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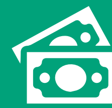

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Readiness for Resolving Nonperforming Loans in Central Asia

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Acronymns

AFR	Agency for Financial Regulation and the Development of the Financial Sector (Kazakhstan)
AMC	asset management company
AQR	asset quality review
DPD	days past due
EBRD	European Bank for Reconstruction and Development
IFRS	International Financial Reporting Standard
LGD	loss given default
MSMEs	micro, small, and medium enterprises
NPL	nonperforming loan
PD	probability of default
PLF	Problem Loans Fund
SME	small and medium-sized enterprises
SREP	supervisory review process
UTP	unlikeliness to pay

Executive Summary

The COVID-19 crisis combined with the global repercussions from the Russian invasion of Ukraine exacerbated the stress on financial systems around the world. More than 150 countries introduced policy measures to support the financial sector amid the COVID-19 pandemic.[1] Such measures included debt moratoria, loan forbearance, and the relaxation of classification and provisioning rules—a truly unprecedented response in its scale and speed.

Central Asia is no exception.[2] Policy makers in the region introduced temporary measures to support the financial sector during the COVID-19 pandemic. But even before one crisis is contained, the region faces another crisis stemming from the repercussions of the Russian war in Ukraine. Central Asian countries have strong economic and financial ties with Russia, which have, in turn, affected trade, remittances, the subsidiary operation of Russian banks, corresponding banking relationships, payment channels, among other systems. The compounded effect of the two crises has increased the pressure on both the repayment capacity of borrowers and the financial management of banks and other creditors.

Under the current uncertainties, regulators and supervisors in the financial sector are faced with the difficult policy decision of whether to reintroduce or extend temporary COVID-19 measures intended to contain the shocks to the financial system in general and to borrowers in particular, including shocks from the Russia-Ukraine war. Financial regulators in Europe and Central Asia have been withdrawing regulatory forbearance measures since 2021, but the response to this action has varied, and new support measures may be needed to address the fallout from the war in Ukraine. In Central Asia, however, because some of the financial sector regulators and policy makers withdrew regulatory forbearance and other support measures only recently, the pressure on the quality of asset can intensify. In contrast, if support measures stay in place for too long, zombie firms can linger in the economy and reduce productivity and growth in the medium to long term, which, in turn, negatively affects the financial sector.

Rising borrower distress is widely expected to translate into an increase in nonperforming loans (NPLs). The unprecedented COVID-19 crisis measures have masked the real health of the banking sector, particularly in the recognition of NPLs.[3] The lingering effect of the COVID-19

1. FCI Global Practice COVID-19 Financial Policy Response Compendium (dataset) as of March 2022.
2. This report covers four Central Asian countries: Kazakhstan, the Kyrgyz Republic, Tajikistan, and Uzbekistan.
3. World Bank Group, *World Development Report 2022: Finance for an Equitable Recovery* (Washington, DC: World Bank Group, 2022).

pandemic, coupled with the new wave of risks arising from the spillover of the war in Ukraine, rising inflation, tightening monetary policy, and significant economic uncertainty have contributed to reversing the economy recovery in 2022 and the forecast for 2023 in Central Asia. A new wave of defaults on bank loans and other debt could be expected.

Supervisors in the region's financial sector need to be prepared for a potentially sharp rise in NPLs. Close monitoring of asset quality—especially the forward-looking considerations of the borrowers' likelihood to repay—continues to be critical. Supervisors in the region will need to upskill in order to understand and assess forward-looking developments in credit quality. Enhanced measures for banks that are dealing with high NPLs should be introduced.

The efficiency of NPL workouts and the readiness of systems that address insolvency co-determine the resilience of the financial system and its ability to cope with NPLs. Banks in Central Asia have limited options for reducing their NPLs because the practices of court-based settlements, alternative out-of-court workout mechanisms, and NPL portfolio sales are not readily available. Instead, banks primarily work out their NPL portfolios by actively seeking to maximize loan repayments through collateral enforcement.

Insolvency systems in Central Asian countries offer a variety of procedures for addressing the problem. Corporate insolvency laws—although outdated in some countries— have made available a wide array of procedures for debtors and creditors to resolve insolvency. For instance, reorganization allows viable but financially distressed companies to gain some breathing room to restructure. However, this option is rarely used in Central Asia. At the same time, reorganization through the judicial system is not always a fast or economically reasonable solution, especially for micro, small, and medium enterprises (MSMEs). In these cases, out-of-court workouts present multiple advantages, allowing for flexible and confidential alternatives to formally addressing insolvency. Furthermore, while corporate insolvency has drawn significant attention in Central Asia—especially after the Global Financial Crisis—consumer insolvency remains an underdeveloped area where only Kazakhstan and Uzbekistan have recently taken initial steps to adopt a legal framework.

This report assesses the NPL resolution framework in four Central Asian countries (Kazakhstan, the Kyrgyz Republic, Tajikistan, and Uzbekistan) and provides recommendations for improving it. Chapter 1 discusses the current trend in NPLs in Central Asia. Chapter 2 assesses how assets are classified and covered. Chapter 3 reviews the NPL reduction workout techniques practiced in Central Asia. Chapter 4 looks into supervisory measures that can be adapted to reduce NPLs. Chapter 5 reviews the role that the insolvency and creditors' rights framework plays in this process. The report concludes in Chapter 6 with specific recommendations for enhancing the readiness of banks and insolvency regimes for dealing with NPLs. Table 1 summarizes these recommendations.

Table 1. Key Recommendations for Improving the NPL Resolution Framework in Central Asia

(a) Enhancing banking supervision, regulatory frameworks, and the capacity of bank supervisors
1. **Prepare bank supervisors to implement International Financial Reporting Standard 9 (IFRS 9) through the following actions:** a. Set up specialized credit risk modeling teams in banking supervision. b. Develop methodologies and tools to effectively supervise IFRS 9, such as IFRS 9 assessment methodologies and IFRS 9 challenger models. c. Provide training on IFRS 9.
2. **Improve credit risk classification and coverage in Central Asian countries as follows:** a. In the Kyrgyz Republic and Uzbekistan, consider expanding the list of eligible collateral. b. In the Kyrgyz Republic, consider the impact of collateral not only in credit classification but also in credit risk coverage. c. In Tajikistan, consider restricting the definition of NPLs in line with international standards by including only the credit risk exposures that are 90 days past due (DPD) (currently 30 DPD) or that have been assessed as unlikely to pay. d. In the Kyrgyz Republic and Tajikistan, consider defining the loss category with credit exposures that are 360/5 past due instead of the current conservative 180 DPD. e. In Tajikistan and Uzbekistan, consider the higher reserve requirements for certain foreign-currency loans.

3. **Introduce a specific regulation to manage high-NPL banks that includes the following:**
    a. A definition of "high-NPL banks"
    b. General requirements that banks need to meet when managing NPLs
    c. Enhanced requirements applicable to high-NPL banks, such as (a) strategic and operational plans for NPL reduction, (b) standardized information templates that force banks to report the expected (forward-looking) NPL trend during a plan's the time horizon, and (c) independent and well-resourced workout units

(b) Improving insolvency regimes

4. **Improve insolvency legal frameworks, particularly to address the following:**
    a. Including state-owned enterprises under the scope of the insolvency law
    b. Allowing the debtor to obtain new financing
    c. Allowing essential contracts to continue
    d. Promoting the adoption of reorganization plans through "cram-downs"
    e. Introducing out-of-court workout mechanisms
5. **Develop consumer insolvency frameworks (initial work has started in Kazakhstan and Uzbekistan)**

Chapter 1. Nonperforming Loan Trends in the Central Asian Banking Systems

1. Countries in Central Asia have suffered a significant rise in nonperforming loans (NPLs) in the aftermath of the Global Financial Crisis. After years of quick economic expansion facilitated by the easing of financial conditions and inflows of foreign direct investment, the Global Financial Crisis triggered a large increase in NPLs. The crisis also resulted in large bank failures in the region, especially in Kazakhstan. A few years later, the Russian Financial Crisis in 2014–15 renewed the pressure on asset quality in the banking sector. In Tajikistan, for example, a deterioration in asset quality affected by weak governance and related party lending, among other factors, resulted in the failure of two systemic banks and two smaller institutions, shaking the financial stability of and the overall trust in the banking sector. Kazakhstan, too, faced further systemic bank failures.

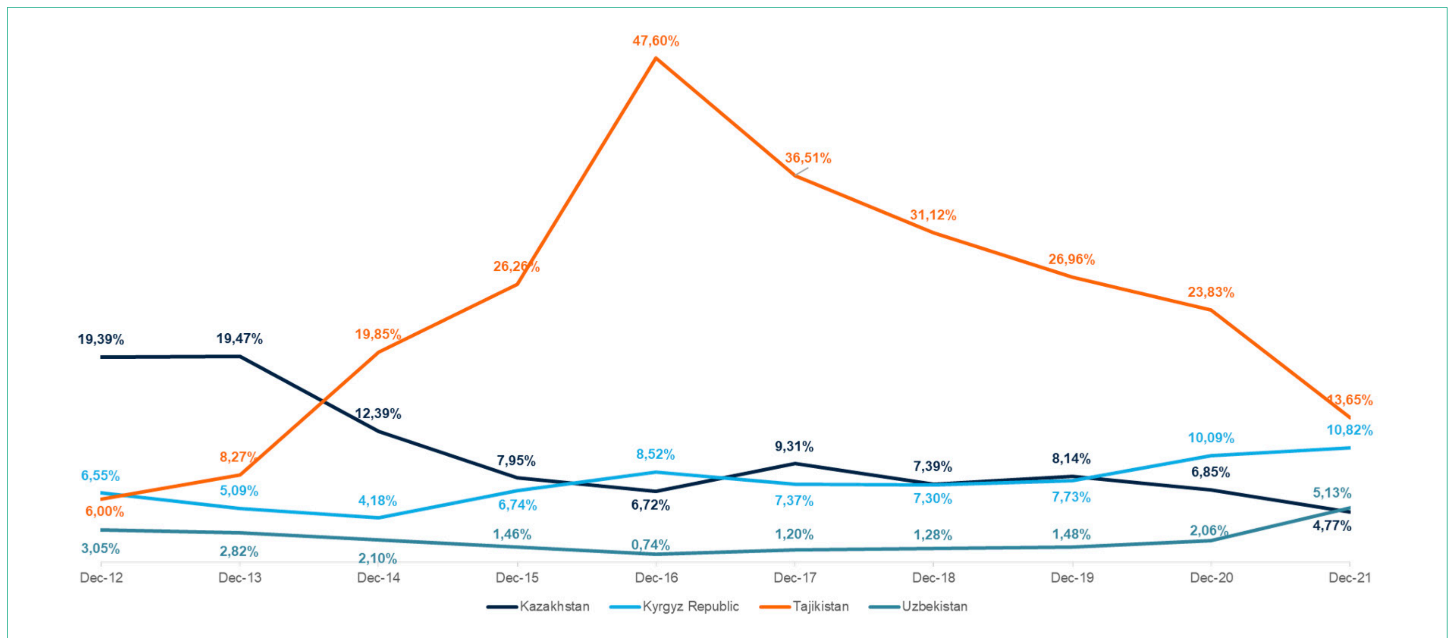
2. Facing these crises in the banking sector, the countries in Central Asia implemented significant reforms to ensure adequate loan classification and coverage and sound risk management. Following the Global Financial Crisis and especially after 2015, financial regulators and supervisors in Central Asia implemented significant reforms in two important areas, among others: (a) the rules for asset classification and coverage and (b) new standards for credit.

3. The reforms, coupled with economic growth and more prudent policies, have resulted in the reduction of NPLs. NPL ratios saw a sharp downward trend owing to economic growth that caused robust loans to grow faster than new NPLs and write-offs. The most significant trend was a reduction in the NPL ratio in Tajikistan, where the ratio dropped from about 47 percent in 2016 to 13–15 percent during 2021. This change is largely explained by drastic actions taken in the financial system (that is, the liquidation of several banks), the strengthening of the regulatory regime for NPLs, and the improvement of the economy.

4. Despite these gains, the COVID-19 crisis has stopped the NPL downward trend in some countries. In the Kyrgyz Republic and Uzbekistan, the NPL ratio has increased because of recessions induced by COVID-19, although in Uzbekistan, the rise comes from a low base. In

Tajikistan, the NPL level in the banking sector has stabilized after it had already dropped, whereas in Kazakhstan, the ratio continued its decline in 2021. Interestingly, the evolution of the NPL level across the Central Asian countries exhibits significant variation (figure 1).

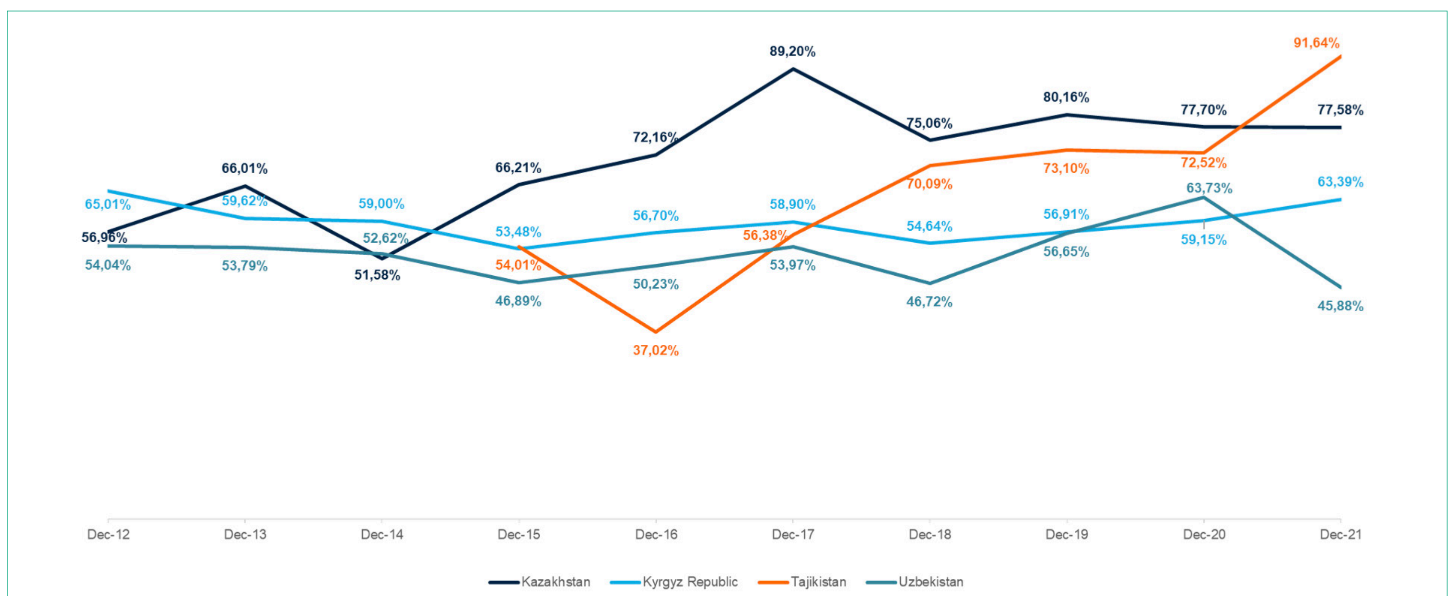
Figure 1. Evolution of NPL Ratios in Central Asian Countries



Source: International Monetary Fund data. For Kazakhstan, the 2021 data are from the second quarter.

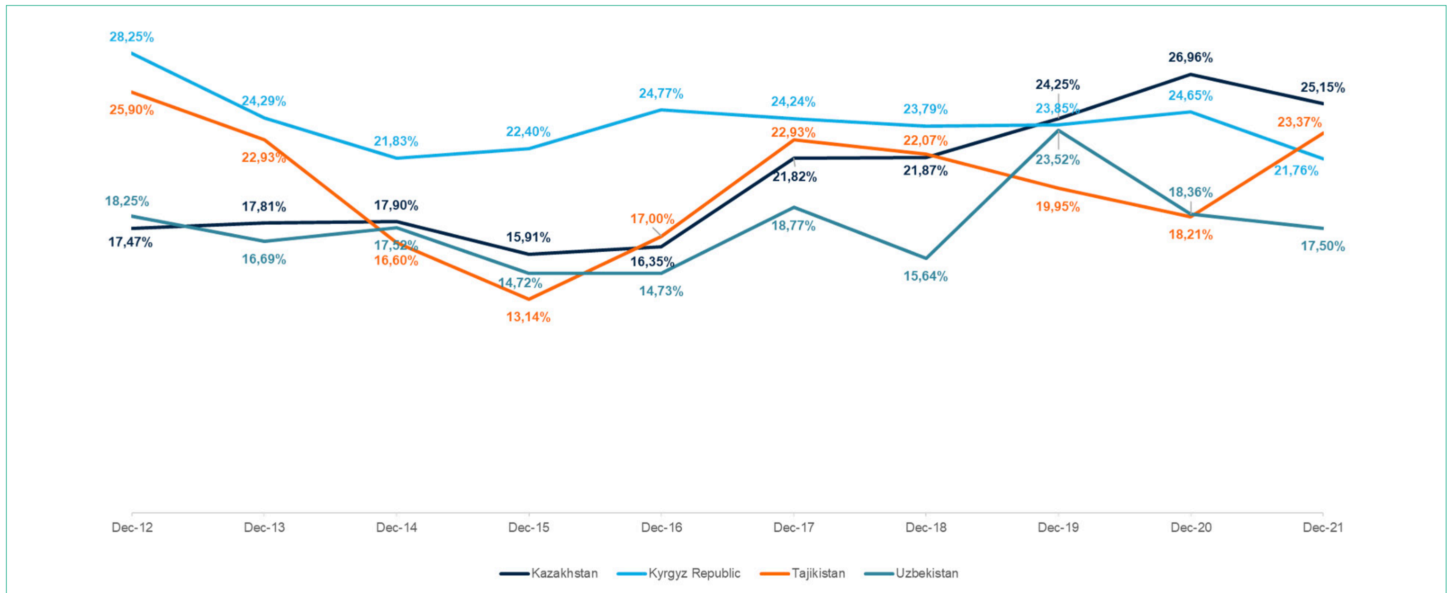
5. On a more positive side, the banking sector's capacity for absorbing losses remains largely sound. NPL coverage ratios are at robust levels, especially in Kazakhstan and Tajikistan (figure 2). In addition, capital ratios continue to be at very high levels in all the Central Asian countries (figure 3). Adequate bank capital and NPL provisioning are the first lines of defense against further losses from NPLs.

Figure 2. Evolution of NPL Coverage Ratios



Source: International Monetary Fund data. For Kazakhstan, the 2021 data are from the second quarter.

Figure 3. Evolution of Solvency Ratios in Central Asia Countries



Source: International Monetary Fund data. For Kazakhstan, the 2021 data are from the second quarter.

Chapter 2. Asset Classification and Coverage

6. Countries in Central Asia significantly enhanced their regulatory standards on credit classification and coverage in the past several years, but some gaps remain. The central banks in the Kyrgyz Republic, Tajikistan, and Uzbekistan have maintained their respective loan classification and coverage standards, which are largely based on the days past due (DPD) of a delinquent loan and on predetermined fixed rates linked to those categories. In Tajikistan and Uzbekistan, there are five categories of loan classification, and in the Kyrgyz Republic, there are six. At the same time, these three Central Asian countries have rolled out new rules on the following three classification issues, among others: (a) forborne loans, including the definition of restructuring and refinancing, and the classification of forborne loans; (b) the requirements for reclassifying a loan that is not overdue but for which there is evidence that the borrower may be unable to pay; and (c) how collateral is considered when determining the loan-loss reserves. In these three countries, banks are currently subject to a dual regime in which credit losses are calculated for financial reporting based on the International Financial Reporting Standards (IFRS), but the regulatory reserves, relevant to regulatory reporting and the calculation of loan-loss reserves for prudential standards,[4] follow the central bank's regulations. Whereas supervisors are largely focused on prudential calculations, concern is naturally growing over the soundness of the estimations of expected losses that banks use for calculating the loan-loss provisions for their financial reporting.

7. In 2018, Kazakhstan's National Bank introduced a regime that requires banks to quantify their loan losses for prudential purposes according to IFRS 9 expected losses, becoming the first country in the region to do so.[5] Under this policy, banks must estimate their loan reserves using their risk parameters, including probability of default (PD), loss given default (LGD), and exposure at default (EAD). The introduction of these rules has been accompanied by the amendment of the Risk Management Regulation[6], which requires banks to develop their own credit risk models and integrate them into their credit risk underwriting and monitoring standards.

4. Including solvency, leverage ratios, or large exposure limits, among others.
5. See Regulation 269, approved by resolution of the Board of the National Bank of the Republic of Kazakhstan, dated December 22, 2017.
6. See Regulation No 188, approved by resolution of the Board of the National Bank of the Republic of Kazakhstan, on "Rules for Formation of Risk Management and Internal Control Systems for Second Tier Banks"

The framework was strengthened in 2021 with new rules that require the use of certain indicators to reclassify assets to stage 2 and 3, bringing the classification criteria broadly in line with IFRS standards. The framework has also introduced backstops on the calculation of expected losses, such as minimum expected losses coverage by stage or minimum haircuts that banks must consider for collateral valuations when quantifying the expected losses. There are, however, outstanding gaps in this framework, and the World Bank team has provided advice to the National Bank of Kazakhstan to eliminate them and enhance the regulatory framework. Table 2 summarizes the loan classification and coverage framework in Central Asia.

Table 2: Cost of Housing (IQD, millions)

	Kazakhstan	Kyrgyz Republic	Tajikistan	Uzbekistan
Loan categories	3 stages (IFRS 9)	6 (3 NPL)	5 (3 NPL)	5 (3 NPL)
Definition of NPLs	> 90 DPD + UTP	> 30 DPD + UTP	> 30 DPD + UTP	> 90 DPD + UTP
Loan forbearance	Comprehensive rules on identification and coverage	Comprehensive rules on identification and coverage	Comprehensive rules on identification and coverage	Comprehensive rules on identification and coverage
Losses/write-offs	As per the bank policy	180 DPD as threshold for the loss classification	180 DPD as threshold for the loss classification, two years for write-offs	365 DPD as threshold for the loss classification
Minimum loan-loss provisions	Dependent on the expected losses	Fixed and increasing	Fixed and increasing	Fixed and increasing
Treatment of collateral	Embedded in the calculation of expected losses, haircuts defined	Very limited recognition in the asset classification	Broad recognition in the asset coverage, including minimum haircuts	Limited recognition in the asset coverage

Note: DPD = days past due; IFRS = International Financial Reporting Standards; NPL = nonperforming loan; UTP = unlikeliness to pay.

8. Kazakhstan's NPL regime strikes a good balance between fostering the development of credit risk modeling capabilities and estimating credit losses conservatively. Although there is a room for improving this regime, particularly with respect to reinforcing the criteria for unlikeliness to pay (UTP) and to identifying and reporting of forborne loans, the regulatory regime provides a good starting point in these areas, and the National Bank of Kazakhstan should focus on oversight of the sound implementation of this policy by the banking sector. In doing so, the bank should build the capacity of its supervisory staff by enhancing their skills in assessing credit losses and developing tools that can equip them to challenge the models developed by banks in estimating expected losses. These tools may include challenger models and supervisory guidance on assessing expected credit losses.

9. Regulators in the Kyrgyz Republic, Tajikistan, and Uzbekistan need to consider aligning the asset classification and coverage standards that they use for regulatory reporting with an IFRS 9 approach to expected losses. However, the timing of the introduction should be carefully planned. Regulators will need to assess whether the banking sector has capabilities for estimating expected losses and whether their own supervisory capacity is prepared to challenge these estimates, especially to avoid losing control over the loan-loss reserves of banks, potentially by maintaining a parallel calculation during the first few years. The loan staging and credit coverage under IFRS 9 are explained in box 1.

BOX 1. LOAN STAGING AND CREDIT COVERAGE UNDER IFRS-9

Stage 1 corresponds to fully performing loans. Stage 2 loans (underperforming) are those for which there has been a significant increase in credit risk since they were originated, whereby the pricing of the loan may be no longer sufficient to compensate for the credit risk that the loans carry. Stage 3 loans (nonperforming) are those that have defaulted (understood as having overdue amounts for more than 90 days) or that are otherwise unlikely to pay. Banks should calculate the expected losses for one year only; however, they should set aside loan-loss reserves for those classified in Stage 2 or 3 that cover the lifetime expected losses of those loans. Therefore, a classification from Stage 1 to Stage 2 commonly results in a material increase in loan-loss provisions.

One of the main challenges of implementing a loan classification and coverage regime based on IFRS 9 is that banks should develop their capacity to calculate their expected losses, as this is essential not only for asset coverage but also for asset classification. The most relevant trigger for classifying loans from Stage 1 to Stage 2 is usually an increase in a loan's probability of default since inception. Therefore, banks should be able to evidence their capability for calculating, for every loan, the risk parameters required to estimate the loan's expected losses, particularly the probability of default (PD), the loss given default (LGD), and the exposure at default. Banks are expected to estimate these parameters by using historical data on the defaults and on losses for the defaulted loans that can feed into their own models for estimating the PD and the LGD, which will be used to calculate the expected losses on a loan-by-loan basis. Ideally, banks should use their own historical data from their loan portfolios and develop their own model capabilities to estimate the relevant risk parameters. Nevertheless, this may not be completely possible—especially for small, unsophisticated banks—because they may have neither the requisite data nor the modeling capabilities. Experience has shown that in such cases, banks are likely to "buy" both the data and the modeling capabilities from third parties (that is, Big 4 audit firms, private credit bureaus, and consulting companies), resulting sometimes in limited ownership of both the inputs and outcomes of the process.

10. The IFRS 9 regime for expected loss-based classification and coverage has undeniable advantages. The implementation of this regime encourages banks to develop their own internal credit risk capabilities, potentially resulting in a more accurate measurement of credit risk, a more risk-based loan pricing, earlier action against delinquent loans, and, overall, a better understanding of the dynamics and risks of their loan portfolios. Furthermore, banks that use IFRS rules in their financial reports, including banks in the four Central Asian countries, align their supervisory reporting with financial reporting, making it easier for them to integrate the loan-loss provisions into their credit risk management framework. Furthermore, accounting for expected losses can also force the early recognition of problems in the loan portfolio, as the change in credit risk in the loan should quickly translate into higher expected losses, enabling banks to take early actions against delinquent borrowers.

11. However, an IFRS 9-based regime for prudential asset classification and coverage requires both the banking industry and its supervisors to enhance their capacity. First, less sophisticated banks may not have access to the data and modeling capabilities that the calculation of expected losses requires, and they may end up effectively outsourcing the full process to third parties, resulting in lack of ownership of the process, a poor awareness of their credit risk, and the inability to integrate the expected losses into their credit risk underwriting, monitoring, and workout processes. Second, allowing banks to fully apply the IFRS 9 for asset classification and coverage may bring significant challenges for banking supervisors, who would need to develop their own capabilities to verify and, if necessary, to challenge the banks' estimated losses. Supervisors in the Kyrgyz Republic, Tajikistan, and Uzbekistan have little experience in statistics because credit risk modeling has been largely absent in these countries.[7]

7. Unlike most European countries, none of these countries allows banks to calculate their credit risk-weighted assets by using internal models, because capital requirements regimes are usually based on a mix of Basel I, II, and III. Nor have they used bottom-up stress testing to estimate future losses for the banks' loan portfolios. Therefore, the experience in credit risk modeling at this stage in the central banks is rather limited to financial stability top-down basic credit loss forecasting.

12. The current level of capacity in the banking sector and its supervisors in these three Central Asian countries necessitates accelerated reforms in order to introduce and implement an IFRS 9 approach for asset classification and coverage. Both banks and supervisors are not well prepared or equipped to migrate to an IFRS regime. However, central banks in the Kyrgyz Republic and Uzbekistan are taking measures to train their supervisors in overseeing expected-loss accounting models. This is a step in the right direction because sooner or later, they will have to adopt an expected-loss regime.

13. During the transition period, central banks in the Kyrgyz Republic, Tajikistan, and Uzbekistan may consider introducing backstop measures. Some countries, including Kazakhstan, have implemented regimes that force banks to estimate expected losses while preserving some rules ("regulatory backstops") that impose certain limits on features such as minimum loan stage coverage or collateral haircuts. Bosnia and Herzegovina banking agencies have implemented a regime that imposes additional criteria for reclassifying loans in stages 2 and 3, imposing minimum expected losses for loans classified in stages 1 and 2 that are higher for banks that are unable to estimate their expected losses and laying out minimum haircuts for collaterals when estimating their expected losses. The Bank of Spain has created a two-tiered regime. Sophisticated banks are allowed to calculate their own expected losses with their own models if they can meet the qualitative requirements laid out in the regulation. Less sophisticated banks that are unable to calculate their own risk parameters must determine their loan reserves by using standardized percentage losses that have been calculated by the supervisors on a portfolio basis using historical information on credit losses. While these regimes may strike a balance between aligning the regulatory regimes and the accounting rules, central banks should be aware that the stricter the backstops, the higher the risk that the regulatory regimes may be considered noncompliant with the IFRS 9 accounting regime.

14. Central Asian countries should examine relevant international experience in migrating to expected loss models to understand what tools supervisors can use to challenge banks' estimates (for example, challenger models, guidance in assessing expected losses, minimum requirements applicable to banks, and so forth). Furthermore, these countries should continue their engagement with the banking sector and with audit firms to gather evidence on the main challenges that the implementation of these regimes may bring and the gaps that may remain after implementation. Since 2018, second-tier banks in Kazakhstan have already been subject to a loan classification and coverage regime that is largely based on IFRS 9. The challenges for them are to continue to build capacity and equip supervisory staff with appropriate supervisory tools.

USE OF THE UNLIKELINESS TO PAY CRITERIA

15. UTP criteria are universally used to classify assets into the nonperforming categories. UTP criteria ensure that banks classify assets into the substandard or doubtful categories based on criteria other than DPD. This is particularly relevant in the context of a bank's forbearance practices and may be even more relevant in the current context of tightening global monetary policy conditions that threaten the balance sheets of households and corporations.

TREATMENT OF LOAN FORBEARANCE

16. To cope with shocks induced by COVID-19, the Central Asian countries introduced measures for the classification and coverage of restructured and refinanced loans (forborne loans); hence the term "forbearance measures." Weak forbearance measures can easily undermine loan classification and coverage standards, allowing a loan to be restructured several times to rehabilitate it or to avoid reclassifying it into one of the nonperforming categories. All four Central Asia countries have the following simple, but mostly effective, rules for accounting for forborne loans: (a) defining forborne loans largely on the basis of the provision of a credit concession, (b) the mandatory reclassifying of forborne loans to worse categories, and (c) defining probation periods for reclassifying a loan to a better category and for not identifying it as forborne. All four countries in this report have abolished the special forbearance rules, with the Kyrgyz Republic being the last country in the region to lift the measures, after renewing them several times.

COLLATERAL TREATMENT

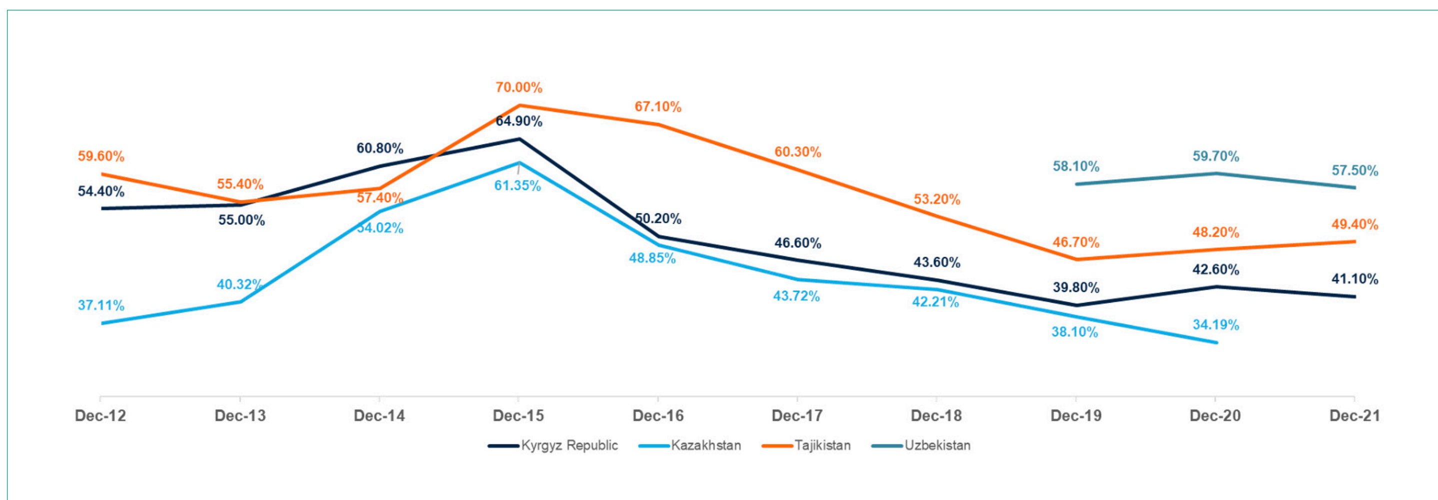
17.The four Central Asian countries treat collateral differently for both asset classification and coverage. The Kyrgyz Republic and Uzbekistan accord very limited recognition to collateral for the purpose of asset classification and coverage. In the Kyrgyz Republic, only high-quality collateral[8] is eligible for classifying a loan as "normal."[9] In Uzbekistan, eligible collateral is likewise restricted to high-quality liquid assets[10] for the purpose of calculating the loan coverage. In Tajikistan and Kazakhstan, on the other hand, there is a broad recognition of collateral, including not only high-quality liquid assets, such as government securities or bank deposits, but also guarantees or residential real estate. In both countries, the regulations prescribe minimum haircuts for the eligible collateral. In Tajikistan, the haircut collateral is deducted from the loan exposure to determine the unsecured portion of the loan, whereas Kazakhstan considers the haircut collateral in estimating the expected credit losses.

18. If collateral was recognized more broadly, banks might feel encouraged to more actively pursue credit risk mitigation techniques, including, for example, providing mortgage loans that consider loan-to-value ratios, potentially resulting in lower credit losses for the banking sector. Uzbekistan and the Kyrgyz Republic may broaden the eligible collateral, subject to prudent haircuts and appraisal rules. Furthermore, the Kyrgyz Republic may also consider collateral when calculating the applicable credit reserves.

OTHER RELEVANT ASPECTS IN ASSET CLASSIFICATION AND COVERAGE: LOANS DENOMINATED IN FOREIGN CURRENCY AND ASSET QUALITY REVIEW

19. The banking sectors in the Central Asian countries are heavily dollarized. Providing loans denominated in a foreign currency can expose borrowers to market risk that can translate into credit risk for the banks, especially for unhedged borrowers who do not receive their revenues in the currency in which the loan is denominated. The share of liabilities denominated in a foreign currency to total liabilities in Central Asia has somewhat decreased over the past decade, but it has been persistently high at 35 to 60 percent depending on the country (see figure 4). On the other hand, the share of foreign-currency loans to total loans has decreased sharply in the last years in Kazakhstan, the Kyrgyz Republic, and Tajikistan, although in the latter two countries, the ratio is still high (see figure 5). The Kyrgyz Republic assigns a higher risk weight when the loan has been provided in foreign currency to a borrower who does not have a material portion of its revenues denominated in the foreign currency. Tajikistan has also defined rules to establish an add-on for the coverage of foreign-currency loans. Neither Kazakhstan nor Uzbekistan has established rules for imposing higher provisioning levels for foreign-currency loans. While banks in Kazakhstan may well consider the currency of the denomination of the loan when estimating expected losses, not all banks in Uzbekistan are likely to do so, but the supervisors may consider the possibility of setting specific rules for covering foreign-currency loans.

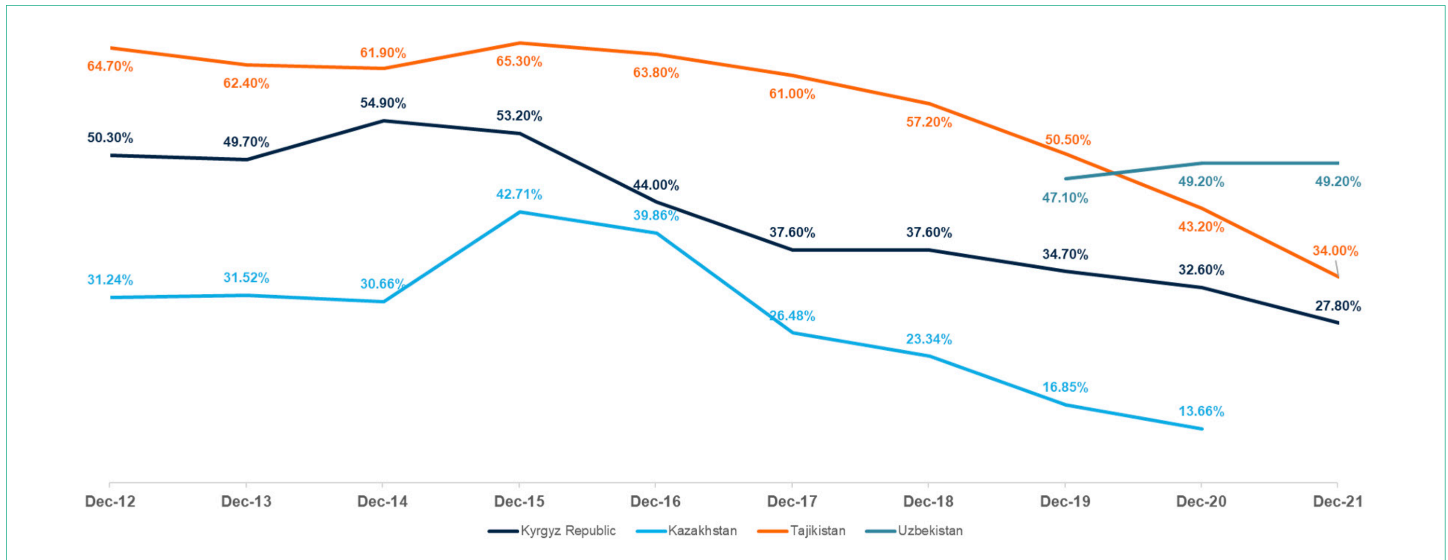
Figure 4. Foreign Currency–Denominated Liabilities to Total Liabilities



Source: International Monetary Fund data.

8. Eligible collateral is limited to government securities issued by the Kyrgyz Republic, pledged deposits in the bank, other securities in the Kyrgyz Republic Stock Exchange, and pledged gold.
9. "Normal" means the safest category and the one with the lowest minimum provisioning levels (0 percent).
10. These assets are government securities; pledges of deposits in the bank; or guarantees by central banks, governments, or international organizations.

Figure 5. Foreign Currency–Denominated Loans to Total Loans



Source: International Monetary Fund data.

20. Kazakhstan has been using an asset quality review (AQR) as part of its supervisory review process. In 2019, the country launched an independent AQR that was based on the European Central Bank's methodology and covers 14 banks, or 87 percent of all banking assets. The exercise was coordinated by Oliver Wyman, and the participants were the main international audit firms as well as about 70 appraised companies. As a result of the exercise, the Kazakh supervisor, the Agency for Financial Regulation and the Development of the Financial Sector, defined supervisory plans and measures for the 14 participating banks. It is expected that the regular AQR will be conducted on a yearly basis, although the full-scale independent AQR will be implemented only every five years. The other three Central Asian countries have not conducted any type of AQR.

CREDIT RISK MANAGEMENT STANDARDS

21. The Central Asian countries have been strengthening the credit risk management standards in their risk management regulations. In all four countries, the regulations require sound credit risk management, including close involvement of the bank's board of directors and the preparation of a credit risk strategy, policy, and appetite. Furthermore, banks are asked to institute sound underwriting standards that include an assessment of the affordability of the loans and the solvency of the borrower. In particular, Kazakhstan,[11] Tajikistan,[12] and Uzbekistan have recently tightened their requirements for credit risk management. Kazakhstan's new standards require banks to apply sound credit risk underwriting standards for the clients who, among other requests, ask for the expected losses to be calculated when the loan is originated.

11. See the amendments to Regulation 188 of the National Bank of Kazakhstan on the rules for the formation of risk management and internal control systems for second-tier banks.
12. See Regulation 247 of the National Bank of Tajikistan in the Risk Management and Internal Control System (2021).

Chapter 3. Workout Techniques for Reducing Nonperforming Loans in the Central Asian Region

22. Banks can use any of the following common mechanisms to reduce NPLs: (a) rehabilitating loans through the successful collection of repayments, loan restructuring or refinancing, or other amicable settlements involving debt forgiveness or court settlements of the amounts due; (b) foreclosing on collateral through either court-based foreclosure procedures or voluntary, out-of-court debt-to-equity swaps; (c) writing off loans that have been classified as nonperforming over a long period of time, (d) selling NPLs or NPL portfolios to third-party investors; and (e) selling NPLs or NPL portfolios to a state-owned asset management company (AMC) or bad bank.

23. Banks in Central Asia primarily work out their NPL portfolios by maximizing loan repayments or restructuring defaulted loans. For borrowers who have seen their repayment capacity adversely affected but who are still willing and able to make loan repayments, the preferred solution is to restructure or refinance the loan to adjust to the new repayment capacity of the borrower. For example, the maturity of the loan can be extended, grace periods can be given, debts can be consolidated under a new single loan, and payments can be reduced for a specific period of time. Loan restructuring has been widely used to accommodate repayments during the COVID-19 pandemic, especially in the Kyrgyz Republic. Overall, bank supervisors should be vigilant to ensure sound registration of restructured loans and to safeguard that this option is not used to avoid reclassifying loans as NPLs. Nevertheless, when a borrower is uncooperative or has seen its repayment capacity severely impaired to the extent that it may be no longer viable, the banks should avoid restructuring the loan and try instead to maximize their chances of recovering the debt first through amicable settlements, potentially with debt forgiveness, and when this is not possible or desirable, through court settlements.

24. For certain secured portfolios, such as mortgage lending, banks can maximize recoveries through collateral foreclosures or debt-to-equity swaps. For secured/mortgage borrowers who have seen their revenues reduced to a level that makes their loan unaffordable, restructuring is not a viable alternative. In these circumstances, amicable settlements can involve debt-to-equity swaps, in which the borrower voluntary agrees to transfer the property of the collateral to the lender in exchange for debt relief. This approach could also cover debt forgiveness when the borrower is cooperative and has no other means to repay the loan. However, when the borrower is uncooperative, the lender may seek to recover the debt by initiating foreclosure procedures in courts, with the target of gaining control of the collateral in the process. Secured lending to individuals, especially mortgage lending, is rather limited in Central Asian countries. Ineffective and slow national court procedures can also undermine both voluntary and court-based settlements, as borrowers see their legal position strengthened by the lack of alternatives through which lenders can enforce the terms that govern collateral.

25. Loan write-offs are another way to actively reduce NPL levels. Writing off an NPL removes it from a bank's balance sheet, so it is no longer reflected as an NPL. While the regulations in Central Asian countries do not include specific thresholds for loan write-offs,[13] they facilitate and encourage them, as per the definition of losses (that is, the loans that should be written off). The Kyrgyz Republic and Tajikistan are very conservative in using 180 DPD as the threshold for writing off a loan, while Uzbekistan uses 365 DPD. Because loans classified as losses should be fully covered with loan-loss reserves, banks have a clear incentive to write them off. Although write-offs are a common way to reduce NPLs, this measure does not in any way imply stopping the actions for recovering a loan.

26. NPL portfolio sales are currently not a viable alternative in Central Asian countries. NPL portfolio sales can be used to swiftly reduce the NPLs, as their ownership and management is transferred to a third-party investor. Portfolio sales have other benefits, such as allowing a bank to focus on its core business, which frees up resources that are tied to bad loans workouts. The existence of a secondary market for NPLs requires several preconditions, such as a credible framework for court-based recoveries, third-party recovery agencies to which banks outsource the loan workout for certain portfolios, and, finally, investors with sufficient capacity and knowledge to value and bid for the NPL portfolios. There are no NPL markets in any of the Central Asian countries to date, although Kazakhstan is taking measures to create the legal and economic conditions to develop a viable NPL market.[14]

27. The transfer of NPLs to publicly owned AMCs could be a mechanism for rapidly cleaning up the balance sheets of the private sector; however, the use of AMCs in this way has many well-known risks. Among other factors, risks determine the transfer price, the use of public funds to buy private assets, the inefficiency in the recovery process, and the political risks embedded in the management of NPLs. The use of AMCs in the region during the past few years has been limited to Kazakhstan,[15] where the Problem Loans Fund (PLF), first owned by the National Bank of Kazakhstan and then by the Minister of Finance, has been used to remove large amounts of NPLs from the problem banks' balance sheets.[16]

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13. Nevertheless, in Tajikistan, banks should provide a clear explanation for retaining in their balance sheets loans that are beyond two years past due. Although this rule cannot qualify as a threshold for loan write-offs, it informally signals the expectation that banks should write off the loans that have been past due for more than two years.
14. Kazakhstan has prepared a draft Law on Distressed Assets that (a) expands the possible types of organizations that can acquire distressed assets, allowing private investors to participate in the acquisition of small and medium enterprise and corporate portfolios but excluding retail portfolios, and (b) establishes a regime for servicing companies such that the management of NPLs can be outsourced by banks and other financial institutions, and AMCs and debt collection agencies can be eligible as servicing companies.
15. The Kyrgyz Republic has used a state-owned bad bank (DEBRA) to acquire bad loans from failed banks. Although DEBRA still continues to operate, it has not been used in the past 10 years to buy assets from any failed banks.
16. In 2020, the PLF also provided guarantees to parts of the NPL portfolio of several banks. Through this approach, the banks can continue managing the NPLs, whereas the credit risk is transferred from the banks' balance sheets. This "synthetic" approach has several benefits over the outright purchase of the loans, such as avoiding the large amount of funding needed to acquire the assets and ensuring that the bank continues to manage NPLs.

Table 3. Mechanisms for Reducing NPLs in the Central Asian Region

	Definitions	Availability in Central Asia and key success drivers	Relevance
1. Repayments/cures	• Defaulted loans can be actively managed toward rehabilitation. • Successful restructuring/refinancing can help to accommodate a borrower's installments to the new payment capacity.	• Broadly available and used throughout the region • Availability of workout units, restructuring, and other amicable settlements tools are the key drivers of success	**Very high**
2. Foreclosures/debt-to-equity swaps	• Banks can recover an NPL by foreclosing on collateral or by accepting debt-to-equity swaps.	• Applicable to mortgage/secured portfolios only • The ineffectiveness of the court foreclosure procedures influences the possibility of achieving successful settlements through foreclosures.	**Low**
3. Portfolio sales	• Banks can quickly reduce the number and amount of their NPLs by selling them to third-party investors	• Absence of secondary developed markets for NPL portfolios • Kazakhstan is making strides toward developing active markets for NPL transactions • Other countries remain largely undeveloped	**Low**
4. Write-offs	• Banks can reduce the number and amount of their NPLs by writing off loans.	• Countries in Central Asia impose strict rules on fully provisioning NPLs (that is, as soon as 180 DPD in the Kyrgyz Republic and Tajikistan) • Loan write-offs can contribute to quickly reducing NPLs	**High**
5. AMCs	• Banks may be able to reduce their NPL levels by transferring them to an AMC.	• Significant use in Kazakhstan in the past few years (PLF), largely absent in the Kyrgyz Republic, Tajikistan, and Uzbekistan • Huge implications for fiscal sustainability, market incentives, and long-term management of problem loans	**Low**

Note: AMC = asset management company; DPD = days past due; NPL = nonperforming loan; PLF = Problem Loans Fund.

28. In summary, banks in Central Asia have limited options for reducing their NPLs because two of the main avenues for doing so—court-based settlements and NPL portfolio sales—are not readily available (see table 3). Court-assisted recoveries are affected by protracted legal processes in clogged courthouses and by usually overwhelmed and often unprepared judges. The secondary market for NPLs has been hardly developed across the region. Whereas efforts are being made in Kazakhstan to create an active market for NPL sales, the current situation is hardly promising in the other three countries.

Chapter 4. Supervisory Measures to Encourage NPL Reduction

29. Banking supervisors have been paying more attention to the negative effects of NPLs on the solvency and the viability of banks. Regulators have launched several initiatives for banks identified as outliers based on their NPL levels. Among other actions, regulators have issued guidelines that detail the expectations that banks need to meet when managing NPLs.[17] The guidelines are comprehensive and cover all aspects of the process related to workout, from setting the strategy for managing NPLs, to ensuring the availability of sufficient human and technical resources to work out the delinquent loans, and to setting the rules for recognizing and measuring NPLs for valuating collateral.

30. Supervisors apply enhanced measures to banks that have high levels of NPLs. These banks are automatically subject to mandatory enhanced measures,[18] including the following:

a. **Annual strategic and operational plans for reducing NPLs.** Banks are asked to set their targets for reducing NPLs on a short- and medium-term horizon, with the breakdown by portfolios (for example, corporate, small and medium enterprises [SMEs], retail, and so forth) and by workout mechanism (for example, repayments, cures, write-offs, portfolio sales, and so forth). The banks' plans are expected to be approved by their boards of directors, and the performance must be reported to the supervisor several times throughout the year.

b. **Dedicated workout units.** Banks need to create a workout unit that reports directly to the management of the bank and is functionally separated from both the lending unit and the risk management unit. The workout unit should have sufficient technical, human, and financial resources to actively manage the NPL portfolio and reduce it to the level set by the bank's board in its strategy.

c. **Regular reporting.** Banks need to report their projections of NPLs with additional templates that break down the evolution of their different portfolios.

17. See, for example, European Banking Authority, *Final Report—Guidelines on Management of Non-performing Loans and Forborne Exposures* (EBA/GL/2018/06, Paris: EBA, October 31, 2018); and European Central Bank, *Guide to Banks on Non-performing Loans* (Frankfurt, Germany: European Central Bank, March 2017).
18. Some supervisors of banks with high and persistent levels of NPLs have required the banks to reduce these levels below a predetermined point over a specific time horizon. For example, certain Cypriot, Greek, and Italian banks have taken this approach when the levels of NPLs were well above 10 percent of their total loan portfolios.

31. The use of these supervisory tools has been uneven across Central Asia. The Central Bank of Tajikistan has issued, with the support of the World Bank, a guideline that requires banks to prepare action plans for NPL reduction together with specific, forward-looking NPL reporting templates that banks need to periodically complete and submit to their supervisor. Banks prepared the plans for the first time in 2017 and have updated them recurrently through 2020. The plans may have been essential in reducing NPL levels in Tajikistan from as high as close to 50 percent in 2017 to a low of about 14 percent as of this writing. Likewise, Kazakhstan's AFR agreed with 14 banks in 2020 to prepare actions plans for reducing NPLs; this agreement was an outcome of the AQR exercise conducted in 2019.[19] Supervisors in the Kyrgyz Republic and Uzbekistan have not requested banks with high levels of NPLs to prepare strategic or operational plans.

32. Against the current macroeconomic backdrop, bank supervisors in the region should speed up their preparations for a potential sharp rise in NPLs. In light of the lingering effect of the COVID-19 pandemic coupled with the new wave of risks arising from the spillover of the war in Ukraine, tightening global monetary conditions, and significant economic uncertainty, bank supervisors in the region need to be prepared for a potential sharp rise in NPLs. Financial regulators and supervisors can take the following immediate actions: (a) prepare detailed regulations on the management of NPLs, (b) request supervised banks with high levels of NPLs to prepare strategic and operational plans for reducing them, (c) require supervised banks to strengthen their workout units, and (d) enhance supervisory capacity to ensure a readiness to assess the workout capabilities across the banking sector.

19. In 2019, the NBK conducted an AQR of the top 14 banks in Kazakhstan. The selected banks accounted for 87 percent of the total banking assets in the country and 90 percent of the total loan portfolio of the banks. The review sought to ensure that the bank was adequately capitalized after fully reviewing the credit classification and coverage of the main loan portfolios. In accordance with the AQR results published on December 30, 2019, no capital shortfall was observed at the banking system level (aggregating results of the participating banks).

Chapter 5. Insolvency Frameworks and Creditors' Rights in NPL Resolution

33. Effective insolvency and creditor rights (ICR) regimes facilitate the expeditious resolution of NPLs. Growing empirical evidence shows that the effective protection of creditors' rights mitigates the risk of banks' exposures, which, in turn, promotes financial sector resilience and access to financing at more affordable rates.[20] Once banks and financial institutions have exhausted their internal debt recovery procedures, they rely on the legal framework to assist them in either restructuring or recouping defaulted loans. Two sets of laws are particularly critical to expediting the resolution of NPLs: (a) enforcement laws, which protect the claims of individual creditors by allowing them to ensure they are repaid through access to collateral, and (b) insolvency laws, which provide an organized collective enforcement regime designed to protect the entire pool of creditors, as well as the debtor, and to maximize this collective recovery. In a post-COVID-19 environment, the role of robust insolvency systems is even more critical in freeing up capital so that it can be applied to more productive uses.[21]

34. ICR systems in the four Central Asian countries provide for a variety of insolvency procedures. All four countries have adopted corporate insolvency laws, although only Kazakhstan's law can be characterized as reasonably modern.[22] In contrast, the insolvency laws of the Kyrgyz Republic, Tajikistan, and Uzbekistan[23] were adopted shortly after they achieved independence or in the early 2000s and have been subject to only cosmetic improvements since they were enacted. One feature that stands out in these laws is the wide array of procedures made available to debtors and creditors for addressing insolvency (figure 6). The laws of Kyrgyz Republic and Uzbekistan, in particular, provide for multiple procedures, many of which can be characterized as reorganization procedures. This development can be considered a

20. See World Bank Group, *How Insolvency and Creditor-Debtor Regimes Can Help Address Nonperforming Loans* (Washington, DC: World Bank Group, 2021).
21. See World Bank Group, *Insolvency Systems and Zombie Firm Proliferation in High- and Middle-Income Economies* (Washington, DC: World Bank Group, 2022).
22. Law on Rehabilitation and Bankruptcy, March 7, 2014, No. 176-V, https://online.zakon.kz/Document/?doc_id=31518958. The law in Kazakhstan includes more advanced practices (compared with the laws in the Kyrgyz Republic, Tajikistan, and Uzbekistan) that align with international standards. The practices include, for instance, the treatment of state-owned enterprises and the confirmation of essential contracts.
23. A new Law on Insolvency of Uzbekistan took effect on April 13, 2022, replacing the Law on Bankruptcy, No. 1054-XII, May 5, 1994. The Law on Insolvency is available at https://lex.uz/ru/docs/6352957 . This report has, however, assessed the 1994 Law on Bankruptcy, as it was the law applicable when the report was being prepared, and not all chapters of the 2022 law were in force by the end of 2022. We recommend conducting a follow-up study to analyze the effects of the newly adopted provisions on the insolvency regime in Uzbekistan.

positive one in the region, as it is generally considered good practice for the ICR system to offer a "menu of options" to debtors and creditors so that they can choose the procedure that best suits their needs. However, these procedures can potentially overlap and create unnecessary complexities that may discourage their use.[24]

Figure 6. Insolvency Options in the Four Central Asian Economies

Kazakhstan

- Bankruptcy procedure, which leads to liquidation
- Rehabilitation
- Debt restructuring
- Amicable settlement

Kyrgyz Republic

- Special administration procedure, which leads to liquidation
  - *In court* or *Out of court*
- Special administration procedure, which leads to restructuring
  - *In court* or *Out of court*
- Rehabilitation
  - *In court* or *Out of court*
- Sanation
- Amicable settlement

Tajikistan

- Pre-judicial sanation
- Insolvency procedure, which leads to liquidation
- Insolvency procedure, which leads to external management (*judicial sanation*)
- Amicable settlement

Uzbekistan

- Pre-judicial sanation
- Bankruptcy procedure, which leads to liquidation
- Bankruptcy procedure, which leads to judicial sanation
- Bankruptcy procedure, which leads to external management
- Amicable settlement

Note: World Bank Group staff research based on the insolvency laws of the four Central Asian countries.

35. Despite the availability of reorganization procedures, they are rarely used in the four Central Asian economies. Country-specific statistics in this respect show clear evidence of weak reorganization culture and a strong focus on liquidation in the countries' insolvency systems (table 4).[25] Indeed, reorganization cases are scarce and sometimes anecdotal across Central Asia. Different factors explain this development, including poor implementation of reorganization procedures as well as a strong sigma toward bankruptcy, which triggers very few applications for reorganization from debtors. In contrast, liquidations are widespread as they are typically initiated by creditors. In Kazakhstan, 1,296 liquidations were open in 2020, whereas only 52 rehabilitation cases were observed in that year, amounting to 4 percent of cases recognized as bankrupt.[26] Similarly, 96.2 percent of cases open in the Kyrgyz Republic as of December 2020 were liquidation proceedings. In Uzbekistan, reports indicate that only four cases have avoided liquidation in the 2018–20 period, all of which were sanation cases submitted by debtors and that led to recovery.[27] The insolvency statistics from these four countries showcase the common ineffectiveness of the ICR systems in these Central Asian jurisdictions, where piecemeal liquidations are the norm.

24. European Bank for Reconstruction and Development, *EBRD Insolvency Assessment on Reorganisation Procedures* (London: EBRD, 2022).
25. Country-specific statistics are available for Kazakhstan, the Kyrgyz Republic, and Uzbekistan only. The authorities in Tajikistan do not publish statistics on insolvency cases, and the World Bank Group's requests for data were not successful. The lack of insolvency data is a concern that has also been highlighted recently by the EBRD.
26. According to the Law on Rehabilitation and Bankruptcy of Kazakhstan, rehabilitation is a court-supervised reorganization procedure under which the debtor is subject to organizational, economic, managerial, and financial measures through a plan intended to restore the debtor's solvency.
27. According to the Law on Bankruptcy of Uzbekistan, court sanation is the judicial reorganization procedure that is intended to restore the debtor's solvency and repayment of debts to the creditors without transferring the powers to manage the debtor's property and business operations to an external organization or individual.

Table 4. Insolvency Data

	Kazakhstan		Kyrgyz Republic				Uzbekistan	
	Bankruptcy cases	Rehabilitation cases	Liquidations of legal entities	Restructurings	Rehabilitations	Settlements	Total bankruptcy cases	Sanation cases
2017	1,248	131	80	8	1	—	n.a.	n.a.
2018	1,633	119	80	10	1	1	n.a.	2
2019	1,654	33	56	11	3	—	8,659	1
2020	1,296	52	96.2% liquidation cases[a]				7,302	1

Source: Kazakhstan: Ministry of Justice of the Republic of Kazakhstan; Kyrgyz Republic: Ministry of Economy and Commerce of the Kyrgyz Republic and the Council on Development of Business and Investments under the Government of the Kyrgyz Republic, presented in European Bank for Reconstruction and Development, EBRD Insolvency Assessment on Reorganisation Procedures—Kyrgyz Republic (Economy Profile) (London: EBRD, 2022); Uzbekistan: the Supreme Court of Uzbekistan and the State Asset Management Agency of Uzbekistan.
Note: — = no reported cases; n.a. = not available.

a. Data for 2017–19 come from the Council on Development of Business and Investments under the government of the Kyrgyz Republic as presented in the EBRD report. Data for 2020 are available from the Ministry of Economy and Commerce of the Kyrgyz Republic, but the information is not disaggregated (http://mineconom.gov.kg/ru/direct/8/83).

36. Besides the overall ineffectiveness in resolving insolvency cases, there are specific, critical legal deficiencies in the countries' frameworks for addressing insolvency. Such flaws negatively affect the countries' reorganization culture, and it is essential to address them in order to increase the effectiveness and importance of ICR systems. These legal deficiencies relate to the following six categories:

a. **Treatment of state-owned enterprises.** State-owned enterprises in the Kyrgyz Republic,[28] Tajikistan,[29] and Uzbekistan[30] are explicitly excluded from the countries' insolvency laws and proceedings. This negatively affects the fundamentals of the ICR system and prevents it from being applied to a significant share of each country's economy. This approach should be revised and aligned with international best practices, which recommend that there should not be a distinction between types of debtors based on ownership.[31]

b. **New financing.** New financing and its protection are critical aspects of an effective insolvency framework. A struggling company that may yet be viable in the long run might urgently need additional financing to pay its employees, suppliers, and operating expenses. However, in the Kyrgyz Republic and Tajikistan, the insolvency law does not provide for the possibility of the debtor obtaining credit after insolvency proceedings begin.[32] New financing provisions are available in Kazakhstan and Uzbekistan, although they are not protected from being voided or declared unenforceable after the reorganization has been completed.[33] Thus, the protection of new financing for the subsequent avoidance of insolvency is an area that might need more attention from legislators.

28. Article 1 of the Bankruptcy Law, http://cbd.minjust.gov.kg/act/view/ru-ru/574?cl=ru-ru and http://cbd.minjust.gov.kg/act/view/ru-ru/574.
29. Article 2 of the Law on Insolvency (Bankruptcy).
30. Article 2 of the Law on Bankruptcy, https://www.lex.uz/acts/955393.
31. According to the World Bank's ICR principles, "The insolvency proceeding should apply to all enterprises or corporate entities, including state-owned enterprises. Exceptions should be limited, clearly defined, and should be dealt with through a separate law or through special provisions in the insolvency law." World Bank, *Principles for Effective Insolvency and Creditor/Debtor Regimes*, 2021 Edition (Washington, DC: World Bank, 2021), 22.
32. While the Kyrgyz Republic allows the administrator to obtain unsecured loans to finance the ongoing operations of the debtor, this provision has limited applicability and is not available in all stages of the reorganization procedure, which is not aligned with leading practices.
33. European Bank for Reconstruction and Development, *EBRD Insolvency Assessment on Reorganisation Procedures*. In particular, the EBRD report examined whether relevant local legislation includes express protection from avoidance actions for new financing provided in connection with a reorganization procedure—that is, whether judicial actions can be brought against legal entities and individuals who provide new financing to an insolvent debtor.

c. **Essential contracts.** The assets of any given debtor are very likely to be closely tied to its commercial contracts. In the Kyrgyz Republic, Tajikistan, and Uzbekistan, the insolvency frameworks do not explicitly allow the continuation of contracts that supply essential goods and services to the debtor. Appropriate provisions that explicitly allow essential contracts to continue are available in Kazakhstan only. And even there, protection against the termination of contracts is available in bankruptcy (liquidation) proceedings only.[34] Protection for essential contracts is not explicitly provided for rehabilitation or debt restructuring.[35] If contracts were permitted to be retained or assigned, it is likely that more value would be generated, and reorganization would be more effectively promoted. This approach should be considered by the four countries.

d. **Adopting a reorganization plan.** Approving a reorganization plan should be as efficient as possible while ensuring that the different interests of creditors are properly managed. For voting purposes, the best practice is to create several classes of creditors based on their similarity and enable these classes to vote separately on the proposed plan. However, in the Kyrgyz Republic and Tajikistan, creditors are not divided into classes for voting purposes. Another important aspect of reorganization proceedings is allowing the debtor to select which creditors will be affected by the plan, leaving some of them unaffected, such as employees or trade creditors. In Kazakhstan, the Kyrgyz Republic, Tajikistan, and Uzbekistan, the debtor does not have the freedom either to choose which creditors are affected by the reorganization plan or to leave out certain creditors whose rights would not be affected. Providing for the possibility to conduct a reorganization in which only some creditors are affected makes it easier to adopt a more flexible and effective reorganization plan.[36]

e. **Out-of-court workouts.** Reorganizing a loan in court is not always a fast or economically reasonable solution, especially for MSMEs. Out-of-court workouts, however, present multiple advantages, as they allow for flexible and confidential alternatives to addressing insolvency in a formal way. They can save viable firms by giving them much-needed breathing room at much lower costs than does a court-based process. However, the legal regimes in Kazakhstan, the Kyrgyz Republic, Tajikistan, and Uzbekistan do not feature any procedures through which a substantial part of the restructuring process is conducted informally.[37]

f. **Creditors' priorities.** For the efficient flow of secured credit in an economy, creditors must be certain that they will be able to receive the proceeds arising from the sale of collateral if a debtor defaults on a loan. When secured creditors cannot be sure that they will be given priority with respect to collateral, they demand lower loan-to-value ratios from borrowers, thereby restricting access to financing. In Central Asia, only Uzbekistan does not give absolute priority to secured creditors when a business is liquidated.

37. Consumer insolvency frameworks are yet to emerge in Central Asia. While corporate insolvency has recently drawn significant attention in Central Asia, especially after the Global Financial Crisis, consumer insolvency remains an underdeveloped area except in Kazakhstan and Uzbekistan, which are the only countries that have recently passed laws on this area.[38] The absence of such laws is a significant impediment to the resolution of consumer loans, as some countries have seen very strong growth in consumer lending in recent years (Uzbekistan, for example). A legal framework for dealing with consumer insolvency allows an overly indebted borrower to offer its creditors a repayment plan, after which the remaining debts are canceled or "discharged." When implemented properly, this framework can have several positive personal, social, and economic effects. Consumers get a fresh start while creditors' recoveries are maximized. In turn, consumers can remain in the formal sector where, no longer under pressure from creditors, they are more eager to be entrepreneurial. This increase in entrepreneurship enhances economic activity and maximizes government revenue via tax collections. Despite specific ongoing initiatives in Kazakhstan and Uzbekistan,[39] the four Central Asian countries overall should focus on this aspect of ICR space.

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34. In particular, according to Article 8 of the Law on Rehabilitation and Bankruptcy, the initiation of proceedings cannot be a basis for a unilateral refusal to perform a contract concluded before the proceedings and may not result in termination of the agreement.
35. See, for example, EBRD's findings in *EBRD Insolvency Assessment on Reorganisation Procedures, Kazakhstan (Economy Profile)*.
36. European Bank for Reconstruction and Development, *EBRD Insolvency Assessment on Reorganisation Procedures*.
37. Until 2020, a partly informal procedure was available in Kazakhstan.
38. A consumer insolvency law in Kazakhstan was enacted in December 2022, after the preparation of this report. The text of the draft law is available at https://legalacts.egov.kz/npa/view?id=13983794. The draft applies exclusively to "consumers" and explicitly excludes individual entrepreneurs, contrary to the World Bank Group's latest ICR principles applicable to insolvency of micro and small enterprises. The law will enter into force in March 2023 and its provisions and impact are yet to be analyzed.
39. In Uzbekistan's 2022 Insolvency Law, Chapter 14 is dedicated to individual insolvency. This chapter took effect on January 1, 2023 (per Article 249 of the law), after the preparation of this report. Its provisions and impact are yet to be analyzed.

Chapter 6. Recommendations

38. In light of the current economic situation, countries in Central Asia should step up their NPL reform agenda. The uncertain economic conditions stemming from global inflationary pressures, rising geopolitical tensions, the negative spillover from sanctions on Russia resulting from close economic ties between Russia and Central Asian countries, and the lingering effects of the COVID-19 pandemic all point to the importance of continuing the NPL reform agenda with the following goals in mind:

a. Avoid an increase in NPLs by ensuring that banks have the tools to actively manage their delinquencies early on and that the bank credit risk underwriting standards remain sound.

b. Ensure (a) that banks do not delay the reclassification and coverage of NPLs through restructuring or other approaches to avoid implementing the regulation and (b) that they comprehensively report their NPLs.

c. Ensure that banks engage in sound restructuring practices only, which should include (a) a thorough, upfront, systematic assessment of the borrower's viability; (b) a comprehensive assessment of the borrower's debt-shouldering capacity if it is determined that restructuring the loan is worth the effort; and (c) repayment obligations that are arranged in a way that matches the borrower's expected cash flows.

d. Force banks that report high levels of NPLs to prioritize the quick reduction of these loans by ensuring that they allocate sufficient managerial, technical, human, and financial resources to this effort.

e. Equip banks with enough of the right tools to manage their NPLs, including facilitating the sale of NPLs or speeding up court-based recoveries.

39. Bank supervisors in Central Asia should build enough capacity to effectively oversee the asset classification and coverage under IFRS 9. Although the benefits of introducing a regulatory regime based fully on expected losses may need to be weighed against costs in the short term, bank supervisors should upskill their capacity to ensure that they are able to assess and challenge the banks' calculations of expected losses. Bank supervisors in the region can take several measures to improve their capacity, such as the following:

a. **Setting up specialized credit risk modeling teams in banking supervision.** Modeling credit risk is becoming common not only in the banking business but also in the regulatory and supervisory framework. Although supervisors may not allow banks to calculate their credit risk–weighted assets by using their internal models, they should be able to challenge the banks' credit risk models in loan-loss provisioning (IFRS 9), in credit risk stress testing, and when supervising credit risk underwriting models. To effectively challenge the banks' credit risk models, supervisors should have a strong statistical background or be supported by the complementary skills of an expert team/unit. Hence, it is important to create a modeling unit composed of experts in statistics and credit risk modeling who have the expertise to support line supervisors when reviewing the credit losses estimated by banks.[40]

b. **Training on IFRS 9.** The Kyrgyz Republic, Tajikistan, and Uzbekistan face the same challenges regarding IFRS 9 implementation. They may provide common trainings on IFRS 9 to build the bank supervisors' capacity to effectively challenge the banks' credit risk models.

c. **Developing methodologies and tools to effectively supervise IFRS 9.** Supervisors require tools that enable them to effectively engage with banks in the supervision of their credit risk models. Building on the experience of other supervisors, the four countries could consider developing the following tools:

  i. **Supervisory IFRS9 assessment methodologies.** This guidance focuses not only on the issues that supervisors should consider at a minimum when reviewing credit risk models but also on the definition of the minimum tests and procedures for comprehensively reviewing the banks' quantifications, among other areas. These methodologies are fundamentally qualitative, since they include a set of criteria on all the issues relevant to supervising IFRS 9 models.[41]

  i. **IFRS 9 challenger models.** Supervisors can use in-house models to develop their own alternative calculations of the banks' expected losses. This enhancement of the supervisory toolkit would allow supervisors to quantitatively challenge the banks' internal credit risk models.

40. The credit risk classification and coverage need to be further improved. First, in the Kyrgyz Republic and Uzbekistan, the limited recognition of collateral may discourage or not sufficiently encourage the development of credit risk mitigation techniques. These countries could consider expanding the list of eligible collateral to residential real estate, particularly if there is evidence that the collateral can reduce the losses of the secured loans and that the assets can be subject to sound risk management actions. Likewise, the Kyrgyz Republic may start to consider the impact of collateral not only in credit classification but also in credit risk coverage. Second, Tajikistan may consider restricting the definition of NPLs to bring it in line with international standards by including only the credit risk exposures that are 90 DPD (currently 30 days past due) or that have been assessed as unlikely to pay.[42] Third, the loss category that forces banks to fully cover the loan exposure is currently set at 180 DPD in the Kyrgyz Republic and Tajikistan. This very conservative practice may discourage banks from recovering loans that have been overdue beyond that date. These two countries may consider identifying the loss category with credit exposures that have been 360/5 past due, as Uzbekistan has done recently. Fourth, given the dollarization of the banking sectors in Central Asia,

40. One of the common challenges for establishing these units is finding the staff who have the right set of skills and knowledge to model credit risk. Many supervisors are attempting to address these challenges by doing the following: (a) upskilling employees of the central bank, which has traditionally been the most successful approach, but it is contingent on the availability of these staff members in the banking supervision department; (b) hiring an individual with the right skill set and building the team around him or her with new hires; or (c) hiring a consultant with experience in supervising credit risk models to train supervisors in this area.

41. For example, the guidance may include minimum standards on the governance of credit risk models (the role of the board, internal validation, risk management, and so forth); on the pooling of exposures by the same risk category; the supervision of models for estimating the PD and LGD; the minimum standards required to manage overlays; the minimum frequency of internal validations of models; the standards to be expected on information and data quality.

42. For example, Armenia has done so recently.

the practice of using higher reserve requirements for certain foreign-currency loans in the Kyrgyz Republic can be applied in Tajikistan and Uzbekistan.

41. To manage high-NPL banks, the four countries in Central Asia could issue a regulation with the following features, among others:

a. **A definition of "high-NPL banks."** The countries should consider laying out criteria to identify banks that should be considered as outliers and therefore subject to enhanced measures for reducing NPLs. Such measures would seek to ensure that these banks actively and decisively work out their NPLs to quickly reduce them while maximizing recoveries.[43]

b. **The general requirements that banks need to meet when managing NPLs.** The regulation should set the requirements that banks need to meet in identifying, managing, covering, controlling, and reporting NPLs. These requirements should be applicable to all banks, not only to those classified as having high NPLs.

c. **The specific enhanced requirements applicable to high-NPL banks.** The regulation should set the requirements that banks above the threshold should meet at all times, including the following:

   i. **Prepare strategic and operational plans for NPL reduction.** In these plans, banks should define their main quantitative and qualitative targets for NPL reduction in the short and medium term. The targets should be approved by each bank's board and subject to constant challenge and control. Kazakhstan and Tajikistan are already doing this, but making the practice a regulatory requirement will allow bank supervisors to more easily enforce it.

   ii. **Use standardized information templates that force banks to report the expected, forward-looking NPL trend during the plan's time horizon.** The information templates force banks to elaborately identify the mechanism through which and the portfolios in which they are expecting to trim down their NPL exposures. The templates also act as a control tool through which supervisors can discuss with banks how they are performing in their NPL reduction plans.[44]

   iii. **Independent and well-resourced workout units.** High-NPL banks should set up workout units with a clear mandate for managing the NPL. The units should be independent of the business and risk management units, and report directly to senior management. The workout units should be responsible for executing the strategic and operational plans defined by the banks' boards, and they should be provided with enough financial, human, and technical resources to reduce their NPL.

42. Central Asian countries should address specific, critical, legal deficiencies in their insolvency frameworks in the following five categories:

a. **Including state-owned enterprises.** State-owned enterprises in the Kyrgyz Republic, Tajikistan, and Uzbekistan should be subject to insolvency laws and proceedings. There should not be a distinction between types of debtors based on ownership.

b. **Allowing new financing.** New financing after the commencement of insolvency proceedings and its protection are critical aspects of an effective insolvency framework because they allow a struggling but viable company to continue to operate. The Kyrgyz Republic and Tajikistan should allow debtors to obtain new financing. While this is possible in Kazakhstan and Uzbekistan, new financing should be protected from being voided or declared unenforceable after the reorganization has been completed.

c. **Allowing essential contracts to continue.** The Kyrgyz Republic, Tajikistan, and Uzbekistan should explicitly allow essential contracts to continue during insolvency proceedings. Kazakhstan does this, but contracts are protected in bankruptcy (liquidation) proceedings only. Protection for essential contracts should be extended to rehabilitation or debt restructuring.

43. In some European countries, the threshold has been set as low as 5 percent. Therefore, all banks reporting NPL ratios above 5 percent are considered high-NPL banks and are subject to enhanced supervisory measures.
44. As mentioned previously, the templates were already introduced, albeit informally, in Tajikistan in 2019.

d. **Adopting a reorganization plan.** One best practice for ensuring that the different interests of creditors are properly managed is to create several classes of creditors based on their similarity. This also enables the classes to vote separately on a proposed reorganization plan. The Kyrgyz Republic and Tajikistan should introduce creditors' classes for voting purposes. In addition, all four countries should accord the debtor the right to choose which creditors are affected by the reorganization plan and to leave out certain creditors whose rights are unaffected. This approach results in a more flexible and effective reorganization plan.

e. **Creating alternative mechanism: out-of-court workouts**. Out-of-court workouts present multiple advantages, especially for MSMEs, as a flexible and economically more viable mechanism for addressing insolvency. Complex insolvency systems and high legal fees deter MSMEs from using formal procedures to tackle financial distress. MSMEs are also frequently operated by natural persons as sole proprietors, potentially putting both the business and the personal affairs of the debtor-entrepreneur at risk. However, none of the four Central Asian countries has detailed procedures for out-of-court workouts, so they should develop these procedures and introduce special simplified procedures for MSMEs.

43. Finally, Central Asian countries should develop consumer insolvency frameworks. Some of the Central Asian countries have recently seen very strong growth in consumer lending. A consumer insolvency framework would allow an over-indebted borrower to offer its creditors a repayment plan, after which the remaining debts are canceled or "discharged." As a result, the consumer would have a fresh start and be able to remain in the formal banking sector while creditors are repaid. While initial work along these lines has begun in Kazakhstan and Uzbekistan, all four Central Asian countries should focus on developing consumer insolvency frameworks.

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