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*The Banking System
in Kazakstan*

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1. Banking system development in Kazakhstan

The Kazakstani banking system, its youthfulness notwithstanding, is developing rapidly. In 1987 before the initiation of economic reforms, the banking system of Kazakhstan was represented by two banks: the Gosbank (State Bank) and Stroibank (Construction Bank). In 1987 three sector banks were created based on the Stroibank: Promstroi Bank (now Turan Bank), Agroprom Bank (Agricultural Industry Bank), and Zhilstroi Bank (Housing Construction Bank). In early 1990 a branch of the USSR Vnesheconombank (Foreign Trade Bank) was created in Kazakhstan. Upon its establishment, Kazakstani banks started for the first time to serve foreign trade transactions (earlier foreign trade was fully centralized in Moscow).

By the middle of 1994, 230 banks had already been created. During the recent fourteen months, a process of reduction in the number of banks has become evident. Significant changes in the number of banks are shown in Table 1. The number of banks has decreased by 32 per cent, from 191 to 130. This reduction is more evident in the private banks — their number reduced by 43 per cent from 56 to 32 — and in commercial banks (reduced from 16 in September 1994 to one in November 1995). The number of joint stock banks shrank by 21 per cent (Statistical Bulletin 1991-1996).

It can be said that during the last five years, the banking system of Kazakhstan underwent rapid growth and expansion (1991 – mid 1994); then it experienced crisis, assets' reduction, and fast consolidation (mid 1994 to present).

An avalanche of bank creation and initiation was registered in 1992-1993. The liberal licensing policy — low charter capital requirements and almost no professional requirements for managers of newly created banks — facilitated the process. To a certain extent, the process was accompanied by a criminalization of the banking business and an accompanying discredit in the eyes of the broad public.

National law also affected the rapid growth of banks. Before mid-1994, opening a bank could be compared in Kazakhstan to establishing a private enterprise or a partnership. Since every bank could share in credit resources, there was no lack of desire to open banks. Moreover, every self-respecting businessman deemed it necessary to have his own bank.

This practice was successfully stopped by the National Bank (NB) of Kazakhstan with the introduction of stricter requirements for opening banks. Particularly important changes took place in April and September 1994. In April 1994 in order to open a bank, charter capital registration in the amount equivalent to USD 500,000 became necessary. In September 1994 in order to improve the banks' equity liquidity, the requirements for the charter capital structure in second tier banks were made stricter. The amount of USD 1.5 million is the minimum charter capital necessary to obtain a license for carrying out foreign currency transactions (except operating cash currency exchange counters), to take money deposits from the population, or to obtain a permit

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to open a branch. Also, rules were introduced for charter capital payment in reliable funds.

As a result of all these changes, two tier banking system has been developed in Kazakstan. The National Bank is the central bank of the country and constitutes the upper level of the banking system. All other banks constitute the lower tier.

Second tier commercial banks can be divided into deposit and investment ones. The deposit banks are prohibited from participating in the equity of legal entities that carry out activities in manufacturing, trade, insurance, and those activities intended to gain profit. The law restricts the banks' right to exercise direct influence over enterprises' management through buy-out of the any interest as is practiced in Japan, Germany, and recently in Russia.

Second-tier banks may be created on the basis of any form of ownership. The state is liable for the state-owned banks' obligations within the funds invested in their charter capital. The government may, by an individual decision, assume and assign additional responsibility to state-owned banks. The state guarantees the deposits accepted by interstate banks from Republic of Kazakstan (RK) residents and is liable for the banks' obligations proportionally to the governmental share in their charter capital. As for other types of banks, the state is not liable for their obligations nor are banks liable for governmental obligations except in cases when the banks or the government assume such liability.

Bank founders and shareholders can include legal entities and individuals — Kazakstani residents and non-residents if the latter are not registered in an off-shore zone. No one bank founder can dispose and (or) manage more than 25 per cent of the bank's voting shares. This difference in share ownership rules for corporations and banks reflects a banks' peculiarity: the management of other people's money.

At the end of 1995, the banking system of the Republic of Kazakstan consisted of 130 commercial banks and included six groups of banks: state-owned, interstate, joint stock banks with partial state participation, private, foreign, and joint banks (see Table 1).

The **state owned** banks include the Exim Bank (crediting of efficient investment projects), the Rehabilitation Bank (financial rehabilitation of large industrial enterprises), and the People's Bank (accumulation of money from the population). These banks perform certain specific functions that correspond to the needs and objectives of the state. Usually such banks provide medium- and long-term credits and sector-oriented loans.

The **interstate banks** are banks which operate in many countries. In Kazakstan, only the Central Asian Bank of Reconstruction and Development was present with a very marginal role.

The **joint stock banks** include former state-owned banks, like the Alem Bank, Turan Bank, Credsoc Bank, and Agroprom Bank. Their characteristics are an initially high level of assets in the balance, a high level of problematic loan portfolio because of their state origin, and apparent conservatism.

The **private banks** consist of new dynamic large banks, and small ones which have insignificant roles. The new dynamic banks include the Kazkommerts Bank, Center Bank, Nefte (Oil) Bank and Temir Bank. Their characteristics are a relatively

long history in Kazakstani conditions (3 to 4 years) and increased activities in new segments of the financial market.

A total of six **foreign** banks are operating in Kazakhstan. They include the Commercial Industrial Bank of China, the Bank of China, a subsidiary of the Dutch Bank ABN-Amro Bank Kazakhstan, Kazakhstan International Bank, branch of the Russian Alfa Bank, TexaKa Bank. Though comparatively numerous, this group does not play any important role like attracting foreign investment. Foreign banks try to penetrate the Kazakstani financial market; however, the National Bank allows only foreign banks with a high rating according to one of the rating agencies (Moody's, Standard and Poor, IBCA) to create subsidiary banks. Also, the banks are restricted in the share of foreign participation for 1995-1997. The total registered charter capital of the banks with foreign participation cannot exceed 25 per cent of the total registered charter capital of all the banks in the Republic of Kazakhstan.

Seven **joint** banks include the Kazakhstan-Turkish, Albaraka-Kazakhstan, the KZI Bank, and others.

The number of banks in Kazakhstan is undoubtedly too large. Poland, for example, where the population is 2.5 times more than that of Kazakhstan, has 90 banks, Hungary 31, the Czech Republic 18. Consolidation of the banks seems necessary, and the newly amended version of the Provision on Liquidation of Banks promotes the process of consolidation. Under the Provision, after the National Bank Executive Board decides to liquidate a bank, the oblast department of the National Bank creates a special liquidation commission. The commission forms so-called liquidated assets and collects claims. Afterwards, it satisfies creditors' claims — bank depositors and clients — in accordance with the Provision which, as a matter of principle, stipulates the priority for satisfying the claims of individual depositors. Then and only then are the claims of the state budget and legal entities satisfied.

According to the National Bank, 62 banks in Kazakhstan are presently being liquidated, and for six of them the liquidation process has been completed. The National Bank established a special organizational unit to tackle these issues, the Department of Control over Liquidation Process, which was separated from the Bank Supervision Department.

In our opinion, the speed of the banks' consolidation process in Kazakhstan should be accelerated. However, consolidation should be initiated at the lower level, and the banks' supervision should facilitate the process. It is also necessary to limit trends toward banking services being monopolized by large banks if the process of bank mergers, acquisitions, and expansion is not accompanied by a better quality of provided services and interest rate reduction.

Of the 130 registered banks, only 48 acquired licenses for foreign currency transactions, and only 37 obtained general licenses (see Table 2). The actual total charter capital amounts to USD 133.3 million which averages 1 million per bank, a very low amount compared to international standards.

Table 2 shows that the majority of commercial banks do not possess sufficiently large charter capital. The smallest banks possess a charter capital of T 1 million (USD 16.6 thousand), and the largest over T 130 million (USD 2 million). At the end of 1995, only three banks in the republic (Exim Bank, KRAMDS Bank, and ABN-Amro Bank) had charter capital of over USD 10 million, and two banks (Alem Bank and

Turan Bank) had charter capital between USD 5 and 10 million. By comparison, an average bank in Poland (which lags behind the developed Western countries in the development of a banking system) has a charter capital 1.5 times larger than the charter capital of any of the three largest banks in Kazakstan.

The limited size of charter capital hinders the expansion of banking transactions and the banks' positive influence on the real economy. Therefore, further development and consolidation of the country's banking system are necessary. Table 3 also shows that during the last three months, there were no radical changes in the charter capital structure.

The number of branches is between 1,010 and 1,050 which is on the average 7.8 per bank. Though the number of banks is too large, the number of branches is apparently insufficient. Let's consider for comparison the density of branches in Western countries (according to applicable international standards, the density is determined as the number of population per one bank branch). There are 717 people per branch in Belgium, 835 in Switzerland, 1,000 in Germany, 1,314 in France, 1,331 in the UK, and 1,780 in Japan. The most "backward" country is the USA which has 2,214 people served per branch. Of course, the authors do not take into account the numerous firms, trade organizations and other companies that are allowed by law to carry out some banking transactions. In Russia the population per branch ratio is 3,100 which is more than 1.4 times larger than in the USA.

In Kazakstan the density is 15,952, persons per one branch, a very low saturation of banking facilities. Moreover, if we exclude the banking structures located in Almaty, the bank density in the rest of the territory is much lower. Also, the concentration of branches is extremely uneven. Two banks possess the majority of branches: the People's Bank of Kazakstan has 28.4 per cent of the branches (296) and the Agroprom Bank 22.5 per cent (235) (see Table 2).

The authors believe that it is necessary to liberalize the procedure for obtaining branch opening permits. For instance, the relevant charter capital requirement could be reduced from USD 1.5 million to 1 million. A marketing analysis of demand for banking services in different regions of the republic is also necessary in order to evaluate the optimum size for banks capable of satisfying the demand and bearing the minimum costs of potential clients' service.

Specialized banks still play a very important role in the Kazakstani economy. The People's Bank, the Alem Bank, the Turan Bank, the Exim Bank, the Zhilstroi Bank and the Rehabilitation Bank are regarded as specialized.

The **People's Bank** (joint-stock savings banks with 100 per cent state participation) has an extensive branch network of 296 branches all over the country, and it specializes in deposit taking and providing other services to the population. Its deposits are state-guaranteed, and the Bank is not yet subject to the National Bank's prudential regulations. Its stage-by-stage privatization is planned.

The **Alem Bank** created by the 31 August 1992 Decree of the RK President acquired a leading position within a very short time, and it gained international recognition as early as 1992. It became the first bank in the country to introduce such international banking systems as SWIFT, REUTERS, VISA INTERNATIONAL, EUROPE CARD, etc. It also owns the first banking card called ALEMCARD and the first street banking machines for cash payment, an automatic teller machine (ATM).

The Alem Bank was the first in the country's history to attract and service foreign loans on behalf of and on the orders of the government. In 1994 it accounted for half of all foreign trade banking transactions. The Alem Bank lost its leading position in July 1995 when the National Bank together with the government closed it for two weeks and announced the bank's bankruptcy over the official TV Channel. This action resulted in deterioration of its banking activities, and it also shows the political risk associated with banking activities in Kazakhstan.

The **Turan Bank**, formerly a branch of the Soviet Promstroi Bank, is now a universal joint-stock bank with 83 branches and a charter capital exceeding T 200 million (USD 6.6 million). The Kazakstani industrial enterprises account for more than 80 per cent of its credit resources.

The **Exim Bank** was created by the President's Decree in July 1994 on the basis of the state share in the Alem Bank's charter capital and profit. Within three months governmental credit lines were transferred to the Exim Bank for servicing. In February 1995, for the first time in Kazakstani history, the Government of Switzerland opened a medium-term credit line against a guarantee of the Exim Bank itself without governmental participation. In August 1995, the President's Decree transferred all functions of the Development Bank which had been operating for about a year to the Exim Bank. The Development Bank was liquidated. The Exim Bank's mandate includes long-term crediting of efficient investment projects, funding of exports, insurance and guarantees for export loans, foreign investments, and foreign trade support projects (Postanovlenie 2.03.96).

The **Zhilstroi Bank** which was created at the end of 1993 has 14 branches. Its main functions include crediting construction through a system of commercial construction companies, creating a system of individual housing savings accounts, and establishing a system of mortgage loans. In the banking services market, this bank supplies such products as beneficial housing loans, credits for construction programs, a housing lottery, etc.

The **Rehabilitation Bank** was created on 29 March 1995 to deal with the financial rehabilitation of large industrial enterprises (Ustav No. 591). The Rehabilitation Bank supports activities of unprofitable enterprises by extending credits, and it finances the restructuring procedures for the largest industrial enterprises of the republic. The money for industrial enterprises' reconstruction and for closing projects is channeled through this bank. Its major tasks are to reduce the second-tier banks' risk from non-payment and to facilitate industrial enterprises — debtors' access to credit resources.

In financial markets which are not fully developed and which can offer only a limited number of financial instruments, certain groups of borrowers may have no access to the market. These are the small and medium scale industries, housing construction, export and import, and enterprises in a poor financial situation, etc. Specialized state-owned financial institutions such as the Zhilstroi Bank, Exim Bank, and Rehabilitation Bank have usually filled the gap.

Because of imperfect risk assessment and the drawbacks of the market, development of specialized financial institutions with state assistance is justified, and many post-communist countries created such banks in order to resolve transitional tasks. The problem is that the subsidized loans and bad management of such institutions very

often generate high costs to taxpayers. An apparent example is the Polish BG⁻ which funds the agricultural industry.

For this reason, all specialized banks must perform their functions temporarily. When the banking services market is developed, the specialized banks should be transformed into universal ones.

2. Role of the National Bank

On currency, drafts and implements with the cooperation of the Ministry of Finance the 30 March 1995 the President's Decree having the force of law on the National Bank (NB) of the Republic of Kazakstan was issued (Ukaz 3.03.95). The NB is the central bank and forms the upper level of the banking system. The National Bank, according to the President's Decree ensures the internal and external stability of the national currency, drafts and implements the state monetary policy with the cooperation of the Ministry of Finance and protects the interests of bank depositors and creditors. The Decree provides for direct reporting of the National Bank to the President and a necessary independence of the National Bank from the current governmental agenda.

The main goal of the monetary and credit policy is control over the money supply and suppression of inflation. The National Bank uses the following classic monetary and credit tools:

- regulation of refinance credit amounts provided by the NB to commercial banks,
- basic refinance rate regulation,
- mandatory reserves mechanism,
- transactions with state treasury securities,
- interventions in the currency market.

The refinance rate fell along with the reduction in inflation. The 3-months credit rate was decreased from 176 per cent in January 1995 to 52 per cent in December. Since 27 March 1996, the refinance rate was 44 per cent. The National Bank tries to keep the refinance rate positive in real terms in order to encourage the inflow of private deposits to the banks. However, refinance rate reduction does not result in a rapid enough reduction of lending interest rates to the full extent by the banks. The reasons are first, their desire to gain short-term profits, and second, lack of real competition in the capital market.

The level of mandatory bank reserves was reduced after 1 April 1996 from 20 to 15 per cent. After July 1, the banks will be paid 50 per cent of the refinance rate if they have reserve account balances. This will allow them to expand their credit activities. Moreover, the banks will be able to offer depositors better interest. On the other hand, this action may result in an increase in the money supply and, under further industrial decline, to greater inflation.

The National Bank participates actively in the securities market operation as the governmental agent for primary allocation and servicing of the 3- and 6-months state treasury bonds (STB). In the future, one-year STB are to be issued. Thus secondary

state securities market has been formed. The short-term NB note auctions will be gradually reduced as the securities market develops. Also, as the banks accumulate sufficient amounts of treasury bills purchased at the primary market, the system of lombard credits against the collateral of state securities is introduced as well as REPO transactions in all markets: credit, gold, and securities (Postanovlenie 31.05.1996).

At present the NB credit interest rates are changing from the official refinance rate to the NB lombard credit rate. The rates of auction and interbank credits are the major indicators of the credit market situation.

On 31 August 1995, the Decree on Banks and Banking Activities in the Republic of Kazakhstan was adopted (Ukaz 1.09.95). The Decree strengthened the National Bank functions with regard to commercial banks:

- the licensing rules are made stricter including requirements for bank founders — their financial status, charter capital formation, managers' qualifications, and reputation. The business plan for the new bank received stricter requirements also;

- the banks are obliged to publish annual reports, including annual balances and income statements by the deadline set by the National Bank after the accuracy of these reports being examined by certified auditors. Unfair advertising practices are also prohibited;

- the chairman of any bank's executive board and his deputy, and the chief accountant and his deputies are appointed (elected) upon the agreement of the National Bank;

- the procedures for bank closing, liquidation, and reorganization were set. These actions are carried out under the decision or with permission of the National Bank;

- for the first time, a clear definition of “banking secret” was set as well as criminal liability for its disclosure for officials, bank personnel, and other persons who, in performance of their duties, had access to confidential information.

In order to ensure banks' financial stability, protect their depositors' interests, and support a stable monetary and credit system, the National Bank regulates banking activities, through those means:

- introduction of prudential standards and other rules and limits obligatory for banks including reserve requirements and provisions against doubtful and loss loans;

- issuance of mandatory instructions and other regulations;

- completion of bank performance inspections;

- drafting of recommendations for banks' financial rehabilitation;

- application of limited remedies to banks;

- application of sanctions to banks.

The prudential standards were brought in accordance with the recommendations of international financial institutions and the Basel Committee for Bank Supervision: minimum charter capital, liquidity ratio, equity adequacy ratio, maximum risk per one borrower, open currency position limits (Postanovlenie 29.02.96).

The new law establishes the model of a state strictly regulated banking system where commercial banks are assigned the role of agents for the monetary policy carried out by the National Bank. The banks are obliged to submit daily balances to the Department of Bank Supervision under the instruction “On the Procedure for Data Submission by the Banks in RK for Calculation of Prudential (Economic) Standards.” Every month banks have to submit statements with a calculation of the equity

adequacy ratio and with comparative tables for assets and liabilities. Banks are fully responsible for the reliability of the data provided. Moreover, the NB carries out complex monitoring of banks' activities in the currency exchange, bills of exchange auctions, and interbank markets, with a day-to-day review of their correspondent accounts which allows it to assess quickly and analyze the banks' financial situation, identify potential problems, and undertake the necessary measures in a timely manner.

In 1994 and 1995 the NB of Kazakstan issued about T 34.9 billion in different forms of centralized credits which is more than 60 per cent of its credits to commercial banks (see Table 4). The borrowers for this program agreed to credit length and terms with the government, the NB, and local authorities. In general, the banks played the role of passive money conduits for such credit. The majority of such funds (91 per cent) was provided to cover the state budget deficit and grain purchase.

It is necessary to emphasize that the broad use of centralized loans slows down the process of banking sector reform since these loans do not require a development of activities usually related to bank crediting such as deposit and credit assessment. The specific credit allocation more reflects political power and the negotiation skills of the borrowers than economic considerations.

The NB of Kazakstan used centralized credit programs for two purposes: to ensure liquidity of the banking system and to support individual enterprises and different industries. Unfortunately, the centralized credits are not an efficient way to achieve any of these goals and should be totally replaced in 1996 by the "discount window" at interest rates that ensures more rational credit utilization, or by credit auctions. As a rule, discount windows or credit auctions do not result in discrimination against any banks or industries as the directive credit programs do.

The NB gradually reduces the amount of refinance credits. Since 6 February 1995 directive credits have not been extended. They were replaced by centralized credits which are distributed through auctions and extended for one, two or three months. Provision of the six-month credits was canceled since the refinance credits are intended to resolve short-term liquidity problems, not to be used as a primary economy funding means as was practiced earlier.

The credit auctions procedure, however, is more complicated than the "discount window". Bid transmission from the banks is technically difficult and deprives small and distant banks of participation opportunities. Besides the procedure takes much time since the NB has to assess the bids and to ensure that there is no secret agreement between banks. And, last but not least, collateral is necessary. In developed countries, only state securities can serve as collateral. In Kazakstan this is practically impossible. Therefore, the NB could allow banks to use some types of commercial loans as collateral during a transitional period.

In the transitional economy with its weak and underdeveloped banking system, the NB's interference is necessary as a financial markets' organizer. During 1994 the organized interbank currency market successfully formed. Since the first quarter of 1995, primary and secondary state securities markets and an interbank money market started to form. In December 1994 the NB Executive Board approved the Provision on Transactions for On-call Loans Provision and Repayment: on-call loans are interbank credits extended for a period under 30 days. Based on the results of the daily interbank short-term credit auctions, the average interest rate in December 1995 fluctuated be-

tween 39 per cent for one-day T 60 million loan and 68 per cent for 30-day T 100 million loans. The players in this market include only large and reliable banks, and they are subject to certain checks by the NB so that the money can be written off the banks' correspondent accounts unconditionally.

In the first quarter of 1996, the NB drafted the Law on Currency Regulation. The major objective of the new version is further currency market liberalization.

Only the second-tier commercial banks that have complied with the NB economic rules and standards during the previous period are allowed to participate in the NB credit auctions which are organized no less than twice a month. The introduction of the lombard credit system is planned; the NB will extend loans to commercial banks against the collateral in the form of securities, particularly treasury bonds.

In 1995 the precious metals' market started to operate. It allows local commercial banks to purchase precious metals from Kazakstani producers, to sell them, or to perform other transactions. At present, seven banks have acquired NB licenses for precious metals' transactions.

The commercial banks are also active in the market of state treasury bonds and short-term NB notes. In the majority of auctions, the demand exceeds supply greatly regardless of the constantly reducing income rate. The reason is the high reliability and liquidity of state securities.

The banking system's development was affected by a reduction in the centralized NB credit amount and the inflation rate. The banks lost a source of income in the centralized risk-free credits and started to earn profit ardently on their own money or money acquired through the auctions at a really positive interest rate. (Earlier, due to inflation, the interest rate was really negative.) Stricter NB reserves requirements, assets, liabilities and risk management, and numerous precedents of license revocation, bank closing, and liquidation urged banks to change their behavior. They began to realize the impossibility of activities based on the high risk for themselves and their clients. They started to diversify services in different financial markets including the market for regional debt obligations.

3. Bank supervision

The reform of the Kazakstani economy requires improvement in the control function of bank supervision. The improvement of bank supervision should be aimed at creating favorable conditions for stable performance of the banking system, at implementing its function as a financial intermediary and conductor of monetary policy signals, and also at preserving the public trust in banks.

In 1995 regulatory practice was aimed at complying commercial banks' procedures with safe conduct standards, at creating incentives and conditions for internal reorganization of banks, at forming reliable internal auditing systems, at finding sufficient resources, and implementing a sound credit and liquidity policy. These efforts showed the real picture of the banks' financial situation but also led to a significant improvement. For instance, in early 1995 more than 65 per cent of the banks violated

economic standards, but by the end of the year this per cent reduced to 52 per cent. Analysis of inspection results carried out by the bank supervision found that banks and branches commit, as a rule, violations in procedures for formation and increase of the charter capital, in procedures for crediting, in rules for carrying out foreign currency transactions (e. g. the timely sale of export foreign currency proceeds at the currency exchange, contract payments on behalf of third parties, and charges for commission and penalties in foreign currency), as well as in time limits and rules of cash transactions. Also in 1995 the Executive Board of the National Bank revoked permits for opening banks and annulled licenses for the banking transactions of 45 banks for violation of established banking laws. Sixty-two banks are in the process of liquidation. The liquidation process was completed in six banks.

These achievements, though very significant, still require additional measures. For instance, adoption of a resolution by the government for the National Bank on accounting standards, wide introduction of the new accounting system, and adoption of a complete set of accounting standards which will largely correspond to the International Accounting Standards (IAS) are required (Programma, 17.05.96).

Presently in Kazakstan, the introduction of the new accounting system is under way. The system has already been introduced in the National Bank and will be established in commercial banks in the second quarter of 1996. The system of mutual settlements (clearing) is being improved, and an intermediary system has been completed which will serve as a basis for the long-term payments system. Adoption of international standards for preparing reports on auditing second-tier banks will allow the bank supervision to improve.

Bank supervision reform is the most crucial factor in reforming the system in general. For reforming this system it is necessary to carry out (a) introduction of international standards, (b) introduction of new equity calculation procedures and standards, (c) real evaluation of banks' capitalization level and their susceptibility to risks, (d) presentation by commercial banks of action plans for recapitalization with regular reports on their implementation to the National Bank.

4. The strategy adopted by the National Bank for recovery of the commercial banks

On 17 May 1996 the National Bank adopted the strategy of a gradual and largely voluntary approach to banking reform providing incentives for the banks to improve their standards and submit to stricter supervision (Programma, 02.96). These incentives, according to the NB expectations, should lead to a continuous increase in better banks and their market share. The concept was developed with the cooperation of the International Bank of Reconstruction and Development and resembles the International Standard Bank program developed by the World Bank for the Central Bank in Russia (Postanovlenie 18.06.1996).

The Kazakstani National Bank strategy has the following inter-related objectives to be phased in over the next three years:

- create a core of banks which will follow better banking practices than the rest;

- gradually raise the level of soundness of the Kazakstani banking system, which will occur as the number of banks taking part in the program increase;
- provide the public with information to recognize the most appropriate banks for their specific needs (see Table 5).

The banks can take part in the program that until 1 July 1996 (regional banks until 1 October 1996) prepare a recapitalization and activity improvement plan and describe steps they will undertake to achieve the assumed standards (see Table 5).

The benefits package is designated to produce the “right” number of banks: enough to form the core of a good banking system but not so many that the National Bank cannot supervise them effectively. The recapitalized banks with an accepted improvement plan by the National Bank will be allowed to possess a stake in the equity of investment banks, accept deposits from physical persons, take part in the credit auctions organized by the National Bank, pursue international operations, distribute international credits guaranteed by the state, issue bonds, letters of credits, certificate deposits, cheques, and serve as an underwriter of public offerings of corporate securities. The banks with an unacceptable plan will be deprived of these privileges.

It can be expected that twenty to thirty commercial banks will meet the set of standards and will strengthen their balance sheets and their banking skills as well as reduce their single borrower, connected party and in-house exposure. The number and market share of these banks will gradually increase, especially in those markets where the program provides an advantage such as dealing with household deposits and with foreigners.

There are, however, two main ways in which the program may fail to produce an overall improvement in the banking system.

First, the benefits of the program may fail to attract a sufficient number of banks, or the advantages granted to those banks may not be enough to prompt a substantial increase in their market share.

Second, the banks not participating in the program may behave in ways that worsen their own performance, as well as that of the whole banking system, by raising interest rates to a point that complicates the whole operation of the “good” banks or by lowering credit standards in lending.

In order to avoid these problems, the National Bank of Kazakhstan should direct part of its supervisory capacity to those banks not participating in the program which continue to grow after introduction of the program.

5. Credits and deposits structure

Banks now provide loans to enterprises and organizations, consumer credit to individuals (in Kazakhstan mostly bank staff, so called in-house lending), interbank loans, loans for purchase of securities, and loans for currency transactions.

For instance, based on their audit results, the People's Bank has the following credit portfolio structure: state securities account for more than half; a fairly large amount of funds is engaged in cash circulation because the People's Bank is the largest

retail currency exchange operator; a lot of credit resources go to the oil and gas companies; and some go to firms that conduct efficient import.

In the Kazkommerts Bank the largest part of its credit portfolio (about 70 per cent) is loans to enterprises and organizations, about 20 per cent to securities, 5 per cent to interbank credits, and 5 per cent to currency and exchange transactions.

In order to ensure the necessary control over and the reliability of the banks' activities and in accordance with the character and scale of transactions, starting from autumn 1995, the banks are bound to classify their extended loans and other assets, identifying both doubtful and loss debts and creating provisions for them.

The loan portfolio is classified regardless of the loan date, purpose, sources, repayment period, and currency. The loans provided by the banks are divided according to quality into the following five categories:

1. Standard loans — if the repayment period is not yet over and the quality is excellent.
2. Substandard loans — related with minor risk of repayment delay up to 30 days and prolonged no more than once.
3. Unsatisfactory loans — where the default time is between 30 and 60 days and prolonged more than once.
4. Doubtful loans — where the default time is between 60 and 90 days.
5. Loss loans which are in default for more than 90 days.

The banks have to submit monthly reports on loan classification and reserves formation for the loan portfolio to the Bank Supervision Department. The reserve amounts and terms are determined depending upon the categories and are described in the NB provision.

Banks accept fixed-time and demand deposits, deposits of legal entities and individuals, and foreign currency deposits.

The fixed time deposits include 3-month, 6-month, 9-month, 1-3 year, 3-5 year, 5-10 year, and over 10 year categories. All time deposits for over six months account together for only 55 per cent of all time deposits which shows a continuing lack of trust in the banking system and the high risk of long-term investments. Certainly, the collective bank deposit insurance system will improve trust in banks. In the near future, competition for the title of the best quality, most reliable, and most diversified bank will strengthen.

Interest rates for fixed time deposits are, on the average, two to three times larger than for demand deposits and differ around 40 per cent in different banks. The most popular are fixed time deposits up to three months which comprise 40 per cent of the total time deposits or, on the average, 16 per cent of all types of deposits. Individuals' deposits are almost 60 per cent of all deposits and are increasing, which is a favorable trend. Tenge and foreign currency individual fixed-time deposits grew by 151.8 per cent in 1995, demand deposits by 86.7 per cent. The largest growth rates were registered in Eastern Kazakstan Oblast, Almaty, Karaganda, and Mangystau.

The foreign currency deposits share is growing: the average amount is USD 900. This shows that the population still considers dollars as the most liquid means of saving. The interest rate, taking inflation into consideration, for Tenge deposits is almost the same as for dollar ones. This makes the dollar deposits preferable since there is no risk of unfavorable exchange rate changes. In general, 1995 was the year of deposit

market rehabilitation due to the high reliability of banks compared to other financial institutions and competitive interest rates compared to other investments.

Any bank can carry out banking activities provided that there are common rules for such activities and internal regulations. The latter are public information and cannot be held as commercial or bank secrets. The banks are obliged to provide this information on their clients' demand.

The banks draft their credit and deposit policies themselves. They can file bankruptcy court suits against insolvent borrowers. There is no prescription time for banks' suits against borrowers for non-compliance with credit agreement terms. Interest and commission rates, as well as tariffs for banking services are established by the banks themselves. The banks are responsible for their obligations to other banks and clients on the basis of the relevant contract terms. At present, there is no system of collective deposit insurance; therefore, many people are not eager to make their savings deposits in the banks. In 1995 the majority of credits (70 per cent) were funded from the enterprises' deposits (T 57 billion) and only some from individual deposits (T 12 billion). During this time, loans provided by the commercial banks decreased almost by half, from T 126 to T 66 billion.

In order to resolve the problem of confidence in the banks, it is necessary to establish a banking deposit insurance system. Such a system could work under the supervision of the Kazakstani Banking Association and could supervise the status of deposits. It could be funded by commercial banks through allocation of a certain share of profit to an appropriate fund. In Russia commercial banks have been allocating 2 per cent of their profit to deposit insurance and bankruptcy funds for more than two years. Such a system could reduce the probability of a "domino" effect.

Full deposit insurance, however, may form grounds for excessive risk-taking by bank managers. Therefore, differentiated forms of insurance are necessary. First, the insurance system should distinguish between demand deposits and other types of deposits, the solution adopted in Chile. The former could receive the state guarantee, and banks could be required to invest demand deposits into government or central bank securities. Other deposits would have no guarantee and bear full market risk.

Second, insurance premiums should be differentiated according to the bank's risk level. The publication of financial institutions' credit ratings and quality of asset structure would be very helpful.

As mentioned, the banks can establish interest rates for loans and deposits. In general, they pay very low rates on current accounts. That is why the enterprises keep only minimum account balances necessary for their operation. It is well known that some banks use checks and payment orders as an additional source of cheap funds. These instruments represent funds which are assumed as being collected, and some banks keep them for several days to satisfy their own needs.

Credit interest rates differ greatly from 60 to over 100 per cent. Some banks lend money at interest rates lower than the real costs. This happens for a few reasons:

First, loan demand is limited since few borrowers can provide collateral or other forms of security which the banks demand for market loans as opposed to directive and in-house lending.

Second, borrowers are important shareholders.

Third, if banks increase deposit interest rates, they have to increase their spread which would discourage their best clients from returning them, leaving banks with a high risk loan portfolio.

Fourth, because of high inertia, inflation expectations lag behind actual inflation.

Fifth, because of money illusion, some people look at the nominal values and do not adjust them for inflation.

Many banks are owned by agencies or industrial enterprises that are at the same time major clients of these banks. They are in fact “pocket banks” where the founders get benefits in the form of credits in their “own” bank. Such an ownership structure — banks are owned largely by the enterprises — helps to perpetuate the practice of connected and in-house lending.

Connected and in-house lending are severely restricted in developed countries, since such practices can lead to serious problems of fraud and because they can put both household deposits and indirectly government funds at risk. Connected or in-house lending can also complicate any attempt to stabilize the economy and delay the process of restructuring the enterprise sector. This is because banks largely owned by enterprises continue to lend to insolvent enterprises, thus retarding the development of both sound enterprises and banks.

In order to resolve this problem in Kazakstan, two provisions were adopted.

The first one stipulates that related persons or entities cannot receive credit in an amount exceeding 10 per cent of the bank's equity. The analysis carried out by the National Bank shows that 7.4 per cent of the banks do not comply with this limit. In other banks, shareholders (related persons and entities) normally use approximately 5 per cent of the equity, i. e. half of the limit.

The second provision concerns banks that are owned by enterprises with more than 50 per cent state participation. The Decree of the President on Banking Activities of August 1995, No. 304, prohibited enterprises with a large state participation to hold shares of the banks. Accordingly, the Ministry of Finance carried out an exchange of all such bank shares for treasury bonds and liabilities of such enterprises with the Ministry of Finance. Then the Government decided to sell all its shares of all banks within several months except a few of them (the Exim Bank, Zhilstroi, Rehabilitation, People's, Agroprom, Alem, and the Central Asian Bank of Reconstruction and Development) which provide specialized financial services or had difficult circumstances that required more time for privatization.

Under the law the banks guarantee the confidentiality of their clients' and correspondents' deposits and accounts. On the other hand, they have to provide this confidential information to investigation, tax, and customs authorities.

The NB actions in the banking sphere may be petitioned to the court. Filing court suits against the NB orders does not suspend their execution.

In general, Kazakstani banks are becoming more careful and increasingly limited in their means. The banking sector is not yet able to implement investment programs with an adequately long credit length. About eight relatively large banks possess a significant monopoly compared to other small and medium banks.

6. Problems of bad debts' restructuring in the Republic of Kazakhstan

The present situation in the banking sector in Kazakhstan is characterized by an on-going accumulation of losses in individual commercial banks which leads to their gradual decapitalization and the deterioration of their liquidity. An acute reduction of inflation during the period between the middle of 1994 and the middle of 1995 resulted in an increase in irregular loans. Data on the 16 largest banks on 1 March 1996 (Table 9) shows that irregular loans (called "risk assets") amounted to almost one-third of all assets (32.2 per cent). This is much better than in the banking system in general where bad loans amount, according to some estimates, to about 55-60 per cent of all commercial banks' portfolios.

The financial situation shown in the consolidated balance of all banks is also somewhat mixed (see Nacionalnyj 1996:14-15). The capital adequacy ratio K1 (see Table 9) which characterizes the relation between equity and all assets is, on the average, 14.3 per cent (27 per cent in 16 largest banks), and such a level can be deemed normal. It is necessary to note a significant improvement compared to 1994 when this ratio was 7.9 per cent which is less than the minimum limit. This shows the positive trends in the system's development. However, the average share of banks that did not comply with the capital adequacy ratio (K1) during the year was 27 per cent.

The liquidity factor K3 that shows the relation of liquid assets to liabilities is 0.52 higher than the required value of 0.3. This limit, however, is violated by 30 per cent of all banks.

Seventeen per cent of banks violated the factor K2 in 1995 (risk size per one borrower — maximum limit of 25 per cent). Maximum risk per one related borrower (maximum 10 per cent) was violated by seven per cent of banks.

In 1995 banks started partially to build provisions for lost and doubtful loans from bank profits. In 1994 such provisions did not exist. The total provisions amounted to T 1330 million of which T 45 million was formed for doubtful loans provided to legal entities and individuals. The remaining amount, T 784 million, was formed as reserves for covering general bank risk. Yet total provisions which amount to T 1330 million is far from the necessary level of provisions calculated in accordance with Basel standards. For example, in 16 large banks only 12.1 per cent of required reserves were created. One of banks formed only 2.7 per cent of all necessary reserves for irregular loans.

The capital adequacy ratio suggests that provisions must be eight times larger than actual figures shown in the banks' data. This points out the need for stricter bank supervision and more active measures to reduce the irregular loans' share in the credit portfolio.

The extremely serious character of this problem lies further in the fact that the banking sector is incapable of an independent resolution to its difficulties. Because of low inflation in Kazakhstan as compared to Russia, the Russian *laissez-faire* approach to bank rehabilitation is not applicable. It is absolutely necessary to undertake urgent measures to place the situation under control, stabilize it, and resolve some of the

major problems of the financial sector so that the banks will become able to achieve financial strengthening and rehabilitation themselves using market instruments.

Analysis of the consolidated income statement of all the banks confirms that the banks are unable to resolve the problem of bad debts. Total returns of all banks increased 170 per cent which is only 0.1 per cent more than inflation. At the same time, costs increased 220 per cent. As a result, all commercial banks obtained a profit of T 8.361 million which is 110 per cent more than in 1994. This means a worsening from two different points of view: (1) the real value was reduced due to inflation, (2) profitability of all banks reduced from 30.7 per cent in 1994 to 19.4 per cent in 1995 (Kommentarii 1996).

This worsening resulted from an interest rate reduction which was to a significant extent caused by the significant reduction in the inflation rate. This also shows that the future possibilities of obtaining high profits are worsening. The profit reduction would be larger if banks had no possibility of investing in securities. It could be said that the securities market development allowed banks to get more income from related transactions.

The main factor which leads to an accumulation of losses is the significant amount of idle assets in the banks' balance as well as a preservation of very low or even negative spreads in some banks. Therefore, real profit becomes impossible which creates prerequisites for a liquidity crisis in the financial system.

A significant share of irregular loans in the banks' portfolio are those given to state enterprises and also loans provided in the past under different decisions of the government. These are, in fact, direct liabilities of the state which it does not recognize. They result in the problem of unclear responsibility since the state blames state banks for the bad financial situation, and banks, in their turn, blame the government for bad management of enterprises and failure to fulfill commitments. The specific aspect of this problem is the lack of any possibility of significantly improving banks' management under a partially non-market environment. All of this requires the government to undertake urgent measures to improve the efficiency of the state enterprises' operation.

State enterprises and state-controlled joint-stock companies accumulated bad debt by not paying back loans received in one or several commercial banks and by simultaneously obtaining new credits in other banks and servicing these latter loans only. Thus, these enterprises transferred their problems to commercial banks.

Restructuring of bad debt in the Republic of Kazakhstan is also complicated by spontaneous privatization of state-owned banks and the subsequent loss of control over these banks by state authorities.

The Rehabilitation Bank established under the World Bank project can concentrate only on large state debtors (until now only 34 enterprises) and will not be able to deal with many other state enterprises with bad loans. It is necessary to undertake measures that would urge commercial banks to deal with restructuring of state enterprises that are not covered by the Rehabilitation Bank program (Polozhenie 9.11.95).

Objective and subjective reasons for the arrears crisis can be identified. Macroeconomic instability, industrial decline, and lack of long-term funding and working capital sources for enterprises finally resulted in low solvency in economic entities. The subjective reason lies in the faith of borrowers who use their beneficial

situation as well as the inefficient work of enterprise managers who have proved unable to adapt to market realities and continue to act as if they were supported by the State Planning and State Procurement Committees.

The arrears problem is being actively discussed in governmental, financial, and academic circles. Different solutions are suggested. The majority of researchers and practitioners agree on the need to introduce bills of exchange circulation. Being used as a credit and settlement instrument, the bill is used to pay for goods and abolishes the problem of working capital deficiency (Polozhenie 18.01.96).

A very popular idea is to start crediting with bank promissory notes instead of common bills of exchange. The proponents of this solution argue that the majority of commercial bills of exchange will undoubtedly not comply with the minimum requirements of liquidity and risk that may be established by responsible financial institutions or other market actors. Some commercial banks, e. g. Turan Bank, are already using promissory notes.

Another solution to this problem, suggested by I. Mandel and the authors of this report, is seen in debt-to-equity swaps where the investor who buys the debt can acquire the rights for the enterprise's management or at least for a part of its assets. Investors usually show interest for enterprises cleared of debts.

There is also an idea of privatizing state shares in exchange for debts (A. Esentukelov). However, potential investors are discouraged by the undefined real price of state stock which was never offered for open sale, and they do not want to deal with the government and the hopeless agricultural sector debts. Additionally, the Kazakstani law does not allow for debt-to-equity swaps during the privatization process.

There are also suggestions especially supported by the Association of Banks (Polozhenie 9.11.95) that the state pay debts of agriculture and other sectors. Others like some presidential advisors think that mutual arrears could be netted as an accounting transaction without reissuing the credit. In our opinion, without essential changes in the enterprise management approach, however, the probability of another arrears crisis still exists (D¹browski et al 1996:97).

The Law on Bankruptcy adopted on 7 April 1995, is also aimed at resolving the accumulated arrears problems, and at the same time it creates an important channel for the structural transformation of the economy (Ukaz 7.04.95). This law will allow the creditors to petition the court to announce a bankruptcy if the debtor does not repay on time. The court may order an external management of the debtor's estate, dismiss former managers, and institute a turnaround or bankruptcy which is followed by a liquidation and sale of a hopelessly insolvent debtor's property. In case of bankruptcy, however, the creditor is entitled to satisfy his requirements almost to the last which makes the formal procedure meaningless.

Of course, the arrears problem has a systemic nature and may be resolved by complex means that would take into account all related interests.

7. The need for a decentralized approach to “bad loans” restructuring

In post-communist countries, three basic approaches were applied to bank rehabilitation and bad debt restructuring:

1. The centralized approach applied in the Czech Republic, Hungary, and Slovenia.
2. The decentralized approach applied in Poland.
3. The *laissez-faire* approach applied in Russia (see D'bwowski et al 1996:84).

The **centralized approach** is usually strongly supported by the World Bank. It includes the creation of a separate financial institution such as the Consolidation Bank (in the Czech Republic) or the Rehabilitation Bank (in Kazakstan). The first main target of such an institution is to take a certain portion of the bad credits from the commercial banks and thus, on one hand, help clean the bank balances, and on the other, create acceptable conditions for debtors.

For example, in Czechia the Consolidation Bank took over a 110 billion crown debt (80 per cent of all non-performing loans of state-owned firms and 50 per cent of the cooperative firms). This amount represented about 15.7 per cent of all loans in the economy. The main resources for covering the transferred non-performing loans were long-term facilities from the central bank (bonds and long term loans). The advantages and disadvantages of this approach are presented in Table 8.

In Kazakstan, due to the establishment of the Rehabilitation Bank, it seems that the centralized approach is pursued.

In the **decentralized approach**, the main responsibility for bad loan restructuring is placed with the commercial banks. These banks are responsible for separation of loans classified as substandard or non-performing, and creation of new organizational units, workout departments, to manage the bad loan portfolio.

In the framework of this approach implemented in Poland, the Ministry of Finance provides the funds for the capitalization of commercial banks. These funds allow the banks to create loan-loss provisions — 100 per cent for loss category loans, 50 per cent for doubtful category loans, and 20 per cent for substandard category loans. The recapitalization amount is calculated on the *ex ante* basis and is set at a level sufficient to ensure that upon creating necessary provisions, the banks will reach 12 per cent capital adequacy ratio, according to Basel standards. (Bank's equity cannot be less than 12 per cent of the extended loans total amount.)

Under this approach, known from Poland, the government capitalizes banks with 15-year redeemable treasury bonds denominated in local currency and bearing an interest rate close to market rates. From the time of privatization of a recapitalized bank, the cost of further servicing and redemption of the bonds transferred to the bank are to be refinanced to the State Treasury from the Bank Privatization Fund.

Within the *laissez-faire approach*, no action on the part of the government is required. Due to inflation, a deep erosion of the banking sector assets and capital takes place, and thus old bad debts virtually disappear. This situation in its classic form appeared in Russia in 1992-1994. A very liberal licensing policy resulted in the rapid creation of a huge number of new banks, many being spin-offs of the old state banks.

Old banks with bad loans were dissolved, and new commercial banks emerged that were not burdened by old loans and old management practices. More than two thousand of the new small entrepreneurial banks have been created in Russia. The new banks operate mostly on a regional (oblast) basis with the larger banks handling international transactions for the regional banks. The natural selection process of the banks that survive the competition continues.

The comparison of all three approaches (see Table 6) demonstrates that the decentralized approach is the most effective one. Polish experience confirms it. During the last two and a half years (from March 1993 to December 1995) the share of the bad loans in the Polish economy declined from 37 per cent to 12 per cent, and the problem of inter-firm arrears practically does not exist anymore.

Also, this approach has other advantages:

- it introduces a mechanism that urges banks to undertake active measures against bad borrowers;

- it trains bank staff to do credit risk assessment, to deal with bad borrowers, and to be responsible for their own actions;

- since the amount of money for capitalization is determined in advance and does not depend upon the total bad loans due to a particular bank, it provides banks with an incentive to try to recover as much bad debt as possible;

- it establishes clear rules for all payers, and reduces the threat of political pressure;

- indirectly, it helps the companies with excessive bad debt and does not require setting up of a state agency to deal with such indebtedness.

The authors of this report recommend the introduction of the Banks and Enterprises Restructuring Program (BERP) (Programma 1996). This Program assumes to resolve radically the bad debts problem of the state-owned enterprises through rehabilitation of the banks' credit portfolios and management of these non-performing assets. In order to achieve this goal, it is necessary to stop the process of transferring the burden from the industrial sector to the financial system and from the financial system to the macroeconomic environment. Also, it is necessary to partially recapitalize the banking system and develop a modern clearing and settlement system.

Implementation of these tasks should lead to risk reduction and an increase in the public's confidence in the national financial institutions.

The proposed program consists of two levels, macroeconomic and microeconomic. The macroeconomic level addresses the relations between the National Bank and commercial banks as well as the banks' recapitalization. The microeconomic addresses the problems of certain enterprises' bad debt to the banks.

The two levels of the program must be parallel. The banks' recapitalization at the macro level without intensive portfolio restructuring at the micro level will lead to the program's failure. Focusing exclusively on bad loan restructuring at the micro-level without legislative and capitalization measures at the macro level will also lead to negative effects. These two levels cannot be separated.

In our opinion, the recapitalization of the largest banks where the state owns the largest share of joint stock is necessary. It is unrealistic to expect that the majority of banks suffering from equity deficit can manage to acquire adequate equity without governmental assistance. The Ministry of Finance must accomplish capital increase

(recapitalization) in order to create reserves to cover long-term losses on loans. Recapitalization must be paid in the form of treasury bonds transferred to commercial banks in 1997. Specific approaches by the National Bank to certain banks suffering from capital deficit should be determined in accordance with the charter capital of the latter and the state share in this capital.

Implementation of the BERP in Kazakhstan, in our opinion, will require adoption of the Law on Financial Restructuring of Banks and Enterprises in the form of *lex specialis*, which should include certain requirements:

- define the steps of bad loan restructuring to be undertaken by the commercial banks;

- allow a bank to initiate the conciliation procedure when its outstanding claims to the enterprise amount to no less than USD 40 thousand or no less than 20 per cent of the enterprise's overall debt;

- introduce a provision under which conciliation agreements become binding for all creditors if signed by creditors holding a total of at least 50 per cent of the enterprise's debt;

- allow banks to convert loans into equity (shares of indebted firms) and hold it for a limited time (two years) in their portfolios. This practice is still prohibited by the banking law of the Republic of Kazakhstan;

- allow for bad debts sale;

- draft appropriate laws on bills of exchange and a market for bad debts.

In order to improve the banking system operation in Kazakhstan, it is also necessary to create a national system for collecting and keeping information on borrowers and creditors. Such a system would reduce the probability of new bad loans in the banking system through increasing borrowers' responsibility for repayment of loans and credits and creating an informational basis for a more sound policy for the banking structures themselves.

8. Privatization of banks

The Republic of Kazakhstan is continuing privatization of second tier commercial banks whose founders and shareholders are state-owned enterprises and enterprises with a majority state interest.

There are a number of reasons for privatization of the banking sector. At present in the transitional economy, state property and monopolization prevail which hampers the development of a healthy competition. Distribution of financial resources still is made in an administrative way. Since a network of large competitive commercial banks is lacking in Kazakhstan, the majority of existing banks provide a very limited set (no more than 20) of services, although in developed market economy countries banks offer their clients between 300 and 500 different kinds of services. Besides, charter capital of commercial banks existing in Kazakhstan is so small that they are unable to compete with large specialized banks.

Privatization of the commercial banks aims also at strengthening their financial stability and preventing uncontrollable watering down of the state share of their

charter capital. One of the documents regulating the process defines the list of banks subject to privatization (Postanovlenie 20.03.95).

Initially, all the larger banks were directly or indirectly owned by the state. Their shareholders were almost exclusively state owned enterprises or government agencies. As the state owned enterprises that are their main shareholders are corporatized and privatized, banks are also privatized.

Almost all banks are joint stock companies and have been created within the last four years. About 30 banks, including most of the larger banks, are spin-offs of the former Soviet specialized banks. The remaining 100 banks (zero-banks) were created from the ground up by their shareholders after 1991.

The ownership structure of these two groups is very different. Ownership in most zero-banks tends to be concentrated, with some banks owned by only a few shareholders. Large banks are often owned by a hundred or thousand shareholders.

In many banks (eleven banks) the formal state share has never been clearly defined, because many banks carried out additional (a second or third) emissions of new shares. For example, the Tsvetmet Bank has already made the fourth emission of shares.

Banks' privatization is taking place through auctions organized by the State Committee for Privatization (GKP). The first auctions for sale of state stock in commercial banks were held in the Central Asian Stock Exchange. The sale was organized by the GKP in cooperation with the Ministry of Finance.

In mid-April 1995 the State Committee for Privatization committed the stock of 46 banks to sale including four banks where the state had controlling stock: Gazprom, Torg, Tsvetmet, and Ak-Zhol. Shares of twenty banks were sold through auctions and the stock exchange; the most prominent of them is the Agroprom Bank. In August 1995 the government sold the remaining state shares of two large banks, Turan Bank and Credsoc Bank (see Table 6). Also, the licenses of 19 banks with state participation were revoked. All the above measures reduced the number of banks with state participation from 90 in early 1995 to 49 by February 1996 (Jermakowicz, Nikitinskaja, Pańków 1996:211).

The role of the Securities and Exchange Commission in these transactions is as yet minimal. Analysis of some banks' emission prospectuses shows that the latter are of very formal nature. The prospectuses include only financial reports approved by local auditing companies and lists of Supervisory and Executive Board members with information on their financial participation in the bank's charter capital. There is no information on marketing strategies, on the banks' structure, their strengths and weaknesses, opportunities and threats, etc. The standards for preparation of prospectuses established by the Securities and Exchange Commission are not satisfactory for an operational full-fledged financial market.

In our opinion, before the end of 1996, privatization of all banks should be completed except of those seven to ten banks whose licenses were revoked. As for the banks that are not committed to privatization in 1996, the state should appoint into their Supervisory Boards not only representatives of different agencies but independent professionals as well.

9. Banking laws: Anglo-American or Continental model of financial system

There are two basic models of financial systems which provide for different functions of banks and capital markets: Anglo-American (A-A) which includes the US, Great Britain, most Latin American countries, and the Continental covering Germany, Japan, and the majority of the European countries.

In the **Anglo-American model**, equity financing prevails. It provides for separation of the typical banking activities (deposit-taking and extending commercial credits) from typical capital market operations (security issues, secondary markets, etc.). In other words, it provides division into deposit banks and investment banks. Also, banks are not allowed to hold control over corporations.

The model is characterized by one-tier corporate governance (boards of directors with executive and non-executive members) and, because of the strong dispersion of shares, lack of shareholders' strict control over boards of directors.

The main strengths of this model are its rational credit policy due to lack of connected and in-house financing and its clear institutional distinction between different banking activities which provides for better specialization and concentration.

The main weaknesses are the lack of borrowers' control and the banks' inability to influence bad debtors.

In the **Continental model**, credit financing prevails. In this model universal banks dominate. Banks engage in deposit-taking and in the extension of commercial credits as well as in underwriting and the brokerage of securities and other capital market transactions.

The Continental model includes the two-tier corporate governance system (supervisory boards and executive boards) and strong direct control by main shareholders over banks' executive boards. Moreover, banks are allowed to control corporations. This model is prominent for its strong connection between banks and firms which facilitates banks' control over companies. Banks are in a position, as shareholders and creditors, to monitor a firm's management through direct access to information, and they can interfere when necessary to prevent failure.

The main weaknesses of this model relate to the fact that close bank-firm ties may be a source of resources allocation inefficiency and excessive risk-taking.

There is no doubt that the National Bank of Kazakhstan adopted the Anglo-American model. The separation of depository banks from investment banks and inability of these first to make an equity investment are some examples of this decision. In our opinion, however, Kazakhstan should choose the Continental model because of Kazakhstan's lack of developed capital markets and the extremely large role of its banks in the transformation process. The Kazakstani banking system, regardless of weaknesses, has developed an institutional basis, organizational structures, and capital and human resources. The very short time necessary for creation of an effective capital allocation mechanism also supports the choice of the Continental model. We should also remember that the Continental model played a very positive role in the rebuilding of many economies after the Second World War (Germany, Japan, Austria).

These factors, in our opinion, determine that the second, continental model should be adopted in Kazakhstan. Banking system reform cannot be postponed until the capital market reaches Western standards and the capital market replaces banks in the function of capital allocation. Banking system reform has to be intensified to secure financing for economic growth.

Adoption of the Continental Model in Kazakhstan will require several changes in the existing regulation. First of all, it will be necessary to remove the existing division between deposit banks and investment banks. The continental concept of universal banks should be adopted. Second, it will be necessary to abolish the principle that banks are prohibited, except investment ones, to participate in charter capitals of legal entities and that banks cannot directly influence forms and methods of enterprises' management through buy-outs of the majority stock. Third, it will be necessary to adopt a decentralized approach in the bad debt restructuring program.

10. Choice of banking system reform strategy in Kazakhstan

Two factors affect the reform strategy choice: speed of reforms and degree of this process's centralization. In order to answer the question of strategy choice, two questions are appropriate:

1. Should the government of Kazakhstan try to attempt a “fast-truck” type comprehensive bank restructuring, or it should pursue a gradual approach?
2. Should the government of Kazakhstan pursue a regulated or deregulated type of banking system reform?

Different countries have used different strategies (see Table 7). For instance, state regulation and a gradual approach were chosen by Far East countries like South Korea and Taiwan. The deregulated fast-truck restructuring approach was adopted in some Latin American countries and Russia.

Some countries' experience shows that countries with strong government regulation like South Korea and Taiwan were successful. The governments in these countries intervene through control over financial institutions, interest-rate management, and the allocation of credits. In Korea, for example, interest rates were deregulated in 1994 and deposit rates will not be fully deregulated until 1997.

Other countries' experiences prove that countries which introduced the “fast truck” deregulation strategy with a limited role for the government as in Latin America and Russia were unsuccessful. Inadequate prudent regulations, severe (latent or manifest) bad loan problems, lack of banking competition, and structural weaknesses in savings and investment performance contributed to this failure.

Which strategy then should be adopted in Kazakhstan?

There is no doubt that in Kazakhstan the two stage approach is necessary. In the first stage a gradual, regulated approach should be adopted. In this respect the approach accepted by the National Bank and described in Charter 4 should be commended. The only problem with this approach is that countries which implement this approach are often not in a position to abandon this policy as in South Korea.

The second stage should be characterized by a slow movement in a direction of a deregulated system. This, however, can be achieved only under certain conditions:

1. Macroeconomic stability has been achieved. (Financial liberalization, particularly the freeing of interest rates, is hazardous under conditions of great macroeconomic imbalances.)

2. Bank competition is strong enough. This competition can be achieved through freeing of interest rates, privatizing government-owned banks, establishing a direct securities market, and lifting barriers on new foreign and domestic bank entry. All these factors should be developed.

3. Credit rationing and allocative efficiency problems are removed which means the need to exclude and reduce the role of specialized state financial institutions.

4. Prudential regulation and bank supervision are strengthened. Bad loan problems and financial crises emerge not because of inadequate supervisory regulations, but because the implementation of existing regulations was weak.

5. A deposit insurance system is introduced that would form the basis for an effective banking system.

This two stage approach should allow for the slow but persistent transformation of the Kazakstani banking system.

11. Conclusions

Undoubtedly in the 1990s, significant progress was achieved in banking system reform in the Republic of Kazakstan.

First, the two-tier banking system was created to replace the former one-tier one. The process was slow since the National Bank was only then being formed as a classic central bank, and the first commercial banks were being created on the basis of state sector banks.

Second, the economic instruments of money supply management were introduced to the National Bank's monetary policy. In 1995 the National Bank was already using classic monetary and credit tools like credits refinancing, prime rate level, mandatory reserves mechanism, state treasury securities, and interventions in the currency market.

Third, the structure of ownership was diversified, i. e. bank privatization had begun.

Fourth, regulations from international practice were adapted to Kazakstani conditions such as the terms of licensing, the introduction of an adequacy ratio, the minimum charter capital, the maximum risk per borrower (related and unrelated), the liquidity ratio, the open currency position limit, and reserve requirements.

Fifth, the role of bank supervision was strengthened and it began to control the banks' operation. Compliance or non-compliance with the standards is the major criteria for a bank's activities evaluation. During the period from 1993 to 1995, licenses for banking transactions were revoked from 80 banks for non-compliance with the standard requirements. In the end of 1995, 62 banks were in the process of liquidation, but only six were liquidated in fact by the end of 1995. Similar problems exist in

Russia where in 1995, 325 banks were to be liquidated, but only six of them really ceased to exist. According to the National Bank, recently the liquidation mechanism has been refined and does not take so much time.

Sixth, an interbank loans market and a state securities market have been created lately. The amount of secondary transactions on treasury bills was T 11.4 billion compared to T 1.7 billion in 1994. The amount of secondary transactions on short-term notes of the National Bank was T 2.2 billion. The state treasury bonds (STB) have become very popular. The actual amount of STB in circulation in 1995 increased 24 times as compared to 1994.

At the same time, there are serious drawbacks in the banking system of the Republic of Kazakstan. The majority of these gaps were described in this paper:

1. Too many banks and too great concentration in the Almaty Oblast.
2. Inadequate number of bank branches.
3. Non-transparent ownership structure.
4. Low capitalization of banks — only 12 of them comply with the minimum charter capital criteria introduced in October 1995.
5. Low credit activity of banks.
6. Overly extensive use of centralized loans by the National Bank.
7. No accepted program to resolve the bad loans problem.
8. Strong pressure to establish specialized banks.
9. No deposit insurance system.
10. Inadequate independence of bank supervision.

The National Bank of Kazakstan needs further reorganization also. It must stop providing bank services to economic entities of the non-financial sector and must strengthen the role and the power of the Supervisory Department.

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Tables

Table 1
Banks in Kazakhstan depending upon methods of forming charter capital¹

Period	State	Inter-state	Joint stock	Private	Joint	Foreign	Number of branches	Total banks
09.94	1		109	72	5	4	1035	191
10	2		109	69	6	4	1011	190
11	2		113	65	6	4	1016	190
12	3		113	65	6	4	1022	191
01.95	3		110	59	6	6	1042	184
02	3		110	59	6	6	1042	184
03	3		106	56	6	6	1038	177
04	3		102	56	6	6	1047	173
05	4	1	99	51	6	6	1048	167
06	4	1	99	51	6	6	1048	167
07	4	1	96	47	6	6	1050	160
08	4	1	88	42	6	6	1043	147
09	3	1	85	40	7	6	1037	142
10	3	1	84	35	7	6	1029	136
11	3	1	83	33	7	6	1039	133
12	3	1	80	33	7	6	1036	130

Source: Authors' computation based on "Statistical Bulletin" No. 2, 1996.

¹ In Table 1 commercial banks are shown as part of private banks, and joint-stock commercial banks as a part of joint-stock banks.

Table 2
Data on a number of commercial banks in Kazakhstan

Data on banks	Number of banks
1. Registered banks	130
joint-stock	80
private	33
2. Number of second tier banks' branches, total	1036
branches of the Agroprom Bank	235
branches of the People's Bank	296
3. Number of banks that obtained licenses for foreign currency banking transactions	48
4. Number of banks that obtained general licenses	37
5. Charter capital of banks (million Tenge)	8662.43
banks that obtained domestic licenses	431.89
banks that obtained general licenses	6543.69
6. Number of banks whose licenses were revoked, total for 1994	33
including transformed into branches of other banks	9
total for January-August 1995	38
including transformed into branches of other banks	9
7. Number banks whose licenses were revoked because of violations of banking laws	53
total in 1994	24
total for January-August 1995	29

Source: Author's computation based on different sources.

Table 3
Charter capital and the number of banks

Charter capital, million Tenge	1.09.1995	1.01.1998
Up to 1	20	18
From 1 to 5	30	27
From 5 to 10	10	8
From 10 to 15	4	3
From 15 to 20	10	9
From 20 to 25	2	5
From 25 to 30	6	3
From 30 to 80	18	17
From 80 to 130	19	21
Over 130	14	16

Source: "Statistical Bulletin" No. 6(7), 11(12), 1995.

Table 4

Information about the centralized credits given by the National Bank of Kazakstan (in billion)

	Total liabilities (including bad loans) on Jan. 1, 1994	Credits issued Jan. 1, 1995	Credits issued on Jan. 1, 1996
1. Credits provided according to the governments decree on "The Republican Budget"			
a) for covering the Republican budget deficit	0.9	4.9	8.6
b) direct credits and credits provided according to the government's decisions	1.0	14.8	0.2
c) credits for spring agricultural activities	2.3	0.4	1.1
d) direct credits for wages and salaries		0.5	
e) credits for purchase of grain			4.4
Total	4.2	20.6	14.3
2. Credits provided to the commercial banks			
a) through the auctions	0.2	5.3	9.1
b) interbak loans			3.4
c) lombard loans			0.2
d) other credits	2.4	0.8	2.6
Total	2.6	6.1	15.3
3. Klientura credits	0.1		0.7
Total in Tenge	6.9	27.4	30.2
Total in US Dollars	1.29	0.76	0.49

Source: Nacionalnyi 1996.

Table 5

Phased standards imposed on commercial banks by the National Bank of Kazakstan

Standards	Dec. 1, 1996	Dec. 1, 1997	Dec. 1, 1998
Adequacy ratio (risk weighted capital – asset ratio)			0.08
Adequacy ratio (risk weighted own capital – asset ratio)			0.04
Exposure to any single borrower	0.50	0.40	0.25
Exposure to any single connected party	0.25	0.20	0.10
Percent of provisions have to be established	0.25	0.35	0.40
Liquidity ratio			0.20

Source: Programma 17.05.96.

Table 6
Banks with state participation subject to sale

Bank	Decree	Status
Credsoc Bank	No. 2/2, of 2 Aug. 1995	sold on 10 Aug. 1995
Energoinvest	No. 2/3 of 31 Aug. 1995	
Ural Bank	No. 2/4 of 31 Aug. 1995	sold on 14 Aug. 1995 ²
Gazprom Bank	No. 2/5 of 31 Aug. 1995	
Turan Bank	No. 2/6 of 6 Sept. 1995	

Source: Jermakowicz, Nikitinskaja, Pańków, 1996.

Table 7
Banking system reform strategies

	“Fast-truck” approach	Gradual approach
Governmental regulation	Poland	South Korea, Taiwan
Deregulation	Chile, Russia	x

Table 8
Different approaches to bad debt restructuring

Centralized approach	Decentralized approach	<i>Laissez-faire</i> approach
Advantages		
<ul style="list-style-type: none"> allows for quick separation of bad debts from a bank's healthy assets. It is assumed that the old banks, after the bad debt separation, can start new commercial activities without the old burdens; this approach, thanks to the concentration of bad debts in a single institution, allows for full focus of the new institution on bad debt restructuring. 	<ul style="list-style-type: none"> it introduces the mechanism that compels the banks to undertake specific actions with respect to bad debtors; this approach teaches the bank's personnel how to assess credit risk, how to deal with bad debtors and how to take responsibility for actions; because the amount of the recapitalization has to be determined <i>ex ante</i> and not depend on the amount of bad loans to be recovered by the individual banks, this creates incentives for the banks to recover as much of the bad debts as possible; this approach sets clear rules of the game to all players and eliminates the risk of political pressures; this approach indirectly helps firms with excessive amount of bad loans and does not require the establishment of a government agency with bad loan working skills. 	<ul style="list-style-type: none"> this is the most market conforming approach and at the same time the easiest approach to implement. It is easy to perform, because no action on the part of the government is needed, and there is no need for effective supervision; this is the cheapest approach because no recapitalization of the banks by the government is required; the small size of the banks eliminates any systemic consequences of bank failures.

² The decision about the shares sale was made practically three weeks after the shares were sold.

Table 8 (cont.)
 Different approaches to bad debt restructuring

Centralized approach	Decentralized approach	<i>Laissez-faire</i> approach
Disadvantages		
<ul style="list-style-type: none"> • it requires the creation of a new agency with loan workout skills. It is difficult to find the highly skilled specialists for bad loan restructuring for the state based institution, and there is no guarantee that this agency will vigorously and effectively recover bad debt. The creation of a new agency does not answer the question of what to do with bad debtors and does not create an adequate incentive system that would insure the institution's active approach toward indebted enterprises; • this approach does not teach banks and other debtors responsibility for their actions. It is not sufficient to replace assets and management. It requires a change in a whole corporate culture of the banking system. This does not address the causes of the problem which lie primarily in the lack of experience and expertise of the banks in assessing credit risk in the market environment; it does not teach banks' personnel responsible behavior and responsibility. The danger still exists that the bad loan portfolio will re-emerge in the near future; • the centralized approach does not create an adequate incentive system within the banks that would insure the banks of an active approach toward indebted enterprises; • most decisions concerning the separation of the loans, and support given to different enterprises is politically based. This creates the danger of political pressures on the credit and restructuring policy toward big debtors. 	<ul style="list-style-type: none"> • there exists a danger that banks preoccupied with old debts will be unable to introduce new standards for their regular credit operations and reorganize banks during the transition period; • there exists the danger that banks will continue to finance the old bad debtors with new loans without setting any restructuring requirements. 	<ul style="list-style-type: none"> • very easy entry into banking sector creates an excellent opportunity for criminal elements to control the banking system. This is reinforced by very weak bank supervision and poor enforcement of regulations; • due to the high inflation not only bad loans erode but also banks equities reduce significantly. (For example the largest Russian banks have an equity in the amount of \$100-150 million.) This hampers effective large credit financing, forces the creation of banks consortia, reduces the banks' credit potential; • because of the government's inaction, there is no enforcement for restructuring of large bad debtors. The responsibility for large firms restructuring stays at the government agencies (not in the banks) which creates the strong pressure on the government for additional subsidies and does not create any incentives for firms' restructuring; • erosion of banks' equity and banks' deposits undermines the public trust in the banking system and undermines the normal functioning of the economic system.

Table 9

Basic financial ratios in sixteen Kazakstani selected banks

Bank No.	Risk assets (RA)	Provisions established	Need for provisions	Charter capital		Equity (E)	K1= E/RA not lower than 0.08	Maximal risk per one creditor/equity (K2)				Liquid assets (LA)	Liabilities (L)	K3 0.3	Balance sum	State share in the Charter Capital (%)	Foreign capital share in the Charter capital (%)
				Real	Registered			Non-related persons	Less than 25% of the equity	Related persons	no more than 10% equity						
1	4197518	37535	1407777	106000	106000	-1899028	-	125049	-	-	-	783860	2933468	0.27	9788085	0	0
6	4849658	410	1258093	520485	1550000	508640	0.11	126000	24.8	-	-	2781009	4402645	0.63	15188163	1.4	32.1
7	1485835	40053	298271	150000	150000	441089	0.30	45600	10.3	15178	3.4	170912	942975	0.18	2614777	0	0
9	9790739	25960	1831856	400000	400000	2082212	0.21	-	17	-	-	2672649	8155103	0.33	21840444	0	10
10	5801016	43918	642025	762515	169873	1988374	0.34	262524	13	-	-	13441480	23109892	0.58	54862760	100	0
21	1302446	23831	113188	80199	100000	316877	0.24	69429	21.9	18060	5.7	642865	1477381	0.44	2677950	0	0
22	730445	35991	177347	120002	120000	326781	0.45	60175	18.4	-	-	268468	685831	0.39	1895088	1	0
48	4956966	67038	670384	127267	127267	1450032	0.29	336213	23.2	14366	9.9	2019558	6575341	0.31	12661721	0	0
53	3317169	13116	894472	200000	200000	237361	0.07	23320	9.82	-	-	-	-	-	-	28.16	0
66	14655718	10092	4382540	280180	436000	1778054	0.12	162954	10	-	-	1685827	5087808	0.33	37418478	51	0
98	1052324	31257	155589	100471	160000	218538	0.21	34500	15.8	1000	0.5	416152	1094531	0.38	201794	-	-
107	1390631	92489	139153	150000	150000	666544	0.48	48421	7.3	34790	5.2	2445230	3025806	0.81	5196988	0	0
199	599377	3535	14438	94500	94500	134140	0.22	18611	13.9	-	-	1252422	1206382	1.04	5601642	0	65.3
225	1286060	3554	3554	603500	597000	787731	0.61	163250	20.7	-	-	2336638	1795979	1.30	3252646	0	71
232	3530276	1624	216054	3204583	3000000	3204359	0.91	205000	6.4	-	-	379851	335313	1.13	6746277	100	0
237	261209	2226	2314	95598	95600	200674	0.77	28347	14.1	-	-	287026	347521	0.83	839320	0	77.8

K1 = adequacy ratio; K2 =risk ratio per one borrower; K3 =liquidity ratio.