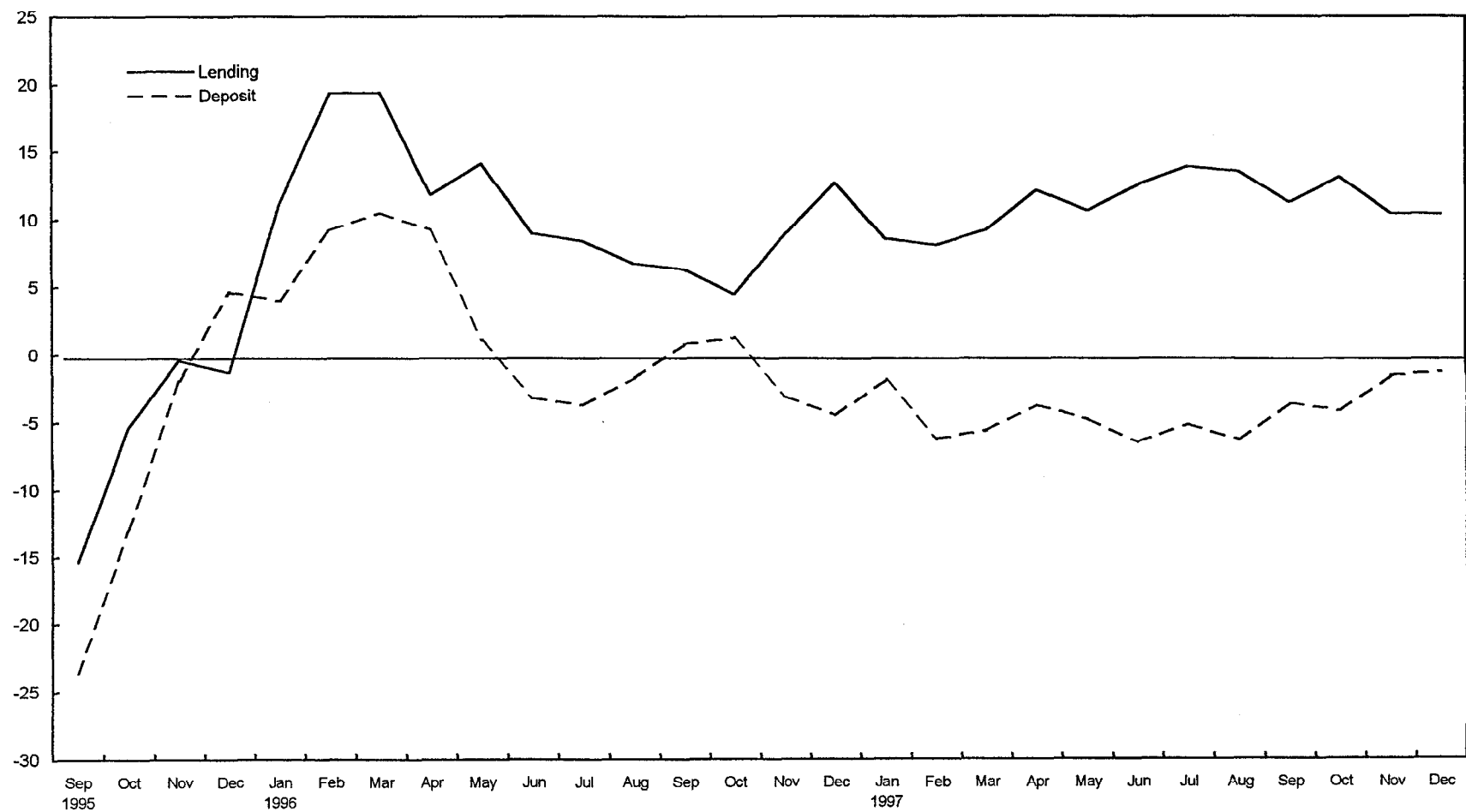
76. Kazakhstan was largely successful in implementing the difficult process of banking system restructuring. The complex tasks of managing individual banking crises and establishing an appropriate operating environment for banks were implemented in a way that avoided a generalized banking failure. A number of profitable banks are now emerging in the market and the number of small and nonviable banks has been sharply reduced. However, the banking system plays a relatively small role in financial intermediation and domestic financial

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<sup>25</sup>And assuming that the currency-to-deposit ratio is larger than the reserve-to-deposit ratio.

<sup>26</sup>Comparable interest rates for earlier periods are not available.

Figure 3. Kazakhstan: Real Interest Rates, 1995-97 1/  
(In percent)



Source: National Bank of Kazakhstan.

1/ Nominal interest rates deflated by annual inflation.

savings remain either small or are held in foreign currency outside the banking sector. These conditions suggest several lessons that can be learnt from Kazakhstan's experience.

### **Sequencing of Reforms**

77. The restructuring process did not begin with a comprehensive plan to deal with both the financial problems of individual banks and the weaknesses in the legal and regulatory environment. Instead, the NBK gave priority to the financial restructuring of banks, leaving operational restructuring and improvements in the operating environment for later. Similarly, the NBK tightened regulations on the entry of banks but postponed measures to facilitate the exit of nonviable banks. These decisions reflected a variety of factors including the government's concern about the financial deterioration of the state-owned banks, the lack of staff with experience in financial matters, and the complex and pressing problems involved in introducing market-oriented economic reforms. Implementation of a more comprehensive approach was also impeded by the poor accounting and reporting standards. While perhaps unavoidable, this sequencing of restructuring permitted a large number of undercapitalized and nonviable banks to continue to operate, posing a threat to the overall financial stability of the banking system. Private sector perceptions of the viability of the banking system were also affected, slowing any improvement in financial intermediation. An earlier commitment to operational restructuring and enforcement of prudential norms could have resulted in a more streamlined banking sector and improved private sector confidence in financial entities.

### **Banking and Enterprise Reform**

78. Banking reform and enterprise reform should be coordinated. Banks mobilize domestic resources for intermediation to viable enterprises and viable enterprises, in turn, provide a needed client base for banks. In Kazakhstan, banking reform outpaced enterprise reform. While the Rehabilitation Bank did attempt to reform large scale metallurgical enterprises, its efforts were not broad based. In addition, development of appropriate audit and disclosure regulations for enterprises as well as improvements in the overall investment climate lagged behind banking system reform. As a result, lending to the enterprise sector was relatively high-risk and emerging banks concentrated their portfolio in low-risk assets such as treasury bills and short-term trade finance. Banks, therefore, suffered from a weak client base and enterprises were unable to raise needed resources in financial markets. Closer coordination between banking and enterprise reform would strengthen both activities and result in a banking system that plays a more active role in financial intermediation.

### **NBK as Lead Agency**

79. The appointment of the NBK as the lead agency resulted in a restructuring program defined largely in terms of supervisory and prudential norms. The government had few alternatives, given the lack of qualified personnel and the work pressures arising from the transformation of the economy. However, linkages with complementary areas of restructuring such as enterprise reform were not emphasized.

## **Prudential Norms**

80. The NBK recognized that prudential norms should be modernized but that significant supervisory forbearance was needed for their implementation. Given weak capital markets and shallow interbank markets, the NBK's ability to enforce all such norms was limited. Accordingly, the NBK opted for an intermediate approach that emphasized transparency. It insisted that nonperforming loans be adequately provisioned but permitted the banks to meet other prudential requirements, including the risk-weighted capital adequacy requirement, over a period of time. In order to minimize risks to the system, the NBK required that all banks develop an acceptable business plan, showing how they would meet prudential requirements over a five-year period, and established measurable benchmarks for the implementation of that plan. In this way, the NBK was clear about the financial conditions of the banking system and stood ready to intervene when any bank was not meeting agreed-upon steps in the restructuring plan. The experience shows that such forbearance is viable when combined with enhanced monitoring and adequate enforcement rules.

## **Operations of AMCs**

81. The AMCs established in Kazakhstan gave priority to restructuring existing enterprises rather than the rapid closure and liquidation of nonviable enterprises. This approach reflected the concerns of the government about the decline of economic activity and the social costs of the transformation. Nevertheless, delays in identifying nonviable enterprises absorbed scarce resources of the government and slowed the emergence of a prosperous enterprise sector. The activities of the AMCs would have been more effective had debtors been quickly closed, assets sold off, and the nonperforming loans quickly liquidated. Such liquidation was a necessary step in the development of a viable enterprise sector.

## **Prevention of a Banking Collapse**

82. The NBK was successful in preventing a generalized collapse of the banking system. The shrinkage of the system in the second half of the restructuring period, including the failure of one of the top five banks in the system, did not provoke a general run on the banking system. Several factors explain this result. First, the interbank market was extremely limited and the failure of one bank did not directly threaten the solvency of other banks in the system. The limited size of the interbank market in part reflected the risk-averse behavior of the largest banks in the system. While People's Bank held the bulk of household deposits and was quite liquid, it limited its exposure to other banks. Other banks in the system were less liquid and less able to lend in that market. Second, the NBK made it clear from the beginning that it would only provide short-term emergency liquidity to banks and would not bail out insolvent and nonviable banks. Bank management, therefore, sought to implement cautious credit policies. Finally, when banks considered "too big to fail" faced financial difficulties, the NBK insisted on a change of bank management, sometimes resorting to conservatorship, and implementation of wide-ranging restructuring policies. Similarly, those banks were prohibited from a wide range of banking activities. These results suggest that the prevention of a

generalized banking failure reflected the combination of avoidance of moral hazard, appropriate restructuring policies and limits on risk-taking by existing banks in the system.

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