



Technical Assistance Report

Project Number: 51235-001
Knowledge and Support Technical Assistance (KSTA)
September 2017

Republic of Kazakhstan: Promoting Finance Sector Resilience

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Asian Development Bank

CURRENCY EQUIVALENTS

(as of 7 September 2017)

Currency unit	–	tenge (T)
T1.00	=	\$0.002956
\$1.00	=	T338.25

ABBREVIATIONS

ADB	–	Asian Development Bank
GDP	–	gross domestic product
ICAAP	–	internal capital adequacy assessment process
ILAAP	–	internal liquidity adequacy assessment process
NBK	–	National Bank of Kazakhstan
NPL	–	nonperforming loan
SREP	–	supervisory review and evaluation process
TA	–	technical assistance
US	–	United States

NOTE

In this report, “\$” refers to United States dollars.

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KNOWLEDGE AND SUPPORT TECHNICAL ASSISTANCE AT A GLANCE

1. Basic Data		Project Number: 51235-001	
Project Name	Promoting Finance Sector Resilience	Department /Division	CWRD/CWPF
Nature of Activity	Policy Advice	Executing Agency	The National Bank of Kazakhstan
Modality	Regular		
Country	Kazakhstan		
2. Sector	Subsector(s)	ADB Financing (\$ million)	
✓ Finance	Banking systems and nonbank financial institutions		0.15
	Central banking systems		0.20
	Inclusive finance		0.15
		Total	0.50
3. Strategic Agenda	Subcomponents	Climate Change Information	
Inclusive economic growth (IEG)	Pillar 1: Economic opportunities, including jobs, created and expanded	Climate Change impact on the Project	Low
4. Drivers of Change	Components	Gender Equity and Mainstreaming	
Governance and capacity development (GCD)	Institutional development	No gender elements (NGE)	✓
5. Poverty and SDG Targeting		Location Impact	
Geographic Targeting	No	Nation-wide	High
Household Targeting	No		
SDG Targeting	Yes		
SDG Goals	SDG1, SDG8		
6. Risk Categorization	Low		
7. Safeguard Categorization	Safeguard Policy Statement does not apply		
8. Financing			
Modality and Sources		Amount (\$ million)	
ADB		0.50	
Knowledge and Support technical assistance: Technical Assistance Special Fund		0.50	
Cofinancing		0.00	
None		0.00	
Counterpart		0.11	
Government		0.11	
Total		0.61	

I. INTRODUCTION

1. The knowledge and support technical assistance (TA) will support the National Bank of Kazakhstan (NBK) to improve its supervisory authority, frameworks, and skills to assess the risk management processes of banks, strengthen bank regulation and supervision, and support the introduction of a risk-based approach as noted by the President of Kazakhstan in his state of the nation address on 31 January 2017.¹ The TA entails the review of the NBK Law (1995), and the review and introduction of the internal capital adequacy assessment process (ICAAP) and internal liquidity adequacy assessment process (ILAAP) reports from banks in line with Basel II and III standards. The TA aims to promote the resilience of the finance sector and support Asian Development Bank (ADB) funding operations to small and medium-sized enterprises.²

2. Subsequent to ADB consultations with the Ministry of Finance, the Ministry of National Economy, and NBK, the governor of NBK requested the proposed TA on 21 June 2017.³ The TA supports pillar 1 of the country partnership strategy in relation to increasing access to finance through banking sector reforms.⁴ It directly supports the performance of other ADB projects in Kazakhstan aimed at supporting micro, small, and medium-sized enterprises by improving the governance of banks and improving the access of micro, small, and medium-sized enterprises to finance, which have been identified as key constraints to economic diversification.⁵

II. ISSUES

3. Kazakhstan's economy depends on oil export revenues, which in 2016 represented 17.5% of its gross domestic product (GDP) and more than 52.0% of export revenues.⁶ While GDP growth was robust at an average 10.2% per annum during 2000–2007, economic performance has been volatile since the 2008 global financial crisis. The economy rebounded with average GDP growth of 6.5% during 2010–2013, but declined to 4.2% (2014), 1.2% (2015), and 1.1% (2016) although it is expected to improve to 2.6% in 2017.⁷ The economic slowdown is largely influenced by the sharp drop in oil revenues, the recession in the Russian Federation, and weakening demand from Kazakhstan's main trading partners. The reduction in foreign exchange income in 2015 prompted the NBK to move to a floating exchange rate regime. The tenge lost 47% of its value against the United States (US) dollar from 2014 to 2016,⁸ and inflation more than doubled to 14.6% in 2016 from 6.7% in 2014 despite price controls and a restrictive monetary policy.

4. The performance of the finance sector mirrors that of the economy. Economic shocks, poor credit underwriting, and currency devaluations have affected the performance and stability

¹ Official Site of the President of the Republic of Kazakhstan. State of the Nation Address. 31 January 2017. http://www.akorda.kz/en/addresses/addresses_of_president/the-president-of-kazakhstan-nursultan-nazarbayevs-address-to-the-nation-of-kazakhstan-january-31-2017.

² The TA first appeared in the business opportunities section of ADB's website on 24 August 2017.

³ NBK letter to ADB dated 21 June 2017 (Appendix 4).

⁴ ADB. 2017. *Country Partnership Strategy, Kazakhstan, 2017–2021*. Manila.

⁵ ADB has provided two loans to support micro, small, and medium-sized enterprises in Kazakhstan under (i) ADB. 2010. *Report and Recommendation of the President to the Board of Directors: Proposed Multitranchise Financing Facility to the Republic of Kazakhstan for the Small and Medium Enterprise Investment Program*. Manila; and (ii) ADB. 2016. *Report and Recommendation of the President to the Board of Directors: Proposed Loan and Administration of Technical Assistance Grant to the Republic of Kazakhstan for the Damu Entrepreneurship Development Fund Supporting Resilience of Micro, Small, and Medium Sized Enterprises Finance Project*. Manila.

⁶ International Monetary Fund. 2017. *Republic of Kazakhstan: Staff Report for the 2017 Article IV Consultation*. Washington, DC.

⁷ ADB. 2017. *Asian Development Outlook 2017: Transcending the Middle-Income Challenge*. Manila.

⁸ From T179 = \$1 to T342 = \$1.

of banks and eroded public confidence in the sector. After consolidations and mergers, the five⁹ largest banks hold about 58% of the banking system assets.¹⁰ High exchange rate volatility resulted in a surge of deposit dollarization from 35% (2010) to 70% (2015). Although the levels decreased in 2016, US dollar-denominated loans remain elevated at 40% of total loans (from 43% in 2015), which indicates a sizeable dependency on currency hedging.

5. The sharp devaluation of the tenge against the US dollar seriously affected the solvency and profitability of some banks, including systematically important banks. Bank loans contracted by 3% in real terms in 2016. As a result, the banking system's depth, expressed by the ratio of private sector credit to GDP, weakened to 41% in 2016 (from 46% in 2015) (footnote 6). In addition, banks' lending in local currency was temporarily constrained by NBK's monetary policy and measures to counter currency speculation.

6. In 2016, banks were moderately capitalized, with a total capital adequacy ratio of 14.3%. While exceeding the regulatory minimum ratio of 7.5%, banking system solvency remains highly susceptible to the volatile economy and unresolved asset quality issues. The significant volume of nonperforming loans (NPLs) will require write-offs and loan loss provisions over an extended period, and low net interest margins will limit banks' ability to generate additional capital through retained earnings. Additional capital will likely be needed to meet Basel III requirements, which are being phased in from 2017 until 2021. The NBK will also need to guide the banks and gain a better understanding of what can be expected from banks under ICAAP and ILAAP, and how to run the supervisory review and evaluation process (SREP) in compliance with Basel II and III Pillar 2 standards.

7. In July 2017, the NBK reported NPLs at 10.7% of all loans. However, there are some doubts about the reported level of NPLs in the sector as banks differ in the way they identify and report impaired loans, including not declaring delinquent loans. In 2016, Moody's estimated problems loans at 37% of total loans.¹¹

8. The NBK has introduced measures¹² to tighten its prudential requirements and credit appraisal guidelines to prevent the future buildup of NPLs, but more improvements are needed to address weaknesses in the sector. This is in line with the International Monetary Fund's mission of emphasizing the need to conduct stress testing and asset quality review of systematically important banks.¹³ Persistent high NPLs affect bank profitability and the ability to extend credit, limiting banks' ability to contribute to economic growth. A resilient financial system is required to support economic growth. To facilitate this, the NBK will need to develop an internal risk-based supervisory methodology consistent with international best practices, and review bank reporting practices and assess the quality of independent audit in its supervisory evaluation.

⁹ This does not factor in the merger of Halyk Bank and Kazcommerstbank in July 2017.

¹⁰ NBK. 2016. *Current State of the Banking Sector of Kazakhstan*. Almaty.

¹¹ Moody's Investors Service. 2017. Moody's Negative Outlook on Kazakhstan's Banking System Reflects Heightened Insolvency Risks. https://www.moodys.com/research/Moodys-Negative-Outlook-on-Kazakhstans-Banking-System-Reflects-Heightened-Insolvency--PR_361819. 7 February.

¹² The NBK is yet to finalize the asset quality review of banks. The TA output requires the NBK to finalize the asset quality review.

¹³ Kazakhstan Staff Concluding Statement of the 2017 Article IV Mission. 8 February 2017.

III. THE TECHNICAL ASSISTANCE

A. Impacts and Outcome

9. The TA is aligned with the following impacts: improved governance, increased economic role of the financial system, strengthened support for small and medium-sized enterprises, and increased infrastructure development.¹⁴ The TA will have the following outcome: improved risk and capital management capability of the banking sector.¹⁵

B. Outputs, Methods, and Activities

10. **Output 1: National Bank of Kazakhstan Law reviewed and revised.** This output will review the current NBK Law and identify the areas of the law that need to be enhanced and improved in relation to the NBK's supervisory control and regulatory role of the banking sector. It will also provide recommendations on potential amendments and additions to the NBK Law.

11. **Output 2: Internal capital adequacy assessment process and internal liquidity adequacy assessment process processes established.** This output will undertake a review of existing bank models under pillar 2 of Basel II and III, and evaluate proposals for different risk quantification by commercial banks and provide advice on the amendments and improvements based on international best practice that can be introduced.

12. **Output 3: Supervisory review and evaluation process established.** This output will review the SREP process of NBK, and provide amendments and recommendations based on international best practice that can be introduced and incorporated in the existing supervision framework.

13. **Output 4: Framework for imposing countercyclical or capital conservation buffers developed.** This output will develop a framework that the NBK can adopt for imposing system-wide capital buffers to banks. It will also provide guidance and recommendations consistent with international best practice.

14. **Output 5: Risk-based supervisory process organization structure established.** This output will review the NBK's organizational structure and provide recommendations on how to improve the organizational structure for implementing a risk-based supervisory process in accordance with international best practice.

15. **Output 6: Actions for improving finance sector resilience identified.** This output will perform a broad review of the finance sector. It will identify key inefficiencies and provide recommendations and actions on how other key government agencies like the Ministry of Finance can address sector inefficiencies.

C. Cost and Financing

16. The TA is estimated to cost \$608,000, of which \$500,000 will be financed on a grant basis by ADB's Technical Assistance Special Fund (TASF-other sources). The key expenditure items are listed in Appendix 2.

¹⁴ Government of Kazakhstan. 2012. *Kazakhstan 2050 Strategy*. Astana.

¹⁵ The design and monitoring framework is in Appendix 1.

17. The government will provide counterpart support in the form of counterpart staff, office accommodation, office supplies, secretarial assistance, domestic transport, and other in-kind contributions.¹⁶

D. Implementation Arrangements

18. ADB will administer the TA through its Central and West Asia Department, Public Management, Financial Sector and Trade Division, which will select, supervise, and evaluate consultants, organize discussions, and provide staff to act as the resource persons as required in the implementation of the TA. ADB's Kazakhstan Resident Mission will provide, as needed, local administrative and coordination support.

Implementation Arrangements			
Aspects	Arrangements		
Indicative implementation period	September 2017–December 2020		
Executing agency	NBK		
Implementing agency	Through ADB's Central and West Asia Department, Public Management, Financial Sector and Trade Division		
Consultants	To be selected and engaged by ADB (with guidance from NBK)		
	Individual consultant selection	12 person-months	\$387,700
Disbursement	The technical assistance resources will be disbursed following ADB's <i>Technical Assistance Disbursement Handbook</i> (2010, as amended from time to time).		

ADB = Asian Development Bank, NBK = National Bank of Kazakhstan.

Source: Asian Development Bank.

19. **Consulting services.** An international banking and financial services regulatory expert will be engaged for 12 person-months under the individual consultant selection method. Lump sum payments and output-based contracts will be considered for consulting services under the TA. The consultant will be engaged by ADB in accordance with ADB's Procurement Policy (2017, as amended from time to time) and the associated project administration and TA staff instructions.¹⁷

IV. THE PRESIDENT'S DECISION

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

¹⁶ Counterpart staff is expected to consist of five NBK staff from the Banking Supervision Department working with ADB on the implementation of the TA. The counterpart staff will allocate 30% of their work time over the implementation period of the TA of about 3 years.

¹⁷ Terms of Reference for Consultants (accessible from the list of linked documents in Appendix 3).

DESIGN AND MONITORING FRAMEWORK

Impacts the Technical Assistance is Aligned with Governance improved, economic role of the financial system increased, support for small and medium-sized enterprises strengthened, and infrastructure development increased ^a			
Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting Mechanisms	Risks
Outcome Risk and capital management capability of the banking sector improved	By 2019: Adoption and implementation by NBK and banks of ICAAP and ILAAP processes in line with international best practice, and improvements on risk assessment processes of the banking industry	NBK and bank reports	External and macroeconomic shocks further affect the banking sector. Banks do not adopt the recommended process improvements.
Outputs 1. NBK Law reviewed and revised 2. ICAAP and ILAAP processes established 3. SREP established 4. Framework for imposing countercyclical or capital conservation buffers developed 5. Risk-based supervisory process organization structure established	By 2018: 1. Review NBK Law and relevant revisions to NBK Law identified and proposed for implementation (2017 baseline: Not applicable) 2. Guidelines on ICAAP and ILAAP improvements consistent with international best practice rolled out for implementation by banks (2017 baseline: Not applicable) 3. Recommendation on SREP improvements consistent with international best practice adopted and implemented by NBK (2017 baseline: Not applicable) 4a. Framework established by NBK (2017 baseline: Not applicable) 4b. Asset quality review of banks finalized by NBK. (2017 baseline: Not applicable) 5. Supervisory process organization structure established by NBK (2017 baseline: Not applicable)	NBK and TA consultant reports NBK, bank, and TA consultant reports NBK and TA consultant reports NBK and TA consultant reports NBK and TA consultant reports	Banks do not adopt and implement recommendations. NBK and banks have inadequate skills and staff capacity to implement recommendations.

Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting Mechanisms	Risks
6. Actions for improving finance sector resilience identified	6. Sector inefficiencies identified and actions for the Ministry of Finance developed (2017 baseline: Not applicable)	TA consultant reports	
Key Activities with Milestones (by 2018) 1. NBK Law reviewed and revised 1.1 Review existing NBK law and provide recommendations. 2. ICAAP and ILAAP established 2.1 Identify risk categories to be quantified for imposing capital charges under pillar 2 of Basel II and III. 2.2 Provide understanding of international best practice of ICAAP and ILAAP processes, and provide relevant training and workshops (as required). 2.3 Review of existing bank models under pillar 2 and evaluate proposals for different risk quantification by banks submitted to NBK. 3. SREP established 3.1 Advise on relevant amendments to introduce risk-based supervision of banks. 3.2 Assist in the review of SREP following submission of ICAAP and ILAAP documents by banks to NBK, and provide recommendations for improvements. 3.3 Evaluate and provide guidance to NBK on how to incorporate ICAAP, ILAAP, and SREP processes in the existing capital adequacy, asset quality, management, earnings, and liquidity supervision framework. Provide relevant training and workshops (as required). 4. Framework for imposing countercyclical or capital conservation buffers developed 4.1 Advise NBK on a framework for imposing system-wide capital buffers to banks, and provide guidance and recommendations on improvements consistent with international best practice. 5. Risk-based supervisory process organization structure established 5.1 Evaluate current NBK's supervisory process, and provide guidance and recommendations on improvements consistent with international best practice. 6. Actions for improving finance sector resilience identified 6.1 Conduct broad review of the finance sector, identifying key inefficiencies and weaknesses. Provide recommendations and actions for the Ministry of Finance to address sector inefficiencies and weaknesses.			
Inputs Asian Development Bank: \$500,000 Technical Assistance Special Fund (TASF-other sources) Note: The government, through the NBK Banking Supervision Department, will provide counterpart support in the form of counterpart staff, office accommodation, office supplies, secretarial assistance, domestic transport, and other in-kind contributions.			
Assumptions for Partner Financing Not applicable			

ICAAP = internal capital adequacy assessment process, ILAAP = internal liquidity adequacy assessment process, NBK = National Bank of Kazakhstan, SREP = supervisory review and evaluation process, TA = technical assistance.

^a Government of Kazakhstan. 2012. *Kazakhstan 2050 Strategy*. Astana; and ADB. 2017. *Country Partnership Strategy, Kazakhstan, 2017–2021*. Manila.

Source: Asian Development Bank.

COST ESTIMATES AND FINANCING PLAN

(\$'000)

Item	Amount
Asian Development Bank^a	
1. Consultants	
a. Remuneration and per diem	
i. International consultant	324.4
b. Out-of-pocket expenditures	
i. International and local travel	62.4
ii. Others ^b	0.9
2. Training, seminars, workshops, forum, and conferences	
a. Facilitators	37.3
3. Contingencies	75.0
Total	500.0

Note: The technical assistance is estimated to cost \$608,000, of which contributions from the Asian Development Bank are presented in the table above. The government will provide counterpart support in the form of counterpart staff, office accommodation, office supplies, secretarial assistance, domestic transport, and other in-kind contributions. The value of government contribution is estimated to account for 18% of the total technical assistance cost.

^a Financed by the Asian Development Bank's Technical Assistance Special Fund (TASF-other sources).

^b Insurance.

Source: Asian Development Bank estimates.

LIST OF LINKED DOCUMENTS

<http://www.adb.org/Documents/LinkedDocs/?id=51235-001-TARreport>

1. Terms of Reference for Consultant

LETTER FROM THE NATIONAL BANK OF KAZAKHSTAN

«ҚАЗАҚСТАН РЕСПУБЛИКАСЫНЫҢ
ҰЛТТЫҚ БАНКІ»

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21.06.2017 № 26-1-01/574

Mr. Sean O`Sullivan
Director General
Central and West Asia Department
Asian Development Bank
6 ADB Avenue, Mandaluyong City
1550 Metro Manila, Philippines

Dear Mr. O`Sullivan,

The National Bank of Kazakhstan would like to express its gratitude for the continuing cooperation with your esteemed institution. We are grateful for technical assistance and advice in enhancing insurance market efficiency and outreach provided to the National Bank of Kazakhstan by the Asian Development Bank over the past three years.

It should be noted that at this stage one of the main goals of the National Bank of Kazakhstan is to reload the financial market regulation and supervision model.

Against this background, we would like to address the Asian Development Bank with the proposal to consider cooperation within the following scope of technical assistance:


- Internal Capital Adequacy Assessment Process and Internal Liquidity Adequacy Assessment Process

№ 0016296

- Revision of CAMELS rating system in Supervisory Review and Evaluation Process framework, including supervisory judgement and risk-based supervision
- Countercyclical and/or capital conservation buffers
- Supervisory process organizational structure, given transfer to risk and judgement based supervision.

This is a critical area to our near and medium-term financial sector tasks, and we would be very grateful for your favorable consideration of this request.

Sincerely yours,



Daniyar Akishev
Governor

cc: Mr. Giovanni Capannelli, ADB Country Director for Kazakhstan