DOCUMENT OF
THE WORLD BANK

Report No: 15430UZ

UZBEKISTAN

CREATING FINANCIAL MARKETS: A REVIEW OF THE FINANCIAL SECTOR

Volume 2: Annexes

March 3, 1997

Country Department III
Europe & Central Asia

Technical Department
ECA/MNA Regions

CURRENCY EQUIVALENT
(December 31, 1995)

Sums 35.5 = USD 1.00

ABBREVIATIONS AND ACRONYMS

GDP	-	Gross Domestic Product
GKI	-	State Property Committee
IMF	-	International Monetary Fund
MOF	-	Ministry Of Finance
NDS	-	National Depositary for Securities
PIF	-	Privatization Investment Funds
PPS	-	Private Participation Shares
SCSSE	-	State Committee on Securities and Stock Exchanges

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VOLUME II: ANNEXES

ANNEXES:

This report is based on findings of a mission that visited Tashkent in October 1995. Members of the mission were Messrs./Mmes. Michael Fuchs (Task Manager), Esen Ulgenerk (Banking), Vincent Polizatto (Supervision and Regulation) and Mark St. Giles (Capital Markets). Messrs. Alain Druet (Rural Finance) and Gregory Jedrzejczak (Capital Markets) also visited Tashkent and contributed to the Review.

ANNEX A

DATA ON THE BANKING SECTOR

Annex A: Table 1

Uzbekistan - Structure of the Banking Sector as of October 1996

Name of the Bank	Founding Date	Company Type	Paid-in Capital in (million Sums)	Total Assets (million Sums)	Number of Branches	Major Founding Shareholders - More than 15% of Paid-in Capital	Type of Activity
A. STATE BANKS							
National Bank	10.25.91	State	1,327	141,138	19	State	Universal
Zamin	11.20.96	State	117	324	9	State	Mortgages for Agricutire
Asaka	01.19.96	State	3,550	9,713	14	State	Saving
Narodny Bank	03.16.92	State	100	41,683	5,808	State	Saving
B. STATE-OWNED BANK							
Promstroybank	06.25.91	JSC	512	76,316	58	Navoi and Almalyk Mining Complexes. Tashkent Tractor Factory. Uzneftgas	Industry and Metals
"Pahta-Bank"	07.01.91	JSC	1,019	53,272	184	Uzbek Academy of Agricultural Sciences. Narodny Bank	Cotton Sector
Turon Bank	12.31.90	JSC	85	4,675	12	Ministry of Melioration and Water Resources Management	Melioration
Galla Bank	08.02.94	JSC	139	7,963	21	Ministry of Finance and Association. "Uzkhleboproducts" (Bread Products)	Grain Sector
Savdogarbank	05.12.94	JSC	178	4,543	58	Ministry of Finance	State trade enterprises
Tadbirkorbank	04.26.93	JSC	80	3,337	155	Business Fund. AF "Kuylyuk"	Private farmers
Legcombank	01.25.94	JS	72	705	2	Uzbeklegprom State Assoc.. Legrominvest State Co.. Tashkent Cotton Assoc.	Apparel Sector
Avtodorbank[1]	12.31.90	JS	25	774		Uzavtotranst State Corporation and related entities, State Insurance Co.	State Transport Sect.
Tashzhilsberbank	04.28.95	JSC	246	1,907	2	Ministry of Finance. Tashzhilinveststroi. Goskomimuschestvo(GKI)	Social Construction
Mevasabsavotbank	11.02.94	JSC	32	2,381	15	Ministry of Finance. Uzpisheprom State Concern	Fruits and Vegetables
Aviabank	12.31.90	JSC	46	533		Pilot complex. National airlines	Universal
Geolbank[2]	12.31.90	JS	12	146		Goskomgeologia, Uzbekgidrogeologia	Mining/Geology
Ilmtechbank	12.31.90	JS	20	332		Sheikh Joint Stock Co.. Kamalak Cooperative	Hospitals/Construction
Alokabank	03.22.95	JSC	40	1,124	1	Poduction Association. "TelephoneAloka"	Communication
Uzprofbank[3]	05.29.92	JS	6	108		Council of Federation of Trade Unions	Trade Union Enterprises
Saekhatinvestbank	04.11.95	JSC	24	81		National company. Uzbektourism. JV Atel. "Uzbekistan"	Universal
Trustbank	06.21.94	JS	23	297		"Vatan" Association Uzoptbirzhetorg (Uzbek Whole Sale Exchange Trade)	Universal
Tashkentbank	12.29.90	JS	16	150		Firm "Fakel". Vneshsnabsvyaz	
C. UNIVERSAL BANKS							
Uzbek-Turkish Bank	05.13.93	Foreign JV	61	2,827		Turkish Agricultural Bank-50%; Pahtabank-50%	Universal
Ipek Yuli Bank	12.31.90	JSC	20	593	2	Religion Board of Muslims. "Turguntosh"	Universal
Investbank	03.16.92.	JSC	19	149		Asia-Modus Ltd. Turkistan Co. Ltd.	Universal
Privatbank	02.28.95	Foreign JV	75	535		Tashmetal. Almalyk Concern. GKI. SIA Phonon-51% - MeesPeerson-49%	Universal
D. PRIVATE/OTHER BANKS							
Andizhanbank	08.30.91	JSC	59	534	6	Andijon Maslokombinat (Butter Production) State Firm. Private Firm Kholis	Regional
Namanganbank	12.27.90	JSC	16	57		Altin vadi Private Co..	Cooperative Banking
Sharkbank[4]	12.27.90	Cooperative	7	58		Leased Furniture Production Enterprise	Cooperative Banking
Parvinabank	05.10.94	JS	17	112		Kadirova Nigora. Firm 'Parvina'	Private Bank
Umarbank	06.14.94	Private	10	26		Nuritdin Batyrov. Private Production Firm	Private Bank
Olimbank	05.10.94	Private	5	10		"IBOD" Company. "Urgut" Joint Stock Company	Cooperative Banking

[1] Data as of April, 1996. The Bank is under liquidation in accordance with the decision of shareholders from August, 1996.
[2] Data as of April, 1996. The Bank is under liquidation in accordance with the decision of shareholders from October, 1996.
[3] Data as of October, 1995. The Bank is under liquidation in accordance with the decision of shareholders from February, 1996.
[4] Data as of October, 1995. The Bank is under liquidation in accordance with the decision of shareholders from March,1996

Annex A: Table 2

Uzbekistan Banking Sector Balance Sheet Items As Of October 1996

(million Sums)

Name of the Bank	Assets								Liabilities and Equity									Total Liabilities and Equity
			Credits						Liabilities						Equity			
	Reserve Requirements	Balances in the Central Bank of Uzbekistan (CBU)	To Enterprises and Individuals	To Other Banks	Total Credits	Overdue Principal	Overdue Interest	Total Assets	Household Deposits	Enterprise Current Accounts	Other Enterprise Deposits	Overdue Central Bank Credits	Credits from the Central Bank	Credits from Banks	Paid-in Capital	Other Capital Funds	Income for the first 9 months of 1996	
A. STATE BANKS																		
National Bank	2,242	1,681	44,308	100	44,408	1,731	15	141,138	8	7,320	1,140				1,327	11,732	7035	141,138
Zamin	7.5	20	14	10	24			324	3	23.7	8			90	117	30	31	324
Azaka		1,265	4,803	55	4,858	11	39	9,713	8	1,930	2		1,948	265	3,550	1,099	112	9,713
Narodny Bank	213.8	276.3	725.1	1,752.3	2,477.4	479	409.3	41,683	4,257	598				19.6	100	402	42.6	41,683
Total:	2,463.3	3,242.3	49,850.1	1,917.3	51,767.4	2,221	463.3	192,858	4,276	9,871.7	1,150		1,948	374.6	5,094	13,254	7,220.6	192,858
B. STATE-OWNED BANKS																		
Promstroibank	1,785	1,830	13,461	6	13,467	865	1,284	76,316	997	8,551	147	27	2,530	293	512	3,228	1,438	76,316
Pahtabank	773	2,235	17,937	32	17,969	1,005	2,840	53,272	257	4,271	346		11,160	654	1,019	3,941	1,651	53,272
Turon	104	108	271	51	322	42	24	4,675	38	424	76			50	85	190	147	4,675
Galla Bank	84	231	4,923	98	5,021	38	19	7,943	8	566	35		4,144	4	139	494	290	7,943
Savdogarbank	137	164	1,131	4	1,135	423	291	4,543	20	794	362			806	178	325	123	4,543
Tadbirkorbank	278	212	618	0.4	618.4	436	178	3,337	43	1,355	348			248	80	306	125	3,337
Legcombank	28	29	255		255	6.6	211	705	2	114	36			155	72	36	17	705
Tashzhilsberbank		176	631	90	721	1.6	9.2	1,907	127	710	121				246	218	168	1,907
Mevasabzavotbank	113	108	519	114	633	217	186	2,381	4	393	16	1	42	193	32	48	28	2,381
Aviabank	55	125	37	50	87	2		533	0.2	260	0.1				46	63	107	533
Sachatinvestbank	1	21	12		12			81		11	30				24	5	6.6	81
Ilmtechbank	45	66	4	4	8	20.5	2.6	332	5.3	179					20	39	27	332
Alokabank	60	73.6	128	30	158	15.5	20	1,124	3	189	48.5				40	45	49	1,124
Trustbank	26	23	74	50	124	3.3		297	0.4	185					23	37	34	297
Tashkentbank	23	24	56		56	9		150		98					16	18	17	150
Total	3,512	5,425.6	40,057	529.4	40,586.4	3,084.5	5,064.8	157,596	1,504.9	18,100	1,565.6	28	17,876	2,403	2,532	8,993	4,228.6	157,596
C. UNIVERSAL BANKS																		
Uzbek-Turkish Bank	522	1,005		150	150	14	26	2,827		2,004					61	169	113	2,827
Ipak-Yuli Bank	88	56	52		52	27.5	20	593	2	284	40				20	61	37	593
Investbank	20	42	18.6		18.6	14		149		106.5					19	18	3	149
Privatbank	66	128	1.3	15	16.3			535		242					76	15	19	535
Total:	696	1,231	71.9	165	236.9	55.5	46	4,104	2	2,636.5	40				176	263	172	4,104
D. PRIVATE/OTHER BANKS																		
Andizhanbank	63	23.8	158	6	164	46	19	634	47	212	50			10	59	52	54	634
Namanganbank	4	2	26		26	1		57	3.7	11	7			12	16	5	0.7	57
Parvinabank	14	27	12		12	0.3		112	0.5	61					17	6	13	112
Umarbank	2	9.4					0.4	26		9.2					10	2	3	26
Olimbank	0.8	0.1	6	1	7	0.4		9.5	0.1	3					5	1	0.4	9.5
Total:	83.8	62.3	202	7	209	47.7	19.4	838.5	51.3	296.2	57			22	107	66	71.1	738.5
ALL BANKS WITHOUT NATIONAL BANK:	4,513.1	8,281.2	45,873	2,518.7	48,391.7	3,677.7	5,578.7	214,258.5	5,826.2	23,584.4	1,672.6	28	19,824	2,799.6	6,582	10,853	4,657.3	214,259.5
TOTAL ALL BANKS:	6,755.1	9,961.2	90,181	2,618.7	92,799.7	5,408.7	5,593.5	355,396.5	5,834.2	30,904.4	2,812.6	28	19,824	2,799.6	7,909	22,576	11,692.3	355,396.5

Source: The Central Bank of Uzbekistan

PRINCIPLES AND APPROACHES TO BANK RESTRUCTURING

Diagnostic Evaluation

1. The first phase in restructuring the banking system should be a diagnostic phase in which the financial condition and operating performance of each bank is assessed. This has the broader objective of determining the condition of the banking system. Once the extent of problems is reasonably known, the process of determining which banks survive in the new financial system can begin. The diagnostic process should start with an evaluation of portfolio quality so that the amount of problem assets, actual and potential losses, and their causes can be determined. Once actual and potential losses have been estimated, the bank's solvency can be determined and its future viability assessed.

Determining Portfolio Quality

2. *Definitions for Grading the Quality of Assets.* In order to determine the quality of the loan portfolio, as well as other assets and off-balance sheet contingent liabilities, it is first necessary to establish criteria by which to evaluate assets. In general, this criteria is used to assess the borrower's financial capacity and ability to repay. Many countries have adopted a system of classification in which assets are classified as standard, substandard, doubtful, or loss. Those assets which are considered *standard* do not exhibit credit weaknesses that might jeopardize collection of the debt in the manner agreed to upon the loan's inception. Such loans are properly structured so that repayment is effected in a timely and realistic manner and are otherwise sound in every respect. In essence, they are good loans to good enterprises. The latter three categories are considered problem assets. Their definitions follow.

3. A *substandard* asset is one which has a well-defined credit weakness, or weaknesses, which jeopardizes the liquidation of the debt. It is inadequately protected by the sound net worth or payment ability of the borrower. Substandard assets are characterized by the distinct possibility that the bank will sustain some loss if the credit weakness is not corrected. Loss potential, while existing in the aggregate amount of substandard assets, does not have to exist in individual assets classified substandard. For example, a substandard borrower is one which lacks adequate cash flow to service or repay its currently maturing debts. This credit weakness may be determined from an actual lack of performance or it may be concluded on a prospective basis through an analysis of the enterprise's financial statements. In some instances, borrowers may appear to perform on their debts but in fact do not. It is only through the capitalization or refinancing of interest which is due and unpaid that the loan appears current. In Uzbekistan, substandard assets might include loans to enterprises which are fundamentally viable but which require a moderate degree of restructuring in their operations to improve efficiency and profitability, a more conducive operating environment, and a stretching out or change in the mix of their liabilities. The objectives of restructuring would be to improve the enterprises' operations so that they are more efficient, more competitive, and sufficiently profitable to adequately service their debts and provide a reasonable return to their owners. In effect, the credit weaknesses in such enterprises are, to a very large degree, controllable and correctable over the short-term with a minimum of state intervention.

4. A *doubtful* asset has all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. One example of a doubtful asset is a

loan which exhibits the characteristics of a substandard asset but which is also seriously past due and inadequately protected by the realizable value of any collateral pledged. For example, assume that inventory is the sole asset of an enterprise pledged as collateral. Its sale under distressed conditions or during a forced liquidation might only bring a fraction of its original cost, thus significantly exposing the credit to a high probability of loss. Further, it might be difficult for a bank to foreclose or repossess the collateral and dispose of it in a timely fashion so that a partial recovery can be effected. This renders the ultimate collection of the indebtedness in full highly unlikely in most cases.

5. Assets classified *loss* are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future. In Uzbekistan, assets considered as loss might include loans to those enterprises which are not viable in the short-term under any reasonable circumstances barring intervention by the state in the form of massive subsidies. These assets would generally fall into three categories:

a) Those that require major rehabilitation over the long-term, most probably involving state intervention. These enterprises could possibly be made viable on their own merits but are not considered worthy of being carried as active assets on the books of the bank.

b) Those enterprises which are not viable but serve an essential social need, e.g., railroads, utilities, airlines, etc. Such enterprises may be kept alive because of their importance to society; however, the costs should be made explicit through direct subsidies from the state rather than indirect subsidies in the form of bank financing.

c) Those enterprises which are not viable under any circumstances. These enterprises should be closed and their assets liquidated.

6. In establishing criteria for grading the quality of credit, it should be understood that many enterprises which are viable today, may not be in the future. Many enterprises will only show up as problem borrowers at subsequent reviews of portfolio quality. Therefore, one should not expect that all problem borrowers would be identified during the initial portfolio review. The process of portfolio review should be a continuous one that is systematically carried out by each bank's own staff, as well as by bank supervisors and auditors, as an integral part of management's controls over the lending function. In this way, problem borrowers can be identified in a timely manner so that measures can be taken to strengthen or otherwise collect the credit before it deteriorates into a hopeless situation.

7. *Scope of the Portfolio Examination.* In order to determine portfolio quality and each bank's financial condition, it is necessary to review a significant portion of each bank's portfolio using criteria similar to that as suggested above. To accomplish this, supervisors and others involved in the review process should evaluate the very largest exposures at each bank, loans which are in arrears, loans which have been renegotiated at preferential terms, problem loans identified by bank management, and loans in which interest which was due and unpaid has been capitalized or refinanced. Typically, the portfolio examination should ensure that at least 70% of the portfolio is reviewed.

8. *Evaluating the Portfolio*. Once the review process has been completed and individual assets have been classified, the results should be aggregated for the portfolio as a whole. The evaluation of the portfolio should consider:

a) The amount of assets and off-balance sheet risks classified in each category as substandard, doubtful, and loss and the aggregate of all assets classified in these categories. The aggregate figure is normally compared to the bank's capital as one measure of the bank's condition. If the amount of problem assets exceeds the bank's capital and reserves, i.e., the ability of the bank to absorb losses, the bank is clearly in difficulty.

b) The amount and composition of assets for which: (i) interest is being accrued but is not being collected, (ii) interest is not being accrued, and (iii) interest is being collected but at rates which are significantly below market rates. This information may not only be indicative of portfolio quality but is also necessary to determine adjustments to the bank's profit and loss statements.

c) The causes and sources of problem assets. If a bank is to survive, it will be necessary to establish appropriate lending policies and controls to correct the unsound practices and banking culture that resulted in the problem assets.

d) The adequacy of provisions for losses and adjustments necessary to bring loan loss reserves to adequate levels. Specific attention should be devoted to determining those assets, or portions of assets, which are clearly non-bankable and which should be removed from the balance sheet of the bank. In many countries, this is done on a loan by loan basis. In other countries, a percentage is applied to the aggregate of assets classified as substandard, doubtful, and loss. Typical percentages are to establish reserves equal to 25% of substandard assets, 50% of doubtful assets, and 100% of loss assets. In addition, a general provision is normally required for the balance of the portfolio. In determining which assets are to remain on the balance sheet, realistic decisions must be made regarding the prospects for rehabilitation of the bank's borrowers.

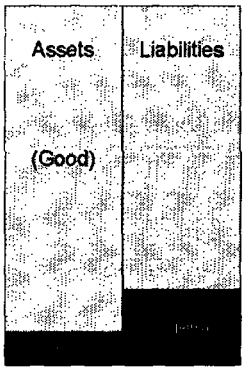
9. In addition to portfolio losses, emphasis should also be placed on quantifying other losses which may exist including those arising from foreign exchange transactions, interest taken into income on non-performing assets, and adjustments to the profit and loss statement which may be required for past due interest which has been capitalized, renegotiated, or refinanced.

Determining a Bank's Solvency

10. After the portfolio has been reviewed, assets graded according to credit quality, and the amount of required loan loss provisions estimated, an assessment as to solvency and the adequacy of capital can be made. This assessment should determine the impact of the necessary loan loss provisions and other adjustments on the bank's profit and loss statement and balance sheet. If, as the result, capital is inadequate or the bank is technically insolvent, based on this assessment, the amount of capital necessary to absorb losses, bring capital to an adequate level, and ensure its ongoing viability should be estimated. Ideally, in a healthy banking system, the volume of problem assets (substandard, doubtful, and loss)

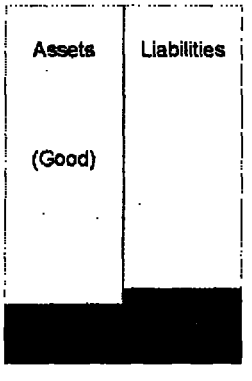
should not exceed 20% to 40% of the bank's unimpaired capital and reserves. Where problem assets represent more than 50% of unimpaired capital and reserves, particularly where many assets are in the doubtful and loss categories, supervisors generally become concerned and may consider the bank to be a *problem* bank. In virtually all developed countries, banks having problem assets exceeding 100% of unimpaired capital and reserves are considered as problem banks. For those banks that are technically insolvent, i.e., capital is fully eroded by losses incurred from provisions and operations, decisions must be made regarding closure and liquidation or restructuring, and the most cost effective manner to allocate losses.

Figure 1:
A Healthy Bank



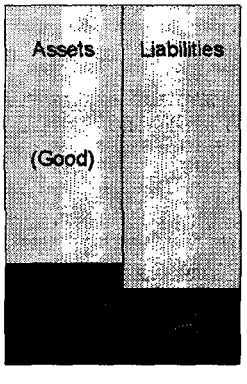
In a healthy bank, the volume of problem assets is typically in the range of 20% to 40% of unimpaired unimpaired capital and reserves. Capital provides the cushion against losses, before depositors' monies and other creditors of the bank are adversely affected.

Figure 2:
A Problem Bank



However, as problem assets accumulate and begin to represent more than half the bank's capital and reserves, supervisors become concerned. Usually, the bank is considered to be a *problem* bank and placed on a formal program of increased supervisory attention and corrective action.

Figure 3:
A Faild Bank



By the time bad assets exceed the capital of the bank, it is technically insolvent. The value of its assets is less than its liabilities. Supervisors must deal with insolvencies in a timely manner to curtail the growth of potential liabilities to the government and to remove distortions which insolvent banks cause in the financial markets, i.e., higher intermediation costs, loss of public confidence, a failure of the payments system, banking panics, and systemic failure.

Financial Restructuring

11. In order to minimize the problems that failed banks cause, it is necessary to restructure or liquidate failed banks in a timely manner. In this process, it is necessary to allocate losses and, in the case of restructuring, it will usually involve the carving out of bad assets on the balance sheet. This process usually results in a consolidation of banking assets and liabilities through mergers, acquisitions, and other combinations, a recapitalization of some banks, and the closure of other banks in which the costs of restructuring are too high to warrant their rescue. Surviving banks must then enter a phase of operational and managerial restructuring by taking measures to strengthen organization, management, policies, systems, and procedures in order to improve operational efficiency and competitiveness. Most importantly, poor lending and other unsound practices must be corrected and a sound banking culture put into place.

Options for Financial Restructuring

12. The following examples demonstrate the experiences of several countries in dealing with financial crisis.

13. ***Basic Approach***. In many countries, there exists a mechanism for dealing with insolvent banks. In the United States, the mechanism is the Federal Deposit Insurance Corporation. In Spain, it is the Spanish Deposit Guarantee Fund. In other countries, insolvent banks are handled less systematically through the central bank or ministry of finance. Notwithstanding the mechanism, the most successful approaches to dealing with insolvent banks incorporate several key fundamental aspects:

a) *The management of the bank loses their jobs*. In fact, it may be necessary to remove several layers of management in order to change the banking culture. Since management is responsible for the day to day operations of the bank, it must be shown that there is a price to pay for failure. In the case of a failed bank, discipline is imposed on incompetent or abusive managers through the loss of their jobs.

b) *The owners absorb losses up to the amount of their investment and their rights and claims as owners are eliminated*. Owners absorb losses, even though they may not have contributed to the bank's problems, in order to impose financial discipline. They have placed their money at risk and must exercise appropriate judgment to ensure that management is safeguarding their investment. When they do not, they must bear the consequences.

c) Bad assets are carved out of the bank's portfolio and replaced with good assets in the form of cash or marketable government securities. Ideally, marketable government securities are used. *These should be liquid and provide a sufficient yield to ensure that the bank can attain profitability*.

14. While there may be variations or refinements to this basic approach, for instance, losses are sometimes allocated to uninsured depositors and other liability holders as well as owners as a way to minimize the ultimate costs to the government, the basic concept, if implemented correctly, results in a shell of a bank, without capital, in which insured or protected deposits and other liabilities are matched

by good quality assets. This shell may then be: a) acquired by another bank through merger or acquisition, subject to the adequate capitalization of the surviving institution; b) sold and recapitalized by new investors; or, c) temporarily operated, with or without new capital, by the government until the bank can be placed in the private sector.

Figure 4A: Basic Approach to Financial Restructuring

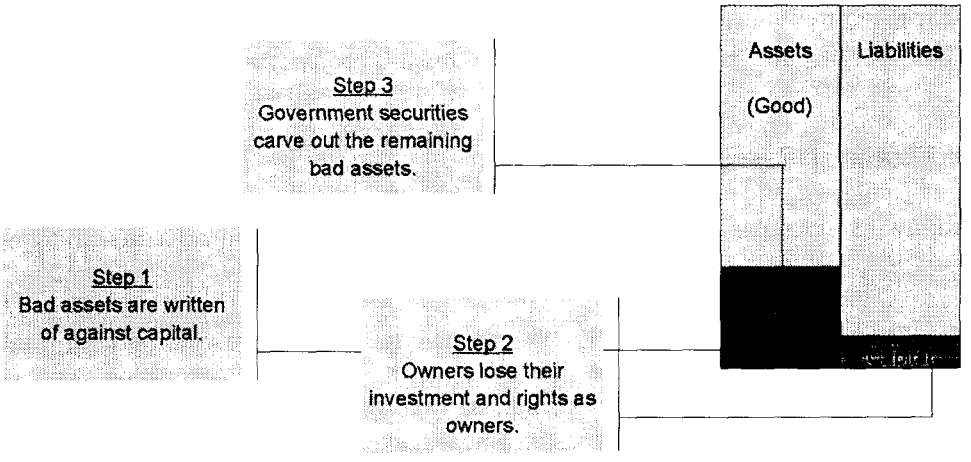
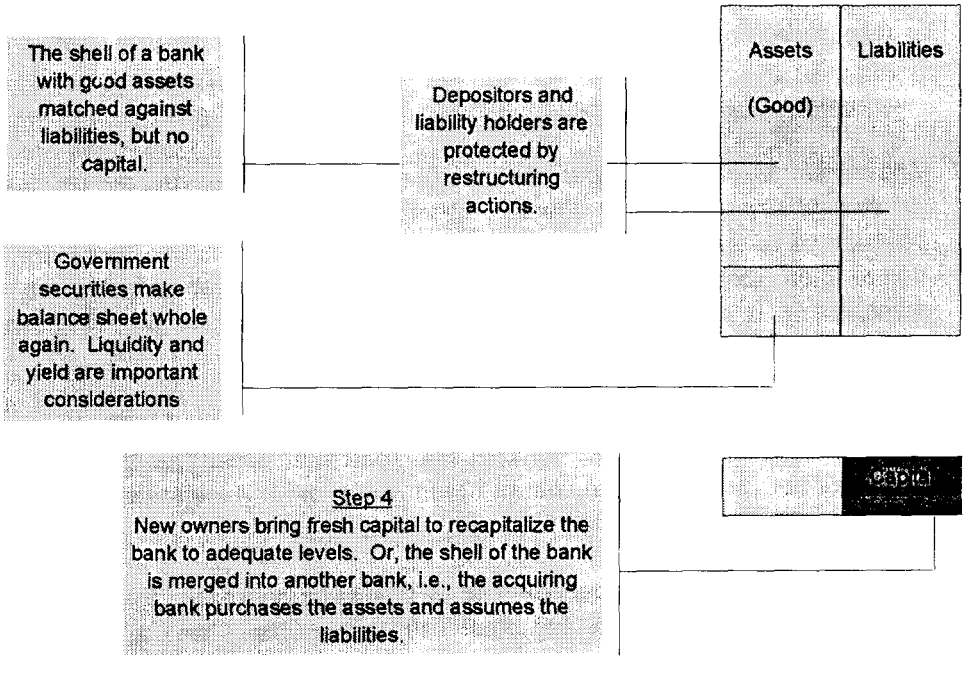


Figure 4B: Basic Approach to Financial Restructuring



15. The carving out of the bad assets with cash or government securities to the point that liabilities are matched by good quality assets is a critical feature of this approach. If bad assets are not removed from the balance sheet and the bank is simply merged into another bank or is sold "as is" to new investors, the resulting institution will most likely be a problem institution. Nothing will have been gained but to delay recognition of losses. Perhaps the only time a bank can be merged without cleaning up the bad portfolio is when the bank and its bad portfolio is sufficiently small enough to be absorbed by a much larger institution which is otherwise sound and for which the bad assets will represent but a small fraction of the larger institution's capital and loss reserves.

16. In carving out the bad assets, the restructuring mechanism not only receives the bad assets purchased with government securities and cash but also all rights to and claims against the bad assets that were written off against the owners' equity as well as all previous write-offs. This is done so that the restructuring mechanism has a better opportunity to recover the monies it has expended to clean up the bad portfolio.

17. Using securities is preferable to cash for the purchase of the bad assets. If cash is injected into the bank, it may have negative implications for monetary policy. In addition, the bank's new management will be faced with the task of investing a large sum of money in a short period of time. In so doing, it may invest unwisely in risks that are not warranted. In using securities, the monetary implications are limited to the debt service requirements on the debt. If the securities are issued at market rates, the bank may be able to sell the securities as needed to meet its liquidity needs. Use of securities may also foster the development of a secondary market for such instruments if one does not currently exist.

18. In practice, the process of recognizing losses, wiping out shareholders, eliminating management, carving out the bad portfolio, and recapitalizing the bank may occur, or seem to occur, almost simultaneously, as in the United States, or, it may occur in phases, interim management operating the bank for a restructuring agency or other receiver until permanent investors or a merger partner can be found.

19. This basic approach to financial restructuring has the distinct advantages of imposing strong financial discipline within the banking system and of minimizing the ultimate costs of bank insolvencies borne by the government. The major disadvantages are that this case-by-case approach may be too slow to deal with general financial crisis, it requires a mechanism to facilitate the process, and there may be few prospective merger partners or new investors to acquire an insolvent bank, thus leaving it in the hands of the government, or a receiver, for an indeterminate period.

20. ***The Philippine Approach***. A variant of the basic approach was used in the Philippines with government-owned banks. Instead of carving out bad assets by purchasing them with cash or government securities, the Philippine government acquired the bad portfolios by assuming certain liabilities of the banks, most of which were foreign borrowings which the government had already guaranteed and social security deposits. The banks were forced to write off all loans which clearly lacked any reasonable hope of recovery. Those problem assets which remained were transferred to a government trust where recovery efforts were to be made. This approach resulted in substantially shrinking the size of the banks. Notwithstanding their smaller size, however, capital remained inadequate to support the remaining assets on the books of the banks. Therefore, the next step which should have been taken to complete the financial restructuring of these banks was their recapitalization through direct injection of capital,

retention of earnings, and privatization, to the extent possible and appropriate. The financial restructuring of the banks was accompanied by changes in management and operations. Since the government was the only shareholder in the banks, it was not necessary to eliminate the shareholder's interest.

21. The advantage of this approach is that the government did not need to issue securities or inject cash immediately. It will, however, bear the cost of servicing the foreign debt obligations and the other liabilities it assumed as principal and interest payments come due. This approach was made possible by the nature of the banks' liabilities. It is a solution which also lends itself to a situation where the bank funds itself through central bank refinance credit. In such an instance, bad assets can be offset against the amounts due to the central bank. This creates a bad claim on the central bank's books. However, this claim is offset by the money issue of the central bank. Ideally, the government would formally recognize the bad asset by issuing a security to the central bank to carve out the bad asset. This approach is far less practical as a solution for banks in which the liability base is principally composed of deposits from the public—particularly when such deposits are regularly used for transactions.

22. ***Debt for Equity Conversion.*** Another variant of the basic approach is to convert certain liabilities of the bank to equity which can then be used to absorb losses. This approach is applicable to those liability-holders whose claims against the bank are not insured or guaranteed, i.e., uninsured depositors and creditors of the bank. Essentially, if the bank were to be closed and liquidated, these parties would lose their uninsured monies on deposit or, for those parties which have extended credit to the bank, their loans or receivables would go into default and become worthless. Therefore, to forestall this eventuality, they may be given the option of converting their claims against the bank into equity. This equity would be used to absorb losses of the bank, but unlike the original shareholders who would have lost their investment, these parties would retain the rights of ownership. If the bank ultimately recovered to a sound condition and dividend payments were restored, these equity-holders might be in a position to receive some reasonable return on their shares. Similarly, the value of their shares would be expected to rise in value. Given the option of losing their monies entirely or having some opportunity to ultimately recover, most parties would choose the latter option.

23. As with the basic approach, the management of the bank would be replaced, the original shareholders would lose their investment, portfolio losses would be recognized, and the bank would undergo significant changes in its operations and credit policies. This approach has the advantage of minimizing the costs borne by the government. It also instills strong financial discipline within the banking system on the part of uninsured or non-guaranteed liability-holders since those parties will seek to place their funds in the strongest, best-managed banks. However, as with the Philippine approach, the liability mix is critical. For one thing, the portfolio problems may far exceed the losses which can be absorbed by a bank's existing capital and reserves and the new capital created by converting debt into equity. Further, using this approach in one bank may lead to runs on other banks since uninsured depositors and creditors will seek to remove their funds as quickly as possible and run to safety.

24. ***The Chilean Approach.*** Another approach to financial restructuring of problem banks was used in Chile. This approach was applied broadly across-the-board to institutions in distress. Bad loans were purchased from banks by the central bank in an amount up to 100% of each bank's capital and reserves by means of ten-year notes paying market rates of interest. However, this was strictly an accounting procedure representing no transfer of funds to the banks. The banks, in turn, were required to repurchase the bad assets from the central bank under the same repayment terms as the notes. While the obligations

to repurchase the bad portfolios were outstanding, the banks were required to devote 100% of their net profits to the repurchase. The final effect of this mechanism was to grant a longer-term for banks to make provisions and write-off loan losses.

25. However, the measures above were not sufficient to deal with the full extent of the problems which were much worse than initially thought. Therefore, for those private banks not intervened, additional measures were taken to force recognition of losses and to recapitalize the banks. Since banks continued to accrue or refinance interest which was due and unpaid from problem borrowers and to take that interest into income, the banks raised the cost of credit to otherwise sound borrowers. As the result, these good borrowers found it increasingly difficult to service their obligations. In effect, the good borrowers were subsidizing problem borrowers by paying higher rates of interest to offset the interest not being paid by the problem borrowers. For this reason, the central bank decided to purchase additional problem loans from the banks at book value for cash in an aggregate not to exceed 150% of each bank's capital and reserves. (The combination of these measures meant that the central bank purchased problem assets from each bank in an amount up to 250% of capital and reserves.) At the same time, the proceeds of the portfolio sales were used by the banks to repay liquidity loans granted by the central bank so that the monetary implications of using cash for the purchase were minimal.

26. To ensure that the existing shareholders of these banks would bear part of the costs, they were required to devote 100% of their dividends to repurchase the problem assets sold to the central bank. The problem assets were indexed and subjected to an annual surcharge of 5%. This had the same effect as if the central bank had made a loan to the shareholders to purchase the problem assets at a real interest rate of 5% per annum. This was tantamount to a write-off of the problem assets and recapitalization in a similar amount. It is emphasized that the obligation to repurchase the problem assets was binding on the shareholders and was not an obligation of the bank. In addition, the obligation to repurchase the problem assets was not extended to new shareholders which may have subsequently purchased shares issued by the bank.

27. For those banks which were intervened, the measures above were not sufficient to remedy their more serious portfolio problems. Therefore, additional stock in the institutions was offered for sale: first, to existing shareholders; second, to third parties; and, third, to a government agency. In the case of the government, the shares could be purchased by conversion of emergency credits, which had been extended to the banks, into equity. However, the government's ownership was not permitted to exceed 49% and was required to be curtailed over five years at a rate not less than 20% per year. To facilitate third-party equity purchases, third parties were permitted to convert credits or claims against the institution into equity or to use government securities to purchase shares. In addition, tax credits were made available to third-parties purchasing shares. After completing the sale of stock in an appropriate amount, the banks were then required to sell their problem portfolio to the central bank under the same conditions as that described above. As in the previous case, new stockholders were not bound to repurchase the problem assets sold.

28. These measures had the effect of giving institutions more time to absorb losses. However, they were not achieved in isolation. Actions were also taken to strengthen the banks' identification and classification of portfolio problems according to risk, to strengthen provisioning policy and to enforce suspension of interest on problem assets, to improve the ability of debtors to service their obligations

through rescheduling of credits made to viable borrowers, and to strengthen bank supervision and prudential regulation.

29. There are some significant advantages to the approach used by Chile. First, the authorities were able to deal with a large number of seriously distressed banks in a relatively short period of time; and, second, there was no need for the government to establish the infrastructure for collecting the bad portfolio since the banks retained, managed, and collected the problem loans. However, there are disadvantages to this approach as well. First, it was not cost effective since banks were being assisted in an indiscriminate way. In some banks, the losses were of such a magnitude that they had lost their capital many times over. These banks should have been closed and liquidated as the least costly approach to dealing with them. Any monies used to purchase bad assets was wasted since the banks never achieved the levels of profitability necessary to retire the central bank notes. Further, there was tremendous pressure on banks to pay a high level of dividends. This conflicted with the needs of banks to retain earnings and build capital to keep pace with asset growth. Another disadvantage was that discipline was enforced only to the extent that owners were denied a return on their investment. This falls far short of the financial discipline imposed by suffering a total loss of one's invested principal.

Options for Allocating Losses

30. In the process of financial restructuring, there are losses to be borne. These losses can be allocated in a variety of ways involving the depositors, creditors and other liability-holders, the enterprises, the owners, the banks themselves, and government.

31. ***The Depositors***. For many individuals, bank deposits represent their entire financial wealth. Individually, these small depositors usually have the least influence in the bank's affairs, have little knowledge of the bank's actual condition, and are least responsible for whatever problems the bank may have incurred. Therefore, as a matter of fairness and to prevent banking runs, public policy in most countries attempts to protect small depositors from losses during a banking crisis. The authorities frequently seek to demonstrate to the public that their monies on deposit will be protected by explicitly insuring or guaranteeing deposits to a maximum amount per depositor.

32. However, large depositors are sometimes called on to absorb losses. The rationale is that the large depositors have wider knowledge of the marketplace and of the bank's affairs. Assuming that adequate information is available in the marketplace, they are expected to exercise greater judgment in selecting the bank at which to deposit their money. By forcing large depositors to absorb losses from time to time, greater financial discipline is imposed within the banking system.

33. ***Creditors and Other Liability-Holders.*** Parties which have extended credit to the bank or holders of non-deposit liabilities are also sometimes asked to absorb losses. This can also have a beneficial impact by instilling greater discipline in the banking system. However, there are also risks if the losses were to lead to a disruption of the payments system or losses at other banks. Before any creditors or non-deposit liability-holders are asked to absorb losses, the authorities should have a very clear understanding of who these creditors are and any systemic linkages that may exist.

34. ***The Enterprises.*** Enterprises, which have bank loans that are to be written-down in part or in whole, could absorb losses if banks were provided the right of offset against their deposit accounts. In

other words, if an enterprise had a bad loan at the bank, the bank could take the enterprise's deposit account and apply it against the outstanding loan balance. This would reduce the amount of losses which would otherwise have to be absorbed by others.

35. ***Owners.*** In all cases of insolvency, except for those where the bank is directly owned by the government, the owners should absorb losses at least equal to their investment-regardless of their role in the bank's demise. The owners have invested their money in the bank and, in so doing, placed it at risk just like in any other investment. If discipline is to be imposed in the financial system, it is critical that owners bear the costs of bad investments.

36. ***The Banks***. Healthy banks, including those that are the survivors of a restructuring process, may be asked to absorb losses. This can occur in a couple of ways. The banks can be assessed directly to cover the loss incurred by a failed bank as has been done in France in Germany. In most cases, this would be a special, one-time assessment on the banks. However, notwithstanding issues of fairness, there are problems in this approach. The banks assessed may experience their own profitability problems as a result. And, in the case of widespread financial distress, it would not be possible for the healthy banks to pick up the losses for all the insolvent banks.

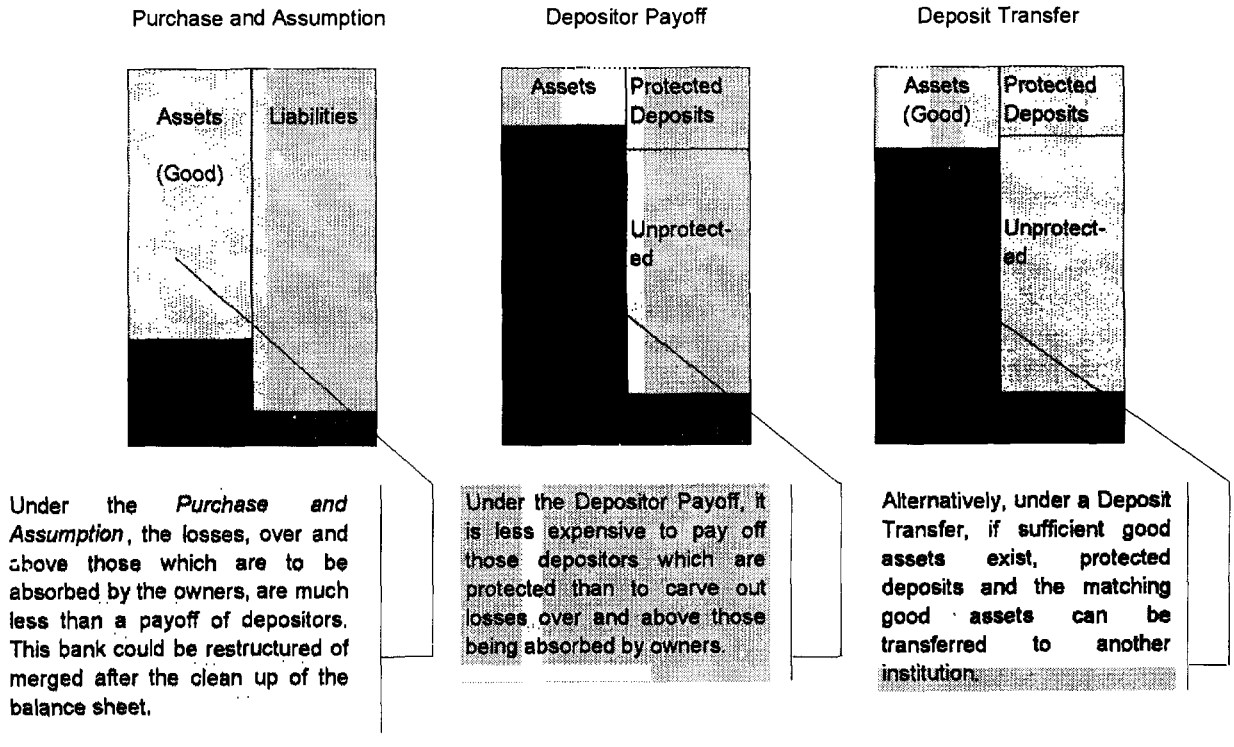
37. The second approach is to establish a deposit-insurance fund into which the banks pay premiums. This fund could be used to carve out the bad assets and deal with insolvencies. However, the fund may initially lack adequate resources to deal with widespread insolvencies without having had a long period to build up its reserves. In such cases, the fund would have to borrow from the central bank or the government, with the hope that the loans could be repaid from future insurance premiums. For this to be successful, strong bank supervision and prudential control would be necessary to prevent a recurrence of significant problems in the banking system. In a manner of speaking, the fund would be mortgaging its future to pay today's bills.

38. ***The Government.*** In the end, the government usually bears the losses that cannot be absorbed by owners and other parties. However, there are numerous ways this can occur. It may involve loans or securities issued by the central bank, as lender of last resort, to a deposit insurance or restructuring mechanism which uses government securities to carve out the bad assets held by the banks. It could involve loans or securities from the central bank issued directly to the banks as in Chile in an across-the-board approach. It may involve the issuance of bonds by the federal government to pay for the carving out of bad assets. It might involve assumption of liabilities, as in the Philippine case. Or, losses may be offset against central bank refinance credit. In fact, there are many possibilities where government must step forward to absorb losses in order to ensure the health and stability of the banking system.

39. For this reason, any financial restructuring should consider the following: First, the authorities should attempt to minimize any monetary impact by issuing bonds to carve out bad assets as opposed to the injection of cash. Such bonds should carry a market rate of interest and be structured so that the banks could sell them if needed as a secondary source of liquidity. Second, the approach to financial restructuring should be based on the least cost to the government where possible (see Figure 5). It should be recognized that some banks should be liquidated as the least cost alternative. In some cases, only small depositors should be protected. Third, any absorption of losses by the government should be accompanied by other measures designed to impose financial discipline within the banking system. These measures,

as discussed earlier, should result in management changes and the elimination of existing owners in the failed banks.

Figure 5: Least Cost Alternative



Options for Dealing With the Bad Portfolio

40. Once the bad assets are carved out of an insolvent bank's portfolio, they should not be forgotten. In some cases, the government may intervene and acquire certain of the bad assets to attempt a long-term restructuring of an enterprise. In other cases, where the enterprise serves an essential social purpose, the government may decide to provide direct support from the fiscal budget. For the remaining cases, stringent collection efforts should be undertaken to recover monies from the problem borrowers by seizing and liquidating the borrowers' assets or through such other means as may be possible. In general, *assets should be liquidated as quickly as possible, regardless of the price obtained for the assets*. It is essential that monies are recovered to be used in other restructuring actions. There is a question, however, of who should undertake these collection activities: the banks themselves, the central bank, a restructuring agency, non-performing asset recovery trust, or deposit insurance type mechanism, a debt collection agency, or some other alternative.

41. ***The Banks as Collection Agents (Internal Workout Unit).*** Once a bank has been restructured and new management and owners are in place, one option for dealing with the bad portfolio is for the

authorities to commission the restructured bank as collection agent for the bad assets. This could be arranged with certain incentives whereby the bank would share in the collections, with an extra percentage or premium paid on a declining scale for collections effected in a timely manner. This approach has the advantage of avoiding the creation of an institutional framework for handling the bad assets. However, it also contains some downside risks. First, collection activities could distract management's attention from its existing portfolio and new lending activities. Second, certain links with the bad borrowers may remain, resulting in renewed pressure for loans and delayed solutions for enterprise restructuring or liquidation. And, third, the bank's operating costs will increase. These costs may well exceed the bank's successful recovery efforts in any given period.

42. Various options exist for external work out units. These include the following.

43. ***The Central Bank as Collection Agent***. The central bank could act as the collection agent. However, the experience of most countries suggests that the central bank is a poor alternative. Most borrowers are even more reluctant to pay when they know the government is involved. Further, the individuals acting as debt collectors are less likely to be strongly motivated to collect bad debts since their personal salaries and compensation are infrequently tied to their success.

44. ***A Restructuring Agency, Non-Performing Asset Recovery Trust, or Deposit Insurance Mechanism***. Many countries have established a deposit insurance fund, non-performing assets recovery trust, or a restructuring agency as the mechanism to carve out and collect or liquidate bad assets. This approach has achieved mixed success in these countries. A distinct advantage of this approach has been that the bad assets are physically removed from the restructured bank so that all links between the borrower and bank are severed. In addition, these mechanisms can employ specialized staff whose sole job is to collect or liquidate bad assets. On the other hand, it requires an agency of considerable size to deal with general financial distress. In the United States, for instance, approximately 5,000 persons are involved in the liquidation or collection of bad assets from the 500 banks that failed during the last five years.

45. ***A Debt Collection Agency***. Another alternative for dealing with the bad assets is to establish or commission a debt collection agency to effect recovery. This approach also has the advantage of physically removing the bad assets from the restructured bank. This kind of agency could be set up by the government with its own funding, with funding from the banking sector, funding from the private sector, or through joint funding. If the agency is afforded independence and appropriate incentives, and is able to attract professionals from the marketplace, it may have a very good chance of success in effecting recoveries.

46. ***Other Alternatives***. The auction of bad assets to investors at the highest bid may be another option which could be considered. However, in practice, poor documentation and ineffective debt recovery laws and procedures could prove obstacles to a successful transaction.

OPERATIONAL RESTRUCTURING

47. The third phase of restructuring should be the operational restructuring of those banks which survive. It is not enough that banks are financially restructured. They must also make changes in the fundamental manner in which they operate if any restructuring is to be lasting. In addition, the banks

must have a clearer understanding of their role in a new banking environment. To accomplish these objectives, each bank should develop and implement strategic, operational, and capital plans to enhance their ability to operate over the medium-term in a restructured banking system.

Strategic Plan

48. Each bank should develop a strategic plan which ensures that it will achieve satisfactory levels of profitability within a reasonable time frame (assumed to be no more than three years). The strategic plan should address the bank's goals and objectives, its strengths and weaknesses, and its potential opportunities and threats. For example, specific objectives of the strategic plan should include targets for return on assets, market share, asset growth, resource mobilization, etc. Factors which might enable such targets to be achieved would include decisions concerning: the types of products and services to be provided or discontinued; the markets to be served (e.g., customers, geographic areas, industrial sectors, etc.); and the branches to be opened or closed.

Operational Plan

49.The bank's operational plan would specify in more detail the bank's strategy and actions to improve profitability and competitiveness through cutbacks in unprofitable services and activities, the introduction of new services and expansion of existing more profitable services, and better cost control. In addition, it would provide the framework for restructuring the bank's staffing and management, including elimination of redundant staff; for formulating operating policies and procedures; and for implementing a new organizational structure. In addition, the operational plan should address the following elements:

50. ***Written Policies and Procedures***. Written policies and procedures should be developed and implemented for all significant areas of the bank's activities including: loans and advances, equity participations, asset and liability management, foreign exchange, and investment portfolio management.

51. ***Management and Staffing.*** The operational plan should address management and staffing with the purpose of reducing redundant staff to a level adequate to profitably achieve the bank's goals and objectives while ensuring that sufficiently skilled staff and managers are attracted and retained. To the extent that management changes are needed or desirable, the plan should specify actions in this area. *It is essential that the former banking culture is changed, even if it requires the removal of several layers of the former management.*

52. ***Financial Planning***. Financial planning systems, including a short-term budget process, should be developed to maximize revenues, control costs based upon cost accounting concepts, and to ensure that cash flows are sufficient to meet liquidity needs. The budget process should provide frequent comparison of budgeted amounts to actual results and should require explanations of significant variances.

53. ***Management Information Systems***. Management information systems should be developed to ensure that accurate and timely information is provided to the bank's decision makers so that they may direct, control, and execute policies in an informed manner. This may involve automation of many of the bank's activities.

54. ***Internal Loan Review***. Loan supervision procedures should be strengthened through establishment of an internal loan review department to appraise the quality of loans and advances on an ongoing basis, to determine the adequacy of and non-adherence to established policies, and to determine the causes of significant problems in the lending area. Early detection and strengthening of problem credits is critical if further banking crises are to be avoided.

55. ***Fixed Assets***. The operational plan should attempt to rationalize the bank's investment in fixed assets. This plan should address the opening and closing of branches, the effective use of existing bank premises, and the curtailment of new investments in banking premises unless supported by satisfactory cost-benefit analyses.

56. ***Internal Controls***. Internal controls, including both accounting and administrative controls, should be strengthened to ensure compliance with policies, to safeguard assets, and to prevent fraud.

57. ***Audit Activities.*** Internal and external audit activities should be strengthened to ensure the integrity of financial reports, to appraise and strengthen the quality of internal controls, and to recommend changes in operations to improve efficiency.

Capital Plan

58. The bank's capital plan would address measures to augment capital as necessary in view of factors such as planned growth, earnings retention, the nature of future operations and attendant levels of risk. Future capital would come from retained earnings and sales of shares to enterprises and individuals. The bank should not be permitted to grow faster than its capital base permits.

CONCLUSION

59. The restructuring of any banking system will require a great deal of flexibility and realistic time parameters, possibly five to ten years or more. Any restructuring must be accompanied by fundamental changes and must involve actions in the enterprise sector as well as the banks. Different solutions or approaches will be needed to deal with the problem of bad assets and insolvent banking institutions. However, one thing that is clear is that to do nothing is to worsen and deepen the crisis.

60. Through the process of financial restructuring, banks and enterprises which are inefficient and loss-making should be permitted to fail. Bank failures should result in the removal of management, elimination of shareholders, and the carving out of bad assets. The least cost (to the government) alternative should usually dictate the decision concerning the best approach to handle any given insolvent bank.

61. The process of restructuring is not an easy one, but it is one which must be started as soon as possible in order to remove the constraints on economic growth and prosperity caused by the misallocation of resources to problem borrowers. In this regard, it should be emphasized that the losses in the banking system already exist, the price of which is being paid in an economy's poor performance. The process of restructuring simply attempts to recognize these losses by allocating them to the appropriate parties, to prevent further losses, and to provide the means for redirecting resources to productive sectors.

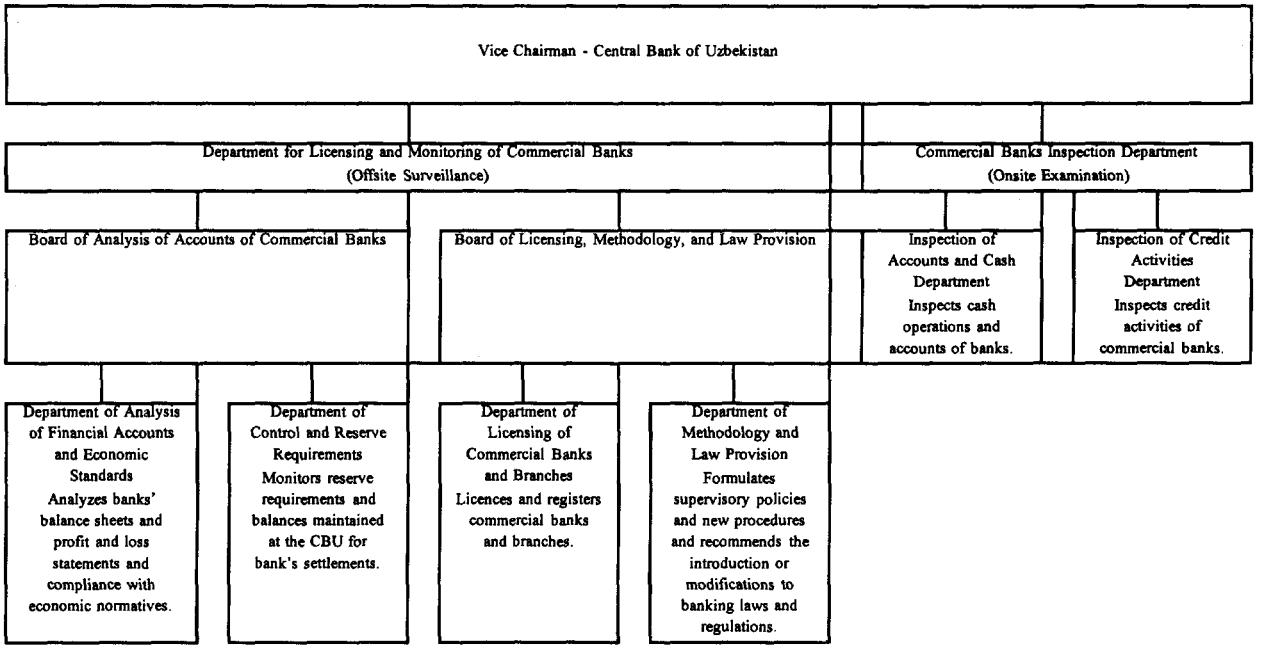
THE STAFFING AND TRAINING NEEDS OF THE CENTRAL BANK'S SUPERVISION FUNCTION

Organization of the Bank Supervision Function

1. Bank supervision is organized along functional lines in two departments reporting to a single vice-chairman of the Central Bank. These departments are the Department for Licensing and Monitoring of Commercial Banks and the Commercial Banks Inspection Department (see Table 1 below). The Department for Licensing and Monitoring of Commercial Banks is responsible, as its name implies, for licensing and offsite surveillance. The Commercial Banks Inspection Department carries out onsite examinations of commercial banks and their branches.

2. A decision has already been taken to establish a third unit within the Commercial Banks Inspection Department. This unit will have the responsibility of inspecting banks' foreign exchange activities. There is also a plan to add a fourth unit, a methodology unit, that would develop new methods and procedures for onsite activities.

Table 1 - Organization of Bank Supervision



3. As noted in the organization chart, units have been established with the sole purpose of enforcing economic regulations and control over banks and enterprises. The Department of Control and Reserve Requirements reviews every payment order and its purpose as a way of ensuring that enterprises and banks spend funds only for allowable uses. Debit and credit advices between banks are reconciled and telexes are sent to the banks indicating that payment has settled. This unit also monitors reserve requirements and correspondent accounts at the Central Bank. Correspondent accounts are debited and

monies credited to special risk funds on the basis of banks' past due loans. The Inspection of Accounts and Cash Department ensures that all cash transactions are valid and properly documented. The purpose of each transaction is reviewed to ensure that enterprises and banks use cash only for allowable purposes such as the payment of salaries and pensions. This control process is directly linked to the *cash vs. non-cash* issue discussed elsewhere in this financial sector report. The foregoing procedures ensure compliance with economic regulations but provide little input into assessing the overall health and stability of the banking system.

4. The scope of these activities reflect a level of micro-management and control that is simply inappropriate in a market economy. In addition, the resources and management required to carry out these activities can only dilute the effectiveness of prudential supervision by shifting the focus away from issues of financial health and soundness. The Central Bank should give serious consideration to abandoning these functions and ensure that the focus of bank supervision is squarely on prudential concerns for safety and soundness.

Staffing

5. More than 150 persons are employed by the two bank supervision departments at the fourteen *oblast* offices and head office. In a well-developed banking environment in which an effective regime of internal controls and internal/external audit exists, and where banks have effective internal systems for identifying, measuring, and managing risk, this would be more than enough persons to prudently supervise a banking system such as that in Uzbekistan. However, in the absence of a well-developed banking environment, the supervisors are faced with perfoming many tasks that would otherwise be routinely performed by bank auditors. As discussed above, they have also been given compliance duties for economic regulations which contribute little to ensuring the health and stability of the banking system. However, these duties require significant resources. Thus, the staffing requirements are greater than what would normally be required in a banking system of this size. In fact, both supervision departments, those responsible for onsite inspection and offsite surveillance, indicate they have insufficient numbers of staff.

6. Nonetheless, 150 persons should be more than adequate to carry out a reasonably effective program of bank supervision in a country such as Uzbekistan, given the current size of its banking system, if the program is appropriately organized and focussed on activities that bear directly on the financial condition and performance of individual banks and the health of the banking system as a whole. Therefore, before additional staff is recruited, the organization of bank supervision and the responsibilities assigned to it should be reassessed.

7. The elimination of compliance activities would free up approximately 50 persons at the *oblast* offices who are now involved in reviewing payment orders and approximately 35 persons who are assigned to verify and validate cash and account transactions. Similarly, nearly 15 persons engaged in these activities at head office could be assigned other duties. Altogether, approximately 100 persons could be shifted from compliance tasks to prudential supervision. There would be a need, however, to concentrate more staff at head office, thus resulting in some movement of staff from the *oblast* offices.

8. While the number of staff is adequate, the overall quality is not. Most staff are recent university graduates with little practical experience. Knowledge of international practices in banking supervision is minimal. An intensive program of training is clearly needed.

9. Turnover in the Department for Licensing and Monitoring of Commercial Banks has been high, reportedly in the range of 20% to 30% annually. This is attributed to the heavy workload, long hours, the opportunity to move to other departments within the Central Bank, and the salary differential with the private sector where salaries are reported to be nearly twice as high. Because of the higher private sector salaries, recruitment is also said to be difficult. The turnover has created a need for continual training of new staff, both abroad and in-house.

10. In order to retain staff, the Department for Licensing and Monitoring of Commercial Banks may wish to consider measures such as pay differentials, employment contracts, and the creation of separate technical and managerial tracks for advancement. In addition, they may wish to appeal to employees sense of public service, *esprit de corps*, and non-monetary forms of recognition. The latter could be achieved in part, for example, by creating new titles for the positions in the department. Instead of the current *economist*, *leading economist*, and *chief economist* positions, titles which are used throughout the Central Bank, titles such as *assistant banking analyst* or *inspector*, *banking analyst* or *inspector*, and *chief banking analyst* or *inspector*, relating more directly to banking supervision could be used.

11. In the Commercial Banks Inspection Department, on the other hand, turnover is said to be virtually nil. This department uses salary differentials of as much as 50% and provides assistance in obtaining housing to retain qualified individuals. In addition, when on assignment, inspection staff is paid a per diem which is three times that paid to other Central Bank staff. A car is also provided to each unit for travel to and from assignments. Thus, these measures have served to limit turnover and retain qualified staff.

Training and Career Development

12. Both departments involved in bank supervision report that training activities are inadequate. Thus far, training of staff has been conducted largely on an ad-hoc basis, taking advantage of opportunities domestically and abroad provided by the foreign donor community. Recently, for example, USAID conducted a 15 day program on onsite examination and offsite surveillance. General banking courses are available at a regional bankers' training center. Otherwise, training has been conducted on-the-job. These activities, however, while increasing awareness, are not sufficient in themselves to transfer the skills needed to carry out highly complex supervisory activities. Training activities should be rooted in hands-on practical experience on-the-job, led by experienced foreign advisors. For this reason, a Canadian firm has recently been contracted to provide technical assistance on bank supervision matters. However, it is unclear whether this assistance will be enough. In the near term, there is a pressing need to develop an effective onsite examination capability. This can be accelerated by creating training teams led by foreign advisors.

13. Using a training team concept, the foreign advisors would mix classroom instruction with on-the-job coaching in the actual conduct of a bank examination. Each trainee would be given a major functional area of responsibility using written examination procedures as a step-by-step training tool. The trainee would write-up his comments for the examination report when he finishes evaluating his area of responsibility. Once an examination is completed, the team moves to another bank where functional responsibilities are rotated. This process is repeated over the course of about six to eight months until all trainees have had a chance to examine each major functional area at least once. Completion of a training

team cycle will not assure a cadre of competent bank examiners, but it will provide a solid base from which examiners may further their knowledge, skills, and experience.

14. Over the medium-term, it will be necessary to develop a formal in-house training program to sustain and institutionalize the supervision function. Such a program need not be elaborate. Nonetheless, a basis core curricula, lesson plans, training materials, and instructional aids should be developed for instruction by Uzbek instructors.

15. The supervision function should also be considered a career choice within the Central Bank. Rotation to other departments should only occur as a means of furthering an individual's skills, knowledge, and abilities in other aspects of central banking. However, at the completion of the assignment, the individual should return to bank supervision. The training of bank supervisors requires a large investment in time and money. In some countries, it is said that five years are required to train a bank examiner to the point where the authorities believe the individual is competent to examine small, clean banks. Thus, it is inappropriate to make this investment and have the person rotate out of the function to another central bank department.

16. To make it attractive for an individual to remain within bank supervision, career development alternatives should be developed. These might include, for example, separate technical and managerial tracks for advancement.

COMMENTS AND SUGGESTED CHANGES TO THE PROPOSED *LAW ON BANKS AND BANKING ACTIVITY*

1. The existing legislation for banks dates from 1992 and is now outdated given the development of the economy and banking system. Therefore, the Parliament intends to adopt new banking legislation at its forthcoming session. The following comments relate to the most recent draft of the proposed new law dated September 22, 1995. On the whole, the draft is a positive step and serves to correct many of the inequities of the existing law. It is worth noting that the proposed law eliminates the special status of the National Bank, thus promoting a more level playing field. In addition, the proposed law permits only one form of ownership, that of a joint stock company. This eliminates the problem of limited liability companies whereby owners can withdraw their capital at will. These are considered appropriate and much needed steps forward in the reform program.

2. The weaknesses in the proposed new law include aspects relating to the licensing of new banks, powers of supervisors, affiliated organizations, sanctions and enforcement measures, corporate governance, the role of the tax authorities, and failure resolution. In addition, several other aspects require attention. The proposed new law also fails to address non-bank financial institutions. A separate law on non-bank financial institutions is planned but has not yet been drafted. The weaknesses in the proposed new banking law are discussed below.

License Application Process

3. Section 13 of the proposed new law addresses reasons for refusing the registration and licensing of new banks. The reasons cited relate strictly to documentation exceptions and other objective criteria. However, reasons related to unsafe and unsound banking practices, the probable unfeasability of the proposed institution, criminal convictions of founders or managers, and the professional unsuitability of proposed managers are not listed as reasons for which an application can be refused. This is unsatisfactory and may lead to the opening of unviable institutions or institutions managed or owned by disreputable or incompetent parties. Further, it is not clear that the documentation requirements in Section 11 for applying for a banking license need to be listed in the law itself. It is also desirable to establish a two-stage approval process whereby the Central Bank gives its preliminary approval based on its initial review of the application, after which the applicants can obtain the banking premises, equipment, and other facilities required to conduct their activities. Therefore, the following language is suggested to replace Sections 11 and 13.

> The Central Bank of Uzbekistan will prescribe the application process, requirements, and procedures for founding a bank or foreign bank branch on the territory of Uzbekistan. Applications for a banking license will be granted in two-stages: a conditional approval, which permits the applicants to proceed with the organization of the bank or foreign branch; and a final approval which, on the basis of a pre-opening examination and satisfactory resolution of any outstanding issues, authorizes the bank to commence operations. The decision for granting a conditional approval of a banking license by the Central Bank of Uzbekistan will be based on qualitative assessments of the capabilities of the founders and proposed managers, the business strategy, the proposed capital structure, and the pro-forma financial plan. The final approval will be issued only after capital is fully paid-up, appropriate banking premises and equipment have been procured, internal controls and security arrangements have been established, the bank's

charter, business plan, operating policies, and organization have been adopted and approved, and key officials have been employed.

Authorized Capital

4. Section 9 of the proposed new law is silent with regard to the form in which capital may be paid-in. From a prudential standpoint, the only acceptable form is cash. The transfer of fixed assets as payment for shares in a bank should be prohibited. Assets in a form other than cash may be difficult to properly value and may deprive management of the opportunity to invest in an appropriate earning asset. The assets accepted in lieu of cash may also lack liquidity. Thus, capital should be paid in a pure form, i.e., cash, that permits management to freely exercise prudent investment decisions.

Corporate Governance

5. The proposed new law is weak with regard to issues of corporate governance. While many aspects of corporate governance are addressed in the joint stock company law and in banks' individual charters, it would, nonetheless, be important to establish certain minimum criteria in the new banking law. These are discussed below:

6. **Duties and Obligations of Members of the Bank's Council.** The law should be specific regarding the duties and responsibilities of the bank's council. The duties and responsibilities of the bank's council should include: the obligation to supervise the affairs of the bank on an informed basis, to refrain from engaging in self-serving practices, to appoint a competent general manager and dismiss incompetent or abusive management, to ensure the bank has a beneficial impact on the local community, to adopt and follow sound policies and objectives for the efficient administration of the bank, to ensure that the bank has established adequate internal controls, to maintain adequate capitalization, to observe laws, rules, and regulations, to ensure adequate internal and external audit, and to ensure that funds are properly invested for the protection of depositors and shareholders.

7. **Minimum and Maximum Number of Members of the Bank's Council.** The law should prescribe the minimum and maximum number of members of the bank's council, say 5 and 15. Each bank's charter would fix the number for that bank within these parameters.

8. **Election of the Bank's Council.** The bank's council should be elected by the vote of shareholders annually. After shareholders vote on the election of members to the bank's council, the bank's council should hold an organizational meeting. At this meeting, the following should be decided: the election of one of their members as Chairman of the Board, the appointment of the bank's general manager or president, and the establishment of the standing committees of the bank's council, e.g., audit committee and loan committee.

9. **Cumulative Voting.** The law should indicate whether cumulative voting is permitted for the election of the bank's council. Under cumulative voting, each shareholder is entitled to vote the number of shares owned times the number of positions to be filled. For example, if eight individuals are to be elected to the bank's council, a shareholder owning 100 shares would have the voting power of 800 votes (8 x 100). The shareholder could distribute the votes among a slate of proposed candidates or use the votes for only one or a few candidates. Thus, a minority shareholder has a better chance of being

represented on the bank's council than might otherwise be possible. This serves to provide greater discipline and to somewhat offset the dominance of large shareholders.

10. **Vacancies in the Bank's Council.** Vacancies on the bank's council between elections should be filled by appointment by the remaining members of the bank's council. The newly-appointed member of the bank's council should serve out the remaining term of the departed member.

11. **Replacement of Members of the Bank's Council.** Members of the bank's council should not be replaced between annual general meetings except through a special meeting and vote by the shareholders. Appropriate notification to all shareholders of the agenda for the meeting should be given at least two weeks in advance of the meeting. The exception is when a member is removed through an action carried out by the supervisory authorities.

12. **Frequency of Meetings of the Bank's Council.** The bank's council is under an affirmative obligation to supervise the bank's affairs on an informed basis. This can only be achieved by regular meetings, whenever there is a need, but not less often than monthly.

13. **Internal Audit Function.** The bank's council should be required to organize an internal audit function which reports directly to it or its designated audit committee. This internal audit function should be empowered to audit any and all banking activities.

14. **Definition of a Quorum.** The proposed law should specify the minimum number of shares which must be voted to represent a quorum. Depending on the type of issue to be voted upon, this percentage will normally be a majority or two-thirds of the voting shares outstanding.

15. **Use of Proxies.** The proposed law should authorize the use of proxies by shareholders. The process of appointing a proxy should be a relatively simple procedure such as the mailing of cards to be filled out by shareholders and returned by mail prior to the meeting of shareholders. On the cards, the shareholder would designate the party who would vote on his behalf. A costly, complicated process involving a notary should be avoided.

16. **Change in Bank's Charter.** The proposed new law should specify the minimum percentage vote required to change the bank's charter. Typically, this percentage could be a simple majority provided that a quorum is represented.

17. **Prohibition on Preferential Treatment.** Bank charters should prohibit preferential treatment or access to credit for major shareholders (say 5% of voting shares). International experience suggests that many banks fail as the result of liberal or abusive loans granted to a bank's shareholders.

18. **Annual Reports to Shareholders and Other Disclosure Requirements.** The proposed new law should require that all shareholders are provided appropriate notice of shareholder meetings; that a general meeting of shareholders is held annually, within five months of the year end; that all shareholders are provided, in advance, information on matters to be voted; and that shareholders receive full disclosure of financial results, together with management's commentary, at least two weeks prior to the annual general meeting.

19. **Shareholders' List.** Banks should be required to maintain a current list of their shareholders. This list should be available for inspection by the public at any time during the bank's normal business hours.

20. **Registration and Transfer of Bank Shares.** Banks should be required to establish procedures for transferring their shares. Until such shares are transferred and registered on the books of a bank, the transfer should not be considered valid. This section of the law should also require that all shares are registered in one's own name, i.e., nominees are not allowed nor are bank shares in bearer form. From a prudential standpoint, it is essential that the authorities know who the owners of banks are.

Loans on Bank's Own Shares

21. Banks should be prohibited from granting credit for the purchase, or on the security, of their own shares. The effect of doing so is to reduce the bank's capital, and thus the cushion that capital is supposed to provide against unforeseen risks. Suggested language is as follows:

> A bank may not extend credit for the purchase, or on the security, of its own shares.

Loans and Transactions Involving Bank Insiders

22. The law should limit the amount of credit that can be extended to insiders of the bank. An insider would normally be defined as the bank's chairman, executive officers, and major shareholders, as well as their business interests and immediate family members. Any credit that is extended to an insider should be at terms and conditions not more favorable than credit extended to similarly situated outside borrowers. In addition, there should be a limit on the aggregate of all such credits (typically 100% of capital). Other transactions should also avoid the appearance of prefential treatment and be conducted at arms length.

Affiliates/Subsidiaries

23. The proposed new law is silent with regard to affiliated organizations. Ideally, the new law should define an affiliate, including operating and statutory subsidiaries. Affiliation typically occurs through common ownership, common management, the ability to control or influence policy and decision-making, or statute. Transactions between the bank, its affiliates, and other connected parties should be restricted. Such transactions need not involve extensions of credit, but could involve the sale or purchase of assets, or tie-in provisions to bank services (such as a credit insurance agency owned in their personal capacities by the members of the bank's council and/or management). All transactions between the bank and parties connected to the bank should be at arms-length and should require prior approval of the bank's council. The proposed new law should specify whether, and what kind, of subsidiaries can be established by the bank with the prior approval of the Central Bank. Normally, these should be limited to activities a bank itself can carry out, e.g., mortgage banking, leasing, factoring, etc.

24. **Financial Holding Companies.** The proposed new law should also envision the creation of financial holding companies. Rather than banks owning other banks or non-bank financial organizations, these organizations would be owned by the financial holding company. Thus, the integrity of each organization could be preserved by creating "firewalls" between the various organizations. This would

enhance the safety of their operations while allowing the financial holding company to offer services to its subsidiaries in a manner that achieves economies of scale. For example, auditing could be performed for each of the subsidiaries by a team of auditors employed at the holding company level. It is unclear, at present, whether and how banks affiliate or whether they can organize holding companies. Therefore, the law may also wish to introduce legislation to address and regulate this possibility. Financial holding companies should be limited to holding the shares of banks and non-bank financial organizations. Commercial activities should be prohibited.

Failure Resolution

25. Section 14, Item 1(f) related to reasons for withdrawing a banking license, suggests that banks can be taken to bankruptcy. However, because banks generally become insolvent before they become illiquid, and because they hold deposits from the public and facilitate payments in the economy, their failure should be handled differently than normal companies. Therefore, the banking law should define bank failure as technical insolvency and/or the inability of the bank to meet its obligations (i.e., illiquidity). Technical insolvency means that the value of the bank's assets after all potential losses are provisioned or recognized is less than its liabilities. The Central Bank of Uzbekistan should be empowered to declare a bank technically insolvent, close the bank, eliminate the rights of shareholders, remove managers, force mergers, the sale or liquidation of assets, appoint a receiver or conservator, and to exercise all such other powers as are needed to resolve banking failures.

26. **Depositor Preference Rules.** Depositor preference rules should be established to govern the payout of proceeds from liquidation. For example, household depositors would be given priority over enterprise depositors which, in turn, would be given priority over other liability holders, etc. Shareholders should rank last on the list and share only in residual collections, if any, after all other claim-holders have been paid.

27. **Primacy of Legislation.** The legislation and rules governing the handling and treatment of failed banks should be given primacy over other legislation.

Guaranty of Deposits

28. The proposed new law retains the State guarantee of household deposits for the People's Bank. This is inappropriate in that it perpetuates the People's Bank's advantage in deposit-taking and is contrary to creating a level playing field upon which all banks can compete. The guaranty of household deposits should be removed.

Holding of Real Estate and Investment in Equity Participations

29. Section 22 in earlier versions of the proposed new law restricted banks to the holding of real estate only as needed for banking premises or acquired through satisfaction of a debt previously contracted, i.e., foreclosure or a conveyance in lieu of foreclosure. However, the latest proposal removes this restriction suggesting that there may be an intent to allow banks to hold real estate more broadly. Banks should be prohibited from holding real estate except for bank premises or for future expansion (the latter should be subject to time limits - say five years). Banks should also be allowed to hold real estate taken for debts previously contracted where the borrower has defaulted and the bank foreclosed.

However, in such cases, the bank should be required to dispose of the property within a limited period (again, five years is considered a reasonable period within which to dispose of the property). Banks should not be allowed to hold real estate for speculation. Assets other than real estate taken for debts previously contracted should be disposed of within a shorter period--say, two years. In addition, limits should be placed on the amount the bank can invest in equity participations. Therefore, the following language is suggested.

> A bank's aggregate investment in fixed assets and equity participations shall not exceed its paid-in capital. In addition, a bank may not own more than 20% of the capital of an enterprise in which it has invested. Assets acquired in satisfaction of debts previously contracted are not subject to this limitation. However, such assets must be disposed of within a maximum period of five years for real property and two years for all other assets except where it can be demonstrated that the bank will use foreclosed property for future expansion of its banking premises. In such instances, a resolution adopted by the bank's council so stating should be passed and maintained in the minutes.

Prudential Reports

30. Section 29 of the proposed new law should not only require timely submission of reports to the Central Bank, but also accurate reports.

Credit File Documentation

31. Section 33 of the proposed new law discusses the collateral requirements for loans. This section can be improved by adding a third paragraph:

> 3. For each loan or advance of 500,000 sum or more, banks are obligated to: a) obtain current and satisfactory financial information on the borrower and, if applicable, guarantor; b) document the nature and purpose of the loan or advance; and c) establish and document the source and plan of repayment.

Role of the Tax Authorities

32. Section 34, regarding confidentiality, states the rights of tax authorities and other bodies to obtain information from banks within their spheres of competence. However, in practice, the authorization is frequently abused and may contribute to banks' inability to raise low costs sources of funds. Rather than requesting information from banks with regard to specific cases of alleged tax fraud, the tax authorities obtain information from banks on a mass scale without due cause. Thus, because individuals and other depositors fear that the tax inspectors may seize their accounts or levy additional taxes, they withhold making deposits and their monies remain outside the formal financial system. The proposed new law, therefore, should be more explicit in limiting the tax inspectorate's rights to obtain information from banks to those instances where there is due cause to justify an investigation.

Bank Audits

33. Section 40 of the proposed new law states that banks are subject to annual audits. The proposal should further state that the Central Bank of Uzbekistan will establish the minimum scope of the audit program, the form and content of the audit report, and the qualifications of auditors.

Powers of Bank Supervisors

34. Section 42 of the proposed new law refers to the Law on the Central Bank. However, the powers of supervisors as stated in the proposed Law on the Central Bank are not sufficient. Among the powers of supervisors that should be explicitly stated are those empowering them to: classify assets as to quality; mandate provisions for loan losses and direct the write-off of non-bankable assets and other losses; examine any affiliate of a bank and to require such information from the affiliate as may be required from the bank itself; inspect any and all records and documents of the bank; and retain working papers and such other documentation, such as photocopies, as is necessary to support examination findings and the work performed.

Sanctions and Enforcement

35. Section 42 of the proposed new law states that banks are responsible for violations of this law and the Law on the Central Bank and must take timely action to eliminate violations. However, it is essential that banks and individuals are made accountable not only for violations of law, but also for engaging in abusive, or otherwise unsafe and unsound practices. Thus, the law should include language such as:

> If it has been found that a bank does not apply the regulations, or is found to be engaging in practices which are, in the view of the Central Bank, considered to be unsafe or unsound, the Central Bank shall undertake any and all such actions necessary to bring about corrective action. These actions will extend to banks and individuals and may include cease and desist authority, civil money penalties, orders to suspend or remove individuals, directives to increase or strengthen capital, and restitution and/or compensation for losses incurred from such practices, in addition to more traditional penalties and sanctions as contained in the Law on the Central Bank.

Tax Deductibility of Provisions

36. The proposed law, or appropriate legislation, should require that loan loss provisions are deducted before taxes as a normal business expense of the bank. This is one of the most essential actions which can be taken to impose discipline on the lending practices of bank managers since provisions required for poor portfolios will be reflected in net losses or poor earnings.

REVISING THE PRUDENTIAL REGULATION OF BANKS

1. Prudential regulations are issued by the Central Bank of Uzbekistan to implement the banking law. The most prominent of these regulations is Central Bank regulation number 10 dated August 2, 1992. This regulation specifies the so-called *economic normatives* within which banks are expected to operate. This regulation defines several ratios related to capital adequacy, liquidity, and large exposures. However, most of these ratios have weaknesses and their reliability, as presently applied, as tools to ensure prudent limits on banking activity is highly questionable. Further, it is inappropriate to base a regime of prudential supervision on compliance with mere ratios. It is far more important for supervisors to understand the banking business and how banks manage the risks of that business. Reliance on ratios tends to distract supervisors from gaining a better knowledge of the way banks work, the nature of their business, and the manner in which banks should identify, measure, and control risks. In other words, ratios must be applied with a context, not a vacuum.

2. In addition, the minimum requirements for some of the ratios as applied to the former state banks are more liberal than for other banks. The normatives are not applied at all to the savings bank. Thus, the regulation gives rise to unfair competitive advantages for the former state banks. The weaknesses in the economic normatives and other regulations are discussed below.

The Economic Normatives - Capital Ratios

3. Four types of capital ratios are calculated for commercial banks. These are described below. However, all four of the ratios, as currently applied, are meaningless because banks have not been required to establish adequate provisions for loan losses and to recognize other known losses. Since all actual and potential losses have not been provisioned or recognized, the amount of capital is overstated. Further, banks in Uzbekistan have been established with capital paid in-kind, rather than cash. One of the more notable instances involved the use of a worm farm as a capital contribution. It is highly unlikely that any serious supervisory authority would permit capital to be contributed in such a form and, if it were to occur, would require that the amount be excluded from capital for the purpose of determining compliance with capital adequacy requirements. Indeed, many countries require all equity participations and fixed assets to be deducted from the capital base when assessing the adequacy of capital.

4. Thus, for the reasons cited above, capital in Uzbek banks is significantly overstated. The use of capital ratios, based on overstated capital, is further worsened by the low requirements within which the banks are expected to comply. The ratios are described below.

5. **Capital to Total Risk-Weighted Assets.** A ratio which compares a bank's capital to risk-weighted assets is the preferred method of calculating a capital ratio and is commonly accepted throughout the world. However, the calculation of this ratio as used by the Central Bank differs substantially from the internationally-accepted guideline issued by the Committee on Banking Supervision at the Bank for International Settlements. A comparison of the two approaches is shown in Table 3 below.

6. As the table illustrates, the risk weights assigned to different classes are much lower than internationally acceptable norms. Under the Central Bank approach, only overdue loans are weighted

100%. Yet, internationally, most assets are considered standard banking risks and weighted 100%. The exception internationally is a weighting less than 100% -- not the norm. By weighting the various categories of assets at less than 100%, the Central Bank is, in effect, saying that these are not standard banking risks. That they are, in fact, less risky than a standard banking risk. This is simply a preposterous supposition and shows that the Central Bank does not fully appreciate or understand the risks of banking.

7. Further, the internationally accepted BIS standard includes off-balance sheet commitments and contingencies. This is done by first converting such items to a credit equivalent using a conversion factor, and then multiplying by the risk factor associated with the obligor. There are also other adjustments that are necessary. For example, intangible assets must be subtracted from qualifying capital under the BIS standard. The components of qualifying capital are also clearly stated and divided between primary and secondary capital. Under the BIS guideline, secondary capital may not exceed primary capital, thus restricting the use of some forms of capital. None of these adjustments are made under the Central Bank's approach.

Table 3 - Comparison of Capital Adequacy Calculations

Description	Risk Factor %	
	Central Bank Approach	BIS Standard
Cash and cash equivalents	0	0
Due from Central Bank	0	0
Due from banks	0	100
Government securities	10	0
Government guaranteed loans	15	0
Investments in state companies	25	100
Buildings and other fixed assets	25	100
Loans to other banks	25	50
Short term loans less than one year	30	100
Factoring	50	100
Long term loans more than one year	50	100
Leasing	60	100
Securities and shares	70	100
Other participating interests	80	100
Overdue loans	100	100
Off-balance sheet commitments and contingencies	Not Included	Included

8. The minimum acceptable standard using the BIS guideline is 8% for *well-managed sound banks operating in international markets*. The minimum ratio should be even higher for small domestic banks and unsound banks. *The BIS guideline also requires that all actual and potential losses are first recognized or fully provisioned.* Any capital ratio is meaningless unless this has been done. The Central Bank requires only a minimum 4% based on much weaker standards and without full recognition of losses in the bank's balance sheet. The bottom line is that banks which meet the 4% minimum requirement may, or may not, have adequate capital. Those that cannot meet even the 4% requirement set by the Central

Bank are grossly undercapitalized by any international standard. Thus, the use of the ratio provides little assurance that a bank has adequate capital. Compliance with the 4% requirement should not provide comfort to the authorities.

9. **Capital to Higher Risk Assets.** This ratio is calculated using only selected categories of assets. Two ratios are used. The first is capital to higher risk assets (refer to the dark shaded area of Table 3 above). This ratio should not be less than 10%. The second ratio is capital to the sum of long-term loans of more than one year, leases, securities and shares, and other participating interests. This ratio should not be less than 15%. In both instances, although a higher capital requirement is applied, it is applied against assets that are weighted by risk-factors of much less than 100%. Loans, which make up the majority of higher risk assets, are weighted 30% and 50%, respectively for short and long maturities. Thus, the result is still a much lower level of capital than is necessary, or required by international standards. Further, as noted above, without adequate loan loss provisions, the ratio is virtually meaningless.

10. **Capital to Liabilities.** The third capital ratio used by the Central Bank is a simple leverage or gearing ratio which compares capital to a bank's total liabilities. Such a ratio is acceptable as a complement to other capital ratios, but should not replace reliance on capital to asset ratios. Since capital is a cushion against unforeseen losses, the most appropriate measure of capital should compare it against the risks which might lead to losses. These risks are generally associated with assets and off-balance sheet items.

11. The current ratio is used appropriately as a complement to the capital to risk asset ratios mentioned above. However, as with the ratios above, there are weaknesses in the use and calculation of this ratio. First, different minimum requirements have been established for former state banks and other commercial banks. Second, the minimum requirements, 4% and 5% respectively, are quite low. A minimum ratio in the range of 8.5% to 10% might be appropriate for a sound, well-managed bank. However, these percentages are roughly twice the existing requirement. Third, since provisions for bad assets have not been made nor have all losses been recognized, capital is overstated. Unless such provisions are made, any ratio computation is pointless.

12. **Household Deposits to Capital.** The last capital ratio is a temporary measure intended to restrict the potential liabilities to individuals in the case of a bank failure. Banks wishing to increase their deposits from individuals must have sufficient matching capital, thus the ratio serves as a tool to restrict or regulate growth in household deposits. The appropriateness of this ratio is questionable since banks should rely on low cost, stable sources of funding such as household deposits. The current requirement discourages such funding and encourages banks to seek alternative, more costly, less stable sources of funding. Instead of restricting banks' access to low cost, stable funding, the Central Bank should seek ways of effectively resolving banking failures. Thus, measures such as this would not be necessary.

13. Rather than relying simply on ratios, the Central Bank should try to bring more judgment into the analysis of capital adequacy. Using capital ratios as minimum requirements, supervisors should assess a bank's individual risk profile; the volume and severity of poor quality assets; the ability of management; plans for expansion; exposure to interest rate, foreign exchange, and concentration risks; the adequacy of internal controls and systems for identifying, measuring, and managing risk; the nature of the national and local economic environments; and other factors which may lead to more than a normal degree of risk

and a higher potential for loss in the bank's activities. The ratios discussed above should be modified to be more in line with international practice. In addition, the Central Bank should establish a minimum floor, at least 5%, on the ratio of qualifying capital to total assets.

The Economic Normatives - Liquidity Ratios

14. Three types of liquidity ratios are used by the Central Bank. However, most countries have recognized that liquidity ratios, such as those described below, have little meaning. They are easily manipulated. For instance, calculated liquidity can be improved by borrowing long and investing in short-term assets. The liquidity ratio will improve. Yet, a bank will have increased its exposure to interest rate risk and potentially worsened profitability. Therefore, most countries use methods which require supervisors to make judgments regarding anticipated funding needs and the means to meet those needs. Measurements of cash flow, in and out, are important. So is an understanding of a bank's anticipated loan demand and depositor withdrawals. An assessment of a bank's ability to borrow or to convert secondary sources of liquidity, such as Treasury bills, into cash is also necessary. Clearly, it is more important for a supervisor to understand how a bank provides for its liquidity needs than to impose a contrived ratio that has little meaning.

15. **Liquid Assets to Demand Deposits.** The first liquidity ratio is a measurement of liquid assets to demand deposits. The ratio is intended to measure a bank's ability to meet depositor withdrawals from its short-term assets. However, as noted above, the ratio is easily manipulated and distracts supervisors from gaining a better understanding of how banks really manage and provide for their liquidity needs. Further, differential treatment is accorded the former state banks as compared to other commercial banks. The former state banks must meet a minimum ratio of 20% while other commercial banks must maintain a ratio of 30%. If a ratio must be imposed, it should be applied uniformly to all banks.

16. **Modified Loan to Deposit Ratios.** The final two liquidity ratios used by the Central Bank are similar to a traditional loan to deposit ratio. However, they have been modified to reflect the maturities of loans and deposits and to include capital and borrowings. The first of these ratios is calculated by comparing loans with a maturity of more than one year to the sum of a bank's capital, deposits, and borrowings having maturities of more than one year. The limit is stated as a maximum and, again, differential treatment is accorded for the former state banks in preference to other commercial banks. The maximum limits are 150% and 100% respectively. The second ratio is calculated in a similar manner except that a three year maturity is used. The limits imposed are 200% for the former state banks and 100% for other commercial banks.

17. The intent of the two ratios above is to limit the amount of medium and long-term loans extended by banks in excess of matching liabilities. However, this approach fails to recognize that banks have core deposits or that banks are in the business of term transformation. Further, the inclusion of capital in the formula is questionable. Instead of imposing rudimentary controls such as this, the Central Bank should encourage banks to develop more sophisticated means of asset and liability management, where bank's evaluate their opportunities to reprice assets and liabilities according to maturity gaps and manage interest rate sensitivity within predetermined limits. Permitting banks to grant variable rate loans at longer maturities would improve loan structuring and repayment. It simply makes no sense, for example, to have a borrower borrow for long-term capital investment needs on a six-month maturity. A longer maturity would permit the borrower to better manage the cash flows necessary for repayment.

The Economic Normatives - Large Exposure Limits

18. **Large Exposures.** The limit on exposure to a single borrower is 50% of capital. This is extremely high by international standards. The commonly accepted norm is 25% of capital and many countries have even lower limits. At the present limits, only two large borrowers need to go bad to cause the insolvency of a bank. This is an unacceptably high risk and the Central Bank, in its supervisory capacity, should take immediate steps to bring this limit down to a more reasonable level.

19. In addition, the Central Bank has issued other regulations related to large exposures:

A. All exposures, defined as the outstanding balance and one-half of off-balance sheet commitments, which exceed 20% of the bank's capital must be approved by the bank's board of directors and reported to the Central Bank. Internationally, a 15% ratio is commonly accepted. The Central Bank should consider a reduction in this ratio.

B. The total of all large borrowers, as defined above, cannot exceed eight times the bank's capital. This limit is consistent with the European Community directives.

C. The aggregate exposure of the five largest loans cannot exceed three times capital.

20. The Central Bank recommends, but does not require, banks to limit their exposure to one borrower to that borrower's capital. Simply stated, the bank should not have more money at risk than does the borrower.

21. The regulations concerning large exposures should be improved to better define a total exposure and the rules for when loans to different borrowers should be combined.

Other Regulations

22. In addition to the so-called economic normatives, there are other regulations with which banks must comply. These include reserve requirements, margin requirements on free reserves, a risk fund on overdue credits, and limits on loans to shareholders.

23. **Reserve Requirements.** Most countries consider reserve requirements to be an instrument of monetary policy and not a prudential ratio. Nonetheless, in Uzbekistan, the responsibility for monitoring reserve requirements is delegated to the bank supervision department. The current reserve requirement is 30% of deposits, including current accounts and excluding borrowings from banks and household deposits.

24. **Margin Requirements.** In addition to mandatory reserve requirements, an amount equal to one-hundred percent of the free balances held by banks in settlement accounts must be deposited by banks in their correspondent account with the Central Bank. Like the reserve account, this account is not remunerated.

25. **Risk Fund.** In addition to mandatory reserve and margin requirements, banks must maintain a risk fund. This fund is established on the basis of overdue *principal* amounts reported to the Central

Bank. The bank's correspondent account with the Central Bank is debited and the risk fund maintained at the Central Bank credited on the basis of overdue status according to the following schedule:

- Loans not overdue 0%
- Loans overdue up to 60 days 25%
- Loans overdue more than 60 days 50%
- Loans overdue more than 1 year 100%

26. Loans overdue for interest only are not captured in the regulation. Furthermore, subjective assessments of portfolio quality are not made. Thus, the risk fund significantly understates the amount of portfolio problems.

27. Amounts carried in the risk fund are available to meet settlements, but may not be used for granting loans.

28. Together, these requirements impose a significant wedge between funding costs and the rates at which banks can profitably extend credit. Thus, banks' earnings are directly affected. As a result, the reserve, margin, and risk fund requirements are creating distortions in the marketplace, as evidenced by the competition for time deposits and the introduction and sale of promissory notes by banks. The reserve requirement should be reduced to a more reasonable level and the margin requirement eliminated. The risk fund should be replaced by a loan loss reserve established through pre-tax provision expense.

29. A draft of a new regulation requiring the classification of assets and provisions to a loan loss reserve based on asset quality is under preparation. However, provisioning rates have not yet been established nor has the tax committee at the Ministry of Finance agreed on the tax deductibility of provisions. Proposed classification categories are: *standard*, *substandard*, *doubtful*, *dangerous*, and *loss*. The draft regulation has not yet been finalized nor approved by the Central Bank's board of directors.

30. It is essential that loan loss provisions flow through the profit and loss statement so that poor lending is reflected in poor earnings, lower dividends, and diminished share value. Thus, discipline is imposed on managers and shareholders. The current approach allows management to escape the introspection that would be necessary if the bank showed negative earnings. Therefore, supervisors should have the authority to classify assets, mandate loan loss provisions, and direct the write-off of bad assets.

31. **Loans to Shareholders.** The preferential access of shareholders to bank credit should be discouraged. Importantly, where necessary, by-laws should be amended to preclude preferential treatment. Loans to any one shareholder are currently limited to 30% of capital. This limit is quite high by international standards and should be reduced to a more moderate level, say 15% of capital. In addition, there should be a limit on the aggregate of all loans to shareholders, say 100%. Shareholders, as used for the purpose of applying these limits, should be defined as those shareholders owning 10% or more of the voting shares of the bank or having the power to influence or control decision-making within the bank. Limits should also be established for loans to other insiders and connected parties.

32. **Equity Participations.** A regulation should be drafted to limit a bank's investment in equity participations. Limits equal to 15% of the bank's capital for a single exposure and 100% of capital for

the aggregate of all equity participations are considered appropriate and consistent with international practice.

33. **Foreign Currency Exposures.** A regulation should be drafted to preclude large uncovered positions in individual foreign currencies and the aggregate of all foreign currencies. Limits of 10% and 15% of capital, respectively, are considered reasonable. Care should be taken to select an appropriate method for determining the net aggregate position of all currencies.

34. **Sanctions and Penalties.** Supervisors may impose monetary penalties in the following cases:

- violations of laws and regulations;
- provision of banking services without a license;
- non-compliance with the so-called *economic normatives*;
- non-performance with Central Bank instructions; and
- other cases stipulated in the legislation.

35. In addition, the Central Bank may revoke the banking license or remove management. Central Bank of Uzbekistan regulation #74 dated April 15, 1994, specifies the penalty amounts for the above infractions based on specific calculations.

36. There are many problems with the approach used by the Central Bank to enforce its requirements and apply sanctions. First, in a banking environment, judgment must be involved. It is not possible for legislation to address every abusive, flagrant, wrongful, or imprudent action. Therefore, most countries have embraced the concept of *safe* and *sound* banking. Banks which engage in actions or practices which, in the opinion of the supervisors, are *unsafe* or *unsound* are subject to supervisory action. A safe and sound practice in one bank may be unsafe and unsound in another.

37. Second, supervisory action should reflect the seriousness of and be appropriate to the situation. It makes no sense, for example, to impose monetary penalties against a bank which does not meet minimum capital requirements--thus, worsening the capital position. Instead, the bank should be prohibited from paying dividends and given a deadline to raise new capital, change its mix of assets, reduce its risk assets, and formulate a capital plan to ensure that adequate capitalization will be achieved and maintained. The result is a prescriptive response rather than a punitive one.

38. Third, where abusive and recurring actions on the part of individuals are involved, monetary fines and penalties should be imposed against the individuals. In some countries, the penalties would also encompass restitution for losses incurred by the bank from illegal or abusive acts such as violations of large exposure limits.

39. The range of actions that can be taken by the Central Bank should be broadened to include many more intermediate enforcement measures. These could include, for example, binding instructions to the bank, i.e., cease and desist orders; removal or suspension of managers, directors, and other interested parties; restrictions or prohibitions on the payment of dividends; civil money penalties against individuals; branching restrictions; etc.

THE LEGAL AND OPERATIONAL FRAMEWORK FOR A *DE MINIMIS* DEPOSIT INSURANCE FUND

Principles and Objectives

1. The present ad-hoc procedures followed in dealing with banking insolvency need to be strengthened through the incorporation of the following principles and objectives. These principles and objectives have successfully guided the rehabilitation and restructuring of financial institutions in other countries.

Legal and Financial Autonomy

2. Legal and financial autonomy is necessary for the Deposit Insurance Fund (the Fund) to be able to deal with insolvent banks. The Fund should be capable of functioning in a manner which:

- is automatic, quick, and efficient with clearly delineated authority and responsibility;
- is free from political interference;
- permits it to develop its own organization and fulfill its staffing requirements for highly skilled personnel unimpeded by civil service salary constraints;
- provides greater financial accountability, enhances public confidence in the government's ability to deal with bank failures and maintains the integrity of the banking system; and
- ensures the **primacy** of its implementing legislation and related legal framework over commercial laws and other regulations which might otherwise provide barriers to the effective handling and treatment of failing or failed banks.

Depositor Protection

3. Household deposits will be protected up to a specified limit determined by the Fund and may be required to share in some of the losses up to a pre-determined percentage. Other depositors and liability-holders will not be protected, but will share in the proceeds from the liquidation of assets according to legal preference.

Removal of Management and Ownership

4. For reasons of equity, efficiency, and financial discipline, existing owners and management should be held accountable for their failures: stockholders' equity and rights should be eliminated and any rights to collections would be handled on a strictly residual basis; the Fund should have the right to remove any or all management.

Ability to Deal With Non-Performing Portfolio

5. In order to facilitate the rehabilitation of failed banks, it is essential that:

- the Fund removes bad assets from the failed bank and replaces those assets with cash or equivalent securities in an amount sufficient to balance assets and deposits;

- the Fund disposes of non-performing assets promptly in order to maintain its cash flow, taking into account the need to rehabilitate economically viable firms and borrowers.

Prevention of Nationalization of Private Banks

6. In line with the Government's policy of fostering private ownership and initiative, the Fund should return restructured banks to the private sector within a maximum period of two years. It should avoid the public perception of nationalization, even for a temporary period, by establishing an independent mechanism to acquire ownership or control of failed banks.

Least Cost and Integrity of Banking System

7. The Fund should operate to minimize the cost to the Government of dealing with the failure of a particular bank as well as the potential costs of resultant ripple effects on other banks throughout the system, e.g., liquidity support.

Operating Policies and Procedures

8. The Fund's operating policies and procedures for dealing with failed or failing banks should be as follows:

- through information obtained from the Central Bank's supervisors and/or other sources, the Fund identifies a bank approaching insolvency or which is insolvent (insolvency occurs when net worth is reduced to zero);

- the Central Bank may provide liquidity support to a failing bank if needed and appropriate until the Fund is able to develop an effective restructuring plan or ownership is taken over. The Central Bank's loans to individual banks would be repaid by the Fund in the case of failure;

- after a thorough analysis of the bank and after all known losses are charged off, the Fund would require the stockholders of the failing bank to replenish capital to at least the minimum capital adequacy requirement;

- assuming that stockholders do not replenish capital, the Fund would deal with the resulting insolvency or near insolvency in four ways:

  - **Purchase and Assumption.** The Fund would cancel the charter, close the bank, and merge its good assets and deposits with a new or existing bank; shareholders'

equity is extinguished when the bank is closed and shareholders lose all claims and privileges; the Fund acquires all bad assets, including previously written-off assets, from the failed bank at current book value less the amount of nominal capital for cash or equivalent securities which would be an amount sufficient to bring capital to zero; a new or existing bank assumes the deposits and purchases the good assets of the rehabilitated bank. The purchase of good assets and assumption of deposits by an existing bank could occur through a bidding process or a forced supervisory merger. As part of the purchase and assumption, the Fund may receive a premium for the going concern value of the bank; the acquiring bank provides additional capital as needed to bring capital to a level which at least meets the minimum capital adequacy requirements of the banking law; the Fund may facilitate the merger with a temporary loan, deposit, or other instrument as needed (such as a *put* option whereby the acquiring bank can require the Fund to repurchase assets acquired which later prove to be bad. The put option would have a cap on the amount of assets that could be sold back to the Fund and an expiration date);

- **Insured Deposits Payoff.** The Fund closes the bank and liquidates it; the Fund pays depositors up to insurance limits and is subrogated to rights of insured depositors; the Fund acquires all assets; the Fund liquidates assets and pays claims of creditors according to legal preference; stockholders receive any residual value.

- **Insured Deposits Transfer.** The Fund closes the bank and transfers insured deposits and matching good financial assets to another bank. The Fund may provide cash or securities as needed to match the deposit liabilities to be transferred. The remaining assets are liquidated by the Fund and claims are paid according to legal preference. Stockholders receive any residual value.

- **Share Purchase and Sale.** Some capital remains but it is significantly below the legally required level; the Fund purchases the stockholders' interest at book value (special care would have to be taken to ensure that all losses are charged-off to avoid overpaying the old stockholders); the Fund takes control of the bank and sells it to a new owner or arranges a merger with another bank; the new owner pays the Fund for its investment and supplies whatever additional capital is needed.

Financing of the Fund

9. Ideally, the Fund should be financially self-sufficient and adequately funded at inception. However, given the level of financial distress thought to exist in the banking system, the initial demands upon the Fund are likely to exceed financing provided through traditional channels. The following explains the sources of financing for the Fund:

- **Primary Financing.** Primary financing of the Fund would be provided through premiums assessed against member banks for deposit insurance; these premiums would

be risk-based and dependent upon a bank's financial condition. Membership in the deposit insurance system is **mandatory** for all banks, although the Fund, at its option, could exclude banks from or terminate membership; an additional source of financing for the Fund is the interest it receives on its investments. The Fund would be required to invest solely in government securities offering safety and liquidity.

- **Secondary Financing.** Secondary financing would be provided through long-term loans from the the Central Bank disbursed either in cash or government securities; in addition, stand-by lines of credit should be available from the Central Bank to meet unexpected funding requirements. These lines would have preference as to repayment by the Fund.

Losses Incurred in Dealing With Failed Banks

10. In restructuring failed banks, **it is the role of the Fund to absorb losses**. However, such losses should be recovered over time from the collection of insurance premiums. Loans made to the Fund by the Central Bank would be repaid in full.

Organization and Staffing

11. The Fund would be established as a separate legal entity with quasi-government status and its own staff and compensation programs. The principal elements of the Fund would include:

- **Board of Directors.** A small board of directors would provide direction and leadership to the Fund. Board membership would include representatives of the Central Bank, the Ministry of Finance, and the private sector with the public sector representatives providing a majority.

- **Chief Executive Officer.** The Chief Executive Officer should be a person with a substantial background in banking, finance, and supervisory matters and should possess the stature to deal effectively with individuals in all segments of government and industry.

- **The Staff.** The staff should be a core group of highly skilled professionals who would manage the work of the Fund, using temporary support from other sources including other government agencies, audit firms, consultants, and the legal profession; the staff should be relatively well paid, on a par with private industry, to attract and retain highly qualified individuals; the staff would focus its efforts entirely on handling failing or failed banks so as not to be distracted by other duties. The staff would rely on the Central Bank to regulate, supervise, and monitor the condition of banks. However, the staff of the Fund would participate in examinations as necessary to ensure the protection of the deposit insurance fund.

Legal Framework

12. The banking law, or separate legislation creating a deposit insurance fund, needs to provide the Fund with the necessary powers and authorities to fulfill its responsibilities. In modifying the legal

framework, care should be taken to harmonize changes with commercial law and other related laws; however, the changes should ensure that the banking law, or separate deposit insurance legislation, is given primacy and that the measures needed to be undertaken by the Fund are in no way diluted. The following items contain some of the important authorities which should be vested in the Fund. The Fund should:

- have a wide array of powers to buy assets, place deposits, make loans, and borrow as needed to fulfill its responsibilities;
- have all the powers of a legal entity, e.g., to make contracts;
- have the authority to exercise such incidental powers needed to carry out its responsibilities;
- have the authority to obtain information from banks and the Central Bank and to require outside audits of banks paid for by banks;
- have the authority to remove prior management and hire new management;
- have the authority to declare a bank insolvent, close it, and extinguish the rights of shareholders and to intervene in an institution which fails to meet the minimum capital adequacy requirements after an unsuccessful call for additional capital from shareholders;
- have the authority to effect mergers of banks and liquidate banks;
- would be required to act as receiver for all failed banks;
- have the authority to operate, manage, and rehabilitate a bank, with or without adequate capital, while attempting to sell or merge it;
- have the authority to take all actions necessary to collect assets acquired from banks. In this regard, the Fund will have full legal rights as successor of the failed bank, e.g., the ability to foreclose assets, restructure loans, convert debt into equity, enter into agreements with collection agencies, package and sell assets, etc.;
- have the authority to set the premium rate, levy premiums, and collect delinquent premiums;
- be exempt from taxation.

IMAGING

Report No.: 15430 UZ
Type: SR