



***Bank failure:
Who is responsible?
Kazakhstani cases***

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Bank failed...

WHO is RESPONSIBLE for its failure?

*All participants of the banking sector,
viz. Deposit Insurer,*

Regulator,

Bank itself

and also market environment

*are responsible to some extent for the
bank failure*

Deposit insurer...

Unlike other parties the Deposit Insurer bears more general or, rather, intangible responsibility for bank failure sequent its public objective fulfillment

Main public objective of the DI:

Protect depositors and prevent bank runs

Deposit insurer...

Is a source of moral hazard for:

Banks

Insured deposits \implies a bank is more likely to take large aggressive risks (in presence of negative shock) \implies generous deposit insurance subsidizes bank's aggressive risk-taking

Depositors

- Care mostly about the safety of their deposits
- Become complacent towards banks
- Their incentives to monitor banks weaken

Regulators and Supervisors

- Deposit insurance prevents social upheavals and deposit's runs \implies Regulator's incentive to take preventive or early resolution' measures decreases
- Insufficient resources of the deposit insurance fund might prevent authorities from closing unviable banks

Regulators & Supervisors...

- **Substantial time lag in regulatory response**
 - ✓ Regulator allows innovations on concealment capacity to expand until their adverse effects can be proven
 - ✓ Regulator's bumbling in market' rumor response, bank's problem detection and resolution
 - ✓ Reluctance to failing and unwinding large or complex banking organizations
- **Asymmetric information**

Distressed banks frequently use disinformation accounting and forecasts to routinely mischaracterize sources of problems and whether they are lasting ones

Market environment

“External” causes of bank’s distress:

- Market overheating
- Adverse economic conditions
- Extra-rapid growth of the banking sector

Market environment (cont.)

- Market overheating (bubble)
 - ✓ stock market (Russia, 1999; East Asia, 1997-1998)
 - ✓ real estate market (Japan, 1991; East Asia, 1997-1998, at present - Kazakhstan)

Real estate' bubble

Real estate bubble, especially in two biggest cities - Almaty and Astana (former and current capitals):

during 2002-2007 the market prices for 1 m² in these cities increased almost 10 times (on average)

Real estate located in Almaty and Astana is widely used as a collateral for bank loans (in retail as well as corporate banking sector)

Adverse economic conditions

- Negative price trend for main export items:
 - ✓ main sources of export earnings are mining, oil and gas whose prices endure considerable changes in the world market
 - ✓ main corporate clients of the Kazakhstani big banks are enterprises operating in aforementioned sectors

Result

Most banks' financial soundness significantly depends on:

- ✓ world market prices on a limited list of export commodities and, consequently, on the financial position of a narrow circle of companies;
- ✓ real estate market's stability

Adverse economic conditions (cont.)

Adverse movements in interest rates or currency values

Last years Kazakhstani banks have been extensively using external funding sources for further financing of local businesses

(IPO's, bonds in USD or Euro, syndicated loans and etc. under floating interest rates, while banks place them in Kazakhstan under fixed interest rates)

Extra-rapid growth of the banking sector

- Intensifying fight among banks for market share in different banking segments
- Alleviation of banks' requirements towards their clients resulting from escalating banks' competition within the restricted market
- Conquest of the external, often riskier, markets (Kyrgyzstan, Tajikistan, Georgia, etc.)

Banks...

- New financial products
- Managerial weaknesses:
 - ✓ Improper risk-management system
 - ✓ Poor internal routines and controls
 - ✓ Frauds and abuses

Banks...

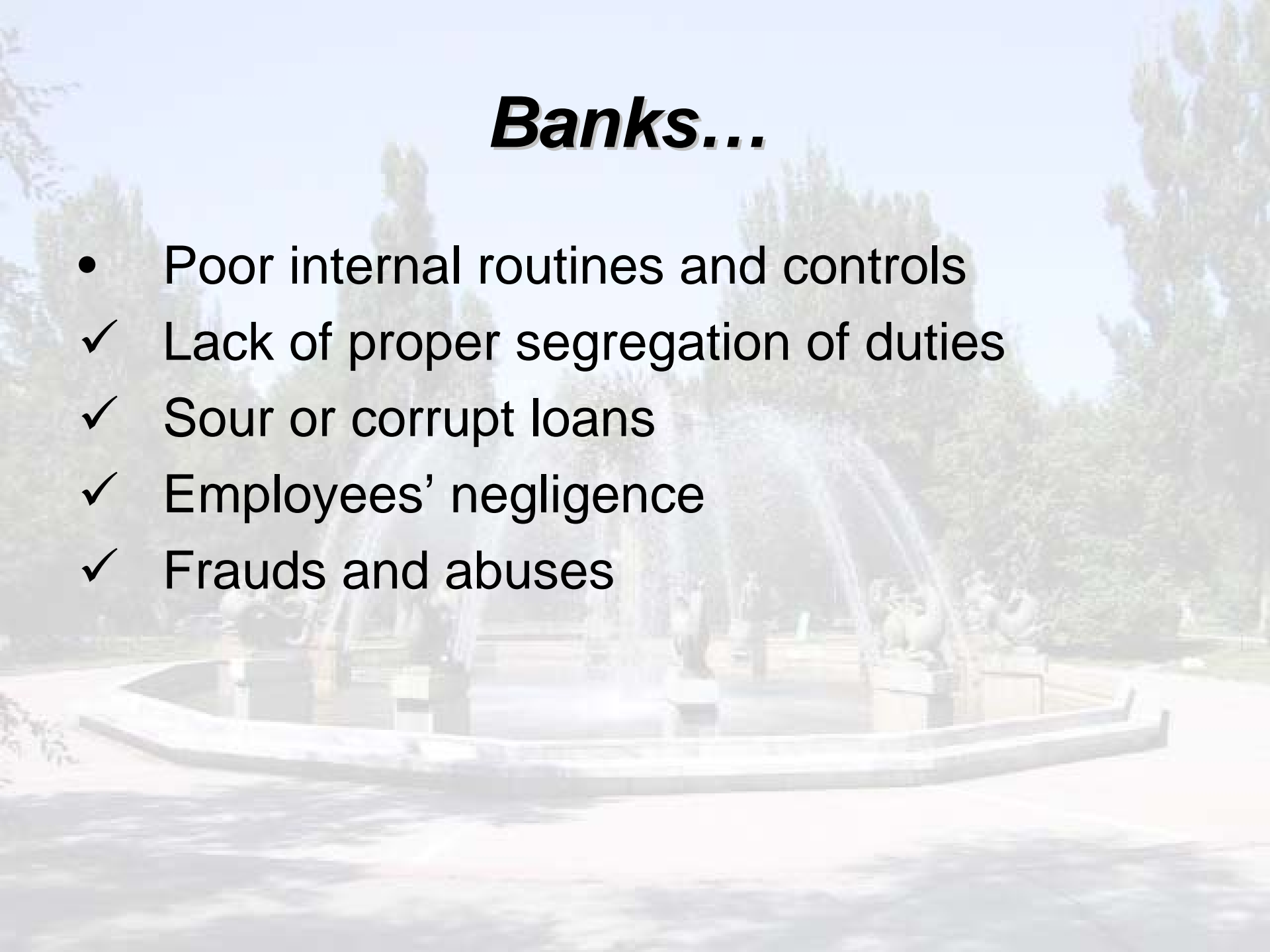
- New financial products
- ✓ Banks are forced to introduce new products without their careful stress-test in order to withstand an intensifying competition
- ✓ Prudential norm in respect of new products are usually not well-settled by regulator for a certain period of time which allows banks to take excessive risks and increase their own nominal profitability in a short-term perspective

Banks...

- Improper risk-management system
- ✓ Interaction of particular bank risk exposures with adverse events
- ✓ Endgame gambles for resurrection of the accounting solvency:
 - 1) funding riskier loans with higher interest rate;
 - 2) expanding duration and currency imbalances

Banks...

- Poor internal routines and controls
- ✓ Lack of proper segregation of duties
- ✓ Sour or corrupt loans
- ✓ Employees' negligence
- ✓ Frauds and abuses



Banks...

- Failure of internal controls against frauds and abuses:
 - ✓ Insider Transactions
 - ☞ Looting by top management
 - ☞ Employees' embezzlement
 - ✓ Customers' frauds
 - ✓ Computer hacking

Bank failures. Kazakhstani cases

There were 2 bank failures in Kazakhstan within 2004-2006 (“Nauryz Bank Kazakhstan” and “Valyut-Tranzit Bank”)

In both cases main reason of the failures – insiders’ frauds

	“NBK”		“VTB”		
	June 1, 2004	Jan 1, 2005	Oct 1, 2005	Oct 1, 2006	Dec 1, 2006**
Assets*	18 888 425	13 982 155	76 252 513	84 296 077	77 728 073
<i>Loans</i>	11 211 221	9 207 182	47 384 935	52 104 577	50 084 603
<i>- classified loans</i>	4 994 085 (44.5%)	8 313 554 (90%)	9 460 900 (20%)	21 438 394 (41%)	47 921 644 (95.7%)
<i>Provisions</i>	1 371 160	6 400 354	1 172 306	2 836 879	57 230 526
Liabilities	15 248 903	11 135 835	61 909 058	57 404 316	53 071 734
<i>Corporate deposits</i>	9 233 009	2 853 610	21 733 361	18 759 645	17 978 669
<i>Individuals' deposits</i>	1 706 743	1 870 130	23 790 144	22 581 562	19 085 516
<i>- including insured deposits</i>	1 678 153	1 838 459	23 238 684	20 251 901	17 357 857
<i>Issued bonds</i>	-	-	4 982 507	6 003 680	6 003 680
Capital	2 268 362	-3 554 034	13 171 149	24 054 882	-32 574 187

* - assets before provisions

** - figures adjusted by the Temporary administration

	“NBK”	“VTB”
Total estimated coverage amount, 000’KZT	772 050	14 500 000
Total reserve fund’s value prior to the beginning of reimbursement payment, 000’KZT	9 230 663	11 984 073
Number of deposits covered in full	27 878	259 744
Total number of individuals’ deposits	28 661	264 777
% of deposits covered in full	97,3%	98,1%
Average quarterly increase in total insured deposits during 3 last years of the banks’ existence, %	21.37 %	12.8%



*The future is bright,
the road is tortuous...*

Lessons learned

1. Bank' forcible liquidation should be a last-ditch administrative measure
2. Regulatory and market requirements for banks' transparency should be strengthen and further promoted
3. The complex of protective measures should be developed corroborant by:
 - reputation and capital of the bank
 - professional standards for bankers and financial watchdogs
 - penalties for fraud and misrepresentation
4. Regulators should continually forestall the further market development and pursue appropriate policy
5. Regulators should be accountable for their tardy actions in the bank resolution process



***Thank you for
kind attention!***