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REPUBLIC OF KAZAKHSTAN AND THE WORLD BANK

JOINT ECONOMIC RESEARCH PROGRAM

QUICK RESPONSE NOTE ON

PRIORITIES FOR FINANCIAL SECTOR REFORM: SELECTED ISSUES AND OPTIONS

Preliminary Assessment

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The main objective of this note is to assist the economic team of the government to reach consensus on strategic priorities and key building blocks before launching future reforms. As such, the note provides strategic directions and a framework, and not a blueprint or roadmap for the areas covered. In addition, some important areas were not covered by the mission (e.g., taxation of the financial sector, or SME access to credit). Developing detailed blueprints would require more in-country time, and a deeper level of collaboration with technical staff from various agencies.

ABBREVIATIONS AND ACRONYMS

ADB	Asian Development Bank
CIS	Collective Investment Schemes
CSD	Central Security Depositary
EBRD	European Bank for Reconstruction and Development
EU	European Union
FSA	Financial Supervision Agency
FSAP	Financial Sector Assessment
GDP	Gross Domestic Product
GOK	Government of Kazakhstan
IBRD	International Bank for Reconstruction and Development
IFC	International Finance Corporation
IMF	International Monetary Fund Institutional Review
IPO	Initial Public Offering
KMC	Kazakhstan Mortgage Company
MEBP	Ministry of Economy and Budget Planning
MOF	Ministry of Finance
MOU	Memorandum of Understanding
NBK	National Bank of Kazakhstan
NFRK	National Fund of the Republic of Kazakhstan
RER	Real Exchange Rate
SME	Small and Medium Enterprises
SRO	Self-Regulatory Organization
TOR	Terms of Reference
USAID	United States Agency for International Development
OCIAPFA	Organizations that Carry Out Investments of Accumulative Pension Funds Assets
APF	Accumulative Pension Fund
MIP	Manager of Investment Portfolio

PRIORITIES FOR FINANCIAL SECTOR REFORM: SELECTED ISSUES AND OPTIONS

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I. KEY MESSAGES

A. Overall Assessment

i. **Kazakhstan has made commendable progress in a short period of time** in developing its banking sector, securities markets and the related pension system. Efforts to create or modernize some, but not all of the infrastructure to support financial system development (e.g., electronic trading platform, payment systems, etc.), and a strong economic recovery since 2001 have resulted in a rapid financial sector expansion.

ii. **Today however the financial sector stands at a key cross roads**: the sector's competitiveness –and to some extent the commendable past accomplishments-- are being threatened by:

- **Growing financial sector vulnerabilities** related to the fast pace of the sector's expansion, borrowings abroad, the concentrated nature of the non-oil economy (including the existence of conglomerates), and bottlenecks and imbalances in the pace of development of the various components of the financial sector architecture (e.g., pension assets). The international experience has shown that a very rapid expansion of credit, well above Gross Domestic Product (GDP) growth, has often resulted, after a short lag, in a sharp deterioration of credit quality.

- **Lack of clarity in determining priorities for a second-generation financial sector reform agenda**. As a result, important and complex institutional reforms (e.g., transition to an independent regulatory agency) have not been given the necessary attention, while resources are diverted to further modernize what is already—with some important exceptions-- a sound legal and regulatory framework. In addition, basic building blocks are not receiving the attention needed (e.g., development of the government securities market, and the further nurturing of the mortgage markets). Lack of setting clear priorities is not only taxing the highly qualified, but relatively small, human resource base available in the relevant agencies, but also undermines the credibility of government's policy towards the sector.

- **Inconsistency** between monetary, fiscal, debt management, securities market and financial sector regulatory policies.

- **The unmet need to synchronize institutional strengthening with the rapid pace of market developments.** It should be noted that institutional development takes longer and requires a sustained effort. As a result, often supervisors fall "behind the curve," creating potential serious imbalances and risks as supervisory agencies catch up with market developments and financial institutions.

B. Options

iii. **Sequencing second-generation reforms is essential.** Legal changes need to be carefully planned given that the current base is for the most part very solid. Work on accompanying regulations is needed to give financial agents clear implementation guidelines. In addition, the supervisory agency should be not only empowered but also operationally capable of monitoring and enforcing prudential regulation.

iv. **The priority reform agenda for the sector should be**: (1) addressing the issues related to financial sector vulnerability and lack of policy coordination; (2) putting in place a few missing building blocks and undertaking a second generation of reforms and institutional development to accompany the rapid market developments; and (3) ensuring effective enforcement of prudential measures. Success in these reform areas can support better intermediation of resources and capital to the real sector of the economy and will foster growth and competitiveness in this sector. This will require that the authorities initiate a carefully prioritized mutually reinforcing package of reforms, most of which will need to be geared to reinforcing key institutions rather than to further modernize legal or regulatory framework.

v. To mitigate vulnerabilities, there is a need for the fiscal, monetary, and financial regulation authorities to:

- **Adopt a package of measures to slow down the pace of credit growth and banking sector expansion** – including inter alia: introduction of reserve requirements on foreign borrowing, and possibly measures to signal the need of prudent cross-border lending and commercial bank's offshore operations. These measures may increase lending margins in the banking sector in the short-term (on average), which in itself are desirable, as it would reinforce the need to contain credit growth. Given the large availability of capital in the market, it is unlikely that such an increase in margins will affect medium or large enterprises—but it may affect smaller business borrowers.

- **To make a concerted effort to strengthen the institutional set up within and across agencies** that will need to serve as the **"eyes"** and **"ears"** of the policy makers regarding structural and business cycle-related risks in the financial sector. Emphasis will have to be given in particular to supporting efforts of the Financial Supervision Agency (FSA) to strengthen key functions including: comprehensive consolidated supervision, prompt corrective action and resolution (including the role of the deposit insurance fund), and onsite examination/off-site analysis in the case of both banking and non-banking services. Some elements of the regulatory framework merit a review to ensure FSA has authority to oversee and control effectively lending to related-parties, sectoral exposures, and loan classification and provision requirements. Institutional development is also needed for the FSA to be able to address some complex issues associated with non-bank regulatory design (e.g. pension, collective investment schemes, securitization, and annuities regulation).

- **Develop and adopt a policy package to provide an "escape-valve" to "park," for a transition period, the excess resources that the pension industry is accumulating.** As it is well known, there is a growing gap between pension accumulations and the available tenge denominated investment instruments. This gap needs to be contained to avoid excessive risk-taking behavior by pension funds, and to take out of circulation excessive resources in the financial system. Some of the options to contain such gap include: (1) addressing (i.e., firmly acting against, or validating) the significant expectations about *short-term* real exchange rate appreciation that impacts decision making at the pension fund level toward an excessive focus on tenge denominated investments at the moment; (2) defining the role that local government debt issuance by either the Ministry of Economy and Budget Planning (MEBP)/Ministry of

Finance (MOF) or National Bank of Kazakhstan (NBK) will play in providing an 'escape valve' for the gap; and (3) addressing institutional constraints for oversees investments. It is possible that these measures will not be sufficient to control the excess liquidity in the pension industry. Hence, it might be necessary to take administrative measures, such as requiring that some pension assets be deposit in the NBK (which in turn will deposit them abroad and offer a real return). From the consolidated government point of view, deposits in the NBK is equivalent to issuing more government debt, but such action may be easier to sell and provide a clear signal of its transitory character. Modeling the magnitude of the gap and its likely duration will be required to firm up any policy package.

vi. In parallel to efforts to mitigate vulnerabilities, a concerted effort is needed to put in place the most fundamental building blocks for deepening and developing the financial sector and securities markets in a sustainable manner. This will include:

- Establishing a blueprint for **developing government debt markets** with the sole purpose of creating the basic yield curve that the market needs to truly value financial assets. This can be done by writing a local MEBP/MOF/NBK joint debt issuance strategy, improving MOF's existing cash management and accounting processes for their debt operations, and improving the current fiscal agency agreement between MOF/NBK. For the joint debt issuance strategy to be credible, a decision must be made (on the basis of various simulations) on the binding volume of domestic debt that MOEBP/MOF will issue, including new debt, and swaps or transformations of existing (domestic and foreign) debt. At the same time, the NBK needs to formulate a clearer plan for intervention in money and foreign exchange markets.

- Developing a **blueprint with options for the development of the pension industry** that would address: (1) the growing gap mentioned as a key vulnerability above; (2) the deepening of the financial sector and securities market (see below) to ensure that investment options do emerge over time; (3) prioritizing and dealing with: institutional, legal, and regulatory/supervision design issues related to industrial organization of the pension industry; strengthening the prudential regulatory and supervision framework to deal with growing industry risks; clarifying the structure and liability of different parties (e.g., custodians, pension funds, and pension fund asset managers) and the sustained improvements in the handling of the payments, identification numbers and accounts.

- **Setting as a priority for the development of** the **securities market** the non-government fixed income market, mortgage and securities, securitization, and collective investment schemes, and the framework (and capacity) to supervise and enforce market integrity in all these areas. In addition, focus is needed on improving the quality and incentive to produce critical information, needed to support development of local securities markets. Given the pressure coming from institutional investors like the pension funds, the focus should be on fixed-income instruments with long maturities, and perhaps even indexed to inflation.

vii. As highlighted in various parts of the text that follows, there are important macro-micro linkages in the above agenda, which require **a strong coordination of fiscal, monetary, debt management, and financial/regulatory policies among the economic team of the Republic of Kazakhstan**.

Summary of Diagnostics and Recommendations

Factor Affecting Financial Sector	Recommended Policy Action
1. Vulnerability of the banking sector due to rapid growth of credit, increased activities outside the country, and risks of related-party lending.	▪ Introduce small reserve requirements on foreign borrowing by banks and non-banks ▪ Consider introducing: (1) sub-limit within the net FX position for any financing in hard currency to the non-tradable sector; (2) a maximum limit to cross-border lending; and (3) a country risk provisioning to encourage prudence in cross-border lending to lesser rated sovereign countries.
2. Strengthen the "eyes" and "ears" of the authorities with respect to structural and business cycle-related risks in the financial sector	▪ Develop and adopt a fully-funded institutional development plan for the FSA, including qualitative benchmarks for the FSA's board to monitor progress and results ▪ Review the banking sector regulation for consolidated supervision, individual increases to minimum capital, prompt corrective action, and resolution of failed banks ▪ Strengthen loan classification and provisioning rules
3. Develop and adopt a policy package to provide an 'escape valve' to the growth in pension assets during a transitional period	▪ Project rigorously the size and possible duration of the 'gap' ▪ For the overseas investment to address this gap, **expectations of short-term** Real Exchange Rate (RER) appreciation must be contained, while at the same time addressing institutional constraints to overseas investments—consideration however must be given on how big of a role the authorities would like overseas investment to provide an escape-valve. ▪ Decide on the extent for the authorities (MEBP/MOF/NBK) to provide investment instruments to pension funds, including the possibility of opening the option to deposit funds in the NBK that are remunerated (with the cost beared by the fiscal authorities).
4. Prepare a blueprint for developing government markets with the sole purpose of creating a yield curve in the most important benchmark points	▪ Decide on volumes of debt to be issued by MEBP/MOF/NBK for establishing a yield curve. ▪ Decide on extent of swaps between foreign and domestic debt, and plans to restructure existing local debt. ▪ Based on above parameters, prepare a concrete **Joint Issuance Strategy** identifying role of NBK notes vis a vis t-bills, extent of concentration of liquidity, calendar of issuances, etc. ▪ Improve MOF accounting and cash management procedures for extending issuance needs projections from the current 1 week to at least 1 month ▪ Improve existing MOF/NBK agency agreement ▪ Consider the appropriateness of establishing an overall Debt Management Office that would coordinate issuances by all public entities.
5. Establish priorities for the further institutional development of the pension system	▪ In the short-term, avoid any sharp change in the prudential and regulatory framework, but work on clearly defining objectives and instruments for future changes. ▪ Review process of entry, exit and competition in the pension industry and the associated changes in the prudential/regulatory framework, if any, which might be needed. ▪ Make a concerted effort to improve the supervision and enforcement of the current regulatory framework

Factor Affecting Financial Sector	Recommended Policy Action
	▪ Introduce a system to value the contingent liability of the government with respect to the guaranteed return to pensioners, and address legal uncertainties regarding the distribution of responsibilities in the event of failure ▪ Develop a detailed plan to significantly improve the administration of payments, ids, and accounts. ▪ Begin assessment on how to structure the de-cumulation phase (this is a medium-term agenda)
6. Setting a priority agenda for the further development of financial and capital markets	▪ Develop a detail strategic plan for Kazakh Mortgage corporation, Kazak insurance, and the specific arrangements to manage the housing program ▪ Conduct a detail diagnostic of the cost of raising capital via different forms of contracts (bank loans, corporate debt and listings, equity IPOs) ▪ Develop the legal and regulatory framework for securitization and collective investment vehicles ▪ Support the further development of supervision and enforcement in the securities market
7. Special queries:[1]	• Dedicated effort will be needed to adequately address the various queries. Hence, the queries that are now considered most important by the authorities can be addressed through follow up or subcontracting.
• Is the financial sector competitive?	• Bank concentration per se does not have to be an issue of major concern, but the broader issue of <u>competition in financial services</u> (particularly for households and small and medium enterprises) was not dealt with properly during this mission. This mission focused mainly on the extent at which there could be inside lending within financial groups, which poses a threat to the system.
• Is interest spread too high?	• Bank left a simple spreadsheet for the MOF/NBK/FSA to be able to assess this. During interviews, large banks indicated that their spread for **prime customers** were quite low (in some cases only fees), suggesting that if something Bank's may not be covering the cost of reserves requirements and taxation
• Is the regulation of stock market appropriate? Are listing requirements excessive?	• This is an important area for future work (Bank can provide methodology or lead it if appropriate)
• Small and Medium Enterprise (SME) access to credit	• Although Bank's are reportedly making an effort to reach SMEs, based on international experience it is likely that this is an important issue to follow up.
• Role of the development bank	• We note no effort by the development bank to find a "niche". Greater assessment is needed but it may be appropriate to increasingly focus the development bank on the financing of infrastructure including "public-private" partnerships. Contracting an independent review on the lesson learned by the DBK during the past few years, and the implication for their future policies may be appropriate

[1] See Attachment 3 for a list of documentation with relevant international experience for Kazakhstan that the mission left with its technical counterparts.

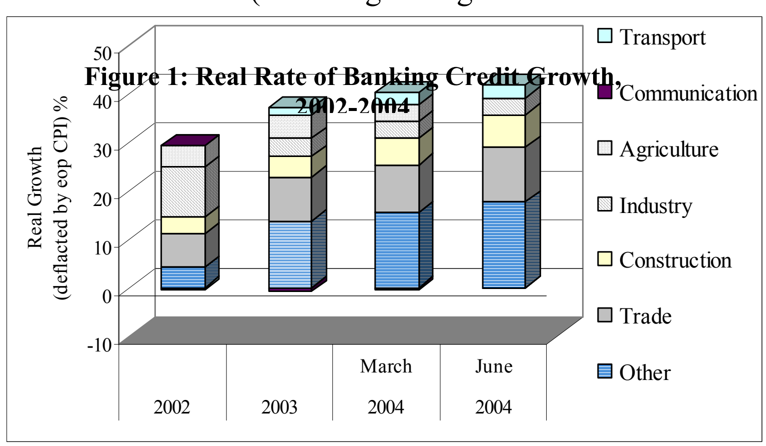
II. MAIN TEXT

1. A World Bank Mission visited Kazakhstan from September 28 to October 8, 2004. The mission worked closely with management and staff from the National Bank of the Republic of Kazakhstan (NBK), Financial Regulatory and Supervision Agency (FSA), Ministry of Finance (MOF), and Ministry of Economy and Budget Planning (MEBP). The mission also interacted with various players in the sector (banks, broker dealers, pension funds, asset managers), with the donor community (International Finance Corporation (IFC), European Bank for Reconstruction and Development (EBRD), United States Agency for International Development (USAID), and Asian Development Bank (ADB) and with the parallel International Monetary Fund (IMF) mission assisting the authorities with the complementary task of defining the road towards adopting the European Union (EU) standards for the banking sector. The mission wishes to thank government officials and everyone else for the kind cooperation and hospitality. The mission's assessment builds on the recent EFSAP Update carried out by staff of the IMF and the Bank, which is publicly available in the web sites of both institutions.

A. CONTEXT AND DIAGNOSTIC

2. **The mission's main objective was to identify the most important building blocks needed to increase the competitiveness and soundness of the financial sector in Kazakhstan**. This was stated in the authorities' letter to the Bank dated August 8, 2004. In this regard, priority building blocks for competitiveness in the financial sector were defined as those that: (1) reduce the vulnerabilities of the system to possible negative shocks; (2) increase the intermediation of savings and investments inside the country at a fair price to savers and investors; and (3) increase the potential for the financial services sector to be itself competitive enough so as to make Kazakhstan become an important hub for financial services in the Commonwealth of Independent States.

3. **The mission discussed various draft Programs and draft Laws that will be commented upon in a more rigorous manner at a later stage**. In addition, during the course of the discussions a number of technical queries were made by various counterparts and the mission made an effort to answer them (including through three Power Point Presentations), but nonetheless some of the technical questions will need to be followed up.



4. **Five overarching issues (which are well-known to the authorities) provided the context for the work of the mission**:

i. A rapid **expansion of credit** by the banking sector (Figure 1) fueled in part by external borrowing.

ii. An **emerging gap** between the assets in the pension funds and the availability of domestic financial instruments to channel this to the real sector in a manner consistent with the fiduciary responsibilities of pension funds.

iii. The presence of conglomerates in the **non-oil sector** of the economy, which like in most other countries with such structures[2], increases the potential risk of insider and related-party lending (although it is beyond the task of the current mission to quantify the extent of such behavior in Kazakhstan) and risk-concentration.

iv. A **positive fiscal outlook** which, paradoxically, constrains the ability of the consolidated government (and depending on the monetary stance possibly also the NBK) to issue local currency government debt instruments.

v. **Strong macroeconomic forces that** provide incentives to reduce the volume of **in-country** (or domestic) intermediation of savings and investment (e.g., expectation of real exchange rate appreciation makes it more attractive to raise capital abroad rather than domestically).

5. The main finding of the mission is that the sector's soundness and competitiveness –and to some extent the commendable past accomplishments-- are being threatened by:

- **Growing financial sector vulnerabilities** related to the fast pace of growth in the sector, the concentrated nature of the non-oil economy, and bottlenecks and imbalances in the pace of development of the various components of the financial sector architecture. These vulnerabilities have been to some extent compounded by **inconsistencies between monetary, fiscal, debt management, securities market and financial sector regulatory policies**. Policy makers in these areas are henceforth referred to as "**the authorities**."

- **Lack of clarity in determining priorities** in the second-generation financial sector reform agenda. As a result, important and complex institutional reforms (e.g., transition to an independent regulatory agency for the sector where basic supervision and enforcement is in need of urgent strengthening) have not been given the attention needed. Similarly the development of basic building blocks for implementation of financial sector policies (e.g., development of the government securities market, proper pricing and valuation of securities in portfolios of pension funds) has at times been a lesser priority as a result of numerous parallel initiatives to further modernize what is already—with some important exceptions-- a sound legal and regulatory basis. This not only taxes the highly qualified, but relatively small, human resource base available in the relevant agencies, but also threatens to undermine the credibility of government policies.

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[2] See Technical Note: Supervision of Financial Conglomerates, June 2004, Chile, Financial Sector Assesment Program, World Bank and IMF.

- **Synchronizing institutional strengthening with the rapid pace of market developments.** It should be noted that institutional development takes longer and requires a sustained effort, creating serious imbalances and risks as supervisory agencies catch up with market developments.

6. As outlined in the Key Messages section above, the mission recommends that the authorities focus on addressing the issues related to financial sector vulnerability and lack of coordination and to put in place the building blocks for a sound and sustainable financial sector that can better intermediate resources and capital to the real sector of the economy. This will require that the authorities initiate a carefully prioritized mutually reinforcing set of reforms.

7. The rest of this note expands on the above points, by dividing them in two areas: (1) setting priorities for the further development of the securities markets and pension system and securities markets; and (2) the need to further strengthen regulatory and supervision framework to deal with vulnerabilities. Some important areas such as competition in financial services, access to credit, and tax treatment and its impact on financial intermediation and costs of capital or securities market liquidity are not treated in this Aide Memoire. These issues (and in particular access to credit by SME including whether or not they face discrimination) deserve attention and should be treated in future work by the authorities.

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B. Setting Priorities for the Further Development of the Pension System and Securities Markets[4]

18. **Kazakhstan has made commendable progress in a short period of time in development of its securities markets and the related pension system that began in 1998**. In particular, the institutional framework for transactions (e.g., electronic orders in trading, payments system) is quite advanced within the CIS region and various segments of the local securities markets are starting to develop (e.g., mortgage markets, corporate debt markets and government debt markets). Beyond this, efforts are being made to develop the information infrastructure and professional associations that support modern securities markets (e.g. credit bureaus, actuaries, financial analysts, etc.).

19. **Despite these advances, development is uneven and the growth of the pension fund sector, a key leading force in the development of the sector, is outstripping the available supply of securities as the financial sector begins to face greater risks**. These include:

i. The risk that **key bottlenecks of the financial system** (e.g., lack of a more developed market for government securities, a related lack of liquidity in all cash

[3] See Attachement 1.
[4] See Attachment 2.

markets, other than in the repurchase agreements, and lack of investment instruments for pensions) undermine its development.

ii. The lack of a more developed money market where the authorities could more actively use indirect **monetary policy instruments** such as repurchase agreements rather than issue NBK notes occurs because debt outstanding on the balance sheet of the Central Bank is insufficient.

iii. **The pressures noted in the above four points have resulted in outcomes, such as** negative real returns on key instruments in local markets due to excessive demand for tenge denominated assets with associated over-subscription of most MOF, NBK or private tenge issues resulting in very low interest rates and tenge flow losses for some pension funds, and accounting losses in the National Bank. If this were to occur on a sustained basis it could trigger future fiscal obligations for the authorities who by law guarantee pensioners a real returns of no less than the compound annual rate of inflation on their accumulated contributions to the pension system.

20. **Although time did not allow detailed analysis for any specific area, the mission focused on six key building blocks**[5]:

i. Government debt markets

ii. Trends in the pension industry and the relationship between macroeconomic policy decisions and its evolution as well as issues in micro-regulatory design in light of experience in other countries (e.g. Chile);

iii. Mortgage markets;

iv. The role of the Development Bank or preferably a development agency in fostering very long term or risk capital instruments;

v. Supervision processes for non-banking services as a complement to the work undertaken on banks, as all these services are provided by financial conglomerates

vi. Other issues of interest to the authorities, such as the potential for securitization, regulation of the stock exchange, collective investment schemes (CIS), and improving the quality of information in the securities markets—including the development of credit bureaus and credit rating agencies.

21. In what follows, we summarize the mission's views with respects to government debt markets, pension industry, and other priorities in securities market development.

[5] In addressing the issues explored in this initial mission the team tried to build on previous analysis undertaken under the Financial Sector Assessment Program (FSAP) and other studies.

(1) Government debt markets

i. Key Issues

22. **The Kazak government debt market is significantly underdeveloped relative to other government debt markets in countries with similar characteristics**. There are however good reasons for this as countries such as **Chile**, **Mexico**, or **Hungary** all had financing requirements for the budget and consequently relatively higher levels of internal debt.

23. **Nonetheless, even after accounting for structural surpluses, the existing government debt market is fragmented and insufficiently standardized in the case of debt issued beyond one year in maturity**. In addition, the market is also heavily concentrated in purchases by three banks, and no substantive liquid benchmark bonds exist that could help in development of a true local yield curve. Private issues are even less liquid at this point.[6]

24. Why then is the existence of a local tenge debt market important even when a country is running a fiscal surplus? It is needed to establish a benchmark for the cost of capital (an essential element for the valuation of pension fund assets or real sector projects), and it facilitates improved debt management. It also provides an important foundation for developing non-sovereign bond markets, and creates a basis for developing more complex securities products and related market infrastructure. Finally, over the medium term it permits the development of indirect monetary policy instruments such as repurchase agreements that are essential for implementation of monetary policy.[7]

25. Despite the possible merits of developing such a local market based on broader economic cost and benefit grounds, a consensus would need to be reached (perhaps with Parliament) that some limited but consistent borrowing by the authorities, whether the NBK or the MEBP/MOF would be warranted. In building such consensus, however, it is important to indicate that countries that have not developed a government debt market tend to have shallower financial sectors (e.g., Norway vis a vis other Scandinavian countries).

ii. Recommendations

26. There are a set of mutually reinforcing actions beyond those already planned that could be undertaken to develop a true yield and zero-coupon curve in the local tenge market. It is critical that processes and policies be designed at all stages that are consistent and credible. This applies to the overall budget plan, the execution of that plan and the roles of all concerned agencies (MEBP, MOF, and NBK). The following crucial inter-related decisions need to be taken:

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[6] Private corporate debt instruments are rarely highly traded and liquid anywhere in the world. See Endo 2001.

[7] This is called for under the Government Financial Sector Development Plan.

- **MOF/MEBP/NBK to decide on the volume for issuance of domestic debt (treasury and NBK notes).** This is a fundamental decision that may involve the need to modify the budget code to allow for the issuance of net debt (or consistent borrowing) in the face of fiscal or cash surpluses and the absence of a consolidated budget deficit.[8] It may also require changing the stand of NBK vis a vis the exchange rate, which would allow the announcement of NBK interventions. Countries (e.g. Hong Kong and Singapore) did take such actions under somewhat similar circumstances (Hong Kong, which has a currency board, relied heavily on the central bank to issue notes). However, it will be important to prepare a very careful case for such actions since one way or another the cost of issuing debt will show in the balance sheets of the government or the NBK. As part of this process, the MEBP/MOF/NBK should jointly announce a borrowing plan public outlining the overall strategy and plan for the year—and stick to it.

- **Decide on the extent and nature of MEBP/MOF/NBK intervention and associated sterilization**. It is conceivable that the announced borrowing plan focus exclusively on developing an aggressive swap policy of outstanding foreign debt for domestic liabilities, along with other actions to restructure existing tenge liabilities. This could be used to build benchmarks in the yield curve especially in the two and five-year segment of the yield curve initially. If the authorities were to decide to issue new debt—assuming that the appropriate political consensus is reached—both the approach to new issues and to restructuring of existing external and internal liabilities will need to be well coordinated. A key question for analysis is the extent of debt issuance or debt restructuring that will be sufficient to allow for development of a liquid set of benchmarks in the local tenge yield curve.

- **Design a written local joint debt issuance strategy** between MOF and NBK and associated Memorandum of Understanding (MOU) and/or overall governance process aimed at developing the market as in many other countries. This usually includes, inter-alia, definition of instrument selection, the pre-agreement that NBK note issuance will focus in the short maturity part of the curve while MOF notes and bonds will be issued more in the longer maturities. Agreement would also need to be reached on: (1) a clear calendar of new issues specifying at least a range for sizes of issues and other characteristics (types of instruments) as well as; (2) where to concentrate new issues (i.e., volume) in terms of maturities. Examine how to use techniques involving the restructuring of the existing debt to consolidate debt in these same-targeted benchmark bonds (e.g. re-openings, debt buybacks).

- **The decisions above will also require that the MOF Treasury carefully study how to improve their existing cash management and accounting processes for**

[8] Projections and analysis shows that there will be a lack of need to borrow perhaps for a number of years depending on the overall fiscal policy stance and the need to also contain inflation where sterilization and foreign exchange operations have already been resulting in increasing debt incurred by the Central Bank.

their debt operations. This should be done with the objective of increasing predictability of borrowings as will be needed to assure that any calendar of new issues can be met. This examination should cover cash projections systems and financing needs, which currently could only be performed a week at a time. It would also include a review of the present accounting and valuation processes in place, and a review of manner in which government's accounts in these matters are audited and even penalized.

- **Improve the current fiscal agency agreement by ensuring that it becomes a legally binding agreement specifying the rights and obligations of the two parties to the agreement NBK and MOF.**[9] The agreement as now drafted should also be altered to allow the NBK to undertake operations to build the benchmarks via buy-backs, re-openings and exchange offerings with a suitable mechanism for seeking MOF approval and for assuring agreement on the nature of debiting of payments or crediting of profits between MOF and NBK.

- **Develop the institutional capacity in the Ministry of Finance and MEBP to oversee and monitor debt management, the annual borrowing plan, and its local debt issuance strategy in general**. This could require the establishment of an overall debt office that would coordinate with all entities undertaking any borrowing or using guarantees so as to properly monitor the overall fiscal risks of the government.

- **Allow for primary market operations for debt issuance on the exchange and open up the local tenge primary market** as planned to promote greater competition and reduce costs of new issuance.

27. The need for strong policy coordination by the NBK, MOF, and MOEBP with respect to the authorities' domestic debt strategy is significant. In this context, the possibility of setting up a separate public debt office (used in some countries) could be reviewed at a future stage.

(2) Kazakhstan Pension Fund Industry

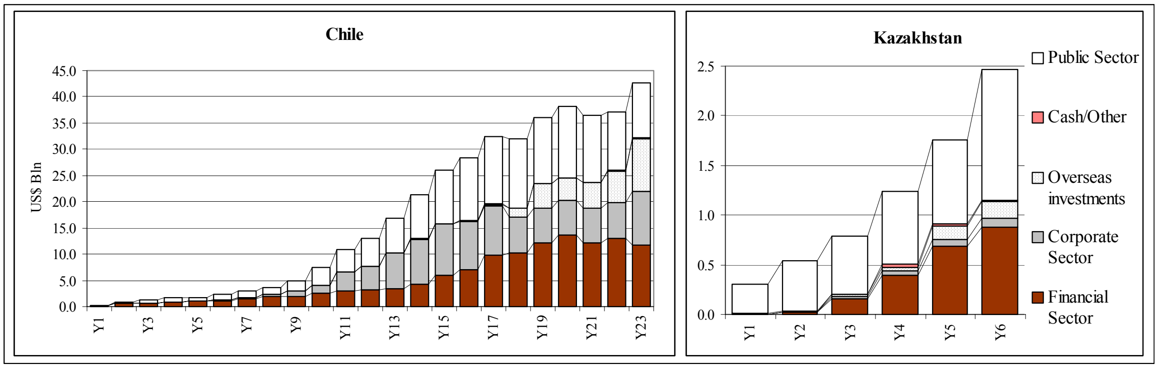
i. Key Issues

28. **The Kazakhstan pension system has been a success when assessed from the vantage point of accumulation of resources; as today assets in these funds account for 8-9 percent of GDP (Figure 2)**. The system has other strengths that include the central collection and payment agency that properly recognizes the negative impact on sunk costs of entry that can arise when these service functions are devolved to each pension fund as in **Chile**. The funds have also invested their resources in tenge denominated resources in a conservative fashion including in government short term bills and increasingly in corporate bonds issued locally and abroad by strong Kazakhstan

[9] Today this agreement entitiled Rules of Issuance. Placement, Circulation, and Redemption of Short Term Notes of the Republic of Kazakhstan National Bank, was approved by Resolution 554, December 20,2001 of the Republic of Kazakhstan National Bank Supervisory Board.

credits. Many of these issuers issue into the Eurobond markets and meet threshold credit risk ratings. Investments in mortgages issued by the Kazakhstan Mortgage Corporation (KMC) have also begun to be more important and this is a natural investment for pension funds.

Figure 2: Evolution of Pension Assets in Chile and Kazakhstan by Investment Instrument, US billion



Source: Chilean Ministry of Finance (Hacienda), and Kazakhstan Financial Supervision Agency.

29. **The commendable introduction of a private pension industry is threatened by a growing "investment opportunities gap".** This can be defined as the difference between the resources that are accumulated by pension funds and the availability of appropriate investment instruments. On the one hand, the growth of the funds are now projected to increase by US$ 900 million to US$ 1 billion a year for the foreseeable future, and could reach US$ 8-9 billion by 2012 and continue to grow until they reach a plateau (in dollars) on or about 2020. Growth in the system is determined by basic parameters (i.e., the contribution rate), the evolution of the economy (e.g., salaries, employment and formalization) and the existing demographic structure etc. On the other hand, under most realistic assumptions for the future development of the local securities markets, equity, corporate, mortgage debt and other forms of asset-backed securities are unlikely to grow at rates sufficient to absorb the growing resources available especially in the next few years.

30. **Pending a detailed assessment of the true magnitude of the "investment opportunities gap", second-generation reforms within the pension system are needed in three broad areas**:

- First: creating a "**escape-valve" for pension funds to "park" resources**, in a safe and sound manner with rates of return greater than or equal to inflation, during the transition period in which more sophisticated tenge denominated financial instruments are not available.

- Second: Ensuring that over time greater development of the financial sector and securities markets results in development of **financial instruments and vehicles** that will allow the pension funds to diversify their risks in a prudent manner, while contributing in a more meaningful way to overall economic development. This can occur if these funds can allocate their growing asset base to important real sector investments preferably indirectly via financial sector investments of different types (e.g. mortgages, securitized instruments, specialized investment funds). This is an area where such innovations and liberalization have to be complemented by actions to improve valuation, regulation and supervision of the pension funds. A discussion of these issues is taken up in greater detail in Section 3 of this Aide Memoir that discusses priorities in the government program for securities market development 2005-2007.

- Third: **Understanding and dealing with institutional legal and regulatory/supervisory design issues** related to industrial organization of the pension industry, the prudential regulatory and supervision framework, the structure and liability of different parties given the government minimum pension guarantee, and handling of the payments and accounts. Such considerations are crucial for efficiency of the system now, during a transition period, and over the long run.

First: Escape-Valve Options

31. **There are four possible candidates that could act as an escape valve where pension assets can be viewed as being "parked" for a transitory period**: (1) commercial banks; (2) riskier domestic investments that provide higher (non-risk adjusted yields); (3) the authorities debt (securities issued by the government or the NBK); and (4) the rest of the world (through voluntary or mandatory measures). Of course, a combination of all of these could be undertaken.

32. **Banks could in principle intermediate more of the pension fund resources**, **since they are and will continue to be the true vehicle for savings-investment intermediation in Kazakhstan**. However, this measure will need to be part of a package that would include: (1) monetary/regulatory measures to slow down credit growth; (2) measures to ensure that borrowing abroad becomes relatively more costly for commercial banks than issuing long-term debt domestically; (3) examining whether the current concentration limits (25% of the issuing bank's capital) on investments in all bank liabilities is currently binding and the implications of relaxing this limit and (4) an assessment on whether current exposure limits to a conglomerate (not just a financial group) will be binding if this option were adopted and whether relaxing such limits is or is not desirable. Current processes for bank supervision as noted in Section B above and issues surrounding the existing credit quality of banks suggest that current adoption of this option is not without risks.

33. **Pension assets could be redirected (at the margin) toward riskier domestic projects, such as venture capital and/or business start-ups, real state investments, and infrastructure projects as some have been arguing**. However, the mission would strongly advise the authorities to not entertain this option. Although pension funds around the world often keep a very small part of their portfolio in so called alternative investments (e.g. in private capital and real estate) this is largely done via investments in closed end funds that in turn invest in such forms of securities. Such funds do not yet

exist in Kazakhstan and even as they are created, the mandatory nature of the pension system and related fiduciary responsibility of the pension fund asset manager suggests that strict regulation and supervision of such alternative investments will be appropriate especially at the formative stage of the pension industry in Kazakhstan.[10]

34. **Creating different investment portfolios to be voluntarily selected by contributors may be too sophisticated for Kazakhstan.** This is in light of the incipient state of development of: the infrastructure to manage accounts and id's (see below), and because the supervision for pension fund investments is at an infant state. If allowing choice for contributors about the level of risk they are willing to bear is important for policy makers, **the route of creating a voluntary pension pillar could be explored**—but this is a major endeavor and should not crowd out the important agenda on the existing defined contribution system.

35. **Some have argued for adoption of the option that pension assets should be invested in the liabilities of agencies such as the Development Bank or the KMC or that they might be best placed in triple A public companies such as the oil and electricity company**. Today certain concentration limits exist relating to these issuers and the mission would suggest that these be observed and that overall diversification of asset price risk (commodity price risk) for pensioners will ***not be*** served by investing directly in an entity like the state owned oil company. Like investments in the National Fund of the Republic of Kazakhstan, pension assets should be placed in a diversified portfolio whose correlation with economy-wide risks is minimized (e.g., fluctuations in oil prices). This is to avoid having the fiscal authorities having to bail out pension assets at the same time it needs to deal with a recession in the economy.

36. **In short, the most likely "escape-valves," for the near term are government securities, NBK notes, and offshore investments.** A key issue is therefore to understand the implications of adopting either of these options. The first strategic decision to be taken is to what extent the authorities (government or NBK) are willing to issue bonds to provide investment opportunities for the pension funds, i.e., over and above those needed to create a yield curve for key maturities or to conduct monetary policy. This would not be unusual since in **Chile**, even ten years after the private pension system was created, the government still accounted for more than half of the pension assets.

37. However, in light of the expected fiscal surplus over the medium term, the mission believes that it is unlikely that the authorities can issue debt sufficient to cover this gap especially given the current large demand for tenge denominated assets by banks, large corporates and other local market participants besides the pension funds. Hence, offshore investments will likely be an important element of the package—and depending on the estimates about the 'gap' it may even be the main "escape valve." This has been recognized by the supervision authorities, which have lifted the ceiling on offshore investments to 40 percent. This strategy is not without risks. In particular, the risk exists

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[10] All around the world the methods to benchmark performance of this asset class is complex due to the challenges of valuing these alternative assets and associated units or shares of such finds.

that once resources are places abroad, it would be difficult to re-channel them back into the domestic economy.

38. **Expectations about short-term real exchange rate appreciation is likely to continue to undermine the incentives to use offshore investments as an "escape valve."** So far less than 10 percent of the pension assets is overseas, and the various sector players met attribute this to expectations about real exchange rate appreciation, but other factors may also contribute to the situation. The expectations are generated by a 'true' sense that in the long run there will be real exchange appreciation driven by the oil outlook (i.e., 10-15 years from now when production reaches a plateau). However, they are also driven by: (i) an inconsistent monetary policy stance in which the authorities' public stance has been that it will let (at some point) the exchange rate appreciate –even if in practice it does not; and (ii) a relatively expansionary fiscal policy, that has pressed up the prices of non-tradables relative to the price of tradables (i.e., the real exchange rate).

39. **Institutional issues may also be contributing to explain the lack of interest in investments abroad.** These issues would need to be addressed to ensure that offshore investments can be used transitorily to ease the gap. These issues include: high transactions costs given that many pension funds do not have the scale to negotiate good terms or even be of interest to many large multinational foreign asset management companies, lack of actual know-how to manage foreign portfolios or measure performance of foreign investment managers, and lack of long dated hedging instruments in tenge/dollar.

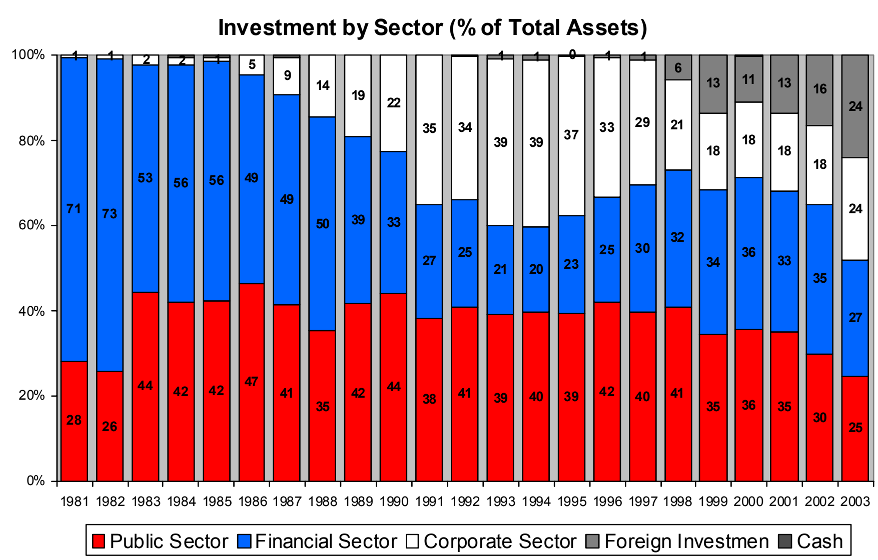
40. **It however may be necessary to consider some administrative measures to ensure that some funds are "parked" abroad.** It is possible that after greater coordination between monetary, fiscal and regulation policies is achieved – in itself a major task -- the appetite of pension funds to invest abroad will not change due to the long-term positive outlook, and the associated expectations of real exchange rate appreciation in the medium to long term. In this case, administrative measures could be taken, such as creating a window through which the NBK would offer the option to deposit certain amounts of pension assets, which it will in turn place abroad (this could be part of the 40% ceiling for overseas investments). In this case, the NBK will either offer a minimum guaranteed return on these funds, or a return equal to that it gets for government assets in the National Fund. Of course, the NBK will be acting as an agency for the MOF/MOEBP, as these are the institutions responsible for ensuring that contributors do get their pension—and hence an agency agreement, including specifying how to cover losses will be required. In practice this option will be equivalent to issuance of government notes—except that some associated cost will be shown in the balance sheet of the NBK, rather than in the state budget. In this regard it may be more acceptable, and also the transitory nature of the arrangement will be clearly conveyed to the public. This type of action is not entirely unprecedented internationally. In fact, the Mexican central bank adopted a measure similar to the one noted just before their systemic reform of the pension system, in an effort to offer a certain degree of safety to contributors.

41. Ironically, the industrial organization of the existing pension system in Kazakhstan (with the possible exception of the largest three pension fund asset managers) is not of a scale sufficient to obtain good terms and conditions from foreign asset managers. In many cases there may literally not be any appetite by foreign asset managers to manage the assets of the smaller pension fund managers when a mandate to manage at least US$ 100 million or more by a foreign asset manager is often the threshold. Hence, the NBK acting as an agent for a number of the pension funds would allow for more effective economies of scale and lower transaction costs in contracting with offshore foreign investment managers. In addition, the expertise of the NBK obtained in managing the assets of the oil fund could be very advantageous as the smaller pension fund managers are not as experienced in managing offshore foreign currency asset portfolios.[11]

Second: Deepening of the Financial Sector and Securities Markets

42. **The mission believes that there is a need to set clearer overall priorities by the Government so as to see results in critical areas such as the variety of fixed income instruments in which the pension funds can invest.** Moreover, there needs to be the realization that this process is not going to be immediate; so that the options and issues discussed above (section C.1.) become even more relevant. There is an important agenda of issues to be considered in this area by the Kazakhstan authorities that are taken up in detail in section C. 3 below that addresses securities market development. That section discusses changes the authorities can make in the near term that can foster a greater variety of financial instruments in Kazakhstan especially via primary market offerings.

Figure 3: Composition of the Pension Portfolio in Chile



43. **Experience of other countries highlights that the process of financial sector deepening and securities market development, in coordination with pension reform, does exist, but takes significant time**. By way of illustration, even in Chile that undertook a similar pension reform

[11] It should be noted, however, that current regulations do allow the smaller pension funds to aggregate their funds into one pool to be contracted out for asset management. Moreover, it could be argued that these entities need to gain first hand experience in managing asset portfolios abroad to become better and more professional asset managers. Hence, filling the gap as a transitory measure via having contributions go directly to a special sub-fund at the Central Bank is not without costs beyond the more important political economy implications of taking such action.

over 20 years ago, key instruments remain, bank related deposits or debt, corporate non-financial company debt, mortgage bonds of different types, and government securities (Figure 3). Privately issued fixed income securities have played a much more important role in the latter 10 years of the Chilean pension system. During the first decade after the Chilean pension reform the vast majority of assets were invested in claims on the public sector (over 40%) and the financial sector (about 35-40 percent on average). In addition, the duration of these investments has systematically increased but this too has been a protracted process that accelerated over the last 5-7 years. Actual liquidity in the secondary market for corporate and mortgage debt in Chile still remains at a more nascent stage.[12]

Third: Institutional Issues in the Pension System

44. **As in the case of financial deepening a set of priorities need to be established in the case of further institutional development of the pension industry in the medium term**. How the industrial organization of this industry evolves in such important areas as the extent of desired concentration, processes for collections and payments and efficiency, and desirable extent of liberalization in portfolio allocation of investments (in light of the compulsory nature of the pension system) will all be important. Over time the development of other pension pillars (larger voluntary pillar) may also be an issue worthy of investigation. Institutional considerations are also very important from the vantage point of reducing vulnerabilities as the mandatory nature of the pension system, its rapidly growing size, and the Government's own minimum pension guarantee, all make it essential that prudential regulations encourage efficient and prudent portfolio management. Finally, over the longer term even the issues associated with de-cumulation via programmed withdraws or issuance of annuities need to be examined.[13]

45. **Discussion of the issues in this area can be divided into six inter-related areas**. These are: (i) the prudential regulatory framework and incentives for sound portfolio and risk management and industrial organization; (ii) supervision and enforcement issues for pension funds; (iii) entry and exit considerations, competition and efficiency; (iv) the structure of the existing government guarantee for future pension payments and its effect on the industry incentives; (v) development of the central agency for pension collections and payments; and (vi) the eventual challenge of developing annuities markets products.

46. **<u>First</u>: The prudential regulatory framework for pension asset management within the recent efforts of the authorities to further modernize their approach to prudential regulation of the securities related activities of financial groups needs to**

[12] For a far fuller discussion of these issues see <u>the background paper on pension prepared for the Chilean FSAP.</u>

[13] As this mission was exploratory and designed to set priorities none of these areas is discussed or analyzed in the detail needed. However, as noted in the recommendations this would be the clear next step. The mission thanks the authorities for the very large amount of material provided in Russion that could be translated and form of the basis for much more in depth work in the areas noted in the future under the Bank and Kazakhstan joint research program.

be analyzed with great care.[14] Specifically, the proposal to apply credit-risk weighted capital guidelines to the pension fund asset managers even when these entities do not engage in a principal function (e.g. they manage these asset pools as "subcontractors" rather than for their own account) may have un-intended and perhaps not positive effects on both industry structure and performance of the pension industry. Imposition of this kind of regulation could result in pension asset managers managing the funds in a manner that complies with the capital regulation that uses credit risk weights (e.g. from Moodys) that have no relation to local conditions as no real credit rating agency exists yet.[15] The impact of the changes envisioned need to also be seen in the context of all the types of prudential regulations now imposed on pension fund asset managers—where yet another layer of regulations would now be present. The current regulatory framework is already complex and difficult to supervise and regulate.[16]

47. Careful consideration regarding how best to design regulations for the pension industry is an area where a **much more systemic review** of existing and proposed regulation is needed. This should include a potential assessment of which specific existing regulations are binding (e.g., concentration limits on issuers, treatment of structured securities backed by collateral) and conditions under which any relaxation would be allowed etc. Such a review needs to be linked to broader issues related to the industrial organization of the pension industry at large and its future evolution. This analysis needs to proceed very carefully.[17] The experience of Chile over the last 25 years illustrates the importance of careful analysis of these issues earlier rather than later.[18]

48. The desire of the authorities to assure better performance especially in environments in which the real interest is negative, as at present, is leading to pressure to

[14] See the document issued by FSA that outlines an approach to capital treatment of a bundle of securities market activities offered by entities within financial groups that includes: organizations that carry out investment management of pension fund assets (OCIAPA), independently carry out investment of pension fund assets (APF); manage other investment portfolios (MIP); conduct brokerage services and manage investment portfolios and provide custodian services (category 1), brokers that provide custodial services, but also manage pension assets (under both OCIAPA or MIP arrangements) and also offer investmentmanagement of portfolios as well as work as custodians (category 2); and registrars that offer transfer agent services.

[15] If the concern it so assure better approaches to assessment of credit risk in the portfolio there are likely to be some other means of achieving the objective short of applying the construct outlined. Many other aspects of the regulation relating to operational risk etc. can of course be considered, but the capability of the FSA to really evaluate comnpliance in light of not having any EDP inspection capacity as at present—may ironically harm the FSA's credibility in the markets.

[16] Today these regulations include: *investment regulations* that already try to address credit risk concentrations, diversification of asset classes; and to some degree related party concerns; *rate of return* regulations; *investment return band* regulations that penalize pension fund asset managers that deviate from the industry average by a certain amount; and *initial capital* regulations intended not to deter entry but to assure seriousness and allow for the risks entailed in managing varying amounts of assets.

[17] This review might also focus on certain more basic regulations—such as valution norms that must be designed creatively in light of the very nascent stage of development of the local government and other private debt markets. The need to measure risk reliably and model market risks will be very important for pension fund asset managers.

[18] See the recent World Bank technical study of Issues in the Chilean Pension Industry that was part of the Financial Sector Assessment.

invest pension assets in increasingly risky asset portfolios (real estate or infrastructure projects) which would be a mistake. At the same time the authorities desire to limit risk via regulation to the greatest extent possible, rather than via supervision can endanger the objectives of sound asset management as noted above.

49. **__Second__: Much greater attention needs to be paid to improvements in the supervision and enforcement of the existing regulatory framework for pension funds (and related securities markets) as opposed to further regulatory initiatives per se**. There is currently very limited staff available to inspect most of the pension funds, pension asset management companies, and brokerage firms that often play a role, and related transfer agents etc. (about 9 inspectors in total). There are almost 100 entities that need to be supervised. When this fact is considered along with the gaps in current skills especially in the key functions of inspections and enforcement it makes it essential that this capacity be strengthened either before or simultaneously with imposition of far more complex prudential regulations. What will be needed is investment in better off-sight surveillance of the funds coupled with a very focused effort on inspections that is guided by off-site analysis. Currently, the FSA lacks an explicit enforcement area/department and, therefore, has not begun to develop related enforcement actions. More than new regulations, no matter how sophisticated, such actions will send a message to market participants that risk management is to be taken seriously. Finally, part of this work as in the case of banking needs to assess how best to assure fit and proper entry and timely exit of pension fund asset managers and issues associated with orderly sale of asset portfolios and transfer of contributors, to other pension funds and asset managers, via actions by the central collection and payment agency. Such issues will arise in the case of either consolidation or failures in the pension industry.

50. **__Third__: At the same time as supervision and regulation needs to be improved there is also a need to improve competition and efficiency in provision of pension services.** For example, the process for permitting entry of foreign portfolio investors (to manage local or offshore portfolios of pension funds) and the extent to which they will truly have incentives to enter in light of the relatively small amounts of funds that can be managed under arrangements with many Kazakhstan pension funds other than the largest three needs to be examined. The extent to which the rate of return band regulations in place hurt larger versus smaller pension funds and have created disincentives for consolidation also needs analysis. The relation of this policy to the desirability of entry for foreign asset management companies into the local market also needs analysis and highlights why design of the prudential regulatory framework needs to take account of competition and concentration implications. Clarification of the use of foreign custodian banks in investments abroad or domestically to see if the delegated powers now given to local Kazak custodians will be possible to impose on a foreign custodians could if resolved also reduce regulatory entry barriers.[19] More broadly the regulatory costs and entry implications of more complex regulations needs to be more carefully assessed. Finally out-sourcing of different pension related services and its extent is in need of

[19] Specifically the delegated reponsibilities given to local custodians by the FSA involve the monitoring of compliance with investment regulations by pension fund asset managers where reports are sent directly to the FSA and the custodian takes on a legal and potentially financial obligation under such an arrangement.

examination. This needs to be examined for all forms of pension related services from back office functions in asset management to some aspects of collection and payment services or disclosures. Time did not permit us to carry an initial review of the exact functions that the central payment and collection agency can itself outsource.

51. **Four: Government's guarantee to contributors, in itself a good measure, complicates the incentives for competition and the prudential regulatory framework**. Under the existing compulsory pillar some form of minimum pension is important to have in place, which in fact does not yet exist. Instead, the government guarantees that contributors will receive an amount equivalent to the contribution made plus compound inflation. Even without this guarantee, there are legal uncertainties in relation to the distribution of responsibilities, in the event of failure, between the pension fund, pension fund asset manager, and the special delegated regulatory role of the custodians. These uncertainties are exacerbated by the fact that the State is committed to ultimately cover any losses to the contributors. These uncertainties relate to which of these parties will be liable to the government in the event of a possible call on it's guarantee. In short, the valuation and accounting guidelines applicable to the operations of each of these parties and the associated legal division of their responsibilities (i.e., between pension funds, pension fund asset managers, and custodians) in the context of the government minimum pension guarantee needs to be reviewed. At the broadest level some assessment of the potential size of this contingent liability for the budget is needed. This analysis, could be accompanied of a broader assessment of whether the present mandatory guaranteed second pillar (managed by the mostly private pension industry) of the pension system is properly dimensioned and present options to reduce its size (via adoption of a voluntary pillar, and the introduction of a basic minimum guaranteed pillar) might also need to be reviewed over time.[20]

52. **Five: Part of the agenda of actions that will need to be taken to assure a more efficient pension system and one that acts on behalf of the interests of contributors relates to the future administration and role of the central payment and collection agency**. As noted in greater detail in attachment 2 product and conduct regulation for pension funds, pension fund asset managers, sales agents, and the process for transfer of contributions to the central collection and payment agency need attention. Specifically, as of today many employers are compensated by different pension funds or pension fund asset managers for "steering" their employees to specific funds. In lieu of marketing to individuals who can only switch twice a year, marketing has been undertaken to employers which creates what is known in economics as "principal agent problems." Hence, solutions to this issue could be explored such as disallowing employers from interfering with the allocation decision by obligating them to only send resources to the central collection and payment agency and leaving it to the agency to discuss with the contributor the choice of pension fund and related fund manager. Pension contribution and collection arrangements also have to be modernized and made more efficient via

[20] This would be one way of reducing some of the pressure (i.e. investment opportunities gap) now occuring in the rapid accumulation phase, but great care would need to be exercised to assure that any changes are consistent with assuring a sufficient replacement rate upon retirement and the de-cumulation phase to better assure old age security.

adoption of one unique identification number and via a process to eliminate multiple accounts different pension fund asset managers (e.g., 6 million versus only 3 million actual individual contributors)

53. **<u>Six</u>: Finally within the next several years there will be a need to assess how best to address the de-cumulation phase of the pension reform as more individual contributors reach retirement age**. Efforts now underway to revamp the solvency margin regulations for insurance companies in life and non-life, issues relating to product and conduct regulations applied to those marketing annuity products; guidelines relating to minimum standards for risk management by insurance companies undertaking to offer annuity products will all need to be addressed. Here the recent evolution of the Chilean annuities markets as well as the experience of other countries (e.g. Australia and European countries) will also be relevant in the context of learning lessons for regulatory design and supervision and enforcement. Recent discussions relating to formation of a public entity to provide annuities would seem somewhat premature until more attention is devoted to understanding the potential evolution of the Kazakhstan insurance market in light of projections relating to the maturation of the existing pension system.

ii. Recommendations

54. For the above-elaborated strategic issues to be submitted for the consideration to the economic council or any other appropriate decision making body, the authorities could benefit from undertaking the following analytical work:

- Preparing projections of the investment opportunity gap under various assumptions for the economy, the demographic variables, and the pace at which investment instruments and opportunities will be developed. Such projections should provide a very clear idea of:

    - How big of an 'escape-valve" is needed

    - How long would the transition period be until the time when the gap can be closed by the development of the securities and financial markets.

    - The probability of a call on the government's guarantee provided on pension contributions based on different scenarios

    - Examining options that will naturally create better prospects for offshore investments and investigating the key reasons that now limit investment abroad, including the $/tenge exchange rate increase.

    - Elaborating on the issues involved in designing an offshore investment policy (countries, currencies, degree of risk, use of hedging products, and the role of domestic and foreign asset managers and custodians).

- The options for curtailing or moderating the expectations for short-term real exchange rate appreciation in the immediate term (i.e., 10-15 years before the real oil boom).

- The extent to which the government will need to take direct, albeit transitory, measures to close the growing tenge investment instrument gap in the short-to-medium term. This could include the option of making mandatory that a portion of the pension assets in the industry be deposited in the central bank (which in turn will guarantee a basic minimum return, or a return equal to that obtained by the National Fund of the Republic of Kazakhstan (NFRK).

55. Once guidance or strategic decisions have been made by the appropriate policy making body, work should intensify on preparing a ***blue print for the pension industry itself.*** This will include but not be limited to:

- Supervision (both on and offsite) needs to be improved swiftly as does the capacity to undertake enforcement actions. This effort needs to be very carefully coordinated with actions to improve these functions in the banking area with FSA. At the margin emphasis in this area is likely to have a much bigger payoff than issuing many new complex regulations that cannot be "credibly" enforced and may even reduce incentives to undertake prudent portfolio management and may also deter entry in key areas by increasing regulatory costs of entry.

- Begin to design an overall reform to the prudential regulatory framework based on clear and agreed upon objectives including minimizing a call on the government guarantee, efficient and competitive provision of pensions services; and the need to support development of the local securities markets in a prudent manner. Any proposals must take into account the broader context of the organizational characteristics of the Kazakhstan financial system and its degree of concentration including existence of industrial and financial conglomerates. As a start there will be a need to better establish the facts as to what aspects of the present investment regime are binding.[21] Any new system would ideally be flexible enough to accommodate the several distinct phases in the evolution of the pension industry that can be foreseen:

    - The transition period in which resources should flow into an "escape valve" .

    - The period when the domestic capital markets could be relied upon to a larger extent.

[21] An assessment of how make changes in the many areas of regulation that are consistent will be a challenge. This exercise will need to account for the industrial organization of the pension industry and asset management and its future evolution.

  - o There may be a period in which pension funds and pension fund asset managers will be consolidating to gain economies of scale, and there may also be a period of failures.

- Measures to address other industrial organization issues and pension payments/accounts/unique identification numbers issues should be developed and undertaken in any case. As noted in greater detail in Attachment 2 a package and in the outline of the issues immediately above, measures will need to be developed to deal with:

  - o Product and conduct regulation for pension funds, pension fund asset managers, and sales agents.

  - o Valuation and accounting guidelines and the legal division of responsibilities between pension funds, pension fund asset managers, and custodians in the context of the government minimum pension guarantee needs to be reviewed.

  - o Pension contribution and collection arrangements also have to be modernized and made more efficient via adoption of one unique identification number and via a process to eliminate multiple accounts with different pension fund asset managers.

  - o Disclosure, including in addition removing the incentives of pension fund managers to market to employers via non-price competition, by modifying the process of transfer of contributions to the central collection and payment agency[22]

- In the medium term (over the next several years) there will be a need to examine the regulatory framework for the decumulation phase of the pension system and the related development of the annuities and life insurance markets. Here the lessons in regulatory design in other countries (Chile, Australia etc.) will be important to take into account.

56. In sum, the steps outlined above and associated background work is needed to assure that the authorities do not take decisions too quickly that can harm their credibility. Moreover, in the near future the authorities should avoid using "micro" instruments for what is inherently a "macro" problem for the pension industry. For instance, the authorities should focus attention on the key broad policy decisions (e.g. on the gap) before making many different changes in the regulatory regime of the pension industry.

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[22] Employers would have to transfer all resources and not be allowed to designate a choice of pension fund on "behalf" of the individual. However, the central collection and payment agency would have to obtain a verfiable indication by each indvidual contribute as to choice of pension fund.

(3) Other Priorities in Securities Market Development

i. Key Issues

57. The mission reviewed briefly a summary of the securities market development plan 2005-2007.[23] This document can serve as a good overall framework to deepen the securities markets, but it needs to be prioritized and some of the envisaged measured tested for feasibility (is there appetite for further privatization, and should privatizations be run through the stock exchange rather than sales to strategic investors?). Detailed comments to this program will be provided at a later stage.

58. Also, given the current pressures relating to exchange rate appreciation, fast credit expansion and rapid increases in pension fund assets (which are contributed on a mandatory basis) the issues relating to financial sector deepening and what actions can have the greatest impact on diversifying the available instruments (beyond government debt) become very important. Simultaneously improved supervision of what will be more complex products offered will also become essential as part of this overall package of reforms.

59. The issues discussed below are divided into those that relate to: (i) setting priorities for the securities market development agenda; and (ii) improving securities market supervision.

The securities market development agenda

60. **Below we outline a more precise sequence of priorities in terms of emphasis within the overall securities market development plan outlined by the Kazakhstan authorities themselves**. In this regard, there are some essential building blocks to support financial sector and especially securities market deepening. This includes the need to understand in more detail the precise costs of raising capital via use of different financial contracts including loans, debt and/or equity, etc. In general, the mission feels that relatively greater effort needs to be placed in the short term on the aggressive development of the Kazakhstan fixed income markets. Areas (a) to (e) (below) outline a possible program of action in specific areas to develop the local fixed income markets in a way that can supply a larger and more diversified set of tenge instruments. As Figure 4 below illustrates, Kazakhstan is by no means starting from zero in this agenda.

> **a. Government Fixed Income Market**: As discussed in section B.1 above, there is a need to make a special effort to develop the domestic government debt market and related yield-curve that can be used to price many other projects and securities.

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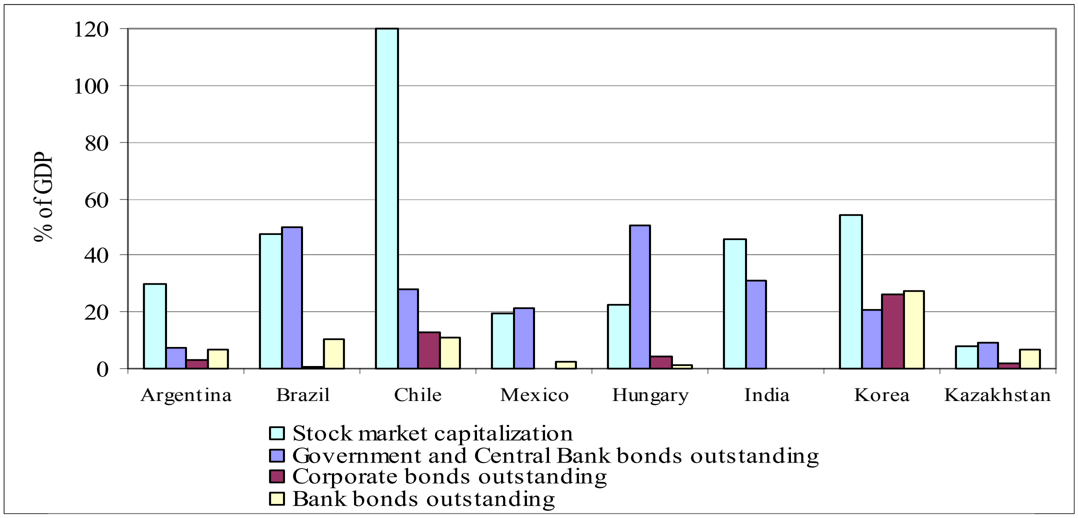
[23] The mission also conducted meetings with staff at the securities regulator responsible for supervision and regulation of the securities markets.

Figure 4: Size of Financial Markets in Kazakhstan and other Middle Income Economies, end 2003



Source: BIS International Financial Statistics, KASE, and NBK.

b. Mortgage Securities: There is a need to examine in detail the steps that need to be taken to continue to develop the local mortgage markets while ensuring that such development does not result in real state "bubles". These instruments are natural investments for pension funds and eventually for the annuities/insurance companies. More important at this stage in the evolution of local tenge mortgage markets, is development of a very standardized primary mortgage market that is not yet present. All terms and conditions of mortgage loans originated by various banks should be more similar as well as pricing conventions, as this is more essential than one-off securitization transactions. Related is the need to collect very detailed information about the housing market on an historical basis; from turnover of homes, to valuation and prices of homes (and related appraisal principles), to statistics on refinancing given the need to model and measure pre-payment risks for originators and the KMC.

KMC's gearing ratio (6 to 1) and processes for buying mortgage loans and selling either mortgage backed bonds or securities backed by pools of mortgage loans into the market is extremely important to foster in a prudent manner. Here management of the risks entailed with the "affordable housing program" and challenges it poses for sound asset/liability and risk management of given that these loans must be provided at below market fixed interest rates for terms of 10 years needs careful review.

c. Corporate and Bank Debt: Corporate and bank debt markets need to be fostered. This can be facilitated via development of a richer set of basic underlying primary contracts between banks and medium to smaller firms. Underlying bank transactions in such areas as factoring receivables, trade receivables, storage warrants or receipts and bankers acceptances or commercial paper that can eventually be large enough to support development of greater securities issuance either via securitization or via sale to investors via collective investment schemes. As part of this process examination in detail of many of the costs of raising capital through different securities contracts is a critical first step in assessing where to give emphasis in regulatory or legal reform

d. Securitization and Collective Investment Schemes: Efforts to develop and pass a Securitization Act that is self-contained and provides clarity as to the rights and obligations or multiple parties to these transactions[24], including clarity in the event of a direct sale, bankruptcy, etc., is essential. Starting this effort now is important so the securitization framework is ready when banks and other entities develop more seasoned portfolios and related data to allow for credible securitization. Despite the rapid growth of credit and other forms of consumer related credit and credit cards, residential mortgages, trade receivables, etc., in the near term these developments cannot be expected to immediately result in large issues of asset backed securities as "seasoning" of these portfolios, their size, and historical default information needs to be developed. Hence, the lead-time to develop the correct legal and regulatory and information infrastructure to support securitization transactions needs to start, in the near term—but under a well-developed plan of action[25].

Collective investment schemes where a law is now complete is critical for the emergence of more types of investment vehicles such as mutual funds, funds of funds, closed end funds involving venture capital; distressed asset funds; special infrastructure debt funds, etc. Like securitization changes in the overall legal and regulatory framework governing the establishment of such collective investment schemes does need to be the initial focus. However, in both these cases there is a need to develop a very clear and not too complex legal and regulatory regime that can be easily understood by foreign investors as well as local market participants.

e. Quality of Information and Development of Securities Professionals. The quality of information is critical for development of new and more sophisticated investment vehicles and instruments. There is a sense that in Kazakhstan this is an area that is still lacking. In many countries this is not limited solely to credit bureaus (just being established as a private concern); or credit rating agencies that do not exist yet in Kazakhstan but are starting to be developed.[26] Self regulatory associations such as the association of bond dealers, pension asset managers, broker/dealers association, association of financiers, accountants, actuaries, etc. can play a role as could self regulatory organizations (if these are eventually defined under the laws of Kazakhstan). Both the stock exchange and even the

[24] This includes: the originator, the special purpose vehicle, legal counsel in such an underwriting, the underwriting bank (if not the originator); the investor etc. These transactions are complex to evaluate and supervise and regulate.
[25] In addition, "false" securitization operation must be prvented, such as pledges of future cash flows by banks which look as a securitization.
[26] Recently Interfax and Moodys have begun to more seriously explore entry into Kasakhstan to develop ratings methodologies and capacity.

Central Security Depositary (CSD) could provide very valuable information dissemination functions. At its inception the authorities may have to engage in a form of public and private partnership to support development of some of these key areas and/or professions. For example, this may apply to credit ratings at least initially, or in coordination with outside investors such as IFC and EBRD. The importance of domestic credit ratings in the local markets will become more evident as many of the actions noted in a-d are undertaken.

61. **Other Initiatives to Deepen Securities Markets:** Other areas discussed with the authorities such as real estate investment, project finance, equity markets, etc. appear to the mission to be of a lesser near term priority. This is not to say that such areas are un-important. Rather it is to argue that the issues in many of these areas (e.g. infrastructure finance) involve lead-time to really start to encourage what is commonly referred to as public- private partnerships and related securities market activities. This requires fairly in depth knowledge of key infrastructure sectors, the existence (as in other areas) of a more developed legal and regulatory framework in such areas as passage of a concession law and an appropriate securitization law to name just two key preconditions. These are preconditions to see adoption of more creative infrastructure financing solutions that can better conserve capital of the fiscal authorities. Today the operations of the Development Bank are tantamount to sharing in the risk of infrastructure development via lending operations with private banks in co-financings. Thus, the process of developing these types of instruments will take time and cannot be seen as a top priority in the short term.

62. Like infrastructure, equity market development, although always desirable, seems far off—fundamentally due to the need to reform corporate governance and improve minority shareholder rights. These are among the most complex issues to progress upon in all emerging markets. Initiatives in the area by foreign investors including EBRD or IFC can be an effective means to begin to raise awareness and impose conditions via specific investments that condition participation on improvements in this area (e.g. IFC).

Securities Market Supervision

63. **As in the case of banking services, the regulatory and legal framework in the area of securities markets is advancing rapidly, while the FSA faces a substantial institutional development challenge to actually implement better systems for supervision and enforcement in this area**. This is especially significant at this time because further development of local securities markets and financial deepening will require concomitant efforts to improve safety and soundness of local securities markets and their integrity. Moving to risk based supervision by the FSA can only become a reality if it builds up rapidly the capacity and number of staff it deploys to supervise and regulate what is now over 100 securities market related entities (e.g. pension funds, asset managers, broker dealers, the stock exchange, central securities depository (CSD) special pension funds asset managers, registrar companies etc.) and about 3000 registered firms where only a small proportion (about 80 are listed). There are about 18 inspection staff altogether to deal with this number of institutions in the securities markets out of a total staff of 300 persons at the FSA. This imbalance is striking and needs to be corrected.

64. **Despite the relatively greater importance of credit risk for financial groups (see section A above) in the case of securities market services, market and operational risk measures and links to capital are far more important**. This issue is especially relevant for the pension fund asset managers given the large size of the portfolios some of them manage. Market valuation and intra-group transactions will need special attention, as will accounting treatment.

ii. Recommendations

65. **The following set of actions might need to be taken to reinvigorate the process of developing the local tenge securities markets and related instruments**.

- Put primary emphasis initially on development of the government debt market. As noted in section B.1. this will entail a series of logical steps and outlining a roadmap of actions between MEBP, MOF, NBK as well as FSA.

- Make efforts to develop the mortgage market which has very great potential in Kazakhstan. Here an effort to develop a detailed strategic plan with KMC and with the new mortgage insurance and guarantee entity will be essential. The existing leverage of KMC and the prospect of having to manage the affordable housing program presents not insignificant risks to the future solvency of the KMC. The potential importance of mortgages for filling the investment instruments gap calls for a special effort in this area.

- Conduct a careful diagnosis of the costs of raising capital via different forms of contracts (bank loans, corporate debt and listings, equity Initial Public Offerings (IPOs) and compare this to various emerging market benchmarks. [27] After this study review the existing listing standards for type A and B firms and see if there is a need to make changes to reduce regulatory costs of issuance.

- Develop the legal and regulatory framework for securtization and collective investment vehicles with an eye toward developing these innovative areas so as to create more diversity of investment instruments. Issues related to capital treatment for the originator as well as treatment of investments in these vehicles by pension funds will deserve special attention.

- Conduct a systemic review of the information infrastructure needed to support development of new financial contracts and instruments. On this basis invest in the education of financial professionals and make this a priority so as to develop Kazakhstan as a net exporter of important financial and information services to other CIS countries thereby building the base of the local market (beyond the current limited population and limited local market).

[27] See the forthcoming working paper by Zervos(2004) on the Transactions Costs of Issuing Debt and Equity. This paper develops a method for determining such costs at the micro-market structure level for three Latin American countries: Brazil, Mexico, and Chile.

66. **Supporting the further development of supervision and enforcement in the securities markets will entail work in the following areas**:

- As part of the broad "Institutional Development Plan" to support development of capacity of the FSA, (see section A) it will be critical to include an entire component to develop the capacity of the FSA in the area of securities market/pensions and insurance supervision and enforcement. Techniques to improve on and offsite supervision will be essential as will development of an explicit Enforcement Department.

- FSA needs to have the power to properly delegate regulatory responsibilities to entities such as the stock exchange or CSD under arrangements where these entities are true self regulatory organizations (SROs). In this case they would have a legal obligation to the FSA to take on certain regulatory functions, and would be legally liable and have an explicit "public interest role".

- Technology applications designed to improve off-site surveillance of pension fund portfolios, asset managers, collective investment schemes, etc. can assist the authorities in focusing very scarce examination resources and in assuring more effective compliance with prudential regulations. This would also allow more effective supervision of systemically important areas beyond the banks such as the pension funds, stock exchanges, and the CSD, etc.[28]

C. THE URGENT NEED TO STRENGTH REGULATORY AND SUPERVISION FRAMEWORKS[29]

i. Key Issues

67. **Fast credit growth, both domestic and cross-border, has outpaced, in recent years, local economic and deposit growth, thereby increasing the risk profile of Kazakhstan's banks**. This is stressing not only the banks' own financial and institutional capabilities but also, and most significantly, the ability of the FSA to identify, supervise, and mitigate the risks that are being accumulated.

68. **The real growth in the loan portfolio of banks constitutes a major credit boom by international standards** (see Figure 1). Empirical studies have shown that credit booms often end in tears, i.e. in a banking crisis. Credit booms are dangerous for several reasons. First, during a boom it is very hard for banks to monitor credit quality. Banks give loans at a much faster speed than usual, and tend to reduce the level of analysis that goes into each loan. They also give loans to new customers, whose credit

[28] Real time monitoring of asset portfolio positions of the pension funds could greatly improve supervision and allow better overall concentration of inspection resources.

[29] See Attachement 1.

behavior they do not know. Second, since the rate of growth of credit is much higher than the interest rate, the banking system as a whole need not collect interest in net terms. The system has the resources to capitalize all interest payments and still give more credit. Under these conditions, borrowers can repay one bank by borrowing from another. Even one bank will have trouble distinguishing between funding a new project and recapitalizing old interest due. Once the credit boom stops, borrowers need to actually pay in net terms to banks and that is when credit quality gets tested. Measures of credit quality during the boom always paint a rosier picture than the underlying reality. Finally in a dollarized system, as mentioned above, while the real exchange rate appreciates, dollar loans become cheaper. When a depreciation occurs, loans become more expensive and harder to pay. Finally, in Kazakhstan some banks may have portfolios highly concentrated in some tradable activities such as agriculture and livestock that are likely to do very poorly in the context of a major real appreciation.

69. **Regulatory changes alone are not sufficient to deal with this situation**. While the regulatory and legal framework for banking services has been rapidly developed concomitant with the industry's accelerated expansion; the development of banking supervision capacity has lagged behind these developments. Accordingly, the strengthening of onsite examination processes is the most ***urgent priority*** that FSA confronts to effectively supervise the surge in banking activities and their growing investments abroad (mainly neighboring countries). It is also important to strengthen the Risk-Based Supervisory orientation of the FSA.

70. **In particular, the FSA does not have sufficient skilled onsite bank examiners to supervise a relatively large number of banks**. In addition, it does not have the capacity to monitor the four largest national banks, which control close to two thirds of the system's assets, and accounts for a significant proportion of the recent industry expansion. Moreover, these large banks are part of complex financial conglomerates, controlled by local economic groups with, presumably, sizeable industrial and commercial interests. Conflicts of interest inside these conglomerates could lead to abuse in the form of risky insider lending.

71. **Effective consolidated supervision is also lacking, which is essential to understand the relationship between the financial and non-financial activities of these groups as well as the true risk-profile of financial intermediaries**. In addition, aggregate credit limits for related parties are, in practice, well above sound supervisory standards. This hurts the incentives for prudent governance of the banks, at the expense of other stakeholders and the overall stability of the system.

72. **Against this background, further regulatory reform --such as the introduction of market and operational risk capital charges-- may distract the bankers, as well as the FSA, from the fundamental need to manage the risks associated with the ongoing credit expansion. It also would distract attention and scarce resource needed to address cross border concentration risks (e.g. Russian exposure), conglomeration, and increased dependency upon foreign funding**. Regulation should limit foreign funding, while a concerted effort to strengthen

supervision is the only way to assess: (1) bankers' capacity to manage credit risk, (2) underwriting standards, and (3) the resiliency of the borrowers' debt service capacity, especially those in the non-tradable sector where currency exposure may be large.

73. **More emphasis is needed in strengthening credit and liquidity funding risk management of the banks.** This will require improving their internal systems of control, management information, and operations. This cannot be achieved solely by regulation, or by requiring additional capital, except to finance the associated investments. It demands a more prominent role of the banks' board of directors to ensure that growth strategy is balanced, and their associated risks strictly governed under controllable limits. Moreover, a thorough review of internal control systems at banks and an aggressive review of potential conflicts of interest are important.

74. **At the same time, the FSA has to improve its processes, capacity, and resources, to supervise onsite**–not just to regulate and analyze data reported. These are major challenges for the Agency, which does not have the same ability to attract talented professionals at short notice, remunerate them according to their skills, and retain their services with an attractive career development path. A realistic and proactive training and remuneration policy is needed. In addition, the associated tasks for the FSA are multiple and interrelated, which requires adopting a clear set of priorities.

ii. Recommendations

75. Although the *Regulatory Framework* is for the most part in place, the mission identified a set of priority measures that should be the focus of the authorities (i.e., Government, the NBK and the FSA) in the short-term:

- **Review the banking legal and regulatory framework** in the areas of consolidated supervision, individual increases to minimum capital, prompt corrective action, and the resolution of failed banks.

- **Review the regulations for consolidated accounting and capital requirements** –scope of consolidation, techniques, deductions from capital, reporting, auditing;

- **Adopt a package of measures to mitigate the pace of credit growth and expansion** --limits to foreign funding and currency transformation, and country risk provisioning (see slides 6, 23 and 24 in Attachment 1);

- **Review and strengthen loan classification and provisioning rules** –refinancing, restructuring, interest capitalization, and general provisions.

76. The bulk of attention should nonetheless be placed on strengthening supervisory capacity:

- **Develop and adopt an institutional development plan for the FSA,** one which is adequately costed, funded and managed, and that includes qualitative benchmarks to monitor progress in processes and results;

- **Reinforce examination skills, increasing the number of examiners, and improving tools and procedures to assess credit risk** –debt service and underwriting assessment;

- **Implement supervisory and examination procedures to review consolidated accounting, and risk management and governance of conglomerates**;

- **Develop procedures, and train examiners, in assessing and rating bank governance, risk management, and control structures** --their adequacy, quality, and effectiveness;

- **Improve the method of supervisory risk assessment (CAMEL)** combining quantitative and qualitative factors that can be linked to additional capital requirements above minimum levels;

- **Strengthen both the methodologies and procedures for assessing and implementing rehabilitation**, and alternative methods to evaluate least cost bank resolution methods;

- **Develop systems and procedures for stress simulation and early-warning**, as well as for costing supervisory fees, and administering supervisory activities and the budget.

- Finally, both NBK and FSA should consider engaging into **formal contingency planning exercises**, to stand ready for swift action in the event of a banking failure.

D. Suggested Next Steps

77. The mission would like to propose the following next steps:

(1) General

- **The Bank would very much welcome receiving the authorities' coordinated views on the assessments and recommendations made in this Aide Memoire (and in the attached slide presentation).**

- If the authorities so wish, the Bank will place this assessment as a discussion note in the Kazakshtan's country office web and solicit views from a broader set of stakeholders.

- Based on the feed back received from the authorities on the Aide Memoire and the attached preliminary outlines **the Bank can launch** a follow up mission to agree on priorities, and identify the areas in which the authorities would like a longer involvement of the Bank. The Bank can also help defining areas for external consultancy and reviewing draft TORs. Bank's expertise would be most suitable for assisting the government with the preparation of:

  - An "Institutional Development Plan" for the FSA
  - The blue print for the development of the Government is securities market
  - The blue print for the development of the pension system

- During the follow up mission, the Bank could jointly with the working group assigned to the relevant areas, draft a concrete working program in each of the above mentioned areas – or those selected by the authorities, identifying the required skills needed and staffing needs (Bank staff and consultants).

- The official assignment of a group of highly qualified technical counterparts from each of the key institutions would be essential for any future work.

- Regardless of the level of Bank involvement, the authorities are encouraged to:

  - Identify skills needed for this work and staffing requirements, with particular emphasis on consulting services needed by the different agencies.
  - Plan for the development of detailed TOR's for the work to be undertaken in each of the priority areas selected.

(2) Regulation and supervision of banks

- The Bank can provide **a template for the institutional development plan for the FSA** if it is agreed that the development of such plan is considered a priority;

- Subject to appropriate confidentiality arrangements, and at the request of the FSA, the Bank could, at a mutually agreed time, proceed to **perform an in depth evaluation of the full supervisory cycle and activities of a selected bank/group case.**

- Since the Mission did not cover explicitly **the framework that governs the accountability of the FSA,** it would like to request the authorities' view on whether such area maybe of priority. More concretely, the Mission did not discuss the benchmarks adopted by its Board to assess the performance of the Agency, as well as the formal written policies approved by the former regarding prompt corrective action, enforcement, and failed bank resolution.

(3) Development of the pension system and securities markets

- The Bank can, subject to final confirmation by the FSA make comments on several documents provided to the mission that are still being translated. These include: 1) the recently issued proposal relating to norms for financial stability for the professional participants of securities markets including pension fund asset managers; 2) send comments and provide input on the effort to evaluate approaches to regulation and supervision of the stock exchange, and 3) comment on the new collective investment scheme law and any draft regulations provided

- Subject to appropriate confidentiality arrangements the Bank can also discuss with the FSA the material provided to the mission relating to inspection processes and enforcement of pension fund and securities market participants.

- The Bank will finalize and send comments on the draft Securitization Law as requested by the MOF and also provide such comments to the FSA for review, subject to confirmation by the authorities.

- The Bank will provide comments to the draft Program and Action Plan Program of Development of Securities Markets 2005-2007.

- The Bank will send to the authorities the final special studies recently undertaken in Chile on their securities markets that have been cleared for publication by the Chilean authorities. The Bank will also share the final draft of the report on the Chilean annuities markets.

- The Bank will facilitate contacts for FSA with other regulators knowledgeable about issues agreed upon after more detailed comments and review has been undertaken of the material thus far provided by the Agency to the Bank.

(4) Other Requests

- The Bank will attempt to identify with other material agencies relevant person(s) (staff or consultants) that could act as a special financial advisor seconded to the KMC to assist them in further developing their operations in Kazakhstan

- The Bank will discuss with the authorities the possibility of assisting in their effort to further modernize the existing administrative arrangements for the centralized collection and payment agency of the pension system—assuming agreement is reached on the importance of this building block for the system.

Annex 1

Power Point Presentation on:

Kazakhstan Financial Services Supervision Authority

Joaquín Gutiérrez
The World Bank – Banking and Financial Restructuring
October 4th. 2004 – Interim Provisional Draft (27 slides included)

Annex 2

Power Point Presentation on:

Issues in Development of Kazakhstan Pension System and Securities Markets: Setting Priorities

Thomas C. Glaessner and Pedro L. Rodriguez
The World Bank – Banking and Financial Restructuring, and Economic Management
October 4th. 2004 – Interim Provisional Draft (56 slides included)

Annex 3

List of Background Documents Provided to Technical Counterparts

1. Technical Note: ***Corporate Sector Issues; Balance Sheet Vulnerabilities and Access to Finance***, June 2004, Financial Sector Assessment Program, Chile, World Bank and IMF

2. Technical Note: ***Supervision of Financial Conglomerates***, June 2004, Financial Sector Assessment Program, Chile, World Bank and IMF

3. Technical Note: ***The Pension Fund Sector***, July 2004, Financial Sector Assessment Program, Chile, World Bank and IMF

4. Technical Note: ***Liquidity In Chilean Securities Markets—***Toward A Road Map For Reform, August 2004, Financial Sector Assessment Program, Chile, World Bank and IMF

5. Reform Roadmap: ***Strategic Choices In Developing Colombia's Debt Markets***, February 2002

6. ***Valuation and Debt market Development: Toward a Framework***, Thomas Glaessner, World Bank

7. ***Derivatives and Economic Policy: Getting Back to Basics***, Thomas Glaessner, World Bank; and *Derivatives in Implementation of Economic Policy within Emerging Economies: Getting Back to Basics*, Thomas Glaessner, For presentation at The 1st International Derivatives and Financial Market Conference organized by BM&F, August 20-23, 2003, Sao Paulo, Brazil

8. ***Experience of a Centralized Valuation: Colombia***, Thomas Glaessner, Central Bank of Colombia

9. ***The Impact of Electronic Trading on Transparency in Bond Markets***, Jens Verner Andersen, Government Debt Management, Danmarks Nationalbank, Sixth Annual OECD-World Bank Global Bond Market Forum, 24-25 May 2004-10-18

10. *Preliminary Comments to the draft Securitization Law*

11. Written answers to 20 questions raised by the staff of the Financial Supervision Agency

12. Detailed slide show of the best international standards for supervision