



# Technical Assistance Consultant's Report

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Final Report  
Project Number: TA- 4747 (KGZ)  
November 2007

## Kyrgyz Republic: Supporting Banking Sector Development

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This consultant's report does not necessarily reflect the views of ADB or the Government concerned, and ADB and the Government cannot be held liable for its contents.

**Asian Development Bank**



## **CURRENCY EQUIVALENTS**

(as of 30 September 2007)

Currency Unit	–	Som
Som 1.00	=	\$ 0.2677
\$1.00	=	Som 37.35

## **ABBREVIATIONS**

ADB	–	Asian Development Bank
CAMEL	–	Capital, Assets, Management, Earnings, Liquidity
IMF	–	International Monetary Fund
MOU	–	Memorandum of Understanding
NBKR	–	National Bank of the Kyrgyz Republic
PRGF	–	Poverty Reduction and Growth Facility
TA	–	Technical Assistance

## **NOTE**

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



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## I. INTRODUCTION

1. This report summarizes the outcomes of the technical assistance (TA) provided to the National Bank of the Kyrgyz Republic (NBKR) under the banking sector component of TA – 4747 (KGZ): Supporting Banking Sector and Capital Market Development, contract S08724. At the conclusion of the TA contract, all of the banking sector policy matrix conditions for the Banking Sector and Capital Market Development Program have been met with two exceptions. As noted in this report, the NBKR now has the capacity to meet these two outstanding conditions, putting full compliance with all the banking sector requirements well within reach.

2. The terms of reference contemplated commencement of work April 1, 2006, with completion by October 30, 2007. The initially agreed workplan with notes on changes and the final status of each key task is included as Appendix 1. Work actually began in March, 2006, due to the requirements of the National Bank of the Kyrgyz Republic (NBKR) to fast-track completion of two prudential guidelines. The workplan agreed with the NBKR would have resulted in early completion of the assignment in June 2007, however, it was later agreed at the request of the NBKR to defer the final mission until September 2007 to provide additional time for the completion of draft assessments of home country supervision. All elements of the technical assistance have now been completed, in advance of the originally planned end-October completion date.

3. The objective of the assignment was to support the staff of the NBKR in implementing policy reform measures in pursuit of the objectives of the Banking Sector and Capital Market Development Program. This involved working closely with the Bank Supervision Department and the Department of Supervision Methodology of the NBKR on four specific tasks:

- i. preparation of two prudential guidelines, one addressing market risk, and the other addressing country risk, to assist banks in implementing the broad provisions of the Regulation on Minimum Risk Management Requirements for Banks;
- ii. review of existing approaches to on-site verification of banks' risk management practices, preparation of revisions as necessary, and as agreed with the NBKR provide training to NBKR staff;
- iii. support the introduction of a formal process for effective home-host supervisory relationships by developing a methodology for assessing the quality of globally consolidated supervision exercised by home country supervisors as well as the quality of parent bank oversight of foreign-owned banks operating in the Kyrgyz Republic; and
- iv. assist the NBKR in preparing a formal assessment of individual bank supervision objectives in 2006, and based on this analysis, develop recommendations for inclusion in the 2007 Supervision Strategy for individual banks as well as for reforms, if needed, to NBKR policies and procedures and the broader legal framework for banking supervision.

4. In addition to the four specific objectives in the original terms of reference, at the request of the NBKR advice was provided on a number of additional topics, and additional training seminars were delivered for both NBKR staff and staff of commercial banks. These additional activities were accommodated within the original three person month time allocation under the project, although an additional two days have been provided for review by the consultant of documents produced by the NBKR after the completion of the final field visit. Two of the four missions undertaken for the assignment were combined with other projects requiring travel to Central Asia, realizing significant savings on out-of-pocket expenses, primarily airfare and per diems, resulting in completion of the assignment well within the original resource envelope.

5. Most of the outputs of the project are available in both English and Russian, but a few, as noted in parenthetical references in this report, are provided in one language only. To minimize costs extensive use was made of translation software. Final polished translations of some documents were not required for operational purposes, and for these the cost of human translation was not incurred.

## **II. PREPARATION OF GUIDELINES ON MARKET RISK AND COUNTRY RISK**

6. Work on preparation of the guidelines on market risk and country risk was accelerated at the request of the NBKR due to their inclusion as end-June 2006 structural benchmarks in the International Monetary Fund (IMF) Poverty Reduction and Growth Facility (PRGF). It would have been preferable to proceed with the timeline contemplated in the Banking Sector and Capital Market Development Program, as this would have provided more opportunity to develop NBKR capacity concurrently with the preparations of the draft regulations, and also provided a longer period than proved possible for industry consultation. Nevertheless, at the request of the NBKR drafts of both guidelines were prepared during home office work in March-April 2006, with NBKR versions reviewed and discussed during the initial field visit. Final versions of the guidelines are included as appendices 2 and 3.

7. The final version of the guideline on country risk contains a weakness in that section 5 requires banks to establish country risk provisions of between zero and 25 percent of the provision established for credit risk for specific assets. This is not wholly consistent with either of the accepted international approaches, and has the practical difficulty that if a loan is otherwise performing as agreed and thus requires no provision for borrower-specific credit risk, requiring an additional 25 percent of the zero provision would result in a zero provision. It is also possible that adding an additional 25 percent beyond the amount required for borrower specific-credit risk might be insufficient in a particular set of circumstances. While this is not a fatal flaw as the existing guideline on credit risk management requires banks to establish adequate provisions taking into account all aspects of the credit, it would be better for the NBKR at a convenient time to amend the country risk guideline to require banks to establish appropriate provisions for country risk using one of the two approaches endorsed by the Basel Committee. Details on these approaches were provided to the NBKR in the original draft guideline prepared by the consultant.

## **III. DEVELOPING CAPACITY FOR VERIFICATION OF BANKS' RISK MANAGEMENT**

8. The two principal elements of this task were the development of on-site examination procedures to be incorporated into the NBKR's existing methodology, and delivery of training. Responding to requests from the NBKR, it was agreed that work on the training component of this objective would be extended beyond the originally planned two seminars for NBKR staff. Following discussion, outlines were agreed during the second field mission for three training seminars to be delivered in January 2007. A one-day seminar was delivered to staff of commercial banks covering both country-risk and market risk. For NBKR staff, training consisted of a one-day seminar on country risk, and a seminar extending over two days on market risk. Presentation materials for the three seminars are included as appendices 4 – 11.

9. Key elements of the seminars were the presentation of realistic examples and group exercises based on mini-case studies, specially prepared to be relevant to the situation of Kyrgyz banks. These specific examples supplemented training courses in risk management

delivered in June 2006 by Bearing Point staff to the NBKR and commercial banks, which provided a good generic introduction to the issues. The seminars for NBKR staff focused on issues relevant to on-site inspection procedures for market risk and country in addition to the overview material covered in the sessions for commercial bankers. The custom exercises and mini-cases are included as appendices 12 – 16.

10. Preparation of on-site procedures for use by NBKR examination staff, which had been planned for completion during home office work in the first half of 2007, was accelerated at the request of the NBKR, with work beginning during the October-November 2006 field visit. Draft procedures on country risk management, using internationally accepted approaches customized for the situation of Kyrgyz banks, were provided in November 2006. A similar approach was taken to the preparation of draft market risk procedures, which were delivered to the NBKR in December 2006. These draft procedures are included as appendices 17 and 18.

11. The NBKR seriously considered the approaches recommended for on-site procedures for country risk and market and prepared for review during the September 2007 field visit a new version of its on-site methodology document. The NBKR approach built on the materials that had been provided, with some further revisions to better suit local conditions. Two aspects from the draft procedures provided by the consultant had not been incorporated by the NBKR. After further discussion, it was agreed that the NBKR would make further amendments to its methodological documents, and that a new draft would be reviewed by the consultant in further home office work. Inclusion of the two topics—an overarching approach to assessing market risk management; and specific review of interest rate-risk management—are necessary to fully meet the ADB policy matrix condition (S.5.).

#### **IV. ENHANCING HOME - HOST SUPERVISORY RELATIONSHIPS**

12. Following discussion with the NBKR to agree on the general approach, the consultant prepared for review an outline of a process to assess the quality of globally consolidated supervision undertaken by home country supervisors. This outline is included as appendix 19. The expert worked with a team from the NBKR to complete a pilot process for one foreign jurisdiction, Kazakhstan, during the January 2007 field visit. Due to other work priorities on the part of the NBKR, the pilot was not fully completed at the end of the mission. The final draft was subsequently provided March 23, reviewed by the expert and finalized.

13. In addition to an assessment of home country supervision, the procedure also contributed to establishing an agenda for bi-lateral discussions between the NBKR and the Kazakhstan Financial Supervisory Authority with a view to enhancing the home-host relationships to the levels outlined by the Basel Committee. The NBKR undertook the bi-lateral meeting in April, 2007, with the ADB providing funding assistance for the travel expenses involved.

14. The process agreed with the NBKR provided that following completion of the pilot, NBKR staff would complete drafts for the three other relevant jurisdictions, which would be reviewed during the last field visit. The NBKR were provided with a range of background and resource material for the three jurisdictions to assist them in following the agreed methodology. At the request of the NBKR, the last field visit was delayed from June to September 2007 to provide more time for completion of drafts. In the event, only one draft—for Russia—was available for review during the field visit. The NBKR had done a very competent job, illustrating development of the capacity to complete such reviews without further assistance. Completion of the two

additional assessments—Turkey and Pakistan—is required to fully comply with the policy matrix condition (S.7.). It was agreed that the NBKR would complete these assessments for subsequent home office review by the consultant.

15. The NBKR prepared a methodological document for home country assessments, drawing on the process recommended by the consultant. This was adopted by resolution of the NBKR Supervisory Committee in July, 2007, serving to incorporate the process into the ongoing practice of supervision. This should ensure that the process continues, and is not just a one-off to meet the policy matrix requirement. The NBKR resolution (Russian only) is included as Appendix 20.

## **V. REVIEW OF ACHIEVEMENT OF SUPERVISORY OBJECTIVES**

16. During the first three field visits the consultant reviewed with NBKR supervision staff progress to date with banks having CAMEL ratings of 3 or 4, and the supervisory strategies developed for 2006 and 2007. The NBKR supervisory strategies are generally appropriate and the cases of the banks posing the largest supervisory challenges indicate that the most significant obstacles to achieving supervisory objectives lie with the judicial system. The introduction of new legislation on anti-money laundering may be of some help, but more generally, without the introduction into the Kyrgyz judicial system of the concepts of deferring to the expertise of the supervisory authority, and limiting the appeal process to a review of the legal merits rather than considering new facts and arguments, the NBKR will face considerable delays and obstacles in the enforcement of supervisory action.

17. During the first field visit the NBKR requested that in addition to the review of supervision strategies, the expert review the history of Ak Bank, which was the first bank to be closed using the 2003 Law on Conservatorship and Liquidation of Banks. Although this work was begun during the first field visit, it has been overtaken by events as major amendments introduced into the Law on Conservatorship, Liquidation and Bankruptcy of Banks in August 2006 significantly change the regime for dealing with problem banks. The changes mean that procedural lessons from Ak bank will not be applicable in future.

18. The August 2006 amendments serve to make the bankruptcy and liquidation of banks once again subject to the Law on Bankruptcy, reverting to the unsatisfactory conditions existing before the adoption of the Law on Conservatorship and Liquidation of Banks. Creditor consent is required under the Law on Bankruptcy for most actions, providing scope for extensive delay and obstruction in problem bank resolutions, and raising numerous conflicts between the provisions of the Law on Conservatorship and Liquidation of Banks, and the Law on Banking, with the Law on Bankruptcy. This latter point has been recognized by Parliament, and the NBKR has been charged with proposing amendments.

19. The initial approach of the NBKR was to take advantage of the opportunity of proposing amendments to introduce various requirements for NBKR approvals to minimize the damage from the introduction into the law of a concept of mandatory rehabilitation of a bank, including the possibility that a court might order restoration of a banking license despite the objections of the NBKR. Considerable effort was devoted to review and discussion with NBKR staff, culmination in the preparation of a set of proposed amendments that would make the best of a bad situation. In September 2007 the NBKR Board opted to pursue the preferable option of proposing amendments to repeal the August 2006 amendments. However, it is not clear that these will be supported in Parliament, and the NBKR may yet have to propose the amendments

drafted with the intent of limiting the damage rather than completely repealing the August 2006 amendments.

## VI. ADDITIONAL TOPICS

20. In addition to the tasks included in the original terms of reference, further work was undertaken to support other aspects of the Banking Sector and Capital Market Development Project, and in response to specific requests from the NBKR for additional training and technical assistance.

21. As a policy condition the NBKR is required to be one of the signatories of an MOU with the bodies represented in the Financial Sector Regulatory Working Commission. During the first field mission the consultant recommended that two MOUs would be more appropriate, one between the NBKR and the non-bank supervisory authority, and a tripartite MOU including the Ministry of Finance as well as the supervisory authorities. The consultant provided the NBKR with samples of such bi-lateral and tri-partite MOUs, and the Basel Committee guidance on essential elements of a statement of cooperation between supervisors. The bi-lateral agreement was signed, and the tripartite agreement was in the final stages of negotiation at the time of the last field mission.

22. The NBKR requested assistance with a draft regulation to implement section 7(4) of the Banking Law dealing with anti-monopoly provisions. While not within the scope of the original terms of reference, comments were provided on the draft regulation during the second and third field visits. Further, at the specific request of the NBKR, a training seminar on the application of antitrust law to the financial sector was developed and delivered for NBKR staff. The presentation materials for this seminar are included as Appendix 21.

23. The NBKR also requested assistance with the implementation of consolidated supervision. While not included in the original terms of reference, consolidated supervision does have some relevance to the work on home-host relationships, and is also related to the policy requirement that the NBKR work with the new non-bank supervisory agency to establish effective consolidated supervision. At the request of the NBKR the consultant reviewed the draft consolidated supervision regulation in home office work prior to the second field visit, and discussed the issues during the second field visit. In response to further requests from the NBKR, the consultant provided advice with respect to reporting requirements, application of prudential standards to groups, use of bank holding company regime, and supervisory approaches to banking groups and conglomerates. In-depth attention to these issues was far beyond what could be addressed in the limited time available, but generic consolidated supervision procedures for on and off-site work, and sample reporting formats, was provided during the final field visit. The draft generic supervisory procedures are included as appendix 22 (English only).

24. During the second field visit the NBKR requested assistance with the development of on-site procedures for to assess liquidity risk management in addition to the country risk and market risk procedures explicitly included in the terms of reference. These were completed and delivered to the NBKR in November 2006. A copy of the draft procedures is included as appendix 23.

25. In August 2006 the NBKR requested assistance in developing a strategy to deal with Basel II issues. While outside the original terms of reference, the consultant prepared a

background note which was delivered to the NBKR within a week of receipt of the request. This background note is included as appendix 24 (English only).

26. During the second field visit, the NBKR requested that the consultant provide examples of approaches taken in other countries to provide the supervisory authority with the legal power to ensure bank auditors were properly qualified and acceptable to the supervisory authority. The issue arose because it had been suggested that because auditors were to be overseen by the new financial supervisory agency, the NBKR should not be involved in vetting and potentially removing bank auditors. The consultant advised that Basel Core Principle 22 requires the supervisory authority to have this power, and provided the NBKR with examples of the legal provisions from a range of countries with varying legal traditions and supervisory structures. A copy of these examples is included as appendix 25 (English only).

## Appendix 1: Workplan and Mission Schedule

(work undertaken in Bishkek in italics)

### A: Assistance with preparation of regulations on market risk and country risk:

Task	Timing	Status
1. Review legal framework and requirements in neighboring countries (home office)	Mar-Apr 2006	Completed on schedule
2. Provide initial drafts (home office)	Mar-Apr 2006	Country risk draft delivered March 25, 2006 Market risk draft delivered April 20, 2006
3. <i>Assist in revising NBKR drafts prior to circulation to industry for comment (field visit)</i>	<i>May-Jun 2006</i>	<i>Completed on schedule</i>
4. Assist with response to industry comments and preparation of final drafts (home office)	Jun 2006	Not requested by NBKR

### B: Development of capacity for on-site verification of banks' risk management processes:

Task	Timing	Status
1. Collect source data for workshop case-studies	Sep-Oct 2006	Completed on schedule
2. <i>Review current NBKR on-site procedures for review of risk-management (field visit)</i>	<i>Oct-Nov 2006</i>	<i>Completed on schedule</i>
3. Prepare draft on-site procedures for on-site review of risk-management (home office)	Nov-Dec 2006	Completed on schedule
4. Prepare training workshop for NBKR staff on country risk (home office)	Nov-Dec 2006	Completed on schedule
5. Prepare training workshop for NBKR staff on market risk (home office)	Nov-Dec 2006	Completed on schedule
6. <i>Deliver training workshop for NBKR staff on country risk (field visit)</i>	<i>Jan 2007</i>	<i>Completed on schedule</i>
7. <i>Deliver training workshop for NBKR staff on market risk (field visit)</i>	<i>Jan 2007</i>	<i>Completed on schedule</i>
8. <i>Review and finalize on-site procedures for review of risk-management (field visit)</i>	<i>May 2007</i>	<i>NBKR draft reviewed Sep 2007—further work required on overall approach to market risk management, and interest rate risk—consultant to review further NBKR drafts in home office work.</i>
9. <i>Deliver training workshop for commercial bankers (field visit)</i>	<i>Addition to original plan—Jan 2007</i>	<i>Completed on schedule</i>

### C: Enhancing Home-Host Supervisory Relationships

Task	Timing	Status
1. <i>Review existing home-host relationships, select jurisdiction (Kazakhstan) for pilot (field visit)</i>	Oct-Nov 2006	Completed on schedule
2. <i>Agree on outline for structured process to assess adequacy of home country consolidated supervision and oversight of Kyrgyz bank by parent (field visit)</i>	Oct-Nov 2006	Completed on schedule
3. <i>Develop plans for formal contacts with foreign supervisors with respect to specific banks, with a view to introducing measures for coordination and information sharing into the 2007 supervision strategies (field visit)</i>	Oct-Nov 2006	Completed on schedule
4. Background research to support assessment process (home office)	Nov-Dec 2006	Completed on schedule for Kazakhstan—delivery of material for Russia, Turkey and Pakistan delayed to March 2007
5. <i>Complete first assessment process, creating a template that the NBKR can then replicate for all foreign-owned banks (field visit)</i>	Jan 2007	<i>Partially completed during Jan 2007 field visit—final completion deferred by NBKR until Mar 23—draft reviewed and finalized through home office work</i>
6. Support NBKR as required in completion of assessments of home supervision and parent bank oversight for all foreign-owned banks (home office)	Jan-Apr 2007	Completed extended to Sep 2007 at NBKR request—subsequent further extension for last two countries—Turkey and Pakistan
7. Provide NBKR with draft agenda for bilateral meeting with foreign supervisors (home office)	Jan-Apr 2007	Completed on schedule for pilot—Kazakhstan—Russian assessment indicated no requirement for a meeting. Assessments of Pakistan and Turkey not yet complete.
8. <i>Review NBKR completed assessments (field visit)</i>	May 2007	<i>Deferred at NBKR request to Sep 2007—Russia draft reviewed and finalized; Turkey and Pakistan still outstanding.</i>
9. <i>Participate in bi-lateral meeting with Kazakhstan FSA (if desired by NBKR)</i>	May 2007 (to be confirmed)	Not required by NBKR.

D: Review of Supervisory Objectives; Identify Legal or Procedural Obstacles

Task	Timing	Status
1. <i>Initial review of supervisory strategies for 2006, focusing on banks rated 3 or 4, and review of AK Bank chronology (field visit)</i>	<i>May-Jun 2006</i>	<i>Completed on schedule</i>
2. <i>Review of legal issues and policies for supervisory enforcement actions (home office)</i>	<i>Jul 2006</i>	<i>Completed on schedule</i>
3. <i>Review progress to date with 2006 supervisory plans and provide preliminary views on 2007 supervision strategy (field visit)</i>	<i>Oct-Nov 2006</i>	<i>Completed on schedule</i>
4. <i>Assist in formal post-review of 2006 supervision plans and work with NBKR to identify any needed legal or policy amendments (field visit)</i>	<i>Jan 2007</i>	<i>Work began in Oct 2006 due to August 2006 amendments of the Law on Conservatorship and Liquidation of Banks—review of NBKR proposed amendments completed Sep 2007.</i>

Planned Mission Schedule (actual dates in italics)

Dates	Planned Topics
May 25-Jun 2, 2006 <i>May 25-Jun 2, 2006</i>	<ul style="list-style-type: none"> <li>• Discuss and agree on a workplan</li> <li>• Review draft guidelines on country risk and market risk</li> </ul>
Oct 27-Nov 3, 2006 <i>Oct 25-Nov 2, 2006</i>	<ul style="list-style-type: none"> <li>• Review current NBKR on-site procedures for review of risk-management</li> <li>• Review existing home-host relationships, select jurisdiction (Kazakhstan) and bank for pilot assessment of quality of consolidated supervision and oversight by parent bank</li> <li>• Agree on outline for structured process to assess adequacy of home country consolidated supervision and oversight of Kyrgyz bank by parent</li> <li>• Review progress to date with 2006 supervisory plans and provide preliminary views on 2007 supervision strategy</li> <li>• Assist as required in preparing an MOU between the NBKR and new State Agency on Financial Supervision and Reporting</li> <li>• Addition to original plan—draft on-site procedures to assess liquidity risk management</li> </ul>
Jan 19-Feb 2, 2007 <i>Jan 21-Feb 2, 2007</i>	<ul style="list-style-type: none"> <li>• Deliver training workshop for NBKR staff on country risk</li> <li>• Deliver training workshop for NBKR staff on market risk</li> <li>• Complete first assessment process for quality home supervision and oversight by parent bank, creating a template that the NBKR can then replicate for all foreign-owned banks</li> <li>• Assist in formal post-review of 2006 supervision plans and work with NBKR to identify any needed legal or policy amendments</li> <li>• Addition to original plan—training seminar for commercial banks</li> </ul>
May 25-Jun 1, 2007 <i>Sep 11- 27, 2007</i>	<ul style="list-style-type: none"> <li>• Review and finalize on-site procedures for review of risk-management</li> <li>• Review NBKR completed assessments of quality of home supervision and oversight by parents for all foreign owned banks</li> <li>• Participate in bi-lateral meeting with Kazakhstan FSA (if desired by NBKR)</li> <li>• Complete any outstanding issues</li> </ul>