

1.1. TAJIKISTAN FINANCIAL SECTOR DEVELOPMENT STRATEGY 2010 – 2015

INTRODUCTION

1. This paper outlines a medium-term financial sector development strategy and time-bound action plan for Tajikistan. An assessment of the Tajik financial sector was conducted by the World Bank and International Monetary Fund (IMF) under the Financial Sector Assessment Program (FSAP) in 2007. The FSAP made a number of recommendations, some of which have since been implemented or are in the process of being developed by the authorities with the assistance of various donors. This strategy summarizes the key vulnerabilities of the Tajik financial sector and proposes broad recommendations, based on the FSAP and additional analysis supported by technical assistance (TA) from the World Bank and the Financial Sector Reform and Strengthening Initiative (FIRST). The attached action plan provides more specific recommendations under each issue highlighted by the strategy within a suggested timetable based on a prioritization of reforms.

2. The strategy has two main sections in addition to the attached action plan. The first section presents background to the Tajik financial sector since the FSAP was completed, summarizing key developments over the last two years and benchmarking Tajikistan against other economies in the Europe and Central Asia (ECA) region. This provides the context for the deeper analysis of the vulnerabilities of the financial sector and proposed recommendations summarized in the second section. The organization of the second section, in terms of the different components of the financial sector, mirrors that of the more detailed Action Plan that is attached at the end of this document and is intended so that the two can be read together.

1. BACKGROUND

3. The financial sector in Tajikistan has grown in recent years, albeit from a low base. Financial intermediation in Tajikistan during the last three years grew substantially, with greater diversification, and the expansion of lending to previously under-served sectors, such as agriculture and small- and medium-sized enterprises. Credit to the private sector as a share of GDP almost doubled between 2005 and 2008 and bank loans as share of GDP increased by 154% during the same period.

4. The recent crisis however has brought to light some of the underlying weaknesses of this rapid growth. The growth in credit to the private sector was narrowly concentrated, with 60% of the increase in lending between 2005-08 going to the cotton sector alone. Furthermore, bank lending to agriculture increased dramatically only in 2008, (by 156% between March 2007 and 2008 and a further 44% by March 2009) following active government intervention through the Ministry of Finance (MoF) in early 2008. With this recent surge, the delinquency rate of banks' loan portfolios has also increased dramatically with 23%-48% of banks' agriculture loans estimated as being in arrears in March 2009.

5. Notwithstanding the government's recent intervention, access to credit and other financial services remains lower in Tajikistan than in other countries, even accounting for the economy's lower income level. Credit to the private sector amounted to 21% of GDP in 2008 (only 14% if directed cotton loans are excluded), among the lowest in the region, and lower than other

countries with similar GDP. Deposits are 11% of GDP, also among the lowest in the region, and the number of bank accounts is equivalent to 2.5% of the population.

6. There are three complementary aspects of financial sector intermediation. The *depth* of the financial sector is a measure of the quantity of resources the sector mobilizes and distributes, usually measured as a share of GDP to ensure comparability across countries. The *efficiency* of a financial sector refers to the cost of financial services for consumers and reflect the cost of mobilizing and intermediating financing. The *breadth* of financial intermediation indicates how widely accessible financing and financial services are for individuals and enterprises operating in an economy. The following sections will present evidence of the financial sector’s under-performance in Tajikistan in these three aspects of financial intermediation relative to other transition economies and identify the likely proximate causes.

1.1 *Depth of the Financial Sector*

7. The financial sector in Tajikistan is dominated by the banking sector. There are twelve commercial banks (including one state-owned bank and two foreign banks), seven credit societies, and eighty-eight microfinance institutions operating in Tajikistan as of January 2009. Banks represent about 95% of total financial system assets in Tajikistan. Microfinance organizations (MFOs) account for about 3% of the system; the share of other nonbank financial institutions (NBFIs) is negligible, and securities markets are virtually nonexistent.

8. All key indicators suggest that the Tajik financial sector has become deeper in recent years. Financial sector depth is commonly measured by the ratios such as M2/GDP, deposits/GDP, banking assets/GDP, and credit to the private sector/GDP. Table 1 below shows that financial intermediation in Tajikistan has deepened in recent years across all measures of financial depth.

Table 1. Financial Depth Indicators, end of year

Financial Depth Indicator (%)	2005	2008
M2/GDP	9.3%	11.1%
Deposits/GDP	7.5%	10.9%
Credit to private sector/GDP	14.4%	26.0%
Credit to private sector (excluding cotton)/GDP ¹	9.2%	14.0%
Bank assets/GDP	13.0%	22.2%
Bank loans/GDP	5.2%	13.2%

Source: NBT

9. Despite this recent growth, financial intermediation in Tajikistan remains shallow relative to comparator countries and thus does not adequately serve the financing needs of the economy. For example, deposits/GDP average about 30% of GDP for low-income countries and 55% of GDP for middle-income countries, some three and five times respectively the share in Tajikistan at the end of 2008.² Moreover, Tajikistan ranks low in credit to the private sector compared to other transition countries (

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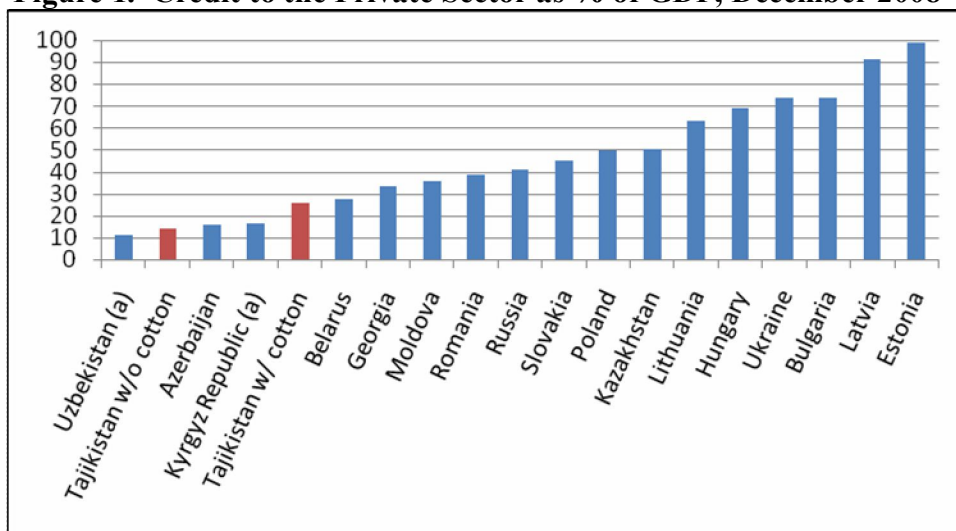
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¹ Excludes cotton loans financed or guaranteed by NBT.

² “Financial Integration and Deepening: Are Poor Countries Lagging?” Mark M. Spiegel, Federal Reserve Bank of San Francisco, 2007. Low-income countries are defined as having GDP per capita < \$825; middle income GDP per capita between \$825 and \$10,065; and high income GDP per capita > \$10,066.

12. Figure 1) particularly when the directed loans to the cotton sector are removed; it also ranks low in bank assets/GDP and deposits/GDP (Figures 2 and 3).

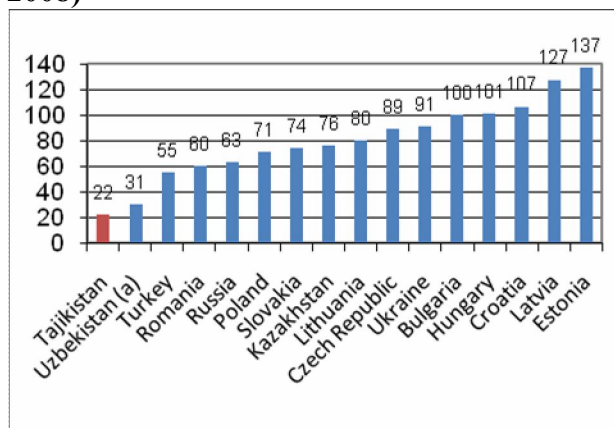
Figure 1. Credit to the Private Sector as % of GDP, December 2008



Source: NBT, International Financial Statistics

(a) Figures for Uzbekistan and Kyrgyz Republic are for 2007

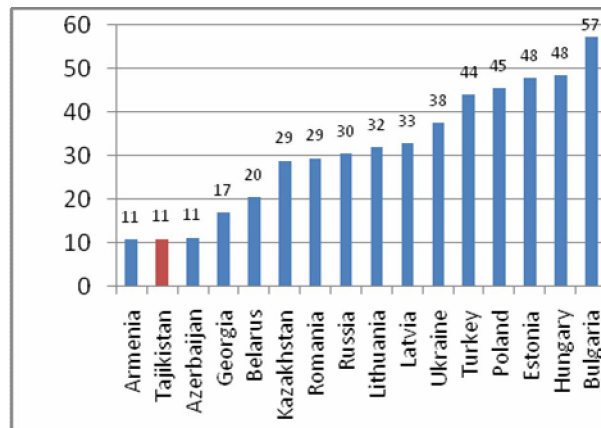
Figure 2. Banking Assets as % of GDP, (Dec 2008)



Source: NBT, International Financial Statistics

(a) Figure for Uzbekistan is for 2007

Figure 3. Deposits as % of GDP, (Dec 2008)



13. **Analysis of monetary aggregates suggests that limited depth of the financial sector reflects low public confidence in the banking system.** Cash (M0) as a share of M2 is a measure of liquidity preference—it declines when the public is willing to put more of its funds into the banking system, and is thus inversely related to public confidence in the system. A lower ratio of cash to M2 indicates a

higher level of confidence. As shown in Table 2, cash outside of banks in Tajikistan accounts for 72% of the total money supply. In OECD countries, cash makes up about 6% of the money supply, and in countries that borrow from the World Bank, it is about 22% on average. The high ratio of cash in Tajikistan is an indication of the low confidence that the public has in banks.

Table 2. Monetary Aggregates, December 31, 2008

Monetary Aggregate	TJS (000s)	As % of M2
M0	1,402,988	72%
M1	1,949,470	100%
M2	1,949,470	100%

Source: NBT

1.2 Breadth of the Financial Sector

14. **The number and structure of bank accounts indicate that access to the financial sector is low.** As shown in Table 3, the limited utilization of the banking system is evident from the low number of individual accounts that is equivalent to only about 2.5% of the population. Deposits of individuals make up only 38% of total deposits, with the rest belonging to legal entities. The use of the financial system for *transactional purposes* is particularly low, with demand deposits comprising only 27% of total deposits and only 3% of individual deposits.

Table 3. Deposits (TJS 000s) and Accounts in the Banking System, December 2008

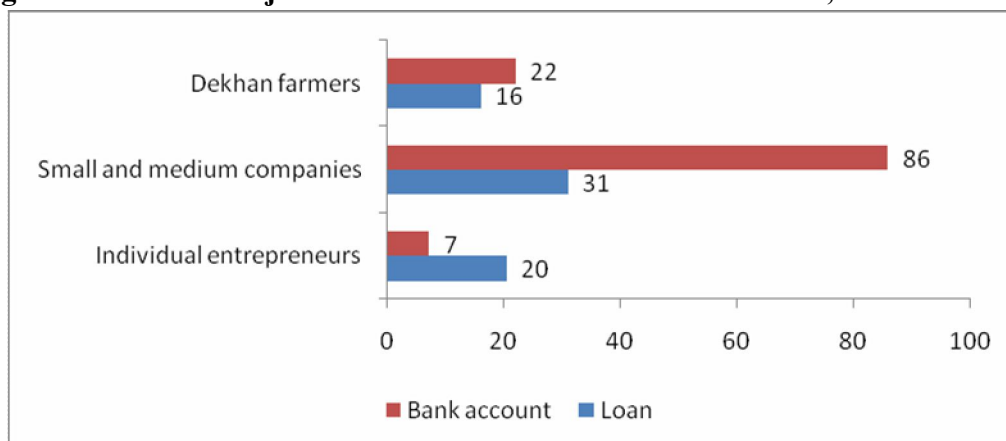
Total Deposits		1,923,488	Total Number of Bank Accounts		253,078
Local Currency Deposits	711,296		Local Currency	134,826	
Foreign Currency Deposits	1,212,192		Foreign Currency	118,252	
Deposits of Legal Entities		1,190,114	Accounts of Legal Entities		42,700
Local Currency	696,170		Local Currency	30,799	
Foreign Currency	1,218,221		Foreign Currency	11,901	
Individual Deposits		733,377	Individual Accounts		210,378
Local Currency	127,420		Local Currency	104,027	
Foreign Currency	605,957		Foreign Currency	106,351	

Source:NBT

15. **Access to finance in Tajikistan for the private sector is also low.** A survey undertaken by the International Finance Corporation (IFC) in 2009 found that the share of small and medium sized enterprises (SMEs) with a bank account and with a loan from a financial institution in Tajikistan varied significantly across different types of enterprises. The results are shown in Figure 4 below. Just 7% of individual entrepreneurs surveyed had an account and 20% had a loan, while the equivalent shares for

dekhan farmers were 22% and 16% respectively. Meanwhile, 86% of small and medium companies in Tajikistan had a bank account and 31% had access to a loan.^{3 4}

Figure 4. SMEs in Tajikistan with a Bank Account and a Loan, 2009



Source: IFC Tajikistan SME Survey 2009

16. The narrow use of the financial sector also reflects limited public confidence both in the local currency. Around 63% of total deposits, and 82% of individuals' deposits, are held in foreign currency (almost exclusively US dollars).

17. Another reason for the low utilization of financial services is that the range of products and services provided by banks in Tajikistan is limited and not always suited to demand. Tajik banks until the recent government intervention in 2007-08 had been lending very little to the agriculture sector, (just US\$22 million annually in March 2007) even though it accounts for almost a quarter of GDP (24.4%). Similarly, banks still do not offer remittance products or services, even though remittances amounted to some 50% of Tajik GDP in 2008. Loans to individuals and SMEs, mainly for trading activities, have grown most rapidly, but commercial and industrial loans still account for the lion's share of the outstanding volume. Average loan maturity is about six months and average loan sizes of the top three banks range from \$10,000 to \$60,000.

1.3 Efficiency of the Financial Sector

18. Tajikistan's financial sector remains inefficient in comparison to other transition economies in the region. Efficiency in a financial system refers to the market frictions (e.g., transaction costs, risks, monopoly power, information asymmetries, etc.) that raise the cost of intermediating funds in a financial system. Interest rate spreads (the difference between deposit and lending rates) are the most common measure of financial efficiency. By this measure, the Tajik financial system is quite inefficient. Ex-ante bank spreads have declined in the last two years as shown in Table 4, but have consistently been among the highest in the region, and are the second highest interest rate spreads in the region after the Kyrgyz Republic (Figure 5).

³ Small and medium company data refers to companies with between 5 and 200 employees. Source: Enterprise Surveys

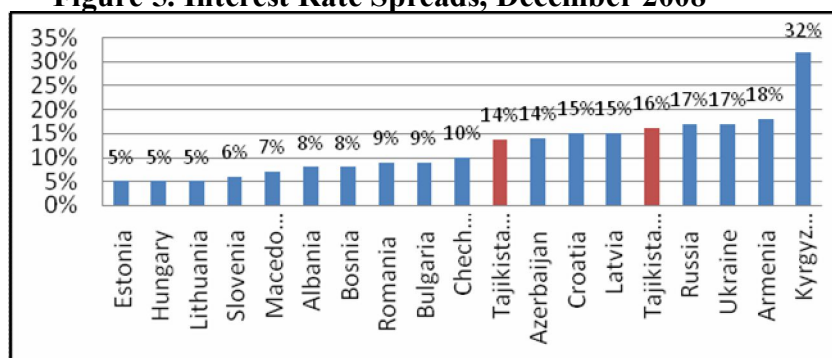
⁴ The relatively high share of small and medium companies with a bank account is largely explained by the fact that it is required to obtain a business license. In principle, therefore, 100% should have a bank account. However, many close their bank account after obtaining their license, and many others do not use their bank account.

Table 4. Average Interest Rates and Spreads (%), 2002-08

	2002	2003	2004	2005	2006	2007	2008
Avg lending rate TJS	14.21	16.13	20.10	25.55	26.53	21.94	19.23
Avg deposit rate TJS	0.36	0.80	0.66	0.68	1.53	0.79	0.88
Interest rate spread TJS	13.85	15.33	19.44	24.87	25.00	21.15	18.35
Avg lending rate FX	16.96	15.30	19.97	21.06	22.76	21.42	17.8
Avg deposit rate FX	0.21	0.96	0.67	0.48	0.32	0.92	1.20
Interest rate spread FX	16.75	14.34	19.30	20.58	22.44	20.50	16.60

Source: NBT

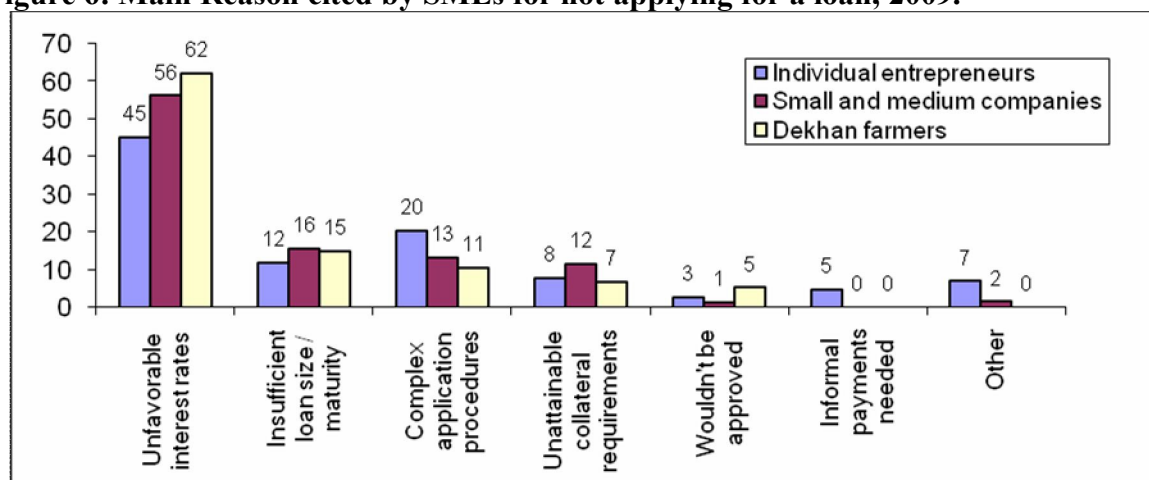
Figure 5. Interest Rate Spreads, December 2008



Source: NBT

19. The main reason cited by SMEs for not applying for loans from financial institutions is **high interest rates**. Among those who needed external financing and didn't apply for a loan, the share identifying each of the following as the main reason is shown in Figure 6. The overwhelming reason cited is high interest rates.

Figure 6: Main Reason cited by SMEs for not applying for a loan, 2009.



Source: IFC Tajikistan SME Survey 2009

20. There are a number of causes for the inefficiency of the financial sector that could contribute to adverse selection of borrowers. The efficiency of a country's financial sector can be

explained by factors at the *institutional level* and *country level*. Inefficiency can occur at the institutional level, for example, because (i) the composition of loans and deposits might imply higher costs (e.g., agriculture lending, term deposits); (ii) a lack of diversity in the loan portfolio can increase risks; (iii) weak loan underwriting practices can lead to a poorly performing loan portfolio; (iv) small banks might not achieve economies of scale to spread their fixed costs across their lending portfolio; (v) modern technology, such as IT systems, credit scoring, etc., might not be used. On the country level, inefficiencies can result from: (i) weak contract enforcement due to corruption or lack of independence in the judiciary, unpredictability or slowness of decisions, or high costs to execute collateral; (ii) a weak information framework due to inadequate accounting standards or practices, lack of transparency in enterprises, or lack of credit information systems such as credit bureaus; and (iii) macroeconomic instability or inappropriate government interference in the financial sector.⁵

21. Using this framework, the main sources of inefficiency in Tajikistan's financial sector are:

(i) At the institutional level:

- **Weaknesses in skills and tools to assess credit risk.** Tajik banks tend to base their lending decisions primarily on collateral rather than on the profitability and projected cash flow of the enterprise and the character and skills of the entrepreneur. Modern tools like credit scoring are not used.
- **Rapid increase in loan portfolio.** Loans have increased significantly in recent years, by 66% in 2006, 123% in 2007, and 45% in 2008, and could lead to a build-up of unrecognized credit risk and give rise to an increase in nonperforming loans (NPLs). Agriculture lending, which is particularly risky, has also grown by 45% in 2008, primarily to the cotton sector, which has a historically poor repayment record.
- **Significant lending in dollars.** Because of the high dollarization of deposits (63%), banks lend largely in dollars, even if the borrowers do not earn dollars. This shifts the foreign exchange risk to the borrowers, thus increasing the banks' credit risk.
- **Diseconomies of scale.** Several small banks do not achieve economies of scale in their operations. To address this, NBT has increased minimum capital requirements in recent years, but also allowed some banks to become "credit societies" with lower minimum capital requirements. These credit societies, as well as some banks, remain inefficient. Most banks do not have modern IT systems to lower cost and increase productivity.
- **Weak governance.** Insider and connected lending is prevalent, and these loans have poor repayment histories. Loan officers sometimes require borrowers to pay bribes to get a loan.

(ii) At the country level:

- **Low public confidence in banks.** There is a weak privacy regime, so confidential customer information is sometimes used (or perceived to be used) by tax authorities, other government officials, and bank officials in a predatory manner to harass customers and even seize their assets. Many banks have a reputation of poor service, leading to lengthy waiting periods (sometimes several days) to withdraw deposits. Finally, many customers still recall having their Russian

⁵ See "Efficiency in Financial Intermediation Theory and Empirical Measurement," Thorsten Beck, March 2006.

ruble deposits devalued and effectively confiscated soon after independence. All of these factors lead to low confidence and, hence, low deposits in the banks.

- **Limited competition among banks.** Banks have segmented the market geographically and by sector, so sometimes operate with significant monopoly power. Also, there is almost no foreign competition—there is one foreign subsidiary and one foreign bank branch, each with very limited operations.
- **Lack of liquidity management instruments.** There are no government bonds or other instruments that can be used as collateral for an interbank money market. Hence, banks have tended to hold excess liquidity (although liquidity has significantly decreased in 2008 and early 2009 due to deposit withdrawals and government requirements to lend to the cotton sector). Moreover, the main monetary policy instrument of NBT is uncompensated reserve requirements, which have typically been maintained at more than 10%. Holding excess liquidity and high reserves raises costs to banks, which must be recovered in higher interest rate spreads.
- **Weak judiciary.** Tajikistan lacks an adequate, reliable, and trustworthy judicial system capable of enforcing contracts and ensuring property rights. Court proceedings are slow and unpredictable, and there can be serious cases of bias where the influential parties receive decisions in their favor regardless of the merits of the case. Opinions and decisions are often secret and not revealed to the parties, and the prosecutor's office wields excessive influence over the judges. Judges are not well remunerated, their conditions of service are poor, and the judicial infrastructure is inadequate. Executing collateral is costly, uncertain, and inefficient. As a result, banks resort to the courts only when absolutely necessary. Whenever possible, cases are settled out of court.
- **Government directed lending.** The government's directed lending through NBT and guaranteed by NBT until 2007 has built up huge debts in the cotton sector, has potentially undermined the credit culture as participants throughout the credit chain are not repaying and not suffering consequences as a result, and has rendered NBT insolvent. The government's directed loans to the cotton sector through commercial banks in 2008 are not performing well (at least 50% are in arrears) and are causing a deterioration of banks' balance sheets and squeezing liquidity. A similar credit line in 2009 risks further damage to bank balance sheets and incomes. The costs imposed on the financial sector by this inappropriate government intervention in the financial sector increases costs and, therefore, interest rate spreads to cover the costs.
- **Lack of credit information system.** Poor information on borrowers makes evaluating their creditworthiness difficult, increasing the risk of lending. Passage of a new Credit Bureau Law is a positive step, as is the plan to establish a credit bureau in the near future. In the meantime, the risks from poor information remain.
- **Weak framework for property registration.** There is no uniform system for title registration on property and related transactions (such as title transfer and mortgage registration). Multiple bodies are involved depending on the type of property (the Bureau of Land Management for land, and the Ministry of Justice (MOJ) for mortgages on property). The information contained in the property registries is not readily publicly available, which, coupled with the lack of appropriate legal mechanisms, fails to protect lenders wishing to use property as collateral. E.g., moveable property is registered in MOJ with modern IT system set up with USAID assistance, but after brief period in 2006 or 2007 when it was available online, now banks must physically come to MOJ in Dushanbe to access registry, so the registry is of limited value for branches outside Dushanbe.

- **Weak accounting standards.** Weak standards and practices lead to non-transparency in the financial position of potential borrowers and raises the potential for increasing credit risk in banks' balance sheets.

2. A FINANCIAL SECTOR STRATEGY: KEY VULNERABILITIES AND RECOMMENDATIONS

22. The financial sector strategy can be broken down into two core pillars: the banking sector and non-bank financial institutions. The strategy addresses the key vulnerabilities of each pillar in the respective policy, legal, regulatory, and institutional frameworks and outlines recommendations. Specific actions under each pillar are detailed in the Action Plan attached as Annex 1.

2.1 *The Banking Sector*

23. To ensure the sustainable growth and stability of the banking sector in Tajikistan, the authorities need to pursue reforms in several areas. The necessary reforms can be broken down into six main areas:

- *Legal framework,*
- *Regulatory reforms;*
- *Bank Supervision;*
- *NBT Governance;*
- *Commercial Banks Governance;*
- *Commercial Banks' Products and Services;*
- *Consumer protection; and*
- *Complementary Banking Sector Infrastructure*

2.1.1 *Legal Framework*

24. Much work has been done in recent years to enhance the legal framework for the banking sector but important shortcomings remain. The FSAP noted that laws and regulations require strengthening in several key areas, notably regarding NBT governance, bank governance, banking secrecy, licensing, consolidated supervision, remedial action, loan classification, payment system, secured lending, and deposit insurance.⁶

25. NBT autonomy and governance require considerable strengthening. NBT should be appropriately capitalized so that its financial independence can be assured (see below). In addition, the NBT chairman and his deputies should be appointed for fixed terms, which do not coincide with the electoral cycle, and the reasons for their dismissal should be explicitly outlined in the Law. The ability of the chairman and board members to determine each others' level of remuneration is highly unusual; the parameters governing the board's remuneration policy should be publicly disclosed. Clear provisions covering conflicts of interest should be introduced in the Law. NBT staff (and all government officials) should be obliged to disclose their personal holdings in financial institutions and

⁶ During the course of preparing this Strategy and Action Plan, several key changes were made to the NBT Law and the Banking Law. For completeness, however, the Strategy and Action Plan include all key actions already taken in 2009, as well as descriptions of the issues that were addressed.

recuse themselves from official decisions affecting those institutions. Legal protection is needed for NBT and its staff for supervisory actions taken in good faith. A legal basis for consolidated supervision is necessary.

26. Both the legal framework for the remedial action regime and its implementation require substantial improvement. This is the case notwithstanding the fact that the NBT has annulled 20 bank licenses during 1996–2007. There is no legal requirement that the NBT take action should it consider the safety and soundness of an institution to be compromised, nor is there, either in law or regulation or in practice, a system for taking prompt corrective action, preferably before matters reach a critical stage. The remedial action regime should be transparent and predictable in its consistent enforcement, which will increase the likelihood of financial institutions complying with supervisory requirements ahead of the need for remedial action.

27. Core aspects of the Tajik deposit insurance system also need to be amended substantially to adhere to best practice. A new deposit insurance scheme was established in 2003 but has significant shortcomings. With the fund’s balances equivalent to less than 1% of estimated insured deposits, the absence of contingency financing arrangements is a key weakness of the scheme. Other problems include the voluntary nature of the scheme, no cap on insurance coverage, and insufficient exclusion of bank shareholders and related parties from coverage.

28. The legal and institutional framework governing secured lending needs to be assessed comprehensively and clarified. The laws governing secured lending are often overlapping and in conflict with each other, creating uncertainty as to the effectiveness of collateral. The framework for property registration and enforcement also has conflicting laws and there is no uniform system for title registration on property and related transactions, with multiple bodies involved depending on the type of property. Other legal and institutional weaknesses include the lack of public availability of information contained in property registries, the lack of a market for land use certificates, and legal uncertainty regarding the eviction of residents of foreclosed properties. The authorities should undertake a comprehensive assessment of the legal and institutional framework for secured lending, including the operation of property registries, in order to design and implement an action plan for reforms.

2.1.2 Regulatory Reforms

29. The NBT operates the only major interbank payments system in the country which is processing an increasing value of transaction each year. In 2002, the NBT launched a Real Time Gross Settlement (RTGS) system that contributed to stronger integration between the central bank and the banks, and an overall improvement of payment and settlement arrangements in the country. Since its launch, the value settled through the RTGS has increased at a rate of nearly 30% per year, while the number of transactions grew at a more modest 6% annually. However, the financial sector lacks other cashless payment alternatives.

30. The existing regulatory framework lacks many of the basic elements that underpin the operation, regulation, and oversight of a modern payments system. The NBT Law provides the central bank with clear, although somewhat general powers to operate and regulate payment systems.

However, key concepts such as the timing of settlement finality, legal protection to the system from insolvency effects, or the timely seizure of collateral pledged in connection with payment systems, are absent in the current framework. These and other relevant concepts (e.g., system access rules, use of electronic signatures and documents in payment and settlement systems) should be addressed through NBT regulations.

31. Ongoing loopholes in asset classification regulations give an upward bias to reported profits and capital and should be closed. The NPL stock is increasing and remains particularly high in the agricultural sector. Loan classification and provisioning rules were recently tightened, but loopholes remain. In particular, loans can be restructured once with no effect on classification but must be classified no better than substandard if restructured more than once. With substandard loans representing 50% of NPLs, this raises questions as to the true quality of these assets, especially with provisions being just 26% of NPLs. At the same time, supervision of classification and provisioning needs to be intensified to ensure banks' implementation of existing rules, particularly in regards to insider lending.

32. The bank licensing regime in Tajikistan and process on remedial action require improvement. The standards that banks need to meet to be licensed and the conditions under which a license can be suspended or withdrawn need to be revised in line with Basel Core Principles and be enforced consistently. The legal or regulatory foundation for the issue of bank licenses in the Banking Law should provide for checks on the suitability of shareholders (including beneficial owners), board members, or senior management.

33. The regulatory regime on the risk management, connected lending and investment activities of banks is patchy and must be strengthened in light of the rapid growth of the sector. In the absence of strong credit risk management capacities, the rapid growth in bank lending may lead to the build-up of unrecognized credit risk. NBT should prepare clear and detailed regulations relating to banks' risk management processes, including their internal processes, infrastructure (i.e., IT systems for assessing risk), and investment activities. The regulations related to connected lending by banks and NBT's right to monitor it needs to be strengthened in line with Base Core Principles.

34. Expanding the networks of banks outside of the main urban areas should be encouraged to enhance access to financial services. In 2006, there were about 220 bank branches, about one branch for every 30,000 people, which is low by international standards. The current licensing requirements for opening branches and representative agencies is excessively complicated and discourages banks from opening new branches, especially outside the main urban areas. The licensing requirements should be simplified, allowing banks to open new branches provided they follow NBT guidelines.

2.1.3 Bank Supervision

35. Much work has been done in recent years to enhance NBT's supervisory capacity, but compliance with Basel Core Principles is still low and the ability of the NBT to intervene when it identifies problems in the banking sector remains limited. On-site examination capabilities have been strengthened, and a robust off-site reporting regime has been introduced. However, the ability of

NBT supervisors to address bank problems—whether compliance, safety, or soundness— is limited given the perceived or real position of power of many bank owners. A transparent and predictable remedial action regime should be established that clearly outlines the process for a structured remedial response on the part of the NBT that will be consistently implemented across all banks. NBT should be required to intervene when the safety and soundness of a bank is at risk.

36. Given the banking sector’s rapid growth, NBT should closely track banks’ loan portfolios, and consider raising provisioning requirements for FX lending. The NBT has recently taken active steps to strengthen its ability to address problems resulting from the growth in lending among Tajik banks, preparing an action plan for taking short-term anti-crisis measures and has recently establishing a Emergency Commission to monitor developments in the sector. The surge in foreign-currency loans poses particularly high risk for lenders and the NBT should consider changing current regulations to raise banks’ provisioning requirements for foreign-currency loans.

37. Throughout the duration of this strategy, NBT should prepare and implement a comprehensive training and capacity-building plan. The implementation of the proposed amendments to the laws and associated regulations that are highlighted in this Strategy will require additional capacity creation within NBT throughout the duration of this Financial Sector Strategy (2009-2013). Areas of particular relevance include licensing; governance; risk-based supervisory systems; consolidated supervision; disclosure policies; payment system supervision; external audits; and public communication of information and issues arising from supervision and consultation with banks.

2.1.4 NBT Governance

38. Following revisions to the NBT Law, governance of the NBT should be brought in line with international practice. The issuance and misreporting of NBT guarantees and pledges for cotton loans revealed weaknesses in governance in NBT. A code of conduct is needed for senior management of NBT relating to financial disclosure and conflicts of interest, including a mechanism to safeguard and monitor disclosed information. NBT should appoint all members of its Board for a fixed term, including the three non-executive members. The internal audit function needs to be strengthened, and board committees established. NBT should consult fully and openly with the Banking Association on modalities of reviewing proposed prudential regulations rather than simply notifying the sector one month prior.

2.1.5 Commercial Bank Governance

39. The authorities have taken major steps to improve governance in the corporate and banking sectors although substantial weaknesses remain. Despite commendable reforms—including the establishment of a central share registry for all open joint stock companies and privatization of medium and large companies—the standard of corporate governance remains weak. According to the 2006 enterprise restructuring and governance indicator of the European Bank for Reconstruction and Development, Tajikistan was rated at “2-” out of a possible “4+.” Out of about 30 European and Central Asian countries in the index, only Turkmenistan was ranked lower.

40. All credit institutions should be subject to annual independent audits of their financial statements and the capacity of the auditing profession should be strengthened. By law, all open joint stock companies—which include all private banks—are obliged to have annual independent audits of their financial statements. This excludes public banks, however, which are subject to external audits only once every two years. All financial institutions going forward should be subject to annual audits.

41. The NBT should be officially responsible for promoting and monitoring good corporate governance in the banking sector. The Agency on Capital Market Development within the MoF has issued an instruction and regulation requiring all corporations, including banks, to disclose beneficial shareholders. However, the Agency doesn't perform any supervisory activity to enforce the regulation in either the real sector or banking sector. Currently, beneficial ownership of banks and interests of beneficial owners in other economic areas are not transparent. NBT should be made formally responsible for promoting and monitoring good governance practices in the banking sector. Subsequently, NBT should put in place a regulatory framework in line with the OECD principles on good corporate governance and the Basel Core Principles and establish an institutional mechanism (in particular strengthening the NBT supervision department) for supervising effectively the adherence of banks' practices to these regulations.

42. The NBT should also work directly with banks to help them improve their risk management, treasury functions, and IT systems. The increased exposure to credit risk of Tajik banks after their recent surge in lending reflects to some degree the lack of modern risk management systems and practices in the sector. The significant fluctuations in banks' liquidity during the same period point to a need to upgrade their treasury management systems and skills. The utilization of IT systems is increasing in the largest Tajik banks but overall is still low across the whole banking sector. This is partly due to the small size of many Tajik banks which does not allow them to enjoy sufficient economies of scale. However, the use of IT varies even within departments of banks that have installed them. The Banks Association, with support from NBT, should review options for banks to create economies-of-scale when deciding on IT systems.

43. It is critical that the government stops directing lending through banks. The increased lending directed by the MoF to the agriculture sector through the private banking sector over the last two years has increased the exposure of these banks to credit risk as these loans are in their portfolio. A central aspect of promoting good corporate governance is ensuring an arm's-length relationship between the government and the banks, which requires that banks be allowed to make their own market-based decisions on the provision of financial services. To phase out directed lending, the government first will mandate the application of the Tajikistan Agricultural Financing Facility (TAFF) methodology for the government financing scheme for the agriculture sector and will commit no additional resources for lending to the agriculture sector. Instead, resources available for lending to the agriculture sector in 2010 will be limited to the amount of 2009 agriculture loans that will have been repaid up to a maximum of TJS 130 million. The government will cease directed lending to agriculture through banks no later than 2012 and allow market-based financial services to serve the agriculture sector.

44. Access to financial services in rural areas remains limited, but with reforms being undertaken in agriculture, opportunities for profitable lending are expected to increase. Therefore, banks should train their staff in products and services specific for rural clients. Banks' skills for extending rural and agricultural credit remain poorly developed, with products and procedures that are not adapted to the needs of farmers and other small- and medium-sized producers in rural areas. Banks' reliance on collateral poses a key constraint in rural areas given that agricultural land cannot be used effectively as collateral. Banks and the Banking Association should provide training, supported by external technical assistance, to their staff in products and services for rural clients that do not use land as collateral.

45. Banks can play a more active role in improving services for remittance recipients and in promoting the deposit of remittances in the banking system. As mentioned above, remittance inflows amounted to about 50% of GDP in 2008 for Tajikistan, but less than 2% remain in the banking system. Available savings vehicles in Tajikistan's financial system are currently limited. Instead, the relatively small share of remittances that is not used for consumption tends to be invested in tangible assets and other financial savings instruments. Efforts should be made therefore to improve banks' services and products to encourage remittance recipients to retain the funds in the system. Banks should also, more generally, improve their transparency, as well as customer service and protection (see below), to improve public confidence and increase deposits.

46. Banks should also expand their range of products and services. Banks could offer more flexible savings and loans products for different consumer purposes, expand card-based systems and transactions, increase use of electronic retail payments, and work with large retailers to fund installment sales. More generally, banks should improve their capacity to develop and test new products. To deepen the banking sector, the use of banking services for payroll (e.g., direct deposit of salaries) and collection purposes should be broadened.

47. NBT could play a leading role in promoting the development of mobile banking. Mobile banking has successfully reduced costs and expanded access to finance in many low-income countries with remote population centers, such as Tajikistan. As a first step, NBT should conduct feasibility study for mobile banking in Tajikistan, including an assessment of demand, the adequacy and reliability of existing infrastructure, and the legal and regulatory framework.

2.1.7 Consumer Protection Regime

48. Consumer protection in the financial sector is weak in Tajikistan and contributes to low public confidence in financial institutions, hindering the growth of the sector. Tax authorities, prosecutors, other officials, and bank staff have (or are perceived to have) unauthorized access to customer accounts and other confidential information, leading to predatory practices. Financial institutions are not always transparent or accurate regarding their ownership, financial reports, advertising, prices for products and services, or other information required by consumers to make an informed choice. At the same time, financial literacy amongst the population is also low. These problems lead to low public confidence in financial institutions that in turn hinder the development and

growth of the financial sector with low levels of deposits (including low level of remittances remaining in banks as deposits), and use of other financial services.

49. The authorities should start the process of building a consumer protection regime in line with good practices worldwide and introduce a financial literacy program. NBT and MOF should initiate a review of the legal and regulatory regime for consumer protection in financial services, particularly focusing on the banking sector, benchmarking it against international good practices. Based on this review, a strategy for establishing a comprehensive legal and regulatory protection regime (including consumer protection institutions, privacy and data protection, customer account handling and maintenance, and dispute resolution mechanisms) should be designed and implemented. This should be coupled with a financial literacy program for the public in order to ensure maximum impact.

2.1.8 Other Complementary Banking Sector Infrastructure

2.1.8.1 Credit Information Systems

50. The establishment of a creditor information system will support better credit risk assessment by banks, reduced costs, and greater access to loans by creditworthy borrowers. The Law on Credit Histories was adopted by the parliament and signed by the president in early 2009. There is now a need to harmonize legislation (e.g., on licensing of credit bureaus) and establish a credit bureau. Once the credit bureau is established, it will be necessary to build capacity in the credit bureau, build capacity in financial institutions to interface with the credit bureau and integrate its information into their credit analyses, and raise public awareness of the importance of credit information sharing for expanding access to finance.

2.1.8.2 Payment System

51. Despite the existence of an RTGS system, its full benefits are not being realized. A large portion of domestic interbank payment transactions continues to be executed through bilateral correspondent accounts. Participants do not have regular access to intraday or overnight credit from the NBT, and there is no queuing system. Leased lines are not always reliable, and in some cases participants are forced to connect through dial-up services or go to the closest NBT branch to submit their payment orders for processing. Crucially, the RTGS system runs on one server only; there is no secondary server to back-up the system. Moreover, responsibility for supervising the payment system is not clearly set out.

52. The NBT should take actions to increase the use and efficiency of the payment system. This would make the system more attractive for participants, leading to a reduction in the number of interbank payments that are processed through bilateral correspondent arrangements. The NBT should establish a centralized queuing system and intra-day credit facility. The NBT could also consider allowing system participants to use their required reserves during the day for payment purposes. The RTGS users group should consult with telecom providers to find a solution to the unreliable leased lines that ensures reliable and continuous automated access to the system. Urgent action is needed in the area of business continuity for the RTGS system. At a minimum, the system needs to be backed-up

with secondary server(s) that are able to resume the operations quickly, without any loss of transaction data, in case of failure of the primary server. The primary and secondary processing equipment should be located in different sites. A comprehensive disaster recovery and business continuity plan should be developed, addressing not only technical issues but also the availability of staff and information procedures. NBT also needs to strengthen and implement fully its payment system oversight function. NBT should establish appropriate organizational arrangements. This includes deciding a proper location within the NBT for the oversight unit/division, and ensuring adequate staffing. NBT should prepare and implement a work plan for assessment, procurement, operation, management, and regulation of the RTGS and a card payments center.

2.1.8.3 Public Registries

53. Corporate governance in Tajikistan is weak, and this limits corporations' access to finance. Good corporate governance, including transparency of information, is necessary for companies to obtain external financing as banks will be able to make more accurate credit risk assessments. However, in Tajikistan, the public does not have access to business registries where such information about companies is contained. The MoJ has put its records in electronic format, but these are currently available online only for other government offices. A feasibility study should be conducted to determine what is needed to provide online access to the business registry, and any necessary legal amendments should be undertaken to ensure such access and to ensure regulatory oversight of the registries..

2.1.8.4 Accounting and Auditing Services

54. Development of the accounting and auditing profession would support the sustainable growth of the banking sector and the private sector's access to finance. Accurate and reliable financial reporting is a critical part of transparency of the operations for all companies. For banks and other financial institutions, accurate financial reports are required to give an accurate view of the financial status of the institution—and early warning of possible future weaknesses in its future financial health. Supervisory agencies need to be able to rely on a bank's financial statements, and in particular, the calculation of capital levels, to ensure that the sector has adequate levels of capital to support the bank's lending portfolio. For enterprises wishing to borrow from a financial institution, it is important to provide accurate financial reports that the bank considers reliable.

55. However, Tajikistan lacks sufficient professional accounting and audit firms. Banks are required to use international financial reporting standards (IFRS), and NBT has the authority to approve the list of accepted external auditing firms for banks. However, no international firms are licensed in Tajikistan, and local firms lack the capacity to audit financial institutions.

Following the completion of an accounting and auditing Report on Observance of Standards and Codes (ROSC), MOF should prepare a plan to implement its recommendations.

2.2 Non-Bank Financial Institutions

2.2.1 Credit Societies

56. The authorities should review the need for the existence of credit societies and develop a plan on their future. These institutions have played a limited role in financial intermediation. There are currently seven credit societies, accounting for only 2% of banking system assets. They are licensed under the Banking Law, but with a restricted license. Credit societies were created in 2005 as a temporary solution for banks that could not meet the US\$5 million absolute capital requirement; since then, several of these institutions have been liquidated. Many are in violation of prudential requirements. The authorities should refrain from licensing any new such entities and develop a plan either to liquidate, consolidate, or transform them, or legally establish a new type of financial institution and license them under appropriate prudential norms..

2.2.2 Microfinance

57. The 2004 Law on Microfinance defines three types of MFOs. Microcredit funds can be created in the form of social funds, with no required capital. Microcredit commercial organizations require a minimum capital of \$10,000 and can borrow from other institutions but cannot take deposits. Microcredit deposit taking organizations are subject to a minimum capital requirement of \$100,000. The microfinance sector has been growing fast in Tajikistan, mainly financing commercial activities but increasingly focusing on rural clients. The number of clients has increased from 27,436 in 2006 to 154,452 in 2009, while the microfinance loan portfolio has increased from \$37 million in 2007 to \$220 million in 2009. This is roughly equivalent to 23% of the aggregate loan portfolio of commercial banks (up from 13% in 2007). MFOs have been fuelling their growth with loans from external foreign investors and remain highly dependent on this source of financing. Deposits have not become a major source of funding, even for deposit-taking MFOs.

58. This dependence on foreign credit lines creates considerable risk related to the exchange rate. Only deposit-taking MFOs are eligible to request a license to make loans in foreign currency. Other MFOs have been borrowing in foreign currency but lending in Somoni. These MFOs have been indexing their Somoni-denominated loans to the US dollar in an attempt to manage the exchange rate risk. However, lending in foreign currency or indexing Somoni loans to the dollar merely shifts the exchange rate risk to the borrowers, most of whom do not earn foreign exchange and are not in a position to manage the exchange rate risk either. The MFOs, in turn, have merely substituted exchange rate risk for credit risk. NBT Instruction No. 168 requires that indexation be stopped, although lending in foreign currency by licensed MFOs is still allowed. Swaps, forward contracts, and other hedging instruments do not exist in Tajikistan. NBT should work with the Association of Microfinance Organizations of Tajikistan (AMFOT) to allow some lending in foreign currency and some indexing, subject to reasonable prudential norms that ensure that these risks are managed. Moreover, where the borrower can demonstrate income or remittances in foreign currency, such lending or indexing should be allowed.

59. There are other aspects of the legal and regulatory framework that could be amended to support the growth of MFOs. NBT currently requires that MFOs obtain prior approval before receiving a foreign currency loan. This makes it difficult for MFOs to maintain the funding levels necessary to grow and remain competitive. NBT should replace this requirement and instead simply require MFOs to register such loans with NBT. The Microfinance Law also hinders the ability of MFOs to raise funds by not permitting them to issue any kind of securities and stocks even though

they are registered as corporations; the Law should be amended to allow such issuance. The regulations of the NBT with regard to reporting and licensing requirements for MFOs could also be simplified rather than requiring that they submit reports similar to those of commercial banks. Current licensing requirements could also be simplified by allowing the bank which holds the account of the MFO to provide NBT with a confirmation of the minimum founding capital rather than requiring the MFO to open a temporary savings account with the NBT and transfer the minimum founding capital to this account and then transferr the amount back when the license is issued.

60. The tax regime and administration facing the MFO sector could also be improved. MFOs in general pay 15% profit tax but a higher 25% tax is levied on additional financial services such as micro-leasing or micro-insurance; the 15% profit tax should be levied on all MFO activities. Further, the Tax Code could be amended to ease the tax burden on Microcredit Funds (MCFs), which are not for profit entities that work in the most remote areas and have the highest operational costs. Finally, some MFOs have been obliged by the tax authorities to pay income and social taxes on salaries *twice* for employees who work at cash service points but are paid through headquarters or the registered branch where they are based.

2.2.3 Insurance

61. Despite growth in recent years, the insurance sector is underdeveloped compared with neighboring countries. Total gross premiums in 2006 were equivalent to \$20 million (or 0.3 % of GDP), an increase from \$8 million in 2005, but the Tajik insurance market remains one of the smallest in the region (Table 5). Several factors contribute to the low insurance penetration, including poverty, income distribution (as growth of life insurance is dependent on the size of the middle class), and the continued lack of understanding of insurance products, low public confidence in the sector, and an out-of-date legal framework.

Table 5. Insurance Penetration and Density in Selected Markets, 2006

	Premium Volume (in USD million)	Insurance Penetration (Premium in % of GDP)	Insurance Density (Premium per capita, USD)	Population (in millions)
Russia	21504.3	2.27	150.9	142.6
Turkey	6618.3	1.62	89.2	74.2
Ukraine	2739.4	2.80	59.6	46.5
Kazakhstan	627.8	0.90	42.3	14.8
Uzbekistan	35.2	0.40	1.34	26.4
Georgia	39.4	0.40	5.43	4.2
Tajikistan	21.0	0.30	1.18	6.5

Source: Sigma and SISS.

2.2.3.1 Policy, Legal, and Regulatory Framework

62. The 1994 Insurance Law, which is the basis of insurance regulatory and supervisory framework, needs significant strengthening. It includes (i) insufficient protection to policyholders against abusive practices and insolvency of insurers; (ii) inadequate legal powers, autonomy, or legal protections for the State Insurance Supervisory Service (SISS) and its staff; (iii) guarantees of monopoly of state-owned insurance companies over 15 different classes of insurance products, which undermine the competitive environment in the sector; and (iv) restrictions on foreign ownership, which deter foreign investment and technology transfer. To begin the preparation of a new Insurance Law, the authorities should conduct a comprehensive review based on International Association of Insurance Supervisors (IAIS) standards and benchmark the current state of the insurance sector, and then prepare a report on different policy options for the structure and development of the insurance sector. Once a decision on the policy framework is made, the authorities should prepare a revised and modern Insurance Law and regulations based on international practices, adapted as appropriate to Tajikistan. Particular attention should be paid to strengthening regulation and understanding of reinsurance and monitoring reinsurance transactions. A plan to strengthen capacity in SISS should also be prepared and implemented.

2.2.3.2 Other Insurance Industry Infrastructure

63. Another weakness of the Tajik insurance industry is its lack of a nationwide insurance association. An industry body could enforce discipline in the insurance market and represent the industry in dialogue with SISS.

64. The lack of timely and good quality insurance sector data prevents a comprehensive analysis of the sector. Loss (or claims) ratios in the sector have generally been very low in Tajikistan (12% in 2006), but based on current data, it is not clear if this is due to resistance of companies to honor policies, under-reserving of technical provision, or under-pricing premiums.. SISS should establish a task force consisting of representatives from SISS, the insurance industry, and other experts to compile historical data for each class of insurance so that SISS and the insurance companies can use them to calculate prudent reserve levels and form the basis of the actuarial practice in Tajikistan.

65. The absence of standardized accounting rules across companies does not allow proper evaluation of the performance of insurers. Accounting and actuarial standards should be applied and reports should be disclosed in a manner that allows current and prospective policyholders, investors, intermediaries, creditors, and supervisors to properly evaluate the financial condition of insurers.

2.2.4 Leasing

66. Leasing is an emerging source of finance for which there is high demand, but the lack of long-term sources of funding is a major obstacle to its development. Despite its rapid growth since the passage of the 2003 Law on Leasing, the volume of leasing remains negligible. However, leasing has significant potential for Tajikistan given the lack of long-term funds for manufacturers' capital investments and because it allows businesses without an adequate credit history to finance equipment based on collateral. There is a large demand for equipment leasing in Tajikistan to acquire new equipment and replace existing obsolete production lines. Banks and leasing companies should

continue to develop leasing products and build capacity to underwrite leasing contracts and attract long-term funding for leasing operations.

67. The legal framework for leasing activities is satisfactory but there is room for improvement. For example, it could be further strengthened by allowing for the re-leasing of equipment. Moreover, the Tax Code should also be amended so that leasing is treated the same as normal bank lending. Currently leasing is treated unequally in that the transfer of an asset from lessor to lessee is subject to VAT payment, whereas no such payment is required when the asset is purchased using a bank loan. This makes leasing less favorable relative to other types of lending and hinders its development.

2.2.5 Capital Markets

68. Capital market activity in Tajikistan is virtually non-existent. Capital markets in Tajikistan lack of benchmark securities and liquidity. Limited transferable collateral precludes repurchase operations by the NBT and prevents the development of an interbank money market. NBT issues certificates of deposit but their auction volumes are small, and Amonatbank purchases almost every issue at negative real interest rates, which suggests lack of competitive market pricing. Moreover, there is no secondary market for NBT certificates. As a result, there are no market-determined interest rates and no yield curve.

69. The government should prepare and implement a program of issuance of government securities in order to, among other objectives, support the development of capital markets. Issuing government securities for different maturities will enable a reference yield curve to gradually be established. This will facilitate the pricing of credit risk in the private sector and create the foundations for the development of the securities markets. The government should securitize the non-marketable government bond on the NBT's books and use the securitized debt to replace NBT certificates of deposit as the NBT's main discretionary market instrument.

70. Efforts should be started also to strengthen the legal, regulatory, and institutional infrastructure for capital market development. Fundamental capital market legal and institutional issues need to be resolved, such as a designating and empowering an appropriate regulatory agency, identifying or establishing settlement systems, establishing custodial arrangements, and creating an appropriate trading platform for securities. A comprehensive review of the current legal, regulatory, and institutional framework for capital markets needs to be undertaken to identify the main gaps with respect to IOSCO core principles. Subsequently, an assessment of different policy options on how to address the gaps in the institutional architecture should be undertaken and then a strategy, including the preparation of the legal and regulatory framework, should be designed and implemented.