Journal of Financial Crises

Volume 3 | Issue 2

2021

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Recommended Citation
Nunn, Sharon M. (2021) "Kazakhstan’s Rehabilitation Bank," *Journal of Financial Crises*: Vol. 3 : Iss. 2, 290-300.
Available at: https://elischolar.library.yale.edu/journal-of-financial-crises/vol3/iss2/14

Kazakhstan's Rehabilitation Bank[1]

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Yale Program on Financial Stability Case Study
June 23, 2021

Abstract

After the dissolution of the Soviet Union in 1991, Kazakhstan officials made market-oriented stabilization reforms to its previously Soviet-planned economy, including removing most price constraints, privatizing various state-owned enterprises (SOEs), and taking steps to prevent the collapse of its banking system. As part of its efforts, Kazakhstan created the Rehabilitation Bank (RB) in 1995 to absorb the large number of non-performing assets from state-owned banks while also assuming a corresponding amount of the institutions' liabilities, essentially "shrinking their portfolios" (Implementation Completion Report 1998). The RB, established with a four-year mandate, either liquidated the debtors or required the firms to restructure. Kazakhstan policymakers also created two other institutions alongside the RB to take the non-performing assets associated with businesses in specialized industries. Overall, loans totaling 11% of the country's gross domestic product were transferred to the RB and the two other asset management companies. The RB's collection methodology and final recovery figures are unclear. The non-performing asset transfers did not have an immediate positive impact on the quality of Kazakhstan's banking system portfolio. Though the portion of the country's loans considered non-performing fell to a third in 1995, the figure rose to 41.3% by the end of 1996. The increase was due to better loan classification and an underlying deterioration in loan quality. Still, some have credited the policy with helping to prevent the banking system's collapse.

Keywords: Kazakhstan, asset management companies, asset purchase programs, Rehabilitation Bank, non-performing loans, non-performing assets.

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[1] This case study is part of the Yale Program on Financial Stability (YPFS) selection of New Bagehot Project modules considering broad-based asset management company programs.

Cases are available from the *Journal of Financial Crises* at https://elischolar.library.yale.edu/journal-of-financial-crises/.

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Kazakhstan's Rehabilitation Bank

At a Glance

Prior to the early 1990s, the Soviet central bank, Gosbank, allocated all financial resources to its republics. Kazakhstan's financial system was historically organized to accommodate this relationship and remained structured this way after the 1991 dissolution of the union. In 1992, the country's banking system was made up of former Gosbank domestic arm National Bank of Kazakhstan (NBK), which became the country's central bank, five specialized state banks, and more than 70 smaller commercial banks. Gosbank previously directed credit to the specialized banks and required them to lend the resources to specific firms. This credit "resembled budget transfers" because debt payment was not enforced (Hoelscher 1998). This contributed to an eventual run-up in non-performing assets.

Summary of Key Terms	
Purpose: To transfer non-performing assets from the country's biggest debtors to ameliorate the poor profitability of state banks, where a majority of the country's deposits were held, to prevent a broader banking system collapse (Hoelscher 1998).	
Launch Dates	First transfer to RB: 1995
Wind-down Dates	Unknown
Program Size	Not specified at outset
Size and Type of NPL Problem	Nonperforming debt equaled 55% of total portfolios in 1994 (Gürgen et al. 1999) Largely state-directed commercial loans
Eligible Institutions	The country's largest banks Open and closed-bank
Usage	At least 11% of GDP transferred (Hoelscher 1998)
Outcomes	No data on recovery efforts available
Ownership Structure	Government-owned
Notable Features	Involved the forced restructuring or liquidation of the debtor firms that had their assets transferred to the asset management company

After the Soviet Union's collapse, Kazakhstan lost its traditional revenue sources, lacked domestic financing from nonbank institutions, and had little access to international capital markets. The country's economy contracted sharply, living standards fell, and the number of insolvent businesses grew, including those to which the main state banks lent. By 1994, an audit showed nonperforming debt in Kazakhstan equaled 55 percent of total portfolios in the country (Gürgen et al. 1999).

To prevent a collapse in the banking system, the assets of which were largely concentrated in the largest five banks, the newly independent NBK established the asset management company (AMC) Rehabilitation Bank[3] (RB) to manage firms that constituted the biggest

[3] Also called the "Rehabilitation Trust" in various sources.

financial burden on the banks. The Ministry of Finance (MOF) also played a substantial role in the RB's establishment and operations (Staff Appraisal Report 1995).

The RB forced the selected firms to restructure or liquidate and took on the businesses' non-performing loans to help clean up their balance sheets, along with the major banks' (Staff Appraisal Report 1995). The central bank considered blanket loan forgiveness but eventually rejected the option because it worried banks would come to expect such bailouts in the future (Hoelscher 1998). The RB took non-performing loans of 45 of the largest insolvent debtors,[4] most of which were large metallurgical and mining companies, and a corresponding amount of liabilities, shrinking banks' portfolios (Hoelscher 1998). "The state in many ways relieved banks of bad loans that had been imposed by authorities" (Implementation Completion Report 1998).

The NBK established the RB as part of a broader financial system stabilization strategy, which included tightening entry requirements for new financial institutions and modernizing the country's legal and regulatory conditions. The NBK also created the Agricultural Support Fund (ASF), which took over loans extended to nearly 4,000 insolvent farms, and utilized the already-existing Exim Bank to acquire loans that export credit agencies funded because of previous government guarantees (Hoelscher 1998).

The RB and the two other AMCs struggled to resolve the bad loans they absorbed. A detailed account of the AMCs' overarching collection methodology does not appear to be available. The government auctioned off some of the bad loans, and later began paying joint stock company Agency on Reorganization and Liquidation of Insolvent Enterprises to deal with the non-performing debts (Implementation Completion Report 1998). The State Property Committee, an entity created to privatize SOEs, also assisted in the sale of a chosen company's assets (Staff Appraisal Report 1995).

Summary Evaluation

The Kazakhstani government struggled to adequately resolve the bad loans transferred to its three AMCs largely because the institutions were unable to comprehensively restructure many of the indebted businesses and farms. By 1998, the RB had provided its restructuring and liquidation services for only 14 of the chosen firms, including liquidating five and pushing for staff reductions in eight (Implementation Completion Report 1998).

The failure to adequately restructure some of the firms stems in part from management and funding problems that arose. The Kazakhstani cabinet made restructuring decisions for the largest selected firms, and the MOF held back most of the funds appropriated for the RB, "making it difficult to make agreed payments under restructuring plans" (Republic of

[4] Various sources give different figures for the total number of enterprises the RB handled. The author chose Hoelscher 1998's 45 figure because of the report's *singular* focus on Kazakhstan's restructuring program and the time elapsed between the program's inception and the report's publish date.

Kazakhstan 2001). World Bank researchers argued that even if the restructuring efforts were ineffective, the process still minimized "allocation of further resources to" the enterprises, "contributing significantly to the health of the banking sector" (Implementation Completion Report 1998).

Even so, the prioritization of restructuring viable businesses took scarce government resources, slowing "the emergence of a prosperous enterprise sector" (Hoelscher 1998). "The activities of the AMCs would have been more effective had debtors been quickly closed, assets sold off, and the nonperforming loans quickly liquidated" (Hoelscher 1998).

Analyses conducted in 1998, four years after the asset transfers began, showed mixed outcomes. The banking sector's balance sheet improved, according to a World Bank review detailing the completion of its financial support for the asset purchase program (Implementation Completion Report 1998). Though the portion of the country's loans considered non-performing fell to a third in 1995, the figure rose to 41.3% by the end of 1996 (Hoelscher 1998). The rise in bad assets was partly due to improved loan classification standards but also an actual deterioration in asset quality (Hoelscher 1998). Still, some have argued that the NBK successfully prevented the banking system's collapse, partially because of "avoidance of moral hazard" and the other concurrent restructuring policies (Hoelscher 1998).

The program did not involve substantial capital injections, nor operational and institutional restructuring of the banks that took on the bad assets to begin with, causing four of the country's biggest banks to undergo further financial stress, which then lead to a subsequent bailout and "merge recapitalization" of two of the financial institutions (Tang, Zoli, and Klytchnikova 2000). Kazakhstan's experience "illustrates how bank restructuring without adequate capitalization and not accompanied by operational and institutional restructuring cannot resolve banking sector problems and may require successive government interventions" (Tang, Zoli, and Klytchnikova 2000).

Kazakhstan's Rehabilitation Bank: Kazakhstan Context	
GDP (SAAR, Nominal GDP in LCU converted to USD)	\$21.25 billion in 1994 \$20.37 billion in 1995
GDP per capita (SAAR, Nominal GDP in LCU converted to USD)	\$1,316 in 1994 \$1,288 in 1995
Sovereign credit rating (five-year senior debt)	NA
Size of banking system	\$3.66 billion in 1994 \$2.17 billion in 1995
Size of banking system as a percentage of GDP	17.20% in 1994 10.64% in 1995
Size of banking system as a percentage of financial system	NA
Five-bank concentration of banking system	NA
Foreign involvement in banking system	NA
Government ownership of banking system	NA in 1994 19% in 1995
Existence of deposit insurance	NA
Sources: Bloomberg; World Bank Global Financial Development Database; World Bank Deposit Insurance Dataset; Cull et al.	

Key Design Decisions

1. Part of a Package: Kazakhstan used asset management companies to take nonperforming loans off banks' books, canceling the banks' corresponding liabilities, but did not inject government capital to ensure banks' ability to sustain losses on other loans.

After the dissolution of the Soviet Union in 1991, the Kazakhstani government was concerned with averting a broad banking system collapse. It focused initially on restructuring the large state banks by dealing with the country's sizeable stock of nonperforming loans. It also heightened the entry requirements for new banks and increased minimum capital requirements (Hoelscher 1998).

The NBK, tasked with running the restructuring efforts, used the RB and two specialized AMCs to take nonperforming loans off banks' balance sheets. It removed the banks' corresponding liabilities to the government, essentially shrinking banks' portfolios (Hoelscher 1998). However, the government did not inject government capital to ensure banks could sustain losses on other loans.

The RB took non-performing loans of 45 of the largest insolvent debtors, mostly metallurgical and mining companies. The Agricultural Support Fund (ASF) took loans extended to nearly 4,000 insolvent farms, and the existing Exim Bank took loans that export credit agencies had funded under government guarantees (Hoelscher 1998).

The RB chose businesses that were the largest burdens on the country's banks. It forced insolvent debtors to liquidate or restructure by cutting them off from any funds outside of the RB itself (Staff Appraisal Report 1995). The RB required insolvent debtors to submit restructuring plans that the RB board would accept or reject, the latter of which triggered liquidation (Staff Appraisal Report 1995). But the AMC "gave priority to enterprise rehabilitation rather than liquidation, developing comprehensive downsizing and restructuring plans for each enterprise" (Hoelscher 1998).

2. Legal Authority: A presidential decree outlined the RB's legal status, structure, responsibilities, and authority.

A subsequent detailed statute would later elaborate management characteristics, according to a World Bank report detailing the RB plan before its full implementation (Staff Appraisal Report 1995).

3. Special Powers: Officials passed new regulations and laws to provide the RB the necessary powers to liquidate and sell assets.

The specific nature of the new powers policymakers granted the RB is unclear.

4. Mandate: The RB's mandate included restructuring and liquidating firms whose non-performing loans it took off banks' books.

The RB prioritized restructuring, potentially because it played a role in overall privatization and liberalization efforts, and as such, appeared to have no strictly enforced mandate to resolve the bad debt on its books (Hoelscher 1998).

5. Ownership: The RB was government-owned.

The NBK established the RB as an entirely state-owned joint stock bank (Staff Appraisal Report 1995). Officials chose the central bank because the NBK's staff was the main source of specialized banking and finance knowledge the government could tap (Hoelscher 1998). A World Bank report detailing the RB's structure suggested the RB began business on the property of one of the country's commercial banks, accessing the institution's communication and computer systems as part of a "fee-based contractual arrangement" (Staff Appraisal Report 1995).

6. Governance: A Supervisory Board comprised of various government ministry leaders oversaw the RB, while NBK employees and local professionals made up the RB's core staff.

The RB's Supervisory Board was chaired by a policymaker of at least "Deputy Prime Minister rank" and included members of the economy and finance ministries, the NBK, the State Property Committee, and outside "independent" finance and business management experts (Staff Appraisal Report 1995). The board's mandate involved approving restructuring or liquidation plans and deciding the amount of financial support a debtor company received (Staff Appraisal Report 1995).

The RB's Management was headed by a local director with finance experience. Officials incentivized management to reduce firms' budgetary costs, cut losses, and keep businesses under the RB's watch for less than three to four years (Staff Appraisal Report 1995). The management incentivization methodology is unknown.

NBK employees staffed the RB because it was the main source of banking expertise in the country (Hoelscher 1998). Other local professionals with experience in finance, law, business, social security, and liquidations were to be recruited as well, with the staff attending courses led by foreign experts and other trainings (Staff Appraisal Report 1995).

7. Size: The government did not set a maximum size for the program at the outset.

Non-performing loans totaling 11% of Kazakhstan's GDP were transferred to the RB and the other AMCs by 1998. The RB took loans equivalent to one percent of GDP, the ASF received assets equaling four percent, and Exim took on loans of about six percent (Hoelscher 1998).

8. Funding Source: The RB's initial funding came from the national budget.

Any operating losses would be funded through the MOF from the state budget and by NBK refinancing facilities and RB bonds, which were guaranteed by the government, at market interest rates (Staff Appraisal Report 1995). The World Bank also helped finance the RB's operations with a loan to the Kazakhstani government (Staff Appraisal Report 1995).

9. Eligible Institutions: Kazakhstan's largest banks were the RB's target creditors.

At the time of the program's establishment, a weak economy and tightening monetary policy exacerbated the nonperforming loan problem, initially brought on by state-directed lending before Kazakhstan achieved independence. To prevent a banking system collapse, the NBK and policymakers focused on removing bad debt that burdened the largest banks, where most of the country's deposits were held (Hoelscher 1998).

10. Eligible Assets: Loans to the largest nonperforming debtors in the country were the target bad assets.

The businesses were selected chiefly by their total non-performing debt and burdens on "creditors in terms of outstanding non-performing net liabilities to banks, enterprises, and the state's budget and extra-budget funds" (Staff Appraisal Report 1995). At the outset, the World Bank stated most of the firms likely to meet the criteria would be majority state-owned (Staff Appraisal Report 1995). The initial plan documents allowed the RB to take on 40 institutions, but the AMC had restructured or liquidated 45 by 1998 (Staff Appraisal Report 1995). Most debtors were large metallurgical and mining companies.

Public service enterprises, such as utilities, were excluded because liquidation would be unrealistic and such firms' "financial problems stem largely from state pricing policies rather than operating inefficiencies" (Staff Appraisal Report 1995).

11. Acquisition (Mechanics): The RB removed the nonperforming loans by also taking on a corresponding amount of a bank's liabilities.

This shrunk the financial institutions' portfolios (Hoelscher 1998).

12. Acquisition (Pricing): It is unclear how RB officials priced the assets the AMC received.

Available program documents do not contain information about the RB's pricing methodology.

13. Asset Management and Disposal: The RB required chosen firms to submit restructuring plans that the RB board would accept or reject, the latter of which triggered liquidation. The RB's nonperforming loan disposal methodology is unclear.

The AMC "gave priority to enterprise rehabilitation rather than liquidation, developing comprehensive downsizing and restructuring plans for each enterprise" (Hoelscher 1998). Privatization was generally expected as part of restructuring plans as well, if applicable. Support from the RB remained "strictly tied to the implementation of the time-phased restructuring plans" (Staff Appraisal Report 1995). If the plans were not implemented completely or if they failed to make the chosen firm financially viable, the business would be liquidated and its assets sold. In a similarly strict ethos, the possibility that a firm's management could be replaced in the event of even "minor shortfalls" in the restructuring process was an "enforcement tool" available to Kazakhstani officials (Staff Appraisal Report 1995).

Most documents detailing the RB's establishment include little to no information about the AMC's nonperforming loan disposal methodology, though the government appeared to auction off some of the bad loans. Authors of a report published three years after the RB's establishment stated the resolution of bad loans on the AMCs' balance sheets were of concern to the Kazakhstani government. Rehabilitation "institutions that received the non-performing loans were not able to make much headway in restructuring indebted farms and enterprises" (Implementation Completion Report 1998).

The failure to adequately restructure some of the firms stems in part from management and funding problems that arose. The Kazakhstani cabinet made restructuring decisions for the largest selected firms, and the MOF held back most of the funds appropriated for the RB, "making it difficult to make agreed payments under restructuring plans" (Republic of Kazakhstan 2001).

14. Timeframe: The RB's initial mandate was four years.

The government originally planned to close the RB, "a temporary institution," after four years (Staff Appraisal Report 1995). In June 1998, the RB was reorganized and renamed the "Rehabilitation Fund."[5] With available documents, details are unknown regarding this new organization's structure, purpose, and funding, and if and when its operations ceased.

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