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Republic of Belarus: Financial System Stability Assessment—Update, including Report on the Observance of Standards and Codes on Banking Supervision

This update to the Financial System Stability Assessment on the Republic of Belarus was prepared by a staff team of the International Monetary Fund and the World Bank as s background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on January 6, 2009. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of the Republic of Belarus or the Executive Board of the IMF.

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REPUBLIC OF BELARUS

Financial System Stability Assessment—Update

Prepared by the Monetary and Capital Markets and European Departments

Approved by Christopher Towe and Marek Belka

January 6, 2009

This Financial System Stability Assessment (FSSA) Update is based on work of the joint IMF-World Bank Financial Sector Assessment Program (FSAP) Update team, which visited Minsk in September 2008. The FSAP Update findings and recommendations were integrated into discussions of the Stand-By Arrangement in November-December 2008.

The FSAP team comprised Michael Edwards (mission chief, World Bank), Vassili Prokopenko (deputy mission chief, IMF), Michaela Erbenova, Yulia Makarova (both IMF), Michel Noel, Alexander Pankov (both World Bank), Michael Boss (Austrian National Bank), Joerg Genner (German Supervisory Authority), and Fernand Naert (formerly Belgium Supervisory Agency). The FSAP team received excellent cooperation from the authorities and market participants.

The main findings of the FSAP are:

- The Belarusian financial sector has so far weathered the ongoing turmoil well, reflecting its relatively closed nature and the dominant role of state-owned banks, but a weakening macroeconomic outlook and a much less favorable external environment raise a variety of challenges. While the new deposit insurance scheme represents a major step forward, further efforts are needed to develop robust and sound crisis management framework.

- The regulatory and supervisory framework has improved since the 2004 FSAP, though concerns remain in some crucial dimensions, especially with respect to the lack of full independence of the supervisory agencies and the restrictions on activities of non-bank financial institutions, which impede the development of insurance sector and securities market.

- The planned overhaul of the government-directed lending mechanisms in the context of the Stand-By Arrangement will help to ensure the long-term viability of the Belarusian banking sector.

The main authors of this report are Vassili Prokopenko, Michaela Erbenova, and Yulia Makarova.

FSAP assessments are designed to assess the stability of the financial system as a whole and not that of individual institutions. They have been developed to help countries identify and remedy weaknesses in their financial sector structure, thereby enhancing their resilience to macroeconomic shocks and cross-border contagion. FSAP assessments do not cover risks that are specific to individual institutions such as asset quality, operational or legal risks, or fraud.

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GLOSSARY

AML/CFT	Anti Money Laundering/ Combating the Financing of Terrorism
BCP	Basel Core Principles for Effective Banking Supervision
BISS	Belarus Interbank Settlement System
CPSIPS	Core Principles for Systemically Important Payment System
ELA	Emergency Liquidity Assistance
EU	European Union
FATF	Financial Action Task Force
FSAP	Financial Sector Assessment Program
GDBS	General Directorate for Banking Supervision
GDP	Gross Domestic Product
IFRS	International Financial Reporting Standards
IOSCO	International Organization of Securities Commissions
MoF	Ministry of Finance
MSME	Micro-, Small- and Medium-size Enterprise
NBRB	National Bank of the Republic of Belarus
NPLs	Non-Performing Loans
OECD	Organization for Economic Cooperation and Development
ROSC	Report on the Observance of Standards and Codes

EXECUTIVE SUMMARY

The Belarusian financial sector has so far weathered recent strains well, but is facing mounting challenges. The latest bank performance indicators remain satisfactory, and the relatively high aggregate capital adequacy ratio of banks provides some cushion for unexpected losses. However, in the context of a much less forgiving external environment and a slowdown in Russia and other main trading partners, the financial system has become particularly vulnerable to credit and liquidity risks. Measures taken by the authorities in recent weeks, particularly the adoption of a blanket guarantee on household deposits in early November 2008, have helped to maintain systemic stability.

Overall, the authorities have achieved progress in modernizing the financial sector since the initial FSAP in 2004. Several important laws and regulations have been adopted in recent years. Privatization of banks and non-financial enterprises has reached a new stage with the elimination of the golden share rule in 2007, and the divestment of government stake in some of the largest banks is now under discussion. The regulatory and supervisory framework has also improved, though concerns remain in some crucial dimensions. In particular, the lack of full independence of the agencies in charge of supervision of bank and nonbank financial institutions, first raised in the 2004 FSAP, continues to pose operational and reputation risks. The regulatory regime for nonbank financial institutions is not supportive of the development of insurance sector and securities market.

Despite some achievements, sound and sustainable financial sector development in Belarus remains constrained by the pervasive government influence. Significant state ownership of banks and nonfinancial enterprises, the large share of bank lending under various state programs, and various administrative controls have reduced the incentives for banks to carry out effective risk assessment and management, and allowed many nonviable enterprises to survive. To better ensure the long term viability of the banking sector, the authorities are urged to overhaul the existing directed lending mechanisms.

The recommendations of the mission are prioritized in Table 1. Appendixes I and II summarize the status of key recommendations made by the 2004 FSAP.

Table 1. Belarus: Main FSAP Update Recommendations

Recommendations	¶	Timeframe
Highest Priority 1/		
1. Carve out government-directed loans from bank balance sheets and concentrate them in a single agency	¶34	Continuous
2. Strengthen independence of the NBRB Board and bank supervisory processes	¶17	Short term
3. Revise the loan classification and provisioning requirements to reflect the entire balance of non-performing loans	¶17	Medium term
4. Engage a qualified experienced consultant to assist the Belarusbank privatization working group	¶36	Medium term
5. Move government deposits from banks to the NBRB in line with the schedule for repayment of corresponding loans	¶35	Continuous
6. Document the framework for emergency liquidity assistance	¶22, 23	Short term
7. Abolish the obligatory reinsurance requirement for local insurance companies	¶19, 37	Medium term
Lower Priority		
1. Adopt a crisis management framework and operational guidelines	¶21	Short term
2. Make explicit the legal power of the NBRB to suspend dividend payout	¶25	Medium term
3. Establish legal certainty regarding the outcome of license withdrawal	¶26	Medium term
4. Provide for a more expedient bankruptcy proceedings	¶27	Medium term
5. Strengthen autonomy of the insurance and securities market supervisors	¶18, 20	Medium term
6. Allow private insurance companies to sell compulsory insurance products	¶37	Medium term

1/ The authorities are committed to implement these recommendations, some of which are included in the Letter of Intent and the Memorandum of Economic and Financial Policies, which accompany this FSSA.

I. Sources of Potential Risk to Financial Stability

A. Macroeconomic Environment

1. **The Belarusian economy has performed strongly since 2004, which masked the build-up of vulnerabilities**. Annual real GDP growth has been around 10 percent since 2004, and despite the substantial increase in energy import prices from January 2007, macroeconomic performance remained robust until the fourth quarter of 2008 (real GDP growth was 8¼ percent in 2007 and 10¼ percent in the first half of 2008).[1] At the same time, international reserves remained low, and structural reforms were lagging. Monetary policy has remained anchored by the fixed exchange rate regime.

2. **Recent global developments have exposed these vulnerabilities**. As discussed in more detail in the accompanying staff report, the demand for exports from Russia and other main trading partners of Belarus has fallen sharply in recent months, while the energy import price is slated for further increase in 2009. Key sources of external financing have dried up.

B. Major Counterparties of Belarusian Financial Institutions

Corporate sector

3. **The corporate sector remains the largest client of Belarusian financial institutions**. Lending to the corporate sector represents over two thirds of the total stock of loans issued by Belarusian banks. A significant share of those loans represent lending under various state programs (directed lending), or lending to enterprises with government guarantees (Box 1).

4. **The financial condition of the Belarusian corporate sector has been satisfactory so far, but is likely to worsen in the coming months**. Despite the negative energy import price shock, a substantial increase in export prices in 2007 helped Belarusian enterprises to maintain adequate profitability. In addition, the productivity of recent years' large investments has turned out to be higher than expected and allowed an exceptionally rapid expansion of non-energy exports to the Commonwealth of Independent States countries. According to the NBRB data, the share of loss-making enterprises decreased from 19 percent in June 2007 to 11 percent in June 2008.[2] This ratio may, however, increase following the

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[1] Until December 2006, Belarus received oil and gas from Russia at the price of internal Russian market, which is significantly below the world market price. As specified by the December 2006 agreement with Russia, the price of Russian natural gas will gradually increase toward the EU level by 2011, and an export duty will be levied on oil exports from Russian to Belarus.

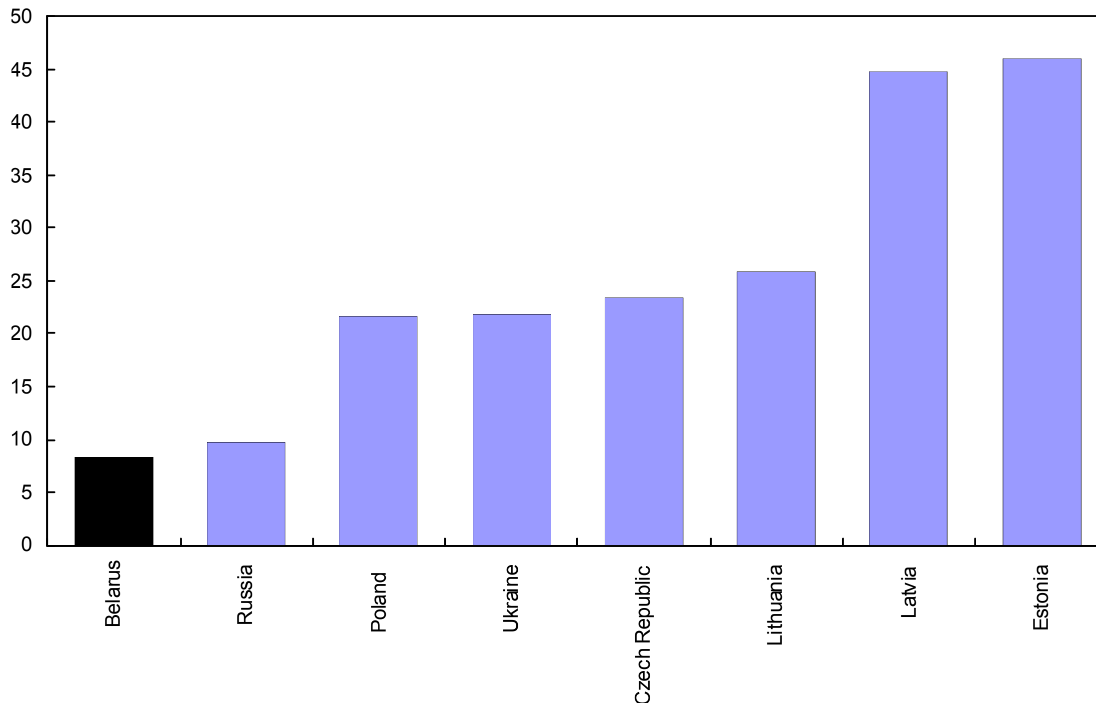
[2] NBRB's survey of financial condition of Belarusian enterprises, January-June 2008.

macroeconomic slowdown in Russia. Despite growing indebtedness, the leverage ratio of the Belarusian corporate sector was only around 33 percent in June 2008.

Household sector

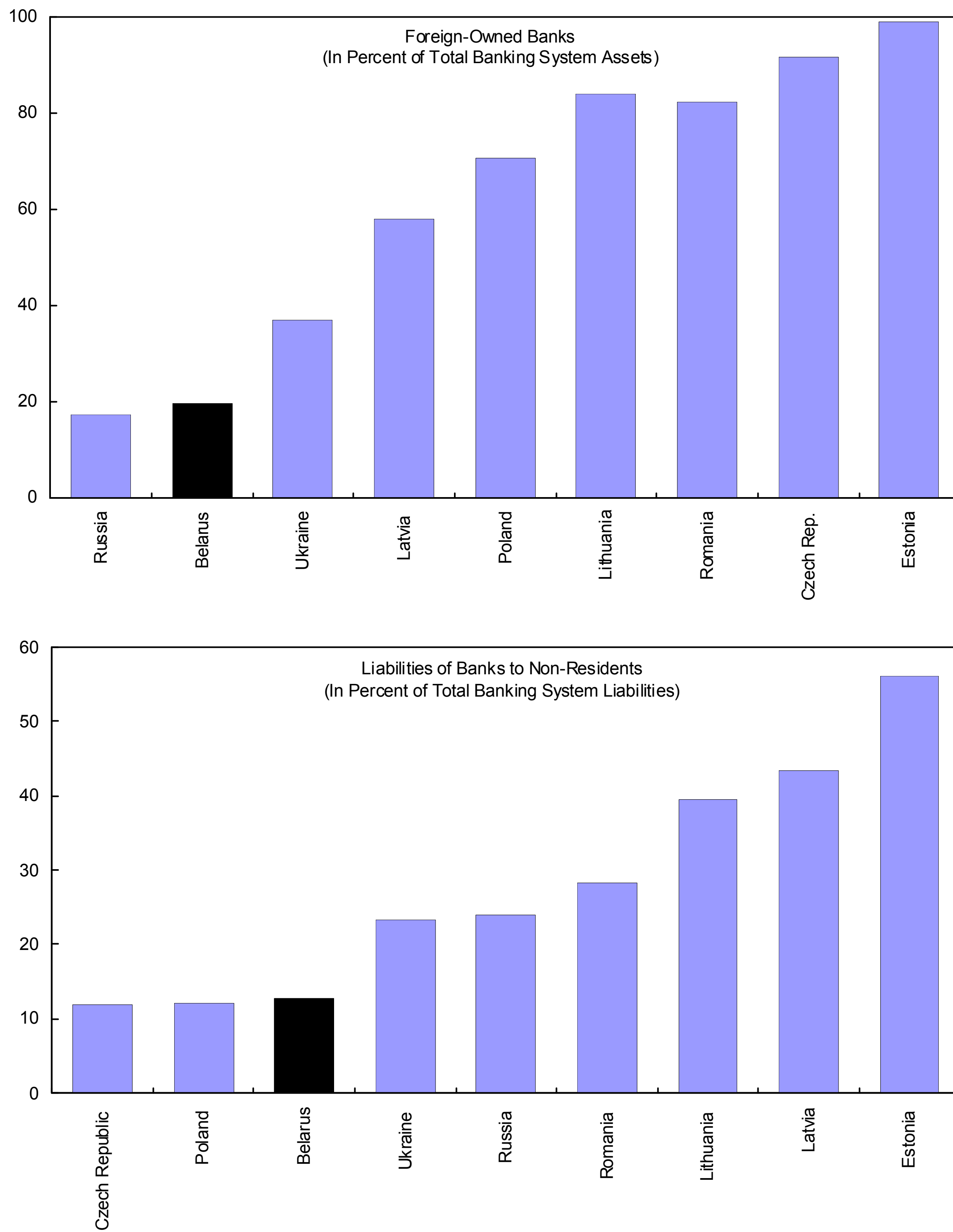
5. **The debt servicing capacity of Belarusian households is satisfactory, which reflects a relatively low level of household indebtedness**. Household debt in terms of GDP (8.4 percent as of end 2007) is one of the lowest in Europe (Figure 1). As a result, household debt-to-income ratio in Belarus is also relatively low. The household debt level will probably continue increasing over the medium term, especially if the macroeconomic recovery is accompanied by the entry of foreign banks.

Figure 1. Selected Eastern European Countries: Household Debt
(In Percent of GDP; end-2007)



Source: Central Banks and IMF staff estimates

Figure 2. Selected Eastern European Countries: Foreign Exposure of Banks
(as of end 2007)



Sources: Central banks, Fitch Ratings, and IMF Staff estimates

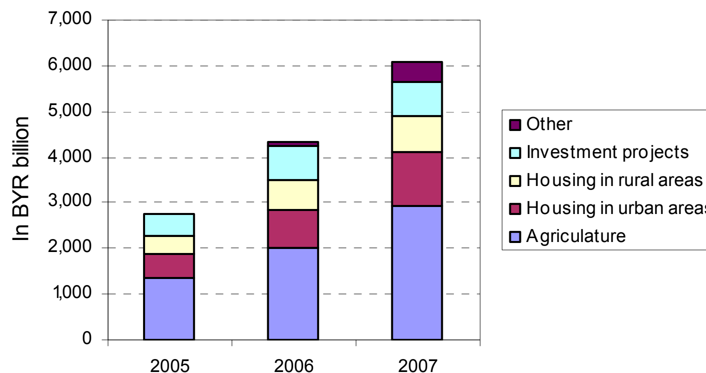
Box 1. Belarus: Recommended Lending

Bank lending under various state programs—or government recommended lending—remains a distinctive feature in Belarus. Every year, the authorities approve a new list of state programs and a list of banks, which are "authorized" to provide financing under these programs. The programs involve lending to priority sectors, projects, and individual companies. Around 30 such programs are in place in 2008, and the nine largest Belarusian banks are involved in their financing. Almost all recommended loans are distributed by the two largest state-owned banks and are predominantly channeled to the agriculture sector (Figure).

Government recommended lending is often provided at subsidized interest rates. In the largest banks, 60–70 percent of recommended credits are extended at subsidized rates. The level of these subsidized rates is defined by the terms of state programs, along with the maturity of the loan. The interest rate subsidy is paid by the Treasury, but only for the part of lending which is funded by non-state sources (deposits excluding government deposits and NBRB funding). In some programs, the compensation is paid by the Treasury directly to the borrower, which is charged a regular, non-subsidized interest rate by the bank.

Government recommended loans are often guaranteed by either central or local governments. As of June 2008, the outstanding stock of government guaranteed loans was around BYR 8.5 trillion (equivalent to around US$4 billion) or one fifth of all bank loans to the economy. The share of guaranteed loans in total loans has been steadily increasing in recent years.

Figure. Belarus: Flow of Government Recommended Lending



Source: NBRB.

Rest of the World

6. **The financial sector in Belarus remains relatively closed to the rest of the world**. The penetration of foreign banks or other financial institutions in Belarus or Belarusian financial institutions abroad is still very limited.[3] However, the share of foreign funding of Belarusian banks has grown substantially over the past few years, which increasingly exposes banks to external developments and risks, even though the dependence on foreign funding remains well below the level of other countries in the region (Figure 2).[4]

7. **While foreign-owned banks rely substantially on funding from their parents, mainly from Austria and Russia, most of the external financing attracted by large state-controlled Belarusian banks are syndicated loans**. Syndicated loans comprise around one third of all short-term debt contracted by Belarusian banks. This form of funding is typically more expensive and less stable than funding from foreign parents. The maturity of syndicated loans contracted by Belarusian banks is typically one year, and the interest rate spreads on these loans are very high, owing to Belarus's low sovereign rating.[5] Since the intensification of global financial turmoil in September 2008, none of the Belarusian banks have been able to attract new syndicated loans at affordable terms.

II. Strengths and Vulnerabilities: Institutions and Markets[6]

A. Banks

Performance

8. **With the exception of liquidity ratios, financial soundness indicators for the banking sector appear satisfactory (Table 2)**. The aggregate capital adequacy ratio has been on a declining trend in recent years, but it was still 16.5 percent as of September 2008. The injection by the government of BYR 3 trillion to boost the capital of four large state-owned banks in December 2008, which is appropriate in the current uncertain environment, has further improved their financial position. The aggregate profitability indicators also appear adequate. The ratio of nonperforming loans (NPLs) to gross loans stood at less than

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[3] Out of 28 banks operating in Belarus in June 2008, 16 banks were majority foreign-owned, but their combined market share was only around 20 percent of the total. This figure would significantly increase in case of privatization of one or two large banks to foreign investors (see Appendix III).

[4] The share of external liabilities of Belarusian banks was 12 percent of total liabilities as of June 2008.

[5] Interest rate spreads were around 300 basis points over the LIBOR on syndicated loans attracted by Belarusian banks in mid-2008.

[6] See Appendix III for a description of the financial sector structure of Belarus.

1 percent since 2007, partly reflecting rapid credit growth, which was nearly 50 percent annually in nominal terms in recent years (Figure 3). However, the loan-to-deposit ratio is very high (165 percent as of September 2008), and some individual commercial banks have at times experienced difficulty in complying with minimum prudential liquidity ratios. Despite the deteriorating macroeconomic outlook, bank deposits have remained broadly stable in recent months.

9. **The reported figures are likely to overstate banks' capital position to a certain extent**.[7] The information on loan quality is distorted by the loan classification and provisioning practices (see details in ¶17). Banks are also allowed to fully include revaluation reserves in regulatory capital. The indicative target for bank NPL ratios, which is annually set by the authorities (2 percent in 2008), may create incentives for misreporting, even though there is no formal penalty for non-compliance.

10. **The performance of banks is significantly affected by the state-influenced lending (Box 1)**. State-influenced lending interferes with the development of a sound risk culture, precluding the proper pricing and efficient allocation of credit in accordance with inherent risks. It also distorts competition among banks and prevents effective real sector restructuring.[8] The four state-controlled banks, which extend the bulk of recommended loans under state programs, are compensated for the burden of servicing the state development and investment plans. In particular, the funding of these banks is bolstered by government deposits, which in some cases are directly linked to particular lending schemes, as well as short-term loans from the NBRB.[9] In recent years, the government has also recapitalized these banks on an annual basis, with the cost averaging 1 percent of GDP per year. This liquidity and solvency support might not be sustainable if the fiscal position deteriorates, and the planned elimination of directed lending in the context of the Stand-By Arrangement should help to improve the long-term viability of the Belarusian banking sector.

Stress tests

11. **Stress test results indicate that the main vulnerabilities of banks relate to credit risk and domestic liquidity risk**. Stress test results show that banks would be significantly

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[7] The precise magnitude of banks' over-capitalization was impossible to estimate. In conducting the stress tests in the context of the 2004 FSAP, banks' capital adequacy ratios were adjusted downwards, taking into account several quantitative factors, most of which relate to under-provisioning of nonperforming loans. Since 2004, the estimated magnitude of over-capitalization of banks related to these adjustments has significantly decreased (Appendix IV).

[8] See Section IV for more details.

[9] In one of the largest banks, the government deposits (often short term or with undefined maturity) represent over half of total deposits.

affected by the simultaneous increase in imported energy prices, a depreciation of the rubel, and higher interest rates, which are all expected to occur in early 2009. Many banks, including some large banks, also face high credit concentration risk, which is not uncommon for a small economy. As to liquidity risk, large Belarusian banks would be affected particularly strongly by a sudden withdrawal of domestic deposits. Although no significant withdrawal of foreign deposits or contagion to the Belarusian interbank market was observed in the course of the mid-September 2008 turmoil in Russia, a hypothetical withdrawal of 50 percent of liabilities to non-residents would cause short term liquidity of eight banks, including some large banks to fall below the minimum prudential requirement.

12. **Nonetheless, the broad finding of stress tests is that the majority of Belarusian banks could withstand a wide range of shocks (Appendix IV)**. Direct effects of interest rate hikes or exchange rate volatility are small due to the short duration of assets and liabilities, and almost matched net positions in foreign currencies. The effects of deteriorating credit quality would be more substantial, though the high initial level of capital would allow banks to absorb significant losses. Indirect effects of exchange rate depreciation are less important in Belarus than in many other Eastern European countries because foreign currency loans are predominantly issued to the export-oriented enterprises, which are naturally hedged.

B. Nonbank Financial Institutions

13. **The nonbank financial institutions are small and not systemically important**. The insurance sector is growing steadily but still remains under-developed, with total insurance premium equal to below 1 percent of GDP. The sector is characterized by a limited composition of assets, a high concentration, a high state ownership, and a weak competition. Other non-bank financial institutions are practically non-existent.

C. Securities Market

14. **The securities market in Belarus is small and illiquid**. At the beginning of 2008, the value of all securities (debt and equity, public and private) in circulation was equivalent to around US$8.2 billion (18 percent of GDP). While government securities represent the largest share of this amount, there is no yield curve on these securities, which could potentially be used as a benchmark for pricing non-government securities. The equity market is nearly nonexistent and is not used to raise capital.

Table 2. Belarus: Key Financial Soundness Indicators for the Banking Sector

(In percent)

	2004	2005	2006	2007	Mar-08	Jun-08	Sep-08
Capital adequacy							
Regulatory capital (in percent of risk-weighted assets)	25.2	26.7	24.4	19.3	17.9	17.1	16.5
Regulatory Tier I (in percent of risk-weighted assets)	21.0	18.7	17.4	14.0	13.3	12.9	12.1
Total capital (in percent of total assets)	19.0	19.0	17.9	16.0	14.6	13.8	13.0
Asset composition and quality							
NPLs (in percent of total loans)	2.8	1.9	1.2	0.7	0.7	0.7	0.6
Provisions (in percent of NPLs)	32.4	48.4	51.3	61.5	59.1	58.7	60.9
NPLs net of provisions (in percent of regulatory capital)	11.4	6.3	6.1	3.8	4.2	4.2	3.7
FX loans (in percent of total loans)	43.8	37.0	33.8	37.6	37.6	37.3	34.7
Loans to state-owned enterprises (in percent of total) 1/	31.7	26.3	25.4	22.4	22.2	21.3	20.9
Sectoral distribution of loans (in percent of total)							
Industries	35.9	29.7	27.3	26.9	26.9	26.2	25.8
Agriculture	12.6	13.4	14.6	14.4	14.8	14.7	15.3
Trade	7.2	7.3	7.7	8.1	8.8	7.8	7.7
Construction	2.1	2.0	2.2	2.7	2.7	3.1	3.6
Households	21.2	26.3	27.8	27.5	27.4	27.7	28.2
Other	21.0	21.4	20.4	20.4	19.4	20.5	19.4
Profitability							
Return on assets (after tax)	1.5	1.3	1.7	1.7	1.7	1.8	1.7
Return on equity (after tax)	7.8	6.8	9.6	10.7	11.3	11.9	12.0
Interest margin to gross income	56.2	63.0	66.2	64.1	62.1	62.0	62.1
Noninterest expenses to gross income	64.2	65.1	60.9	55.3	55.4	54.8	54.4
Liquidity							
Liquid assets to total assets 2/	27.7	30.4	24.1	22.6	24.7	21.9	20.7
Instant liquidity ratio 3/	64.9	117.8	128.9	104.1	115.8	110.9	n.a.
Current liquidity ratio 4/	63.0	95.9	96.7	98.8	110.6	97.5	91.8
Loans to deposits	123.2	119.9	135.0	144.3	147.7	152.4	165.2
Foreign exchange deposits to total deposits	46.5	38.0	34.7	38.2	39.9	38.3	37.9
Foreign exchange liabilities to total liabilities	51.4	44.6	41.2	44.7	46.6	44.5	40.8
Market risks							
Net open position in FX (in percent of capital)	n.a.	13.1	9.5	4.8	n.a.	n.a.	n.a.
Share of private securities in total assets	0.7	0.5	0.3	1.7	1.9	1.7	n.a.

Sources: National Bank of the Republic of Belarus; and staff estimates.

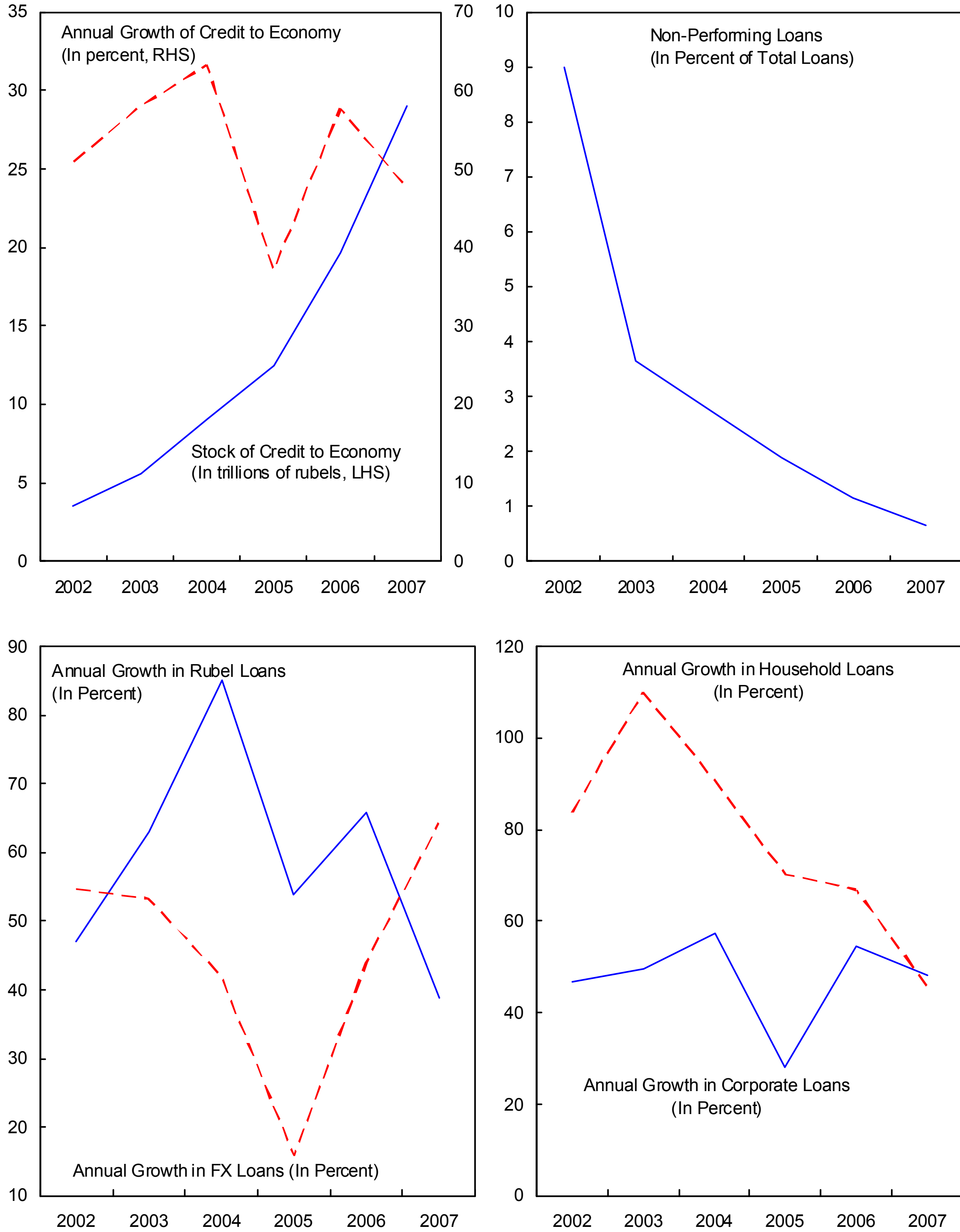
1/ State-owned enterprises are defined as enterprises with a 100 percent state ownership.

2/ The definition of liquid assets was broadened from 1/1/2004 to include all assets with a remaining maturity of less than 1 month.

3/ Ratio of demand assets to demand liabilities.

4/ Assets/liabilities with a remaining maturity of less than 1 month.

Figure 3. Belarus: Indicators of Credit Growth



Source: NBRB, IFS and staff estimates

D. Money Market

15. **The money market remains fairly shallow and segmented**. One large state-owned bank is the dominant borrower, reflecting its tight liquidity condition, which results from the heavy involvement of this bank in government recommended lending programs. The money market interest rates fluctuate within the interest rate corridor set by the NBRB's overnight credit and deposit rates. The corridor is sufficiently wide, and some volatility in money market interest rates occasionally takes place.

III. Strengths and Vulnerabilities: the Policy Framework

A. Regulatory and Supervisory Frameworks

Banking sector

16. **The majority of recommendations made in the context of the 2004 assessment of the Basel Core Principles for Effective Banking Supervision (BCPs) have been adopted or are in process of implementation**. As a result, an overall improved level of compliance with the BCPs has been achieved.[10] The banking supervision directorate of the NBRB is moving from a compliance-based to a more risk-based supervision at an appropriate speed. It applies a good mix of off-site analysis (including regular contacts with board members and senior management of banks) and on-site inspections. The major challenges facing bank supervision are the implementation of consolidated supervision, the introduction of international financial accounting standards for the banking sector, and enhancing the risk management processes and procedures and the risk culture in the banks.

17. **There are, however, several key issues which compromise the effectiveness of banks' regulatory and supervisory framework.** These include:[11]

- Concerns regarding the independence of banking supervision, raised in the 2004 BCP assessment, continue to pose potential operational and reputation risks for the performance of the NBRB. As a member of the government and a representative of the banking sector are both members of the Board of the NBRB, the decision making processes in prudential supervision may be subject to a potential conflict of interest.

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[10] See the summary BCP assessment in Annex I.

[11] The ability of banks to effectively assess, price, and manage credit and related risks has also been affected by the interest rate ceiling on rubel loans to the corporate sector (300 basis points over the NBRB's refinancing rate). Following the recommendations of the FSAP mission, this ceiling was suspended in mid-November 2008, and its permanent elimination is envisaged in the context of the Stand-By Arrangement.

- Given its pervasiveness and impact on the asset composition and profitability of banks, the state-influenced lending has the potential to significantly distort the quality of bank supervisory analysis.

- Loan classification and provisioning regime departs from best international practices in several aspects. In particular, granting a borrower a concession, such as a prolongation or restructuring of a loan, does not have an impact on loan classification. In the event of an overdue payment, impairment test with respect to other loans granted to the same borrower is not required. Loans guaranteed by the central and local governments are classified as standard irrespectively of the condition of the borrower and its ability to service the loan, though the government guarantee can be called upon only after the expiration of the loan maturity.[12]

Insurance sector

18. **The autonomy of the insurance supervisor is unduly restricted**. The insurance supervisor is located within the Ministry of Finance (MoF). Its limited autonomy was further eroded in 2006, when the government transferred state-owned insurance companies under the administration of the MoF. The transfer placed the insurance supervisory team in a conflict situation, since the MoF is now acting as the owner, the manager, and the supervisor of the state-owned insurance companies at the same time.

19. **The competition among insurance companies is severely constrained by the limited scope of authorized activities of private insurance companies**. Private insurance companies are not allowed to provide compulsory insurance. State-owned enterprises can buy insurance only from state-owned insurance companies. The reinsurance business is in the process of being monopolized by the state-owned reinsurance company, which was established in 2006.[13]

Securities markets

20. **The regulatory and supervisory framework for securities market in Belarus has many deficiencies**. The securities regulator, which is located within the MoF, lacks

[12] A significant portion of guaranteed loans have long term maturities. For guaranteed loans extended before January 2009, the guarantee can be called only after the expiration of the loan maturity. See Section IV for more details.

[13] Under the laws relating to retention limits, an insurance company's retention of any one risk may not exceed 20 percent its own capital. Starting in November 2006, insurance companies are required to cede a gradually increasing proportion of their excess retention, which these companies could freely purchased in the international market, to the state-owned reinsurance company Belarusian National Reinsurance Organization. This reinsurance company will ultimately have the exclusive right to access the international market for reinsurance.

operational independence, and its powers and resources are limited. In particular, the securities regulator is not provided with the powers to issue regulations, to issue, suspend, or revoke licenses of regulated entities, or to trace the ultimate controllers of the regulated entities. The overall objective of the securities regulator is not defined. The MoF is currently preparing a new law on securities, which should address these shortcomings.

B. Financial Safety Nets and Bank Resolution Framework

Institutional set-up

21. **The ongoing global financial turmoil and the prospective sale of some of state-owned banks to foreign banks underscore the need for having an institutional framework for dealing with a potential financial crisis**. Such a framework still needs to be formalized in Belarus, defining roles and powers of various authorities, and setting practical guidelines for coordination and information exchange. Due to the possibility that adverse developments in systemically important institutions can require use of public funds to prevent wider economic disruption, the MoF should play a central role in such arrangements. The new Agency for Deposit Insurance should also be involved. In many countries, such coordination often takes the form of memorandum of understanding.

Emergency liquidity assistance

22. **Currently, there is no documented policy for the provision of emergency liquidity assistance (ELA)**. Internal understanding exists within the NBRB about key principles of ELA, but a formalized policy as well as a more detailed operational framework are missing. Such a framework should describe: (i) the circumstances in which ELA could be granted, (ii) the types of institutions that could get ELA, and (iii) the terms and conditions for granting ELA, including collateral requirements. The existing monetary policy, financial stability, and payment systems committees of the NBRB can be used as a basis in setting up the operational framework for ELA.

23. **The use of new uncollaterized NBRB lending to banks should be avoided**. In October 2008, the NBRB was allowed to provide ELA to banks without collateral, and some banks have already used this facility.[14] While the available collateral in the form of government securities, NBRB bills, and bank bonds is relatively limited (as of June 2008, these securities were equal to only around 6.2 percent of total banks' assets), there are concerns that this new uncollaterized facility can unintentionally be used for solvency support to non-viable banks. This facility should be used only in exceptional circumstances. At a minimum, the provision of uncollaterized ELA should include specific requirements to

[14] This facility can be extended for up to 30 days at a penalty rate of the NBRB's Lombard rate plus 300 basis points.

be imposed on the bank's activities, such as increased supervisory oversight or limitations of certain risky activities.

Deposit insurance

24. **The new deposit insurance framework levels the playing field across the Belarusian banks**. The Law on Deposit Insurance was passed in July 2008 and is effective from January 2009. It represents a clear improvement over the previous set of legislation that covers a very complex system of deposit insurance. In particular, the law: (i) treats state and non-state owned banks equally; (ii) treats foreign and local currency deposits equally, thereby reducing the incentives for dollarization; (iii) regulates relations of compensation of bank deposits by a specially created legal entity—the Agency for Deposit Insurance, with a mandatory membership for all banks; and (iv) covers only household deposits (see details in Table 3). In early November 2008, the authorities extended a full guarantee on all household deposits with a view to preventing a potential run.[15] These arrangements will need to be kept under review, but only once the financial sector and macroeconomic situation stabilizes, will it be appropriate to begin consideration of a removal of the blanket guarantee.

Remedial action framework

25. **The NBRB has a wide range of powers to deal with a bank in distress, though it has no right to stop dividend payout by banks**.[16] Currently, the NBRB receives *ex ante* notifications on intended distribution of profits, but it lacks an explicit authorization to prohibit or limit the distribution of dividends. Having the power to stop dividend payout would enable the NBRB to prevent weakening of a bank's financial condition in times of stress, while ensuring that bank owners do not derive undue benefits.

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[15] The contingent liability of the government related to the blanket guarantee is currently equal to 10.5 percent of GDP.

[16] In particular, the NBRB can: (i) request a bank to implement measures for financial rehabilitation, including revision of its asset structure; (ii) request removal of bank managers; (iii) propose to bank shareholders to increase bank capital; (iv) temporarily suspend a banking license or particular activities for up to one year; and (v) revoke a bank license. The NBRB is also entitled to impose stricter prudential requirements for individual banks, and to appoint temporary administration. Temporary administration has been imposed in two banks in the recent past.

Table 3. Belarus: Deposit Insurance

	Old Framework (effective until December 31, 2008)	New Framework (effective from January 1, 2009) 1/
Covered institutions	All banks except the six largest 2/	All banks
Covered deposits	Household deposits in rubel and foreign currencies	Household deposits in rubel and foreign currencies
Coverage limit	Equivalent of US$1,000	Blanket guarantee
Co-insurance	No	No
Premium	0.05 percent of deposits per month, if the amount of insured deposits does not exceed the capital of the bank; if the amount of insured deposits is above the capital of the bank, the contribution rate increases by 0.05 percentage points for each incremental amount of deposits equal to the capital of the bank	0.3 percent of deposits per quarter 3/
Target for the size of the fund	No target	5 percent of the insured deposits; if the fund reaches this amount, the premium reduces to 0.15 percent of deposits per quarters
Timeline for compensation payments	No timeline specified	No more than one month after the withdrawal of bank license
Mandate of the deposit insurer	Pay box administered by the NBRB	A new agency which will remain a pay box

1/ The Law on Deposit Guarantee of July 2008 established a coverage limit equivalent of €5,000, but a Presidential decree of November 4, 2008, has subsequently extended a full guarantee on all household deposits in all banks. While this is a temporary measure, the decree did not specify the date until when the blanket guarantee is in place.
2/ Two largest state-owned banks benefit from a full guarantee on all their deposits, and are not required to pay any contributions. Four other large banks benefit from a full guarantee on all foreign currency deposits, and a guarantee on rubel deposits up to the equivalent of US$1,000, on which they pay a monthly premium of 0.005 percent.
3/ There will be a three year transitional period for the largest bank, Belarusbank, during which the premium paid by this bank will gradually increase every quarter from 0.005 to 0.3 percent.

26. **Furthermore, the supervisory decision to withdraw banking license is potentially reversible by courts**. The courts can void the decision of the NBRB to withdraw a banking license, and require the restoration of banking license within 15 days. Although the courts must have the responsibility to ensure that the supervisory authority in charge does not overstep its legal powers, the courts should not be able to reverse supervisory decisions. The shareholders' interest should be protected by an appeals process for monetary compensation. The current arrangement may also pose an obstacle for a prompt payment of depositors from the Agency for Deposit Insurance.

27. **The regime for bankruptcy of credit institutions is overly lengthy**. Bankruptcy can only be initiated after the revocation of banking license or the certification of the NBRB to the court. While the time limit for this certification is one month, the court has four months to declare its ruling, which creates a potential for a long period of legal uncertainty.

C. Financial System Infrastructure

Payment systems

28. **The payment system architecture is good**. The Belarusian payment system received high marks by the 2004 assessment of the Core Principles for Systemically Important Payment System (CPSIPS), and has been further improved since then. In the course of 2008, all inter-bank payments were gradually transferred to the Belarusian Inter-bank Settlement System, which is a real time gross settlement system. As part of this transfer, payment fees were decreased and the number of staff reduced. Appendix II provides the status of the 2004 CPSIPS recommendations. No formal CPSIPS reassessment was made in the context of the FSAP update.

Credit registry

29. **The NBRB maintains a credit registry, which is planned to be expanded in January 2009**. The registry was established in 2007. The information which is currently included in the registry contains the financial description of loans (amount, currency, date of origination, date of repayment, guarantee, etc.) which exceed an equivalent of US$10,000. Starting from January 2009, the registry will include a broader set of data on all loans, independently of the amount. This information will include, for example, the classification of the sector of activity and the value of collateral. Making the expanded credit registry fully operational should be priority in the short term, though over the longer term, the creation of a privately-operated credit bureau with a comprehensive coverage (i.e., including also non-financial data) should be considered.

Accounting standards

30. **Belarus is in the process of adopting international financial reporting standards (IFRS), and some reporting asymmetry is likely to take place in 2009**. The IFRS will be applied by banks and some nonfinancial enterprises starting in 2009, but concern remains with respect to disclosure. Neither banks nor nonfinancial enterprises will be required to publish IFRS-compliant financial statements, which is likely to negatively affect the market discipline. Banks will have the discretion to publish their annual reports according to either IFRS or national accounting standards, and the reporting to the NBRB is based on national standards.

Anti-money laundering and combating the financing of terrorism

31. **The legal framework for the anti-money laundering and combating the financing of terrorism (AML/CFT) has undergone several key changes since the 2004 FSAP**.[17] A new Law on AML/CFT became effective in March 2006, and an NBRB instruction on AML/CFT issues for banks and non-bank financial institutions was passed in February 2008. The instruction sets out, *inter alia*, criteria for organization of internal controls, staff qualification and responsibilities, and know-your-customer requirements. The NBRB hosts periodic seminars for banks, provides methodological assistance, and has entered into cooperative agreements with several other central banks.

IV. Developmental Issues

A. Banks

32. **While development goals are funded through public resources in many countries, the current system in Belarus is complex and distortive**. Large number of lending schemes under the government auspices inhibit effective bank competition, undermine sound credit underwriting, and ultimately results in higher costs for the Belarusian economy. Also, the current framework does not provide incentives for the needed real sector restructuring.

33. **The authorities' decision to change the status of government guarantees from January 2009 represents a significant improvement, but it will apply only to newly issued guarantees**. Until January 2009, government guarantees covered only the loan principal amounts, and could be called only after the expiration of maturity of the loan, if the

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[17] An AML/CFT assessment was conducted in Belarus by the Eurasia Group in mid-2008. The assessment was undertaken in accordance with the methodologies of the Financial Action Task Force, but its results are not expected to be available before early 2009. Hence, this FSSA Update can not reflect on the Eurasia Group findings and recommendations.

bank exhausted all legal means to recover the debt.[18] Starting from January 2009, government guarantees cover both principal and interest rate obligations, and become subject to immediate and unconditional execution upon debtor's delinquency. This change should significantly improve banks' position, at the cost of possible complication of fiscal management, but the risks stemming from the outstanding stock of guarantees issued before January 2009 will remain on the banks' books.

34. **Setting up a dedicated development agency would help address the distorting effects arising from the government guaranteed lending**. Initially, such a development agency could accumulate all existing government-directed loans and associated state funding from commercial banks. Going forward, this agency could become the exclusive source of funding for state development programs. The authorities' intention to establish such an agency as part of a broader process of carving out government-directed loans from bank balance sheets is welcome. The operations of this agency should be included in the budget.

35. **Placements of government deposits and deposits of state-owned enterprises at commercial banks should not be allowed to hamper effective competition**. All deposits of the state budget should gradually be directed from banks to the NBRB, in line with the schedule of repayment of corresponding loans, while deposits of state-owned enterprises should be offered to banks on a competitive basis.

36. **The ongoing bank privatization should also bring long-term benefits, if conducted properly**. The benefits of privatization include enhanced risk management, better resource allocation, and deepening of financial sector. However, there have been instances of failed bank privatization in other transition economies. To ensure that new owners of privatized banks are able and willing to contribute to the achievement of the above objectives, the authorities are encouraged to engage a qualified, experienced, and reputable consultant to help analyze financial condition of each bank slated for privatization, assess strategic options, and develop a time-bound restructuring and pre-privatization plan.[19] Further, the privatization transaction process should ideally be structured in such a way that it results in attracting strategic investors capable of know how and technology transfer, as well as reliable funding support.

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[18] The NBRB has to certify that this activity has been sufficient.

[19] At the time of writing, the authorities intend to sell the minority stakes in the two largest banks and the controlling stakes in two other large banks. A special working group on privatization of Belarusbank, the largest bank in the country, was formed in mid-2008, consisting of representatives from NBRB, various Ministries, and the bank itself.

B. Non-Bank Financial Institutions

37. **The development of insurance sector could be stimulated by granting private insurers more freedom**. The tightly-controlled insurance market that now prevails does not lend itself to the far reaching reforms required. Private insurers should be able to offer mandatory insurance. Motor third party liability insurance, for example, is mandatory in most countries, but can be offered by private companies. The requirement for insurance companies to reinsure a gradually increasing share in excess of retention limits with the Belarusian National Reinsurance Organization is not only damaging effective competition but may also result in a significant concentration of risk. In addition, all insurance companies should be subject to the same degree of taxation treatment.[20]

38. **Further measures are also needed to enhance the development of private securities market**.[21] The legal and regulatory framework covering the protection of minority investor rights should be strengthened. The existing program of privatization of state-owned enterprises should be accelerated, thereby increasing the supply of traded shares. The MoF should design and implement a plan to strengthen government debt management with the objective to develop a domestic government bond yield curve that can be used as a benchmark for the pricing of non-government debt securities.

C. Access to Finance

39. **The level of financial intermediation in Belarus is small, and the access to finance remains limited by regional standards**. As of March 2008, loans per capita in Belarus amounted to an equivalent of only US$415, compared to US$939 in Russia and US$1,370 in Kazakhstan. The level of per capita deposits and the penetration of ATMs and branches of financial institutions are below the levels of neighboring countries. Only several banks are actively working with micro, small, and medium-sized enterprises (MSME), which are among the smallest banks in the system. While these banks offer an array of products to MSMEs, some of which are backed by donor-financed credit lines (eg, EBRD's Microlending Program), the cost of these services remains relatively high. As a result, only a small fraction of Belarusian entrepreneurs receive these services. The provision of MSME loans in the regions is much weaker than in Minsk.

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[20] Currently, premium paid for employee benefits are not tax deductible for enterprises unless paid to state-owned insurance companies.

[21] In recent months, the authorities have taken a number of steps to stimulate development of the domestic securities market. The ban on trading of shares distributed to the public under the mass privatization program in the mid-1990s was lifted. New rules require all equity trades to take place on-exchange, thereby stimulating increasing liquidity on the Belarus Currency Stock Exchange.

40. **The access to finance could be facilitated by regulatory changes and by attracting additional donor resources**. The NBRB should consider modifying the formulae for calculating the ceiling for microloans which are granted under the simplified approval procedure. The present formula imposes unnecessary constraints on banks working in this market segment. Contract enforcement is quite strong, but serious barriers remain to the foreclosure of personal residences taken as collateral, which are expected to be address by the recently enacted Law on Mortgages. The limited availability of long term credits may be expanded through attracting additional donor resources.

APPENDIX I

Belarus: Status of the Key Recommendations of the 2004 FSAP

Recommendations	Status
High Priority	
Commence fundamental financial sector reform, with an essential first step of stopping, or at least winding back, the policy of recommended lending	The policy of directed lending has not been stopped or even scaled back, but it will be curtailed in the context of the Stand-By Arrangement.
Develop a plan for bank restructuring, incorporating:	
- the removal of nonperforming recommended loans from bank balance sheets;	No action, though the share of NPLs has declined markedly since 2004.
- changing the composition of government banks' boards;	The government decree No 694 of May 16, 2008, specified duties of bank directors nominated by the government, which include adherence to sound business practices. The composition of boards of privatized banks has changed. In particular, the NBRB terminated its representation on the governing boards of four banks.
- refraining from measures that create moral hazard and distort the financial markets, such as directing deposits of state owned entities for liquidity provision purposes; and	No action. Directing deposits of state-controlled entities continues to be used as a measure to support liquidity of banks involved in the state program financing.
- elimination of caps on lending rates and informal recommendations to banks to lend at close to the refinance rate.	Eliminated in December 2009.
Increase NBRB independence, and provide banking supervision with greater autonomy.	The NBRB resolution of November 15, 2005, assigned the responsibility for banking supervision to the First Deputy Chairman of the NBRB, and expanded the resources of the supervision department.
Enhance and better enforce the system of supervisory remedial measures.	Worsened. The 2006 Banking Code modified the list of NBRB's remedial measures by eliminating monetary penalties.
Increase the awareness of bank borrowers of the risks implied in unhedged foreign currency lending.	The NBRB regulations of September 28, 2006, require banks to develop and implement internal policies and procedures to ensure effective risk management.
Medium Term and Developmental	
Accelerate the transition to International Financial Reporting Standards (IFRS), especially in the banking sector.	In process. The NBRB regulation of September 27, 2007, requires banks to prepare annual financial statements based on both Belarusian accounting standards and IFRS, starting from 2008.
Approve the proposed new structure of the deposit insurance system.	Done. A new deposit insurance law was passed in July 2008, effective January 2009.
Phase out the golden share rule.	Done. The golden share rule in relation to banks was eliminated by the Presidential decree of August 24, 2006, and the golden share rule in relation to all other corporate entities was eliminated by the Presidential decree of March 4, 2008.
Consolidate all substantive legal provisions in the Law on Securities and Stock Exchanges and remove inconsistencies with other laws, such as the Civil Code.	The Ministry of Finance is preparing a new law on securities and stock exchanges, which will be consistent with other laws.
Implement a phased opening of the insurance sector to domestic and foreign private competition, reduce excessive regulation, relax licensing, tariff setting and controls, and implement a more level playing field in taxation of insurance premiums.	No action.
Strengthen the role and independence of the insurance supervisory authority to ensure adequate on- and off-site supervision.	No action.

APPENDIX II

Belarus: Status of the Recommendations of the 2004 FSAP in the Area of Payment System

Recommendations	Status
Understanding and management of risks *(CPs II-III)* Make available an instrument and procedures for the provision of intraday credit to participants. Allow a greater share of reserve holdings to be used intraday for payments purposes.	The intraday credit facility is in place, and the share of required reserves which banks can use for payment purposes was increased on rubel-denominated liabilities from 10 to 30 percent in 2005 and on foreign currency liabilities from 0 to 30 percent in 2007.
Security and operational reliability, and contingency arrangements *(CP VII)* A comprehensive risk analysis and management framework should be elaborated, documented and implemented and a risk analysis should be made regularly. Business continuity and contingency procedures should be defined, documented and subsequently, regularly tested. Security and performance requirements for communication services should be further elaborated and adherence control strengthened.	The NBRB's approach to analysis and management of risks in the area of payment system and the ways to minimize those risks were reported in the Protocol of the Financial Stability Committee of December 26, 2007. Main payment system risks were presented in Chapter V of the Financial Stability Report of July 2008. The NBRB instruction of May 28, 2008, on payment system oversight has a section on payment system risk analysis and minimization. The procedure to ensure uninterrupted functioning of the payment system in an emergency situation were formulated in the contingency plan of June 30, 2005.
Efficiency and practicality of the system *(CP VIII)* Elaborate on the justification for the large difference in fees and ensure consistency in fees applied. Assess accuracy of cost allocation between BISS and the NBRB clearing system. Develop the cost calculation methodology further and consider including at least some of the investment costs (e.g. software development) in the costs to be recovered. Shorten the operating time and consider introducing some throughput guidelines to banks.	The NBRB regulation of April 27, 2007, aims to transfer all interbank payments to the BISS during 2008. As part of this transfer, payment fees have been reviewed and decreased.
Criteria for participation *(CP IX)* Introduce explicit rules for (voluntary and enforced) exit.	The criteria for access to and exit from the payment system were set by the NBRB instructions of March 10, 2005.
Governance of the payment system *(CP X)* Critically assess and strengthen the governance arrangements for BISS. The roles, duties and the controls thereof could be further clarified in detailed service level agreements between the NBRB and its payment system subsidiaries. Address overstaffing in the Belarusian Interbank Settlement Center and the Center for Banking Technologies, and administrative overhead in general.	The fees charged to banks are now paid directly to the NBRB. The number of staff in the Belarusian Interbank Settlement Center was reduced.
Central Bank Responsibilities in applying the CPs *Responsibilities A-D* The NBRB should formally establish an oversight function (separated from the operational function) and, subsequently, ensure sufficient training in building up oversight competence. Define and make publicly available the main NBRB payment system oversight objectives and policies. Establish an Action Plan for addressing the shortcomings identified in the assessment of BISS against the Core Principles.	New Concept of payment system oversight (July 20, 2007) defines the payment system oversight function of the NBRB, its goals and principles. The NBRB regulation on organization and implementation of the payment system oversight of May 28, 2008, provides methodological basis for payment system oversight.

Belarus: Recent Structural Developments in the Financial Sector

The Belarusian financial sector has grown rapidly since 2004 but remain relatively small compared to other countries in the region (Figure 4 and Table 4). Total assets of financial institutions increased to BYR 54 trillion in June 2008, up from BYR 16 trillion in December 2004, but this was still an equivalent of only around 50 percent of GDP.

The financial sector is dominated by banks. While many European countries have bank-dominated financial sectors, the share of nonbank financial institutions in Belarus is particularly low (less than 2 percent of the total financial system assets).

The banking sector is highly concentrated. As of June 2008, there were 28 banks operating in Belarus, with five largest banks accounting for 84 percent of the market share (in terms of assets). High concentration among commercial banks is not unusual for transition economies as well as other countries with a comparable population to Belarus (Figure 4).

State-owned banks continue to dominate the sector, though there are ambitious privatization plans. Four of the five largest banks in Belarus are state-owned, and the combined market share of all state-owned banks was 76 percent as of June 2008. The authorities have almost finalized a deal to sell one mid-sized bank to a foreign investor, and there are plans to sell the minority stakes (15 percent) in two largest banks and the controlling stakes in two other large banks.

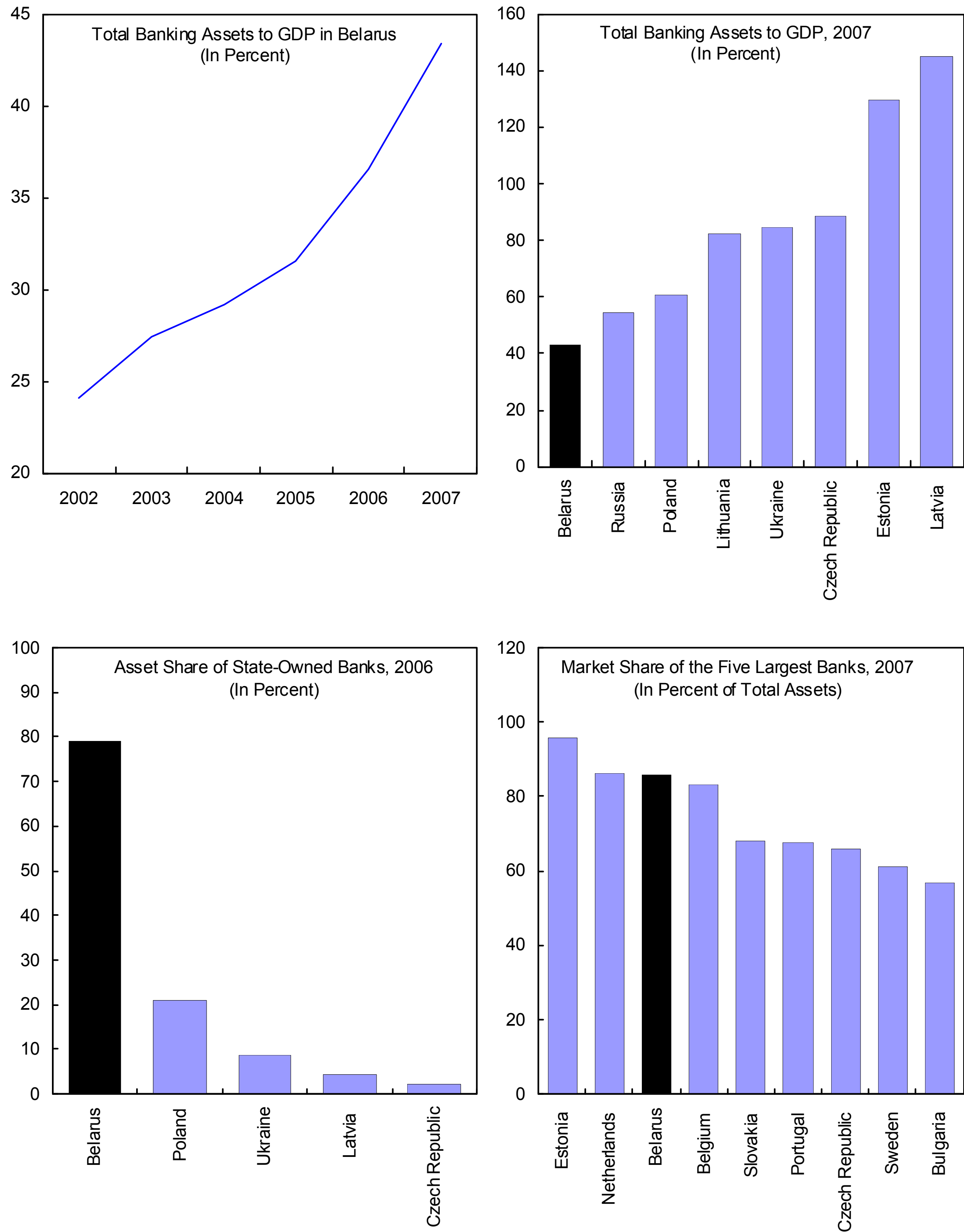
Table 4. Belarus: Financial System Structure
2004-2008

	Dec-04			Dec-05			Dec-06			Dec-07			Jun-08		
	Number	Assets (RBL trln.)	Percent of GDP	Number	Assets (RBL trln)	Percent of GDP	Number	Assets (RBL trln.)	Percent of GDP	Number	Assets (RBL trln.)	Percent of GDP	Number	Assets (RBL trln.)	Percent of GDP
Commercial banks	32	15.4	30.8	30	21.4	32.9	30	30.0	37.9	27	43.0	44.7	28	53.3	48.8
Private	26	4.2	8.4	24	4.8	7.4	25	6.3	8.0	22	10.1	10.5	23	12.8	11.7
Domestic	7	1.1	2.2	6	1.3	2.1	7	1.9	2.4	6	1.7	1.7	7	2.2	2.1
Foreign	19	3.1	6.2	18	3.5	5.3	18	4.4	5.6	16	8.4	8.8	16	10.6	9.7
State-owned	6	11.2	22.5	6	16.6	25.5	5	23.7	30.0	5	32.9	34.2	5	40.5	37.1
Insurance companies	29	0.3	0.7	27	0.4	0.7	23	0.6	0.8	23	0.8	0.9	23	1.0	0.9
Total financial system 1/	61	15.8	31.5	57	21.8	33.6	53	30.6	38.7	50	43.8	45.6	51	54.2	49.7

Sources: NBRB and Ministry of Finance.

1/ The financial sector in Belarus also includes some leasing companies and securities dealers, but these institutions are very small and there are no precise data available on their numbers and size.

Figure 4. Belarus: Indicators of the Banking Sector Structure



Source: NBRB, IFS, ECB, EBRD, and IMF staff estimates

APPENDIX IV

Belarus: Stress Tests

In 2007, the NBRB instituted a stress testing exercises on Belarusian banks. The stress testing framework was initially designed taking into account the work done by the 2004 FSAP. The NBRB has subsequently set up a unit in charge of stress testing. The first issue of the Financial Stability Report in July 2008 describes the methodology and results of the stress tests implemented based on the December 2007 data, and it is expected that future publications of the Financial Stability Report will also include a section on stress testing.

Methodologies and assumptions

The stress tests done for the purpose of the FSAP update were based on end-June 2008 data. The tests were designed and implemented jointly by the FSAP update team and the NBRB staff, and were based on a top-down approach. The results of stress tests were calculated for all 28 commercial banks individually, for the aggregate banking system, and for several peer groups of banks.[22] Although under-provisioning of long-term loans remains an issue, no specific adjustments to the pre-shock capital adequacy ratios were made.[23]

A variety of sensitivity stress tests were undertaken. These tests considered a deterioration in the credit portfolio, fluctuations in the exchange rate, fluctuations in the domestic and foreign interest rates, and sudden liquidity withdrawals. The shocks were calibrated using a variety of methods, taking into account historical experience of Belarus.

In addition, three macroeconomic scenarios were considered. Two scenarios assumed an immediate increase in energy import prices to the international levels, which would result in

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[22] The peer groups included three groups of banks classified by size (large, medium-sized, and small banks) and three groups of banks classified by ownership (state-owned, private domestically-owned, and foreign-owned banks). Banks with a market share in total system assets above five percent were considered as large, those with a share between one and five percent were considered as medium-sized banks, and those with a share below one percent were considered as small banks.

[23] In conducting the stress tests in the context of the 2004 FSAP, banks' capital adequacy ratios were adjusted downwards, taking into account several factors, most of which relating to under-provisioning of nonperforming loans. As a result of these adjustments, the aggregate capital adequacy ratio was reduced by 6.4 percentage points (for more details, see the FSSA of June 2005, IMF Country Report No 05/216). Since 2004, the magnitude of the possible over-capitalization of banks related to these adjustments has significantly decreased (Table 5). As of June 2008, it was around 2-3 percentage points. Therefore, while keeping in mind this over-capitalization bias, it was decided not to implement such adjustments to the capital adequacy for the purposes of stress tests.

a decrease in GDP growth, an increase in interest rates, and pressures on the exchange rate. One of these scenarios assumed that the NBRB would be able to withstand pressures on the rubel which would depreciate only moderately, while the other scenario assumed a sharp currency depreciation. The third scenario was based on the assumption of a significant increase in employee wages, which was scheduled to take place within the next two years. A wage increase would put additional pressure on profit margins of companies, leading to a possible increase in NPLs, in particular in the agricultural sector where the profitability is already very low. In addition, inflationary pressures will rise and as a consequence interest rates would go up.

Results

Overall, results of stress tests suggest that the Belarusian banking system can withstand a wide range of shocks affecting capitalization (Table 6). This is largely due to high capitalization of banks, with the aggregate capital adequacy ratio of 17.1 percent. The baseline capital adequacy ratio for small banks is almost 40 percent, which enables these banks to absorb all major shocks while maintaining the capital well above the prudential minimum.

One main vulnerability for the banking system would emerge in the scenario of an immediate increase in imported energy prices. Even assuming that currency reserves are sufficient to withstand the pressure on the rubel that would certainly emerge within such an environment, the aggregate capital adequacy would shrink by around one third, though it would remain well above the 8 percent threshold. Only three banks with a combined share of 19 percent in total assets would fall below this threshold. Assuming that such a scenario is followed by a devaluation of the rubel, the system capital adequacy ratio would fall to just over 8 percent, and several large and mid-sized banks would be severely affected.

Sensitivity analysis shows that the above results largely reflect the exposure to credit risk. Increase in interest rates would put pressure on credit quality through indirect effects, as most loans have floating interest rates. The depreciation of the rubel would also lead to problems in servicing foreign currency-denominated loans, though this type of risk seems to be less important in Belarus than in many other Eastern European countries because foreign currency loans are predominantly issued to the corporate sector which is naturally hedged through exports.[24] Direct effects of interest rate risk are minor and those of foreign exchange rate risk insignificant, due to almost matched net positions in foreign currencies.

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[24] In many other Eastern European countries (eg, the Baltics, Croatia, Hungary, Poland), foreign currency denominated loans are often issued to households—which typically have income in local currencies—for real estate purchase.

Many banks face high concentration risk with respect to individual borrowers. This is due to the highly concentrated economic structure of Belarus. Assuming a loss given default of 45 percent, the default of the five largest debtors would leave four banks representing 27 percent of total assets undercapitalised with a CAR below 8 percent.

Liquidity risk is another important source of vulnerability of the Belarusian banking sector. As a result of a sudden withdrawal of 20 percent of household and corporate sector deposits, the aggregate current liquidity ratio, which measures assets with a remaining maturity of less than one month over liabilities with a remaining maturity of less than one month, would fall from almost 100 percent to below 50 percent (Table 7). Large banks would be affected especially strongly, with their current liquidity ratio falling to 33 percent (or only one half of the minimum regulatory requirement). Liquidity risk is also high with respect to foreign funding. Although no significant withdrawal of foreign deposits or contagion to the Belarusian interbank market was observed in the course of the mid-September 2008 turmoil in Russia, a hypothetical withdrawal of 25 percent of liabilities to non-residents, would cause current liquidity of three banks, including some large banks, to fall below the minimum requirement.[25]

[25] In relation to foreign owned banks, liquidity risk stems largely from refinancing through parent banks, while for domestic banks, including state-owned banks, this risk can relate to the refinancing in international markets.

Table 5. Belarus: Status of Adjustments to the Banking Data for Stress Testing

2004 FSAP adjustment recommendation	Status
1. Formation of general provisions	
Belarusian banks were assumed to form general provisions equal to 2 percents of their total loans, which were then subtracted from the amount of regulatory capital.	In May 2007, the NBRB authorized banks to create general provisions. While this has not yet become a widespread practice, banks are required to form and maintain a reserve fund equal to 15 percent of the authorized capital. As of mid 2008, the size of this reserve fund was approximately equal to 2 percent of the total loan book.
2. Increase in specific provisions for loans prolongated by official decrees	
It was assumed that 70 percent of the rescheduled loans distributed to enterprises of agricultural and industrial sub-sectors were in fact loss (NBRB's estimate), and should be fully provisioned for, while they were classified as substandard and provisioned for at 30 percent.	Currently over 90 percent of all loans prolongated by official decrees are concentrated in one large bank. According to NBRB estimates, provisioning these loans would lead to a decrease of the aggregate CAR by 0.2 percentage points. Hence, the impact on the banking system's CAR would be insignificant.
3. Increase in specific provisions for the estimated amount of underreported NPLs	
The NBRB on-site inspections in large banks revealed that a part of loans needed to be reclassified and there were substantial underprovisioning for underreported NPLs in largest banks in the country. Therefore, it was assumed that the six largest banks need to increase their provisions for bad loans by 10 percent.	The NBRB reports a major improvement in this area since 2004 with the majority of banks complying with the asset classification requirements. The under-reporting of NPLs revealed in the course of recent onsite inspections is insignificant. A respective adjustment would results in only around 0.05 percentage points decrease in the aggregate CAR.
4. Increase in specific provisions for unclassified part of long-term NPLs	
The rules on the formation of provisions for loan losses authorize banks to establish specific provisions for loans with a remaining maturity of over one year only for the amount of payment overdue. It was assumed that specific provisions for long-term NPLs should be increased by 12 times. This assumption was borne out by the estimation of the average remaining maturity of long-term loans (3 years) and the average number of annual payments scheduled for bank loans (4 times, or quarterly payments).	NBRB estimated the impact of provisioning for the unprovisioned part of long-term NPLs (remaining maturity of over one year) by using the short-term NPL ratio as a proxy for estimating the total NPL ratio, which would result in a 2 percentage points decrease in the aggregate CAR. Although no adjustments were made in the 2008 FSAP stress tests in respect to the unclassified long-term NPLs, the insufficient provisioning for these loans is still a relevant issue that needs to be addressed by NBRB in the near term.
5. Reduction in the amount of revaluation accounts included in the regulatory capital	
Belarusian banks were allowed to fully include their revaluation accounts in the calculation of Tier II capital. It was assumed that only 50 percent of these revaluation accounts are included in the regulatory capital.	The share of revaluation accounts in total capital has been gradually falling from 30 percent in 2001 to 14.6 percent in 2004, to 11 percent as of September 2008 and it is envisaged by the NBRB to drop to 10 percent by the end of 2008. Hence, adjustment in respect to revaluation accounts is becoming less relevant over time.

Table 6. Belarus: Multivariate Stress Testing Results for CAR

(In percent, unless noted otherwise)

	Aggregated CAR							Distribution of individual banks' CAR											
	Total	Size 1/			Ownership 2/			Number						Share in total assets					
	ALL	L	M	S	SOB	FB	PB	< 4	4-8	8-10	10-12	12-16	>16	< 4	4-8	8-10	10-12	12-16	>16
Baseline CAR (prudential minimum: 8.0 percent)	**17.1**	**15.9**	**17.3**	**39.4**	**16.6**	**17.8**	**32.0**	**0**	**0**	**1**	**2**	**3**	**22**	**0.0**	**0.0**	**2.4**	**16.4**	**50.2**	**31.0**
Sensitivity Analysis																			
Credit risk																			
Increase in NPLR																			
Increase of NPLR by 5pp	14.8	13.4	15.4	38.2	14.2	15.9	30.7	0	1	2	2	2	21	0.0	2.4	16.4	48.1	2.5	30.6
Increase of NPLR by 10pp	12.4	10.9	13.4	37.0	11.6	13.8	29.3	1	2	2	0	4	19	2.4	49.0	15.5	0.0	5.9	27.2
Increase of NPLR by 15pp	9.8	8.2	11.3	35.7	8.9	11.6	27.9	3	2	0	2	3	18	51.4	15.5	0.0	2.5	3.9	26.7
Increase in loans categorised lost by sector																			
Increase of lost loans in sector Households by 15pp	14.1	12.9	14.0	36.9	13.7	14.4	30.3	0	2	3	2	0	21	0.0	11.4	43.3	15.5	0.0	29.8
Increase of lost loans in sector Corporates by 15pp	8.0	6.2	10.2	35.3	6.8	10.8	27.2	4	1	2	1	2	18	26.9	40.0	2.5	19.9	3.4	7.2
Increase of lost loans in sector Agriculture by 50pp	11.5	9.1	17.1	39.2	9.2	17.7	31.9	1	1	1	2	2	21	19.9	2.4	7.4	17.0	42.1	11.1
Concentration credit risk																			
Default of the largest debtor with LGD=45%	16.1	14.9	16.2	38.2	15.6	16.7	30.7	0	1	1	2	3	21	0.0	2.4	9.0	15.5	43.3	29.8
Default of the 5 largest debtors with LGD=45%	13.2	12.1	13.2	35.2	12.9	13.4	26.7	0	4	2	2	0	20	0.0	26.9	1.7	42.1	0.0	29.3
Default of the 10 largest debtors with LGD=45%	10.9	9.8	10.8	33.1	10.7	10.9	23.4	3	3	2	0	3	17	11.8	16.7	42.1	0.0	3.3	26.0
Foreign exchange induced rate credit risk 3/																			
Depreciation of Belarusian Ruble by 10% (NPLR: +67%)	16.9	15.6	17.1	38.9	16.4	17.4	31.5	0	1	0	2	3	22	0.0	2.4	0.0	16.4	50.2	31.0
Depreciation of Belarusian Ruble by 20% (NPLR: +175%)	16.6	15.3	16.8	38.6	16.2	17.0	31.1	0	1	0	2	3	22	0.0	2.4	0.0	16.4	50.2	31.0
Depreciation of Belarusian Ruble by 30% (NPLR: +281%)	16.3	15.1	16.6	38.2	15.9	16.6	30.9	0	1	1	1	3	22	0.0	2.4	9.0	7.4	50.2	31.0
Interest rate induced credit risk 3/																			
Increase of Belarusian interest rates by 500bp (NPLR: +215%	16.2	14.9	17.0	38.8	15.6	17.3	31.4	0	0	1	2	3	22	0.0	0.0	2.4	16.4	50.2	31.0
Increase of Belarusian interest rates by 1000bp (NPLR: +392	15.5	14.0	16.7	38.5	14.7	16.9	31.3	0	1	1	2	2	22	0.0	2.4	9.0	15.5	42.1	31.0
Increase of non-domestic interest rates by 100bp (NPLR: +51	17.0	15.8	17.2	39.1	16.5	17.7	31.7	0	0	1	2	3	22	0.0	0.0	2.4	16.4	50.2	31.0
Increase of non-domestic interest rates by 200bp (NPLR: +10	16.9	15.6	17.1	38.9	16.4	17.5	31.4	0	1	0	2	3	22	0.0	2.4	0.0	16.4	50.2	31.0
Market risk																			
Foreign exchange rate risk																			
Depreciation of the Belarusian Ruble by 30%	17.0	15.7	17.3	39.6	16.5	17.9	32.2	0	0	1	2	3	22	0.0	0.0	2.4	16.4	50.2	31.0
Appreciation of the Belarusian Ruble by 30%	17.2	16.0	17.3	39.1	16.8	17.8	31.8	0	0	1	2	3	22	0.0	0.0	2.4	16.4	50.2	31.0
Interest rate risk																			
Increase of Belarusian interest rates by 1000 bp	14.9	12.9	19.5	38.9	13.4	18.6	30.3	0	0	1	2	3	22	0.0	0.0	7.4	11.4	68.0	13.2
Decrease of Belarusian interest rates by 500 bp	18.7	17.9	15.8	39.7	18.7	17.4	33.2	0	1	1	0	5	21	0.0	2.4	1.2	0.0	66.6	29.8
Increase of foreign interest rates by 200 bp	16.9	15.7	16.7	39.1	16.5	17.4	31.7	0	0	1	2	3	22	0.0	0.0	2.4	16.4	50.2	31.0
Decrease of foreign interest rates by 200 bp	17.3	16.0	18.0	39.6	16.7	18.3	32.4	0	0	1	2	2	23	0.0	0.0	2.4	16.4	48.1	33.1
Macro Scenarios																			
Energy Price Shock	12.6	11.3	12.4	36.2	12.1	13.3	28.3	1	2	3	0	2	20	2.4	16.4	50.2	0.0	2.6	28.4
Depreciation of the Belarusian Ruble by 5%																			
Increase of Belarusian Rubel interest rates by 660bp	Implied overall shocked NPLR: 11.0% , increase: +9.1pp, +464% (3)																		
Increase of non-domestic interest rates by 100bp																			
Increase of NPLR due to GDP-decline by 5pp																			
Energy Price Shock with Currency Breakdown	8.1	6.6	7.9	33.4	7.5	8.7	25.1	4	3	1	2	3	15	20.9	48.5	0.7	2.6	21.4	5.9
Depreciation of the Belarusian Ruble by 30%																			
Increase of Belarusian Rubel interest rates by 1000bp	Implied overall shocked NPLR: 19.6% , increase: +17.6pp, +900% (3)																		
Increase of non-domestic interest rates by 200bp																			
Increase of NPLR due to GDP-decline by 10pp																			
Accelerated Wage Increase	16.1	14.9	15.7	38.3	15.6	16.5	30.6	0	1	2	1	2	22	0.0	2.4	16.4	8.1	42.1	31.0
Increase of Belarusian Rubel interest rates by 300bp																			
Increase of non-domestic interest rates by 100bp	Implied overall shocked NPLR: 5.2% , increase: +3.3pp, +167% (3)																		
Increase of corporate NPLR by 1pp																			
Increase of agriculture NPLR by 5pp																			

[1] Sub-groups by size are large banks (L) with share in total assets above 5 percent, medium sized banks (M) with share in total assets between 1 and 5 percent, and small banks (S) with share in assets below 1 percent.

[2] Sub groups by ownership are state owned banks (SOB), foreign owned banks (FB), and domestic privately owned banks (PB).

[3] NPLR is the ratio of NPLs in total loans sensitive to the risk factor under consideration (i.e. foreign currency loans for foreign exchange rate induced credit risk, floating rate loans in respective currency loans for foreign exchange rate induced credit risk, and total loans to households and corporates in the macro scenarios).

Table 7. Belarus: Results of Liquidity Stress Tests

(In percent, unless noted otherwise)

	Aggregated Liquidity Ratios							Distribution of banks' individual Liqidity Ratios							
	Total	Size 1/			Ownership 2/			Number				Share in total assets			
Current Liquidity Ratio (CLR) 3/	ALL	L	M	S	SOB	FB	PB	< 0.35	0.35-0.7	0.7-1	> 1	< 0.35	0.35-0.7	0.7-1	> 1
Baseline ratio (prudential minimum: 70)	97	93	102	146	89	110	157	0	0	9	19	0.0	0.0	64.4	35.6
Domestic Withdrawal															
Withdrawal of 10% private sector deposits	75	66	94	142	58	104	159	0	3	8	17	0.0	60.2	12.3	27.5
Withdrawal of 20% private sector deposits	48	33	84	132	18	96	143	2	3	10	13	59.9	9.8	22.7	7.6
Withdrawal of 30% private sector deposits	31	18	69	118	3	82	121	4	6	9	9	75.4	7.0	15.7	1.9
Non-Domestic Withdrawal															
Withdrawal of 25% of total liabilities to non- residence	83	80	76	139	79	89	148	1	2	11	14	1.2	59.9	26.6	12.2
Withdrawal of 50% of total liabilities to non- residence	70	68	50	136	68	68	147	1	7	7	13	1.2	69.5	17.5	11.8
Withdrawal of 75% of total liabilities to non- residence	55	54	26	133	56	47	146	6	4	6	12	28.6	51.4	16.3	3.7

[1] Sub-groups by size are large banks (L) with share in total assets above 5 percent, medium sized banks (M) with share in total assets between 1 and 5 percent, and small banks (S) with share in assets below 1 percent.

[2] Sub groups by ownership are state owned banks (SOB), foreign owned banks (FB), and domestic privately owned banks (PB).

[3] The Current Liquidity Ratio is the ratio of liquid assets over liquid liabilities, both with a maturity up to one month.

ANNEX I: SUMMARY ASSESSMENT OF OBSERVANCE OF THE BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

The assessment of observance of the *Basel Core Principles for Effective Banking Supervision* (BCP) was performed in accordance with the guidelines set out in the October 2006 Core Principles Methodology issued by the Basel Committee. The assessment was conducted in September 2008, in the context of the IMF-World Bank FSAP Update mission. The assessment reflected the legal and regulatory framework together with the banking supervision practices of the Republic of Belarus as of September 2008. As requested by the authorities, the assessment covers compliance with both the essential and the additional criteria. The assessment was undertaken by Joerg Genner (German Supervisory Authority) and Fernand Naert (formerly Belgium Supervisory Agency).

Information and methodology used for assessment

The BCP assessment was based on: (i) a self-assessment conducted by the NBRB in September 2008 in accordance with the 2006 Core Principle Methodology; (ii) detailed interviews with staff from the NBRB; (iii) review of laws, regulations, and other documentation on the supervisory framework; and (iv) contributions from and discussions with members of the FSAP Update team.

Institutional and macroeconomic setting and market structure—overview

The financial system in Belarus is dominated by banks. As of June 2008, there were 28 licensed commercial banks, including five state-owned banks, seven locally-owned private banks, and 16 foreign owned banks. Five banks dominate the market with a combined market share of over 80 percent of the total assets. In addition to banks, the Belarusian financial system includes a small insurance sector, while other non-bank financial institutions are almost non-existent.

The NBRB is empowered as the bank supervisory, regulatory, and licensing authority by virtue of the Banking Code of the Republic of Belarus. The NBRB operates a comprehensive and transparent system in exercising its exclusive right to grant banking licenses, to maintain observance of bank legislation and regulations, and to impose and enforce prudential rules. The NBRB's General Directorate for Banking Supervision (GDBS) is responsible for licensing and supervising banking institutions. This Directorate is further divided into: (i) Banking System Stability Analysis Department, (ii) Off-site Supervision Department, (iii) Inspection Department, (iv) Prudential Supervision Methodology Department , and (v) Registration and Licensing Division.

Preconditions for effective banking supervision

The preconditions for effective banking supervision are broadly in place, but some gaps remain. The short-term macroeconomic outlook remains uncertain. While the state has a wide influence on banking sector business through ownership of the major banks, there are also concerns with governance of some private bank. The quality of banking supervision may also be affected by the information infrastructure (accounting and asset classification requirements) and the rapidly evolving legal framework.

Main findings

The NBRB has made substantial progress toward establishing its bank supervision system at the level of international best practice. In particular, there has been significant improvement in supervisory processes. The GDBS applies an appropriate mix of off-site analysis and on-site inspections and has begun leveraging off the work of other relevant parties such as external auditors, and to a limited extent, banks' internal audit and risk management. The supervisor has a comprehensive understanding of the market and the supervised institutions. The majority of crucial issues raised in the previous BCP assessment in 2004 have largely been addressed.

However, a range of external factors have a distortive effect on banks' risk management and the GDBS's assessment of banks' financial position. Sound risk assessment and management is impaired by the existence of state program lending and interest rate ceilings. Accounting and prudential standards are weak with regard to identification and write-offs of impaired loans. These factors have the potential to significantly impair the effectiveness of banking supervision. However, in the view of the assessors, the GDBS has to date succeeded in dealing with the challenges resulting thereof.

Objectives, independence, powers, transparency, and cooperation, CP 1

The powers of the NBRB as the only banking supervisor are established in law and a suitable legal framework for banking supervision is in place. The GDBS has transparent processes and adequate resources. However, there are major concerns stemming from the composition of the board of the NBRB—which is the supreme decision making body in prudential matters—that allows interference by representatives from the government and the banking sector. Individual supervisors are protected from law suits when carrying out their work in good faith. Arrangements are in place for exchanges of information with other supervisors, both at home and abroad, subject to the protection of confidentiality. There are, however, questions regarding their effectiveness.

Licensing and structure, CPs 2–5

The legal regime and the effective practice limit the use of the word "bank" and its derivatives only to licensed institutions, and the licensing of institutions as banks appears to be adequate. A comprehensive set of criteria are established in law for the licensing of banks. These criteria include "fit and proper" tests for the bank managers, as well as review of the strategy, business plans, and internal controls of the organization. However, suitability tests of shareholders are not performed. The GDBS has sufficient power to address prudential concerns stemming from the ownership structure of and from investments made by banks.

Prudential regulations and requirements, CPs 6–17

There is a generally satisfactory regime for the supervision of risks in the banks, which cover all the major issues such as credit, market, liquidity, operational and interest rate risk. The capital adequacy regime is based upon the simpler approaches of Basel Capital Accord. However, both weaknesses in the national accounting framework and the significant share of lending under state programs have a potentially significant distortive effect on the informative value of reported capital adequacy ratios. Capital adequacy requirements on a consolidated basis are in the process of implementation. Determining the effectiveness of risk management in banks and assessing the amount of risk exposures is an integral part of the GDBS's ongoing off- and on-site supervision. However, there is room to further advance the forward-looking qualitative risk assessments.

Abuse of financial services, CP 18

The legal framework for dealing with the abuse of financial services covers all the basic elements that are needed. There are rules for "know-your- customer," and there is a financial monitoring unit which collects the data on transactions over a certain amount as well as the data on all suspicious transactions. The GDBS monitors the effectiveness of these arrangements as part of its on-site work.

Methods of ongoing supervision, CPs 19–25

The NBRB performs both off-site analysis and on-site inspections as an integral part of its supervisory approach, and receives a comprehensive set of regulatory reports. There are regular contacts between senior management and board members of the banks and GDBS officers in charge of supervising the institutions. There is a broad range of remedial actions at the GDBS's disposal. Exchange of information and cross-border cooperation with relevant foreign (home) supervisors are limited. The NBRB has not been invited to join colleges of supervisors nor are there regular contacts, despite realistic expectations of the GDBS and its commitment to support home supervisors.

Table 8. Belarus: Summary Compliance with the Basel Core Principles

Core Principle	Comments
1. Objectives, independence, powers, transparency, and cooperation	
1.1 Responsibilities and objectives	The legal framework is adequate with regard to responsibilities and objectives of bank supervisor.
1.2 Independence, accountability and transparency	The NBRB is the sole state body exercising banking supervision and is in legal terms independent. However, the Chairperson of the NBRB's Board, which is the supreme decision making body in prudential matters, is a member of the government, while the Deputy Prime Minister and a chairperson of the board of a commercial bank are members of the Board of the NBRB. There appear to have been cases of pressure to exert forbearance with regard to the observance of key prudential requirements (eg, risk concentration, limits on connected lending, provisioning for impaired assets) with a view of ensuring the financing of state programs by banks.
1.3 Legal framework	The legal framework for banking supervision appears to be adequate.
1.4 Legal powers	The NBRB appears to have at its disposal an appropriate toolbox of supervisory measures and sanctions.
1.5 Legal protection	The law and a collective agreement in place provide for adequate legal protection for NBRB employees while performing their supervisory duties. The regime has proven its effectiveness in practice.
1.6 Cooperation	NBRB is enabled by law to exchange information with both domestic and foreign authorities having competence in the field of banking supervision. The arrangements with the Ministry of Finance are not satisfactory, and the investigative powers of the State Control Committee constitute a threat to the confidentiality of supervisory information.
2. Permissible activities	The legal regime and the effective practice with regard to the permissible activities of institutions that are licensed and subject to supervision as banks, and to the use of the word "bank" in names appear to be adequate.
3. Licensing criteria	The NBRB has no right to refuse to amend and supplement a bank's license on the grounds that the legal, administrative, operational, or ownership structure of the bank will hinder effective banking supervision on an individual or consolidated basis. There are no requirements with regard to the professional skills and business reputation of the members of the supervisory board of a bank and those for executive directors pertain only to banks' CEO and CFO. The capability of a bank's founders to provide financial support to the bank is not provided for as an element in assessing the appropriateness of an application.
4. Transfer of significant ownership	The NBRB is empowered but not formally required to oversee the ongoing suitability of all significant shareholders of banks. There is no requirement to inform the NBRB about developments which may negatively affect the suitability of significant shareholders after the acquisition. Neither is there a power to suspend the voting rights of an existing shareholder, or to request a dilution of shareholdings.

Core Principle	Comments
5. Major acquisitions	The NBRB has all the necessary powers to review major acquisitions or investments by bank, against the prescribed criteria, and to confirm that such investments do not expose the bank to undue risks or hinder effective supervision. Individual investments and the sum of all investments may not exceed caps set at relatively small proportions of a bank's regulatory capital, which do not have prudential grounds and hinder risk assessments.
6. Capital adequacy	The capital adequacy framework is based upon the simpler approaches of the Basel Capital Accord, which reflects the level of sophistication of the banking sector. Although the GDBS has the power to set higher capital adequacy standards, if warranted by changes the economic environment, it is not entitled it to set capital adequacy requirements for individual banks to address specific risk profiles or weaknesses in the risk management processes, or to make deductions from regulatory capital on a case by case basis if its capacity to absorb losses is doubtful. Currently, capital requirements are applied on an individual basis only. National accounting standards depart significantly from international best practices, which affect the evaluation of capital adequacy.
7. Risk management process	Decisions on risk taking can be impaired by vested interests, especially as far as state owned banks and/or practices such as recommended lending and direct investments are concerned. “Targets” on risk taking like indicative ceilings for problem assets share or caps on interest rates or margins prevent the banks from developing a risk culture. There is no obligation for bank senior management to ensure that banks have adequate and effective risk management processes and procedures. Discretionary powers of the supervisor are limited. The use of mechanical formulae dominate over qualitative judgment and risk assessments on a case by case, bank by bank basis, both by banks and the GDBS.
8. Credit risk	There is a sufficient framework for the management of credit risk by the banks and its assessment by the GDBS. However, the existence of recommended lending and state guarantees has a distortive effect on the management of credit risk. It remains unclear, to what extent banks and the GDBS are aware of the potential impacts of foreign currency- and interest rate-induced credit risk, and if these specific causes for credit risk are properly addressed.
9. Problem assets, provisions, and reserves	The regulations neither requires nor encourages an impairment test with regard to all loans granted to the same borrower or group of borrowers in the event of an overdue payment. A delinquent payment does not trigger in practice the provisioning or write-off of the entire exposure, potentially understating losses already incurred. A recommendation of the GDBS not to exceed indicative thresholds of non-performing loan ratios further reduces the likelihood that impairments are appropriately recognized and accounted for. The impairment test does not apply on the entire exposure to a borrower or a group of borrowers. There are potentially significant differences in evaluating bank assets under national accounting standards and IFRS.
10. Large exposure limits	The Banking Code sets prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties that are in line with international best practices. Corresponding large exposure limits are to be introduced on a consolidated basis in the course of the implementation of consolidated supervision.

Core Principle	Comments
11. Exposure to related parties	The framework for dealing with exposures to related parties and the corresponding potential risks is in line with international standards. Nevertheless, exertion of control is not explicitly mentioned in the Banking Code and banking supervisors do not have discretion to apply it on a case by case basis. More fundamentally, given the ownership structure of the banking sector, as well as the existence of recommended/guaranteed lending, and the composition of the NBRB supreme body, a significant part of the lending, especially of the state owned banks' lending, should be qualified as related lending from a prudential perspective, and be treated accordingly.
12. Country and transfer risks	
13. Market risks	
14. Liquidity risk	The shallowness of the interbank market makes banks vulnerable to liquidity risks, in particular as banks depend also on foreign funding.
15. Operational risk	The framework with regard to operational risk appears to be reasonably adequate, but the current reporting and information requirements towards the NBRB do not allow fully adequate periodical assessment of banks' internal systems and procedures for coping with operational risks. There is no practice to evaluate procedures of risk management at the level of bank groups and bank holdings yet.
16. Interest rate risk in the banking book	The present regime is reasonably commensurate with the nature of banking structures and operations in Belarus, though there are no enforceable instructions. The NBRB's internal procedures with regard to assessing interest rate risk in the banking book and those for the assessments of the same during inspections need better formalization.
17. Internal control and audit	The overall regime for internal control and internal audit appears to be adequate with regard to the size, nature and complexity of banking entities in Belarus. The role and composition of supervisory boards should be significantly enhanced and the NBRB should be empowered to oversee their designation and functioning.
18. Abuse of financial services	The key role in AML/CFT is entrusted to a department of the State Control Committee; the functioning thereof has not bee reviewed by the FSAP-team. The overall framework and its functioning have been assessed in mid-2008 by a team commissioned by the Eurasia group. The report of this mission not yet being available, a caveat is to be formulated with regard to the effectiveness of the overall regime in this area. Prudential regulations and supervisory practice with regard to AML/FT appear to be reasonably well established and functioning. NBRB does not, however, require banks to report to it, in parallel with their reporting to the SCC. There are no specific legal or regulatory requirements with regard to "publicly exposed persons."
19. Supervisory approach	The legislation does not establish mandatory requirements for banks to submit on their own initiative information about significant unfavorable developments in their business, except the explicitly indicated information. Communication of such events to the supervisor should be mandatory.
20. Supervisory techniques	The overall supervisory review process appears to be adequately structured and is effectively functioning; its exposure to possible undue external interference at the decision-making stage remains, however, a major weakness. Absence of suitability requirements for members of the Supervisory Board of banks is also a problem.
21. Supervisory reporting	

Core Principle	Comments
22. Accounting and disclosure	National accounting standards for banks differ from the IFRS mostly in accounting for loans with state subsidized interest rates. The existence of two parallel accounting standards and the reliance for prudential reporting on national accounting may impede proper assessment of banks' financial position by the NBRB. Limited number of qualified auditors with knowledge of the IFRS constitutes a significant impediment for the enhancement of external audit quality and building synergies with supervision.
23. Corrective and remedial powers of supervisors	The NBRB has a wide range of corrective and remedial powers, but it can not limit dividend payout by banks as a preventive measure. The NBRB also has no power to remove all executive board members of banks.
24. Consolidated supervision	Supervision of banks on a consolidated basis is being introduced, but prudential norms still have to be applied to all aspects of the business conducted by the groups. The NBRB has identified a number of bank holding groups. Reporting on a consolidated basis, financial as well as prudential, has been introduced. Capital requirements, and prudential limits on large exposures and on exposures to related parties as well as other risks will be imposed on a consolidated basis in 2009.
25. Home-host relationships	The NBRB has established contacts with foreign supervisors of banks with representative offices and establishments in Belarus. Exchange of information or strategies to that effect are not yet elaborated, since some foreign supervisors appear to be reluctant to do so.

Recommended action plan and authorities' response

Recommended action plan

Table 9 lists the suggested steps for improving compliance and provides recommendations where deficiencies are assessed.

Authorities' response to the assessment

The Belarus authorities were in broad agreement with the BCP assessment. They provided a number of technical suggestions and factual corrections to the draft version of the assessment, which have been taken into account. Regarding the assessment of independence, the authorities were of the view that there had been significant achievements towards more independence in recent years, and in practice, banking supervision is sufficiently independent despite the framework that has the potential to result in impaired decision making.

Table 9. Belarus: Recommended Action Plan to Improve Compliance with the Basel Core Principles

Reference Principle	Recommended Action
1.2 Accountability and Transparency	Make all decision making bodies fully remote from external interference.

Reference Principle	Recommended Action
1.6 Cooperation	Improve domestic cooperation on bank supervisory issues Enhance confidentiality of prudential information.
4. Transfer of Significant Ownership	Increase the efficacy of the existing framework by extending its scope to increases of shareholdings. Incorporate the concept of significant influence for the purposes of ownership control into the Banking Code. Introduce a notification requirement with regard to developments that may negatively affect the suitability of an approved shareholder, and extend the scope of the notification requirements to shareholders. Grant the GDSB power to suspend voting rights or request dilution of existing shareholdings if developments occur which would have entitled it to reject its approval to a transfer.
5. Major Acquisitions	Lift the caps on investments which are based upon percentages of shareholdings.
6. Capital Adequacy	Review the ability of reported regulatory capital to absorb losses. Grant the power to set capital adequacy requirements for individual banks to address specific risk profiles or weaknesses in the risk management processes. Grant the power to make deductions from regulatory capital on a case by case basis if its capacity to absorb losses is doubtful.
7. Risk Management Process	Limit the potential impact on decision on risk taking resulting from external factors such as ownership structures, lending under state programs, or administrative targets. Incorporate in the Banking Code an explicit obligation of the CEO and senior management to ensure that banks have adequate and effective risk management processes and procedures. Reduce the use of mechanical formulae and apply more qualitative judgment on risk assessment.
8. Credit Risk	Separate recommended lending and lending against state guarantee from the remaining book. Ensure that potential impacts of foreign currency- and interest rate-induced credit risk are identified and managed.
9. Problem Assets, Provisions, and Reserves	Encourage early recognition of losses and immediate write-offs. Extend the scope of impairment tests to cover all exposures of a borrower/group of borrowers. Ensure more realistic assessments of the current value of future cash flows. Increase frequency of on-site inspections and/or perform target inspections at individual banks as required. Identify and assess differences in reporting data based on the national standards and IFRS.

Reference Principle	Recommended Action
11. Exposures to Related Parties	Incorporate concept of exertion of control in the Banking Code, and grant discretion to apply it on a case by case basis. Remove/limit external factors which impair decisions on risk taking and increase risk of supervisory forbearance.
13. Market Risks	Ensure risk management processes remain commensurate once banks develop an appetite for taking higher risks and invest in more complex financial instruments.
18. Abuse of Financial Services	Move to a more qualitative approach and provide for a proper publicly exposed persons regime.
19. Supervisory Approach	Progressively move to a more qualitative approach. Leverage off external and internal auditors work. Require filing of banks internal risk management and audit reports for off-site analysis.
22. Accounting and Disclosure	Pass to a single set of accounting standards, preferably IFRS. Promote enhancement of the quality the audit profession.
23. Corrective and Remedial Powers of Supervisors	Enable the NBRB to restrict or reinstate the powers of all senior managers in banks. Enable the NBRB to stop or limit dividend payout by banks as a preventive measure.
24. Consolidated Supervision	Continue to implement prudential requirements on a consolidated level. Hold the major bank in a group responsible for compliance with the requirements resulting from supervision on a consolidated basis in cases where the parent of the group is not itself subject to supervision.
25. Home-Host Relationships	Require consolidated supervision by home supervisor for groups acquiring banks in Belarus.