



Bank supervision: the role of the human factor

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Kyrgyzstan's banking system has been developing successfully since 2000. The system has annually increased by 15-20%. By Jan. 1, 2008, bank assets had reached 42,056 million soms (\$1.2 billion), including loans worth 20,773 million soms (\$593 million) and deposits worth 19,279 million soms (\$550 million). The coefficient of banking sector assets to the GDP of the country has increased to 31%.¹

The successful and – more importantly, stable – development of the banking system (aside from several cases of bank bankruptcy) is the result of improved macroeconomic conditions, an enhanced operating environment, and a strong system of regulation. However, positive growth indicators do not take into account latent threats, which might lead to a crisis in the financial system and, hence, the whole economy. The most important threat is the decreasing potential of specialists in the field of bank supervision, a key element of the system of state regulation of commercial banking.

The bank supervision system in Kyrgyzstan and its history

The Bank Supervision Division (BSD) of the National Bank of the Kyrgyz Republic (NBKR) is responsible for bank supervision. The BSD consists of the Bank Inspection Division (BID), the External Supervision Division (ESD), and – less related to direct bank supervision – the Problem Bank Monitoring Division (PBMD). In accordance with international practices, banking activities are supervised in two ways: 1) distant supervision – the analysis of bank activities (by the ESD) on the basis of banks' required regular financial reports; 2) complex, direct check-ups in the banks by the BID.

The ESD receives financial information directly from banks and also from external sources, including media reports and letters from state agencies and private individuals. Thus, there is a certain functional division: while the ESD monitors bank balances on a daily basis, the BID deals with the annual bank inspections and checks the financial sustainability of the banks. Its evaluation is based on the international system known as CAMEL, which involves checking a financial institution's "Capital, Assets, Management, Earnings, and Liquidity."

During the Soviet era, there was a united banking system and, hence, there was no need for bank supervision. After the fall of the Soviet Union, Kyrgyzstan's new government gradually realized there was a need for a bank supervision system. The legislative and institutional formation of the supervision system began in 1993-1994.

The goals of bank supervision are not only inspection and control, accepted as supervisory responsibilities in Soviet times. Since the country's economic situation and economic principles have changed, the first range of supervision tasks now includes estimating the risks involved in the activities of economic units, ranging from possible faults in accounting

¹ According to the official data of the National Bank of Kyrgyzstan (www.nbkr.kg).

to miscalculations in developing strategic plans. This change in basic principles of operation is fundamental to understanding the issue of bank supervision in Kyrgyzstan.

According to some experts, the absence of a strong system of bank supervision – in Kazakhstan, for example – has created many difficulties and crises in national banking sectors. In neighboring Kazakhstan, bank supervision, which should ideally function as a counterbalance to the intensive and uncontrolled growth of banks, was not able to accomplish this task. As a result, Kazakh banks became highly dependent on external funding, which led to high volatility and uncertainty in solving internal problems. This, in turn, was intensified by an external pressure – the risk of a world economic recession.

The question of cadres

The first wave of specialists, who performed the supervision function in 1993-1998, established the basic principles. The second wave of employees, who came to the bank supervision structure in 2000-2001, learned from their senior colleagues. However, the third wave of employees, who are currently supervising the banking system, matured in 2006-2007 and, unfortunately, were not able to inherit the necessary experience and sufficient qualifications.

The reasons that led to the outflows of specialists from the NBKR were various: the first wave moved into the commercial banks in 1999-2000, when there was a need to develop the banks' internal and external risk management systems (an increased demand for internal auditors and risk-managers); the next wave left because of unsatisfactory material and social conditions at the NBKR.

And still why do the most qualified specialists leave the bank supervision system, what is their most important motivation? Neither the scientific community nor the NBKR itself has conducted research on bank supervision in Kyrgyzstan, and there is no work dedicated to the problem of cadre outflow.

Still, it is no secret that the major reason bank supervision specialists leave NBKR is the low salary level there. The state regulator cannot compete with commercial banks in terms of salaries for highly qualified specialists. While substantially investing into the training of cadres for its own purposes, the NBKR is often forced to let a specialist leave, even though it is in need of specialists. At the same time, the increasing outflow of specialists does not seem to be of great concern to NBKR's leadership, even though it should be.

Bank supervision is the vanguard of the NBKR; it is at the core of events in the financial system. This structure, if one may say so, is the elite division in any agency that deals with the regulation of a national financial system. It is bank supervision that performs independent financial evaluations of the conditions of commercial banks, a kind of barometer that defines the condition of a banking system's health and serves as the connecting element to secure interactions between the regulator and the financial institutions. Along with this, bank supervision specialists represent the state, and others may judge the professional competence of the whole regulation system based on the bank supervision cadres' qualifications.

The low salary level for bank supervisors at NBKR is the key factor motivating them to change jobs, but it is not the only one. While underlining the problem of the low salary level as the fundamental reason, specialists remain silent about many other factors: some do not see enough opportunities for career advancement; others do not like the bank's principles; a third group leaves under the pressure of disappointment in the overall activities of the NBKR. In each case when an employee decides to leave, he or she has an individual set of reasons, which are not always identical to others' reasons. The point is not to blame the

management, but to point out that sufficient attention has not been paid to this problem, and hence, there are no appropriate conclusions.

Another significant issue that leads to the dissatisfaction of employees in the banking supervision division is the nature of the work involved in performing their duties. As mentioned above, the main task of supervision is risk estimation, i.e., the estimation of the internal and external risks of the bank that is being evaluated. However, in practice, during the inspection, staff members are requested by senior managers to concentrate on checking the credit portfolio. According to unwritten and unregulated internal normative requirements, a comprehensive evaluation of a commercial bank is implemented by studying more than 70% of the credits in the bank's credit portfolio; otherwise the results of the evaluation will not be accepted. Even if major risks are identified during the credit portfolio check-up, the inspection team must study other significant aspects of the bank's activities.

At the same time, according to the latest data, there has been rapid growth in the number of banks and branches, as well as in their credit portfolios. However, the number of bank supervision inspectors has not increased correspondingly. Therefore, the management must move away from the strict requirement of a mandatory evaluation of the majority of a bank's credit portfolio, and move towards a flexible method of selection. It should be emphasized that the requirement to check the majority of credits leads to a situation in which the creative work of a specialist is replaced by the monotonous process of studying the credit records of banks' loan recipients.

Major risks

Cadre outflow from the bank supervision division is extremely dangerous for the whole banking and financial sector. A specialist with poor qualifications will not be able to perform a quality evaluation and conduct an analysis of the sustainability and stability of bank operations in the long term, which is very dangerous. The evaluations simply turn into fiction, which does not benefit the commercial banks, the taxpayers, or the state.

From the positive perspective, the rapid turnover of specialists in the bank supervision division leads to the incorporation into the division of "fresh" young people who strive to gain new knowledge and are eager to learn quickly. The problem here is the absence of instructors. The experienced bank supervision specialists leave without sharing their knowledge and experience with the younger generation. The absence of a knowledge-sharing tradition results in a situation in which young people who do not have the necessary skills, experience, or knowledge, carry out inspections.

Therefore, at the moment, the most concrete problem is the question of how to retain experienced employees at the NBKR until they share their knowledge with the next generation. In developed countries, bank supervision division employees constitute a kind of "sacred caste." They are protected and well cared for. Salaries in the bank inspection structures in such countries as the USA or Great Britain are still lower than in commercial banks. However, the employees in these structures appreciate belonging to this circle of specialists. For them, the most important motivating force is the moral component of the work, rather than the material one.

Several words can be said about the period of time that is necessary to train a bank supervision specialist. As a result of the complexity of the tasks that an inspector faces, a specialist must have extensive knowledge of banking, law, and economics, as well as some specialized knowledge of accounting. A specialist must also have skills in analytical thinking, written communication, negotiation, and leading discussions. The average period of time needed to train an inspector for the lowest stage of supervision is 1-2 years; it takes

another year to train a leading inspector and 1-3 more years to prepare a chief specialist. Thus, the period of training and preparation for a mature chief inspector, who can be responsible for managing inspection activities, is almost 5 years.

While conducting inspections of banks that are under the observation of powerful structures, inspectors constantly feel psychological pressure. From one side, the commercial banks pressure them with demands for a loyal attitude. From the other side (in the case of non-qualitative inspections) there is the possibility that they might bear a serious responsibility, even a criminal one. Thus, the inspectors are caught between two "fires": the necessity to perform their functions properly and the necessity to protect their own interests. Given this situation, specialists' confidence that top management will support them in a controversy is one of the foundations of bank supervision.

Recommendations to the leadership of the state regulator

Is it possible to prevent cadre outflow and build the foundation for a system of succession in the bank supervision structure? In our view, the followings steps are necessary:

Firstly, when a bank supervision specialist asks to resign, it is necessary to deeply consider his or her reasons for taking this step.

Secondly, there should be a separate budget for employees of the bank supervision structure, especially for the most experienced specialists. This would be a way to recognize the necessity of having higher rewards for bank supervision employees.

Thirdly, the consideration of not only material rewards of the job, but its moral character, should be encouraged. It is necessary to improve the prestige of bank supervision.

Fourthly, it is important to show that the management will support bank supervision employees.

Fifthly, it is necessary to perform internal analyses to identify and eliminate the reasons for cadre outflow from the bank supervision system.

Certainly, these measures are not sufficient; there are more methods for motivation and the list may be extended. At the moment, the most important point is to recognize the problem of cadre outflow from the bank supervision system and take the most necessary steps to stop it.

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