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SELECTED ISSUES

October 23, 2017

Approved By
Middle East and Central Asia Department

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AN EXAMINATION OF TAJIKISTAN'S TAX POTENTIAL[1]

Tajikistan has had notable success in raising tax revenue to GDP ratio over the last 15 years. However, fiscal buffers have been used up in the wake of the external shock. Staff estimates suggest there is considerable potential for Tajikistan to raise revenues to support fiscal consolidation that aims at containing the public debt and building buffers. Key to reach revenue potential is making the tax system fairer, more efficient, simpler, and more productive. This will also help improve economic efficiency, and support income growth and job creation.

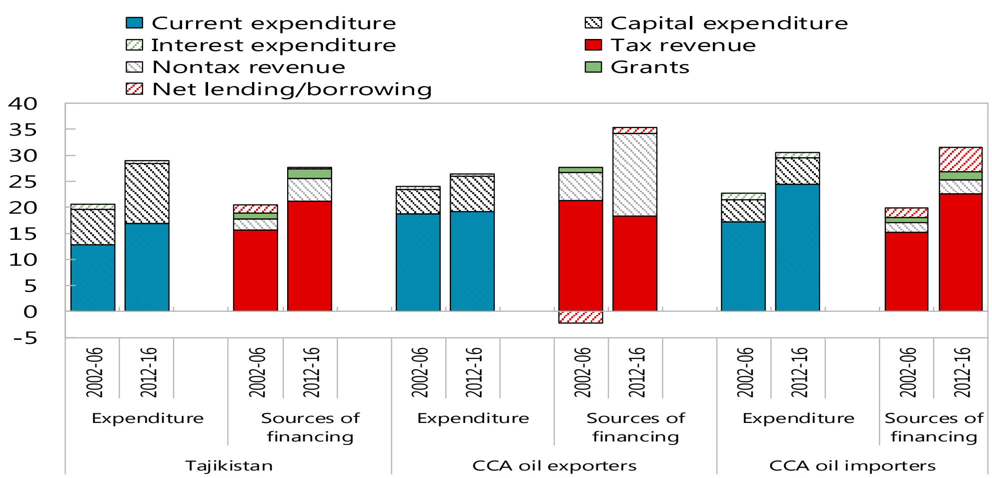
A. Context

1. **Public spending in Tajikistan increased by some 8 percentage points of GDP on average over the last 15 years.** More than half of this increase was used for capital spending, a testament to the authorities' determination to close the infrastructure gap. Capital spending in 2016 explained close to half of the spending envelope. Public spending was overwhelmingly financed by domestic tax revenue, which increased from 16 to 21 percent of GDP between 2002–06 and 2012–16 (Figure 1). Although similar increases in public spending and domestic tax revenues were also noticeable in other oil importing Caucasus and Central Asian (CCA) countries (Armenia, Georgia, and Kyrgyz Republic), on average, public spending in these countries was more oriented towards current spending and the increase in domestic tax revenues was greater. CCA oil exporters bucked the trend, with a more modest increase in public spending and a decline in domestic tax revenue on average, reflecting the collapse in commodities prices since late 2014.

Figure 1. Tajikistan: Public Spending and Sources of Financing

(in percent of GDP)

Tajikistan and other non-oil exporting CCA saw a strong increase in public spending and tax revenue



Source: National authorities; and IMF staff estimates.

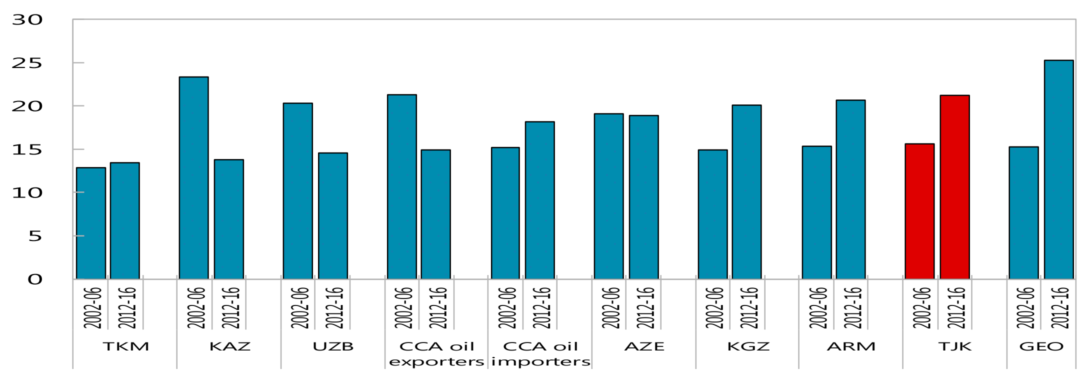
[1] This SIP was prepared by Dalmacio F. Benicio,

B. Tax Revenue Performance

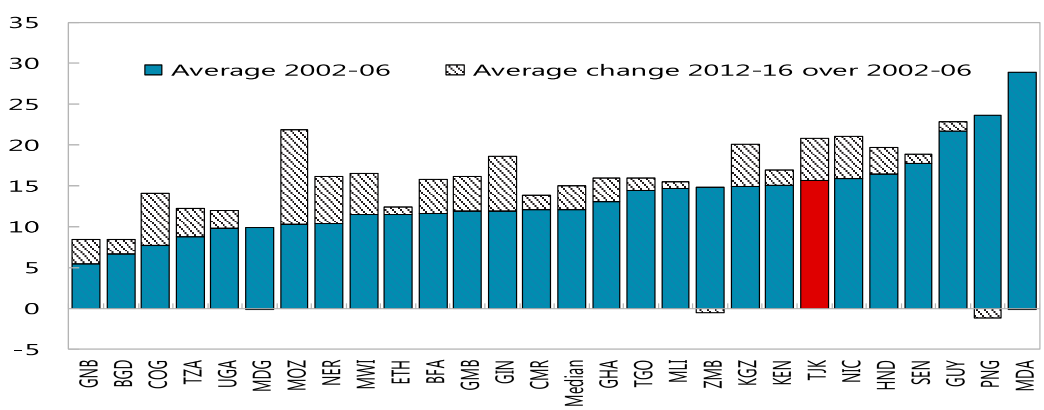
2. Although the increases in tax revenues to GDP over the last 15 years were broad based among CCA oil importing countries, Tajikistan stands out. Because of strong tax collection, Tajikistan's tax revenue to GDP was second only to Georgia (Figure 2, top chart). In part, this shows the late start of tax system reforms in Tajikistan because of the civil war during the 1990s, signaling more potential for progress than in other countries where revenue mobilization reforms had already been implemented. There is, however, more than a catch-up process in the country's progress. For perspective, an international comparison suggests that Tajikistan boosted its tax revenue at twice the rate of median low income countries even though it had started from a higher base (Figure 2, bottom chart).

Figure 2. Tajikistan: Tax or Non-Oil Tax Revenue (in percent of GDP or non-oil GDP)

Tajikistan outperformed CCA peers in tax collection increase and tax revenue to GDP ratio.



Tajikistan boosted its tax revenue to GDP at twice the rate of the median low income country

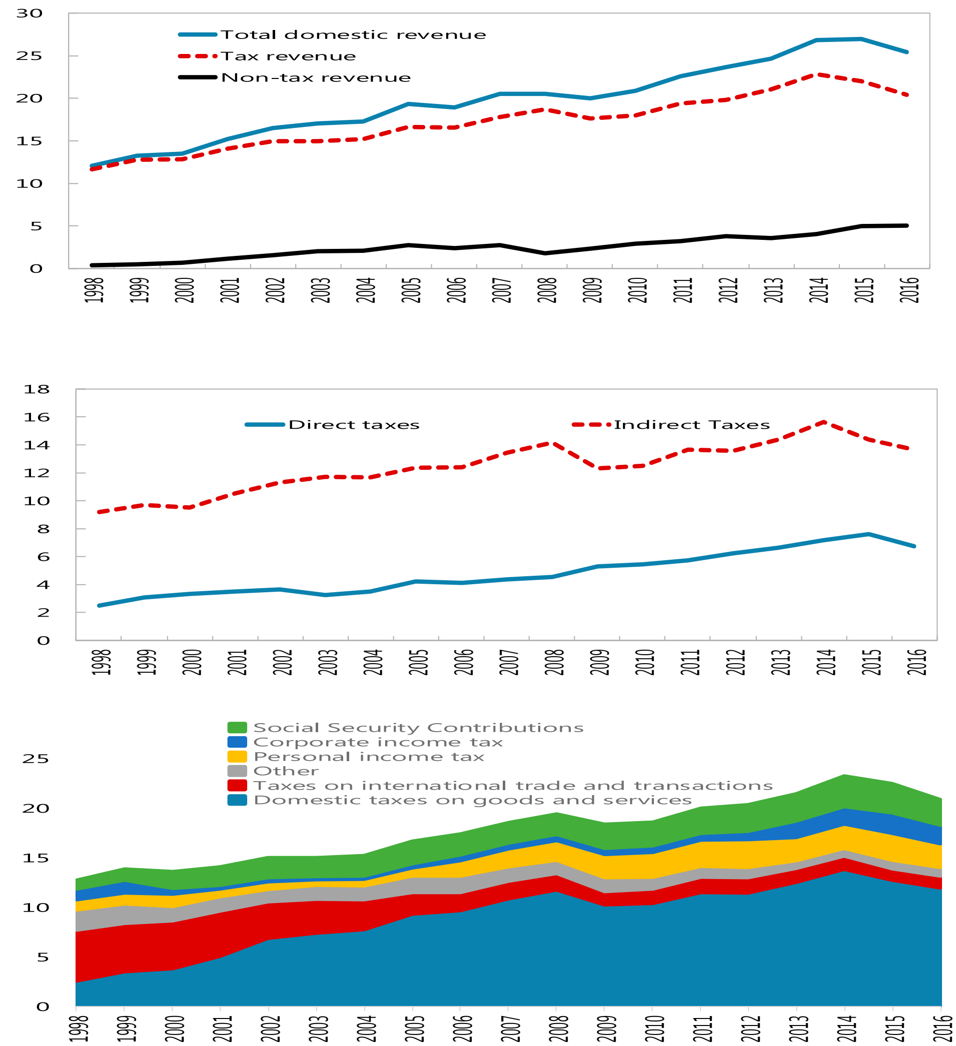


Source: National authorities; and IMF staff estimates.

3. **Tax revenue has shown significant reliance on indirect taxes (value added tax and import duties).** A longer view of domestic revenue performance in Tajikistan shows that tax revenue has been a key driver in the doubling of domestic revenue to 25 percent of GDP since 1998. Tax revenue has made up on average about 88 percent of total domestic revenue, with indirect taxes making up on average about 76 percent of this total (Figure 3). Domestic taxes on goods and services— including the value-added tax which is levied at 18 percent on domestically produced and imported goods and services—displaced taxes on international trade and transaction as the main source of tax revenue, explaining about half of the tax collection in 2016 and 77 percent of the increase in the tax to GDP ratio over the last 15 years. However, direct taxes on income, which make up about a third of tax revenue have yet to realize their full potential. Despite the progress thus far, the continued development needs and fiscal sustainability concerns point to a need to further raise revenues over the medium term.

Figure 3. Tajikistan: Development in Domestic Revenue, 1998–2016

Indirect taxes on goods and services led the expansion of domestic revenue since 1998



Sources: National authorities; and IMF staff estimates.

C. Estimating Tax Potential

4. This paper examines the question of Tajikistan's tax potential to assess the scope to raise more revenues. It empirically examines the factors that explain the maximum tax revenue and tax potential. This question is relevant as Tajikistan considers its fiscal strategy going forward.

5. Fenochietto and Pessino (2010, 2013) estimate the maximum tax revenue a set of countries can attain given their economic characteristics.[2] They use a panel dataset for the period 2000-12 for 113 countries, including 17 revenue dependent natural resource producers to determine the maximum tax revenue in percent of GDP that a country can collect given its economic, social, institutional, and demographic characteristics. They also examine its relationship with the actual tax revenue. The difference between the maximum tax revenue and actual tax revenue represents tax potential which partly reflects possible gains in tax revenue that can be reached through increased collection efficiency and the relative acceptance of taxation in exchange for public goods and services. So, a positive tax potential does not always suggest the need to mobilize more revenue, but might also suggest some tax policy choices and a preference for low taxation (even if that means fewer public services provided).

6. Tajikistan's maximum tax revenue and tax potential were estimated based on the same model with an extended dataset that includes CCA countries. The maximum tax revenue is estimated using Mundlak's (1978) random effects model, which allows for identifying inefficiency from unobserved heterogeneity across countries—that is, the random effect is correlated with the explanatory variables. The estimated model is as follows:

$$y_{it} = \alpha_i + \beta' x_{it} + v_{it} - u_{it}$$

$$\alpha_i = \gamma \bar{x}_{it} + \delta_i$$

$$\bar{x}_{it} = \frac{1}{T}\sum_{i=1}^{T} x_{it} \;\; and \;\; \delta_i \sim iid(0, \sigma_\delta^2)$$

where y_{it} is the log of total tax revenue (the sum of tax and social security contributions) in of GDP for country i in period t for oil importers and the log of non-oil tax revenue in percent of non-oil GDP for oil exporters; x_{it} is a vector of variables that affect tax revenue for country i in period t as described below; α_i is a country-specific effect correlated with (the average of) the explanatory variables and δ_i is a country-specific random disturbance; v_{it} is a zero-mean normally distributed error term for country i in period t; and u_{it} is an exponentially distributed (non negative) random variable independent of v_{it}.[3] Hence, in this setup, $\beta' x_{it}$ corresponds to country i's (deterministic) tax frontier, v_{it} is the noise, and u_{it} represents the tax potential, that is the extent to which country i is

[2] The terms maximum tax revenue and tax frontier may be used interchangeably.

[3] This differentiated treatment of oil exporters is meant to estimate the potential for revenue mobilization that is not related to oil activities, as these fluctuate substantially with the externally driven price of oil.

away from its maximum level of tax collection. The vector of exogenous variables x_{it} includes the following, taken from the World Development Indicators:

LDG: log of real GDP per capita (purchasing power parity constant 2005);

LDG2: square of LGD, to account for the nonlinear concave relationship between GDP per capita and tax revenue (the increase in tax revenue as GDP per capita increases becomes marginally smaller).

TR: trade openness, as measured by the sum of imports plus exports in percent of GDP;

AVA: value added of agriculture in percent of GDP;

GINI: distribution of income, as measured by the GINI coefficient;

GOV: dummy variable to control for the fact that central government revenue is used in place of general government revenue in some countries due to data restrictions;

PE: total public expenditure on education in percent of GDP; and

OIL: dummy variable for revenue-dependent oil-exporting countries

7. The Regression results provide strong cross-country evidence that maximun tax revenues are dependent on countries' economic characteristics. The results based on the full sample of countries and on a restricted sample of developing and emerging market economies with GDP per capita less than $20,000 are presented in Tables 1 and 2 below. The results are broadly consistent with Fenochietto and Pessino (2010, 2013). Potential tax revenue is derived as the difference between the maximum tax revenue for each country and the 2013-16 average actual tax revenue. The estimations produce a time-invariant tax effort for country i as exp $(-u_{it})$, which takes values between zero and one. This corresponds to the average ratio over the entire sample period (2000-13) of a country i's actual tax revenue to its estimated maximum tax revenue. To reflect more recent developments, potential tax revenue is derived using the average actual tax revenue from 2013-16.

8. Empirical analysis shows that Tajikistan's average tax performance seems below the tax frontier suggested by the model. Tajikistan's tax potential ranges from a low of 5.9 percentage points of GDP based on estimates from restricted sample of developing and emerging market economies to a high of 8.7 percentage points of GDP based on full sample estimation (Figure 4). While Tajikistan tax potential is lower than richer CCA countries—suggesting higher tax effort, it is much higher than in Azerbaijan and the Kyrgyz Republic. It is broadly in line with low income peers. Moreover, Tajikistan tax potential is not static. As the country grows, the ability of its government to collect higher revenues and citizens' acceptance for higher taxes typically rises—and the tax frontier that applies to the country moves up as GDP per capita increases.

Table 1. Tajikistan: Full Sample Estimation

Variable	Coefficient	Standard error
Constant	-3.2868**	1.6692
LGD	1.9800***	0.2018
AVA	-0.001	0.0016
PE	0.0151***	0.0047
TR	0.0017***	0.0047
GINI	-0.0024	0.0017
GOV	0.2045***	0.0489
LGD2	-0.1036***	0.0115
OIL	-0.0774	0.0567
	Inefficiency	
Sigma u	0.6805***	0.04698
Sigma v	0.0984***	0.002
Lambda	6.9186***	0.0468

Source: IMF staff estimates.

***, **, * equals 1%, 5%, 10% significance level.

Table 2. Tajikistan: Restricted Sample Estimation

Variable	Coefficient	Standard error
Constant	2.3162	1.6933
LGD	2.1706***	0.2212
AVA	-0.0005	0.0017
PE	0.0226***	0.0054
TR	0.0022***	0.0003
GINI	-0.0029	0.0018
GOV	0.1850***	0.0423
LGD2	-0.1157***	0.0127
OIL	0.0926***	0.0413
	Inefficiency	
Sigma u	0.4792***	0.0392
Sigma v	0.1031***	0.0025
Lambda	4.6465***	0.0392

Source: IMF staff estimates.

***, **, * equals 1%, 5%, and 10% significance level.

Figure 4. Tajikistan: Estimated Potential Tax Revenue
(in percent of GDP)

Tajikistan tax potential is lower than richer CCA countries yet is broadly in line with low income peers.

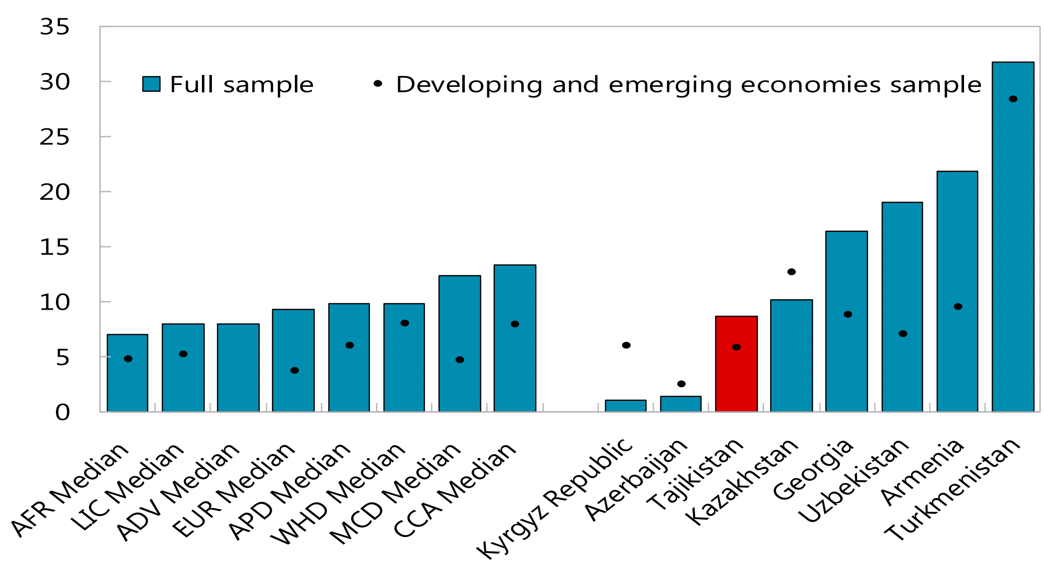
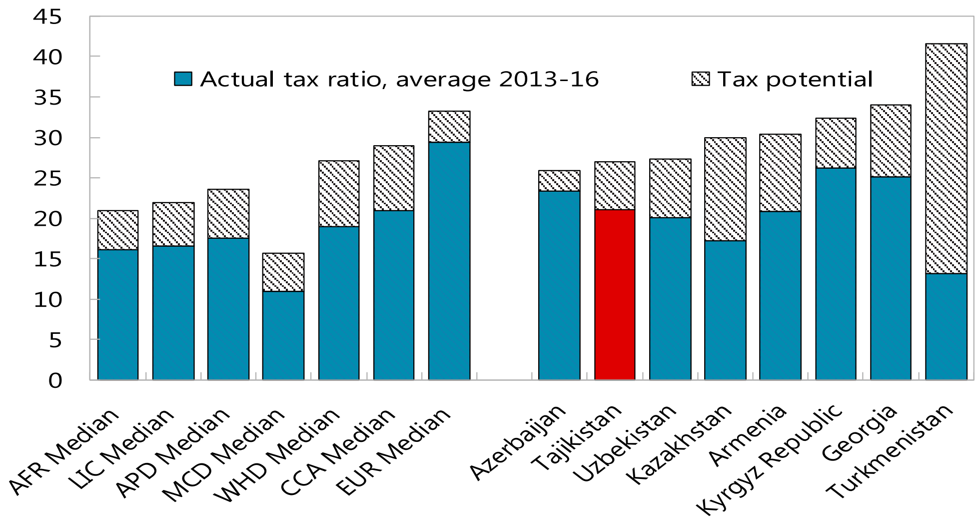


Figure 4. Tajikistan: Estimated Potential Tax Revenue (concluded)
(in percent of GDP)

Actual tax collection and Tax Potential



Sources: National authorities; and IMF staff calculations.

D. Challenges and Prospects

9. **The empirical results support the view that there is room to improve Tajikistan's tax-system**. The progress achieved in mobilizing domestic revenue over the last 15 years is impressive. However, Tajikistan's tax potential estimates range between 5.9 and 8.7 percentage points of GDP. As the need for fiscal consolidation becomes more pressing and given the recent decline in tax revenue as a share of GDP, Tajikistan will need, more than ever, to tap into the additional revenue potential if it wants to maintain macroeconomic stability and continue development efforts in a sustainable way.

10. **Revenues should be raised in a way to make the tax system fairer, more efficient, simpler and more productive.** The following measures areas should be considered to improve tax administration and boost actual revenue collection in Tajikistan:

- **Limit exemptions that jeopardize revenue and good governance, and are hard to reverse**. The VAT is the most important tax on goods and services and the main source of tax revenue. Notwithstanding, its base as currently defined has recently been narrowed by exemptions and special preferences, and this risks eroding its productivity. Enhance revenue by eliminating VAT exemptions to broaden the base.

Table 3. Tajikistan: Exemptions by Tax Categories
(percent of GDP)

	2013	2014	2015	2016
VAT	8.3	7.1	8.1	9.2
Domestic	4.0	4.4	5.1	5.4
External	4.2	2.8	3.1	3.7
Excises	0.1	0.0	0.0	0.3
Customs duties and fees	1.4	1.4	1.5	1.6
Total	9.8	8.6	9.7	11.0
Memo item				
Nominal GDP (millions of Somoni)	40,520	45,610	48,400	54,470

Source: Authorities Data

- **Improve tax compliance to reduce distortions and raise revenues.** Doing so would involve: (i) better mobilizing information from the increasing number of transactions done via financial institutions and mobile banking to improve compliance, (ii) making greater efforts to ensure tax compliance from high income individuals and companies, as they account for a large share of the taxable income, and (iii) modernizing large taxpayer management, including changing the definition of large taxpayers to rely largely on turnover. The management of large taxpayers should be centralized and the many large taxpayers that are currently managed outside the Large Taxpayers Inspectorate (LTI) should be brought under it. The number of LTI audit staff should be increased and their skills improved. Strengthen land and immovable property tax also offers some potential, subject to any tax administration capacity limitations.

11. These measures would ensure a fairer and more efficient tax collection system and support income growth and job creation. While there may be concerns on some of the individual reforms being regressive, benefits in terms of improved governance and the progressivity of the additional expenditure being financed should be considered when assessing the measures. At the same time, the constraints arising from limited tax administration capacity in a low-income country context will need to be addressed.

References

Fenochietto, Ricardo, and Carola Pessino. 2010. “Determining Countries’ Tax Effort.” Hacienda Publica Española/Revista de Economia Publica 195 (4): 65–87. Instituto de Estudios Fiscales.

Fenochietto, Ricardo, and Carola Pessino. 2013. “Understanding Countries’ Tax Effort.” IMF Working Paper No. 13/244, International Monetary Fund, Washington.

THE CHALLENGES OF THE TAJIK BANKING SECTOR[1]

Despite recent progress in terms of access to banking services, Tajikistan's banking system is still characterized by a low level of financial inclusion and high financial stability risks. This paper assesses the weaknesses and the steps already taken by the authorities toward restoring financial stability and makes a case for designing a higher mix of financial development and stability. This would require a comprehensive, ambitious and outcome-oriented strategy, aiming to enable proper market discipline, upgrade the institutional environment, and strengthen the individual players through a clean-up of their legacy problem assets.

A. The Current Mix of Financial Development and Stability in Tajikistan

Financial development

1. **With the lowest GDP per capita in the region, Tajikistan is faced with key challenges in terms of financial development**. Financial development is defined as a combination of access (ability of individuals to access financial services), depth (size and liquidity of markets), and efficiency (ability of institutions to provide financial services at low cost and with sustainable revenues).[2] the indicators that are used to measure financial development include:

- *access*: accounts per thousand adults, number of branches, percentage of firms with lines of credit;
- *depth/size*: deposits to GDP, private sector credit to GDP;
- *efficiency/structure*: assets' market share of the 3 largest banks, cost to income ratio, net interest margin, non-interest income/total income, overhead costs/total assets, return on assets, return on equity, credit to government and SOEs to GDP, lending-deposit spread.

However, due to the limited data availability in Tajikistan and neighboring countries (for the purpose of a peer analysis), the following analysis is focused on a subset of these indicators.

2. **While being low in absolute terms and in comparison, to regional peers, access to financial services has increased materially in recent years**. In 2014, 11 percent of Tajiks older than 15 years were reported to have an account at a financial institution (versus 18 percent in the Kyrgyz Republic and 41 percent in Uzbekistan).[3] The number of commercial bank branches per 100,000 adults was reported at 7 in 2013 (versus 8 in the Kyrgyz Republic and 38 in Uzbekistan). The number of automated teller machines per 100,000 adults was reported at 10 in 2013 (versus 21 in the Kyrgyz Republic and 8 in Uzbekistan). The number of borrowers from commercial banks per 1,000 adults

[1] This SIP was prepared by Thierry Bayle.

[2] See 'Rethinking financial deepening: stability and growth in emerging markets', IMF Staff Discussion Note.

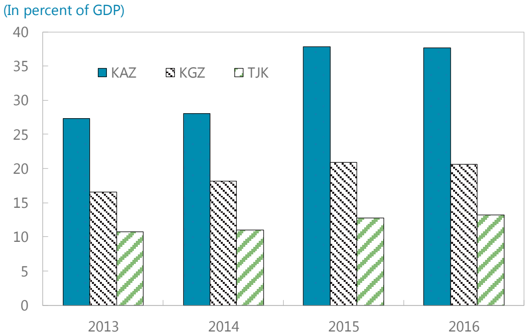
[3] According to World Bank indicators.

reached 34 in 2013 (versus 42 in the Kyrgyz Republic and 47 in Uzbekistan). Despite lagging behind peer countries, signs of increasing access to financial services have been reported recently.[4] In 2016, the percent of Tajiks (15 years and older) with a bank account rose to 55 percent, thanks to the development of the branch network and other separate operational subdivisions of banks and microfinance organizations. Access also improved as a result of the sharp increase in the number of bank payment cards issued (from 36,872 in 2007 to 1,620,334 in 2016), and the growth in the number of leasing and insurance companies, pawnshops, and credit unions.

3. **Further efforts to enhance access to remote banking services, including through the Internet (Internet banking) and through mobile communication devices (mobile banking), are underway.** The number of accounts for which remote banking services are provided has increased significantly, from 1,570,400 in 2015 to 1,776,988 in January 2017, including through the Internet (from 37,110 to 59,748) and by means of mobile communication devices (from 37,215 to 48,742). This rapid development will likely continue, given the project launched by Tajikistan in October 2016 on the introduction of electronic and digital financial services through the introduction of e-services (including mobile money products).[5] This will also be supported by the recent adoption of a law "On Payment Services and Payment Systems", to further develop the legal and institutional framework for providing payment services, and their supervision. The law also establishes requirements for the interaction of credit organizations and mobile operators in the provision of payment services, which will contribute to the development of mobile banking services.

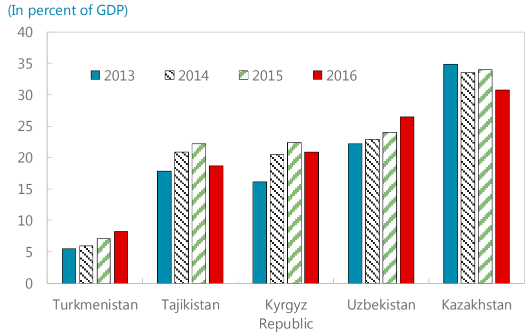
Figure 1. Tajikistan: Size of Banking Sector

Banking Sector Deposits
(In percent of GDP)



Source: IMF Staff Calculations.

Credit to the Private Sector
(In percent of GDP)



Source: IMF Staff Calculations.

4. **The depth of the banking sector appears to be still limited, especially with regard to the mobilization of savings.** Two ratios are relevant to assess the depth of the banking system: deposits to GDP illustrates the importance of savings collected by the banks, while 'private sector credit to GDP focuses on the extent to which the banks finance economic activity. As illustrated in the tables below, intermediation seems to be very limited, with a ratio of deposits to GDP stuck

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[4] Report on the National Development Strategy of the Republic of Tajikistan for the period up to 2030 (Dushanbe – December 2016)

[5] This project has been launched in the framework of the World Bank's Global Finance and Markets Program (GPF) in Europe and Central Asia to increase financial penetration and access of the population to financial services.

around 10 to 12 percent, which lags behind neighboring countries. This cross-country comparison is more favorable to Tajikistan in respect of the credit to the private sector.

5. **Many of the available indicators point to a very low *efficiency* of the Tajik banking sector, both in absolute terms and from a cross-country perspective.** As illustrated in the table below, the benchmarking of Tajikistan against other regional peers in 2015 highlighted the lack of profitability (large negative returns on assets or equity) of the banking sector, partly explained by a weak revenue generation (low net interest margin), a high cost structure (high cost-to-income, high overheads costs to total assets), and the high cost of credit risk (due to the significant impairment costs on non-performing loans). These features contribute to a high lending-deposit spread, which is not conducive to a cost-effective intermediation.

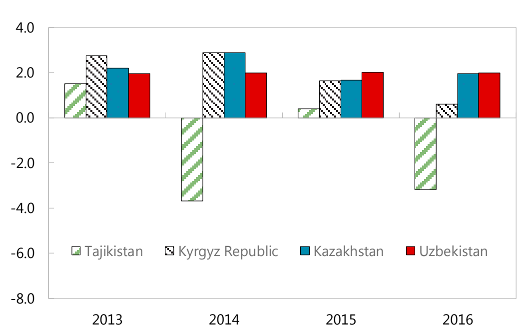
Table 1. Tajikistan: Efficiency and Structure of Banking System, 2015

	Tajikistan	Regional Median	Income Group Median	High Income Median	Expected median	Kazakhstan	Kyrgyz Republic	Turkmenistan	Uzbekistan
Cost to Income Ratio (%)	163.8	53.9	54.9	53.6	49.2	50.2	63.9	45.2	52.7
Net Interest Margin (%)	2.2	3.8	4.4	1.8	8.1	1.7	6.6	0.4	3.0
Non-Interest Income / Total income (%)	71.6	36.8	31.0	34.5	44.7	85.1	31.5	77.4	57.0
Overhead Costs / Total Assets (%)	7.5	2.7	3.0	1.4	5.7	2.4	4.9	0.8	2.7
Return on Assets (%)	-7.8	1.1	1.3	0.8	3.0	1.1	1.7	0.7	1.2
Return on Equity (%)	-69.8	6.6	12.3	8.8	13.6	3.1	11.7	19.4	13.6
Credit to Government and SOEs / GDP (%)	3.5	6.9	6.7	15.8	2.8	3.0	1.4	-	-
Lending-Deposit Spread (%)	21.6	6.5	6.9	3.9	11.5	-	21.6	-	-

Source: Finstats (for Tajikistan, banks and microcredit organizations).

6. **Since 2015, the profitability of Tajik banks has deteriorated further, in contrast to banks of peer countries.** As a result, the difference in efficiency of the sector is likely to have also increased.

Figure 2. Tajikistan: Return on Assets
(In percent)



Source: IMF Financial Soundness Indicators.

Financial stability

Asset quality, solvency and financial resilience

7. **The Tajik banking system is characterized by longstanding weaknesses arising from the combination of poor asset quality, weak solvency, low efficiency and profitability, which hindered its capacity to absorb the external shocks.** The high level of non-performing loans (NPLs) has mobilized an overwhelming part of banks' resources, whether in terms of funding cost or management capacity, which impedes the origination of new loans. This burden on net banking income has been further exacerbated by the increase in provisioning required as a result of arrears and/or declines in collateral valuation. As a result, the profitability of the banking sector has remained negative or close to zero since 2014. The ensuing negative impact on internal capital generation has weighed on the banks' solvency, as reflected by the decrease of their capital adequacy ratio from a peak 25.9 percent in December 2012 to 7.1 percent in June 2016, before the state's bank recapitalization plan of December 2016 raised this ratio back to 15.1 percent. All these features are closely intertwined and hinder banks' capacity to tap new investors, either through equity or long-term debt. Short of access to long-term resources, their funding base is essentially deposit-based. For those Tajik banks whose depositor base has shrunk, this has resulted in a breach of regulatory thresholds, and even a resort to emergency refinancing with the central bank.

Table 2. Tajikistan: Banks' Financial Soundness Indicators of the Republic of Tajikistan

Indicators	2010	2011	2012	2013	2014	2015	2016
Capital adequacy							
Regulatory capital to risk-weighted assets	27.1%	24.4%	25.9%	22.1%	14.7%	11.1%	15.1%
Regulatory Tier 1 capital to risk-weighted assets	23.7%	21.2%	23.3%	20.2%	12.0%	8.3%	26.4%
Earnings and profitability							
Return on assets (ROA)	1.2%	0.2%	0.8%	1.5%	-3.7%	0.4%	-3.2%
Return on equity (ROE)	6.3%	0.9%	3.9%	7.8%	-24.2%	3.7%	-27.2%
Interest margin to gross income	50.4%	46.4%	33.2%	40.4%	32.0%	41.9%	44.5%
Noninterest expenses to gross income	62.3%	86.3%	75.8%	65.9%	66.5%	64.1%	171.9%
Asset quality							
Nonperforming loans net of provisions to regulatory capital	5.3%	3.8%	5.7%	27.3%	51.3%	92.4%	131.4%
Nonperforming loans to total gross loans	7.4%	7.2%	9.5%	15.9%	25.0%	29.9%	54.0%

Source: National Bank of Tajikistan.

8. **The results of asset quality reviews (AQRs) of the largest banks have shed light on vulnerabilities in the banking system, the most prominent of which is credit risk.** The significance of credit risk is illustrated by the ratio of NPLs to total loans (measuring the overall quality of the banks' loan portfolios) and the ratio of net NPLs to capital (measuring the level of capital encumbrance from unreserved loans). As evidenced by the table, the asset quality has deteriorated sharply, to the point that more than half of the banks' portfolios are now in arrears. In addition, even after assuming that their '*expected losses*' may be considered to be fully covered by the provisions, these loans inherently give rise to higher '*unexpected losses*', which would absorb around 1.3 times the total banks' capital. The AQRs highlighted that this capital encumbrance due to problem loans was exacerbated in many banks by the sizable amounts of their repossessed properties and foreclosed assets, highly exposed to valuation risk.

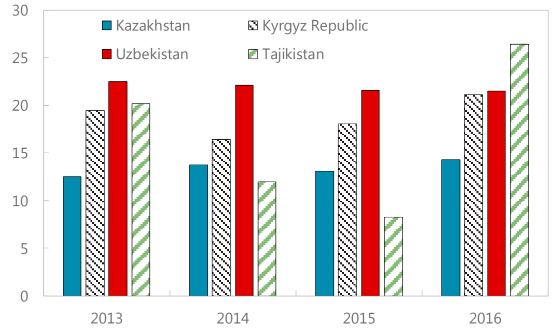
9. The vulnerability of the banking system to credit risk is compounded by many peculiar characteristics of the Tajik banking system, which together make a strong case for a crucial strengthening of bank governance and risk management. The first feature is the high contribution of *related party-lending* to the increase of NPLs or foreclosed assets, which the AQRs have pointed to in several instances. Although the auditors often mentioned they were unable to obtain comprehensive information about the magnitude of this practice, banks frequently report themselves the materiality of such exposures to related parties. The second characteristic is the *concentration of credit risk*, as highlighted by the frequency of banks' breaches with the regulation on large exposures and the overall importance of these large exposures relative to regulatory capital on a system-wide basis (165.7 percent as of end-2016, against 58.5 percent as of end-2012). This concentration of credit risk is all the more critical since the overwhelming majority of these large exposures is non-performing, therefore contributing to a major part of banks' impairments. Another factor relates to the *lack of risk mitigation* provided by collateral, due to the inefficiency of registrations by lenders or foreclosure processes themselves, especially in the context of judicial proceedings. A last compounding factor is the materiality of *indirect credit risk* associated with the unhedged borrowers whose indebtedness is denominated in foreign currencies, and who are consequently exposed to an exchange rate shock. All these factors significantly increase the challenges related to the identification, monitoring and management of credit risk, which the banking system needs to address, with appropriate guidance of the NBT.

10. This overall weakness of the Tajik system has to be put into the perspective of peer neighboring countries. The graphs below provide evidence that the key performance indicators for solvency and asset quality for the Tajik banks compared quite favorably against peer countries until around mid-2014, but both of them deteriorated sharply since then, to the point they have now become the worst in the region (before allowing for the recapitalization in end-December 2016). In this respect, it should be emphasized that the NPLs reported by Tajikistan include exposures which are *more than 30 days past due,*[6] which is more stringent than the FSI criterion, limited to exposures *more than 90 days past due*. Furthermore, the sharp increase of the NPL rate stems—partially at least—from the recent implementation of a more stringent policy by the NBT to increase transparency, thus reflecting the identification of problem loans accumulated over previous years.

[6] The regulatory definition also includes exposures to debtors assessed as *unlikely to pay* their credit obligations, regardless of the existence of any past due amount or of the number of days past due. However, in practice, short of forward-looking information, Tajik banks usually do not detect such unlikelihood to pay before the loan is overdue.

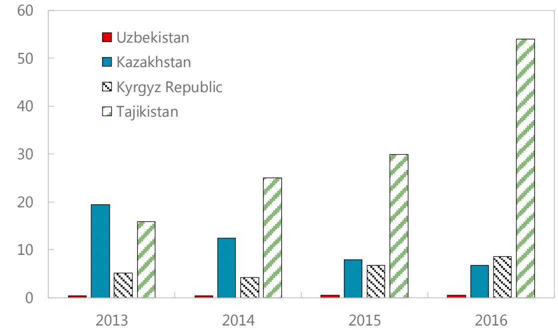
Figure 3. Tajikistan: Financial Soundness Indicators

Tier 1 Capital to Risk–Weighted Assets
(In percent)



Source: IMF Financial Soundness Indicators.

Non–Performing Loans to Total Gross Loans
(In percent)



Source: IMF Financial Soundness Indicators.

Bank restructuring under way

11. The above-mentioned system-wide weaknesses should not hide wide differences across banks between ailing institutions and others, whose solvency and regulatory compliance are not questionable at present. Against this background, the AQRs have provided valuable insight into the financial and prudential situation of the banks reviewed, even though the issue of the viability has not been addressed in depth. With this caveat, the Tajik authorities have been able to better assess the risks and impairment needs, and the ensuing regulatory gaps, for some banks.

12. Two systemic banks have been recapitalized with government bonds fully collateralized by banks' assets and have become majority state-owned. A recapitalization plan has been adopted by the Tajik government on December 11th, 2016, aiming at the recapitalization of four ailing banks[7], for a total amount of TJS 3.85 billion (USD 488 million at that date) in five-year government local currency bonds at 2 percent interest. Subsequently, however, this plan has been amended to differentiate between the two systemic banks, TSB and AIB, whose recapitalization by the state has been confirmed for a total amount of TJS 3.32 billion (i.e. 6.1 percent of 2016 GDP), and the two smaller banks, TPB and Fonombank, which will be liquidated. Pursuant to this revised plan AIB is now 87 percent owned by the state and TSB 85 percent owned. The banks have sold these government bonds to the NBT, while retaining the 2 percent per annum charge on the amount of their "recapitalization". Existing chairmen/CEOs have been retained, and the ones that had been removed during temporary administration have been reinstated.

13. This plan is a system-wide policy response from the authorities to the crisis that prevailed at the end of last year. Against the background of temporary administrators' mandates nearing their deadlines, without a possibility of further extension, for two of the banks concerned, the authorities were faced with the straightforward alternative between the rehabilitation of their

[7] Two of which had been put under temporary administration, whose term expired in November 2016.

financial status or the revocation of their banking license and their liquidation. A noteworthy merit of this plan has been to broaden the scope of resolution measures to four banks, thus paving the way for a comprehensive approach to the banking crisis. Another key virtue of the plan is that it now includes the liquidation of two small banks, obviously insolvent and unviable, whose costly rehabilitation at public expense would have increased moral hazard.

14. There are however grounds for considering that the plan is not fully consistent with best international practices in terms of bank resolution. Its credibility and capacity to provide a sustainable response to the crisis may be put into question, to the extent it does not tackle the source of the banking distress, nor does it solve the banking distress itself, and last, it may foster adverse developments in the banking sector.

The source of distress – inadequate bank governance – is not tackled

15. As evidenced by the AQRs, TSB and AIB are saddled with a huge legacy of NPLs, inherited as a result of inadequate governance. Such failure of governance translated—among others—into (i) inappropriate loan approval, monitoring, and collection processes; (ii) widespread lending to related parties; and (iii) material shortcomings in respect of accounting and prudential reporting. The reinstatement of top managers is unlikely to allow a prompt overhaul of the banks' governance and internal risk management frameworks, not only because of their own track record in terms of managerial competence and setting of proper business strategy and risk tolerance levels, but also because of their links with the largest non-performing borrowers.

Inadequate recapitalization

16. The plan falls short of providing capital that would be eligible for regulatory purposes. The fact that these banks have been recapitalized with 5-year government bonds instead of cash has many implications, including the following:

- The full collateralization of these government bonds converts the State's stake into a secured claim, such that this claim ranks ahead of unsecured claims and, accordingly, the core function of capital (i.e., to absorb losses first in liquidation) is not met.

- The *short-term maturity* of the government bonds raises a doubt about the permanence of the scheme – also a core feature of regulatory capital. Until their 5-year maturity, the bonds must be redeemed by the banks in regular instalments[8], and the bank's capital is reduced accordingly.

- The *fixed remuneration* of the "capital" provided (2 percent per annum) drags down the banks' profitability, heightening the risk of (re) failure, even more since these bonds account for a substantial share of assets; the viability of these banks is thus critically threatened.

[8] 5 percent in 2017, 20 percent in 2018, and 25 percent per annum thereafter.

17. Furthermore, even if the mentioned amounts would be recognized as capital for regulatory purposes, they fall significantly short of allowing the banks to meet prudential requirements. These recapitalization amounts should be compared with the gaps estimated on the basis of call reports for each type of regulation, without taking account of FX-related requirements[9] and capped by the total amount of liabilities. Even after taking into account the recapitalization of December 2016, the capital shortages to meet the regulatory requirements are very significant, especially those on large exposures and related parties.

The potential for adverse aftermath

18. Short of providing the banks with the capital needed to fill their regulatory gaps[10], the plan so far requires continuing supervisory forbearance to allow banks to operate as a going concern, and accordingly fosters moral hazard in the whole banking system. Such widespread forbearance—being applied to entities which together make up for half of the banking system's deposits—can represent a benchmark for other banks, which could call for an equitable treatment in respect of regulatory enforcement.

19. Shielding shareholders from losses and maintaining/reinstating managers will also increase moral hazard. Exempted from bearing the first losses despite government intervention, shareholders preserve their shares—at most on a diluted basis—and will benefit from any upside in the recapitalized banks: this asymmetric risk profile is conducive to excessive risk-taking, at the expense of taxpayers. Absent credible sanctions against wrongdoing, the banks' board members and senior managers will lack appropriate incentives to meet best standards in exercising their "duty of care" and "duty of loyalty".

20. Last, but not least, adverse consequences could also stem from restrictions on lending[11], which will deprive households and corporates from new financing from the two largest systemic banks and contribute to further depressing the economy. This could foster a vicious spiral, by exacerbating the borrowers' difficulties to meet their current commitments and, potentially, increasing provisioning needs.

B. The Case for a Better Mix of Financial Development and Stability

21. The mix of low financial development and high financial fragility that currently prevails in Tajikistan is an impediment to economic growth. The limited access of economic agents to financial services and the low depth and efficiency of the latter deprive these agents of the benefits of channeling their savings toward credits for investment or consumption purposes.

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[9] The compliance with such FX-related capital requirements is assumed to be achieved by closing the excessive FX positions, rather than through a capital increase.

[10] Ac Actually, the amount of "recapitalization" has been allocated primarily for the purpose of improving the capital adequacy ratio, which is not necessarily the most stringent prudential requirement.

[11] The NBT has prohibited these two banks from extending new credits in excess of TJS 300,000.

Likewise, faced with solvency and liquidity constraints, the financial system is too weak to be able to carry out its intermediation function properly, hampering growth.

22. As highlighted by recent economic literature[12], financial deepening would contribute to fostering economic growth, provided however financial stability is warranted, in particular through proper regulation and supervision. On the one hand, the financial development helps to intermediate larger capital flows while containing large swings in asset prices and exchange rates, which contributes to increasing the resilience to shocks. On the other hand, if conducted without adequate prudential safeguards, it can also lead to credit booms and subsequent busts. Therefore, policymakers should be extremely cautious in devising a balanced supportive policy, aimed both at (i) facilitating financial deepening through market-enabling policies and (ii) safeguarding against a potential increase in risks by upgrading the institutional environment and fostering market discipline.

Market-enabling policies

The reduction of state intervention

23. As emphasized by the 2015 FSAP, government-directed lending has significantly contributed to weakening banks' asset quality over the past years. Through such practices, the state has obviously helped support some key sectors of the economy (e.g. construction, energy …) and/or players (flagship public enterprises), but it has also distorted the decision-making in the loan origination process. The ensuing concentration of credit risks has had adverse consequences on the risk-return of some banks' loan portfolios, even resulting in critical NPL accumulations.

24. Given the recent nationalization of two large banks, which may exacerbate the potential for such directed lending and the risk for misallocation of credit, there is a strong case for strengthening bank governance. Even as a majority shareholder, the state should refrain from using banks to pursue developmental objectives or support loss-making state-owned enterprises. State-owned banks should be allowed to originate, price and monitor credit on an arms-length basis, in the same way as privately-owned banks. This would not only be a prerequisite to their own restructuring and return to viability, but also a key condition to limit the economic and fiscal cost of credit misallocation.

The promotion of competition in the financial system

25. Although they report (net) loans for less than 15 percent of GDP, commercial banks dominate the financial system in Tajikistan. As of end-2016, the system was composed of 18 banks, 38 micro-credit deposit organizations, 14 micro-credit organizations, and 34 micro-credit funds, with the banks accounting for 80.6 percent of the total (net) loan portfolio. As highlighted by the 2015 FSAP, the insurance sector is small and practically no capital markets activity is reported.

[12] See in particular 'Rethinking financial deepening: stability and growth in emerging markets' (IMF Staff discussion paper – May 2015), 'Financial inclusion: can it meet multiple macroeconomic goals?' (IMF Staff discussion paper – September 2015).

Short of a significant role of the non-bank financial sector in fostering credit to the economy, the efficiency of the banking sector is key to credit growth.

Table 3. Tajikistan: Size of Banking Sector

	30.09.2014			31.03.2016			31.03.2017		
	Number	Assets (mln Somoni)	Percent amounts	Number	Assets (mln Somoni)	Percent amounts	Number	Assets (mln Somoni)	Percent amounts
Commercial banks	17	13310	85%	17	14653	84%	15	17447	87%
Banks full owned by the state	1	1812	12%	1	2643	15%	1	2983	15%
Banks with majority foreign participation	7	1345	9%	7	1924	11%	6	1951	10%
Microfinance Institutions (MFIs)	121	2265	15%	99	2746	16%	86	2700	13%
Microfinance depository organizations (MDOs)	41	1912	12%	38	2339	13%	38	2323	12%
Microcredit organizations (MCOs)	42	192	1%	27	224	1%	14	199	1%
Microcredit funds (MCFs)	38	160	1%	34	184	1%	34	178	1%
TOTAL	138	15575	100%	116	17399	100%	101	20147	100%
(In percent of GDP)		34.6%			31.9%			32.1%	

Source: National Bank of Tajikistan.

26. However, the efficiency of the banking system is hampered by the low level of competition and pricing distortions that stem from the weak financial situation of the largest banks. With a market share of 46 percent, four insolvent banks have long weighed on the capacity of the banking system to properly select and price credits to the economy. Against this background, there would be a strong need to promote competition between players that could build on sound governance and shield against the risk of adverse selection and excessive gambles. Revamping the cost structure of the system is urgently needed, too, which requires banks to cut their operating costs (in terms of staff and/or branch network) significantly in order to generate sufficient earnings to cover the impairment costs and start building capital internally. In the longer term, competition should also be enhanced by promoting the development of capital markets as alternative sources of finance to bank loans.

The promotion of financial transparency

27. The need to make the environment more business-friendly would also command increased transparency on the parts of both banks and borrowers, with a view to supporting an effective market discipline. As far as banks are concerned, the task is to improve disclosure of quantitative and qualitative information so as to allow the stakeholders (investors and depositors) to have a comprehensive and timely understanding of these banks' risk and profitability profiles[13]. In particular, there would be considerable scope for improvement regarding the publication of information about the exposure to various risks (credit, market, operational, liquidity, and interest rate risks), the risk management and risk mitigation techniques used, and the formation of profit and

[13] The NBT has already improved system-wide statistics aimed at disseminating economic and financial data to the public, based on the requirements of the Special Data Dissemination Standard and the General Data Dissemination System. However, these data are aggregate and do not provide any bank-specific information.

loss. The adoption of IFRS in 2015 has of course contributed to the quality of bank disclosures by ensuring their consistency and comparability, but strong implementation challenges still lie ahead. Worth noting, in particular, is the persistent absence or lag of IFRS-compliant disclosures by most banks, including the largest ones. Such measures would help promote confidence over a medium-term horizon and foster the development of an active secondary market in banks' stocks and securities.

28. Increased transparency on the part of borrowers should also be achieved through the development of central credit registers and/or credit bureaus. The current paucity of information about the creditworthiness of borrowers, whether companies or households, all constrain the quality of credit appraisal and results in a predominance of collateral-based lending. The dissemination of information about the borrowers' indebtedness, already provided by the credit bureaus, should indeed be complemented by independent assessments of the clients' capacity to meet their commitments, based on their own cash flows[14] rather than the realization of their collateral. This may still require substantial progress to improve the comprehensiveness and reliability of the information gathered by the credit bureaus, and the current projects of the authorities to this end are worth commending[15]. Such efforts are key to improving the efficiency of credit granting and pricing, and, more broadly, to broadening access to finance, especially for small- and medium-sized companies.

Upgrading the institutional environment

29. In order to address the risk-return tradeoffs of market-friendly policies as described above, the institutional environment would need to be strengthened. This will need to be done through concerted efforts on the legal, regulatory and supervisory front.

The regulatory and supervisory framework

30. Beyond playing a key advisory role in the revision of financial legislation and market-enabling initiatives recommended above, the NBT should become the driving force of an ambitious policy dedicated to the development of the banking sector. Indeed, the current plight of the sector does not allow it to fully perform its intermediation function, so that the degree of transformation and leverage provided by the Tajik banks falls short of what is needed to support inclusive growth. While the onus is on the banking sector to restore profitability, capital, and liquidity to support financial development, the NBT should ensure that the regulatory environment, governance, and supervisory capacity will assure that the future financial sector growth and development are prudent and sustainable.

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[14] The AQRs have confirmed that the information on borrowers' cash-flows or business plans was frequently lacking in the banks' credit files.

[15] The NBT has submitted to the government draft amendments and additions to the Republic of Tajikistan Law on the Credit History Bureau, to make the provision of such (complete, accurate, and timely) data compulsory.

31. An aggressive road map would need to be drawn, aimed at (i) filling the residual gaps highlighted in the 2015 FSAP, and (ii) laying the foundations for a more robust, innovative, and risk-aware banking system. Beyond solving the legacy problems with a short-term horizon (NPL resolution, capital, and liquidity restoration), the NBT should engage in a medium-term strategy for rebuilding a regulatory and supervisory environment that is conducive to sound and prudent risk taking by banks. Such a strategy should be pursued consistently with the key recommendations on strengthening banking supervision, which are part of the two-year action plan set up with IMF technical assistance.

32. The regulatory agenda, as dictated by the gaps identified in the context of the last FSAP, should prioritize progress on (i) increasing the appropriateness of capital requirements, (ii) strengthening internal governance, and (iii) improving the transparency of ownership structures. Regarding capital requirements, clarification of the scope of their application would be urgently needed, with a view to ensuring that they must be calculated and complied with on a consolidated basis, i.e. including all financial subsidiaries and controlled entities. Moreover, the wide differentiation of risk profiles across the Tajik banks makes a strong case for setting capital requirements tailored to the risks these banks are exposed to, taking into account the nature, scale and complexity of their activities. Last, there would be ample merit in extending these capital requirements to the coverage of operational risk. As far as internal governance is concerned, the regulatory revision should seek to update the current regulation on corporate governance – dated 2011 – in view of the last revision of the 'Corporate governance principles for banks' by the Basel Committee[16], especially in respect of the collective oversight and risk governance responsibilities of the Board and the strengthened key components of the risk governance. With regard to the ownership structure, a major benefit would stem from a better identification of the ultimate beneficial owners of banks, which would allow a closer monitoring and supervision of related-party lending and bank internal governance.

33. Based on such revised legislation and regulation, the most important challenges however lie with supervision, which should shift from rules-compliance oversight to risk-based and forward-looking supervision, with (i) a more proactive approach to bank governance, internal control and risk management, and (ii) rigorous enforcement of sanctions in case of regulatory breaches. In the wake of the progress already achieved recently in key areas, such as systemic banks' asset quality reviews, and the increased provisioning, the NBT should focus its efforts – with the support of the technical assistance – on the qualitative assessment of banks' internal processes. This orientation should complement the regular, monitoring of banks' compliance with the quantitative norms, so that a more proactive stance can be taken by the NBT when risks build up, well before regulatory thresholds are breached. In order to get such insider and forward-looking views of the banks' risk profiles, the NBT will need, however, to considerably enhance its supervisory capacity, both for off-site monitoring and on-site examination. The former should, in particular, devote more efforts to stress testing in order to allow the earlier detection of potential vulnerabilities, possibly with TA from the World Bank. As to the latter, staffing should be

[16] Published by the Basel Committee on Banking Supervision in July 2015.

increased in quantity and expertise, so as to ensure closer examination cycles, while leaving scope for targeted examinations.

The financial safety net

Resolution framework

34. **Alongside with a strong supervisory mechanism, a proper resolution framework is key to provide the NBT with adequate bank resolution powers, designed to minimize cost to public taxpayers without disrupting financial stability.** The practical objective would be to enable the NBT – to be formally designated as the resolution authority – to deal with troubled banks expeditiously and at an early juncture, including by exercising transfer and bridge bank powers. Beyond the short-term benefit of giving the NBT more leverage in the present context of the nationalized banks' restructuring, this revision should be considered as a unique opportunity to align Tajik legislation with the FSB's Key Attributes of Effective Resolution Regimes[17].

35. **The current framework for bank recovery and resolution is under-developed, and the authorities' efforts to strengthen it must be encouraged.** The NBT is not empowered to require banks to prepare and test recovery plans, and accordingly no bank recovery planning framework has yet been established. The NBT has some powers to intervene in distressed banks, including early intervention measures and powers to appoint an administrator, but these powers are very limited in scope and can be countered by the courts, i.e. either suspended or reversed. Amendments have recently been drafted by the authorities to strengthen resolution powers (i.e., transfer of assets and deposits to a bridge bank or other lending institution, transfer of assets to asset management companies, transfer of shares, write-offs of shareholders, bail-in of some unsecured and uninsured creditors). To be aligned with the international standards, these legislative proposals should also provide for the non-suspension and non-reversal of resolution decisions of the NBT[18], while preserving the right to monetary compensation, especially to ensure that no party is rendered worse off under a resolution than they would have been had the bank been placed into winding up under the liquidation law.

36. **Beyond the initiatives required to make the resolution framework more robust and legally effective, there would also need to warrant appropriate resolution funding mechanisms that do not exacerbate moral hazard.** To this end, the law should explicitly prevent the NBT from acquiring shares or guaranteeing the liabilities of a troubled bank, so as to protect the central bank's balance sheet and avoid any conflict of interest with its supervisory mandate. On the other hand, the law should provide for government funding of resolution transactions for systemic cases, subject to the prerequisites that (i) the provision of such public funds is necessary to preserve financial stability, (ii) alternative private sources of funding have been exhausted, and (iii) the losses have been allocated to shareholders.

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[17] Key Attributes of Effective Resolution Regimes, Financial Stability Board, October 2014.

[18] Except in cases where the NBT acted in a criminal manner or was otherwise in breach of applicable norms.

Deposit insurance scheme

37. Parallel initiatives could usefully strengthen the deposit guarantee mechanism, to improve its operational capability and its contribution to financial stability. The regime of the Tajik Deposit Insurance Fund (DIF), established in 2003, underwent significant improvements in 2011, but was not tested until the liquidation of two small banks in early 2017. The execution of this first test – both in terms of amount and promptness of payouts – will be crucial to support the DIF's credibility in ensuring depositor protection and confidence in the banking system.

38. If the current payout experience confirms the capacity of the DIF to carry out the 'paybox' mandate it is presently assigned to by the law, there would be strong arguments for broadening this mandate so that the DIF may also contribute to resolution funding. With such an extension of its mandate, the DIF would thus be empowered to help finance a restructuring transaction that involves a transfer of insured deposits, provided the least cost test is met, i.e., the cost of the restructuring transaction is less than the cost of reimbursing insured deposits in liquidation, net of expected recoveries. Were a bank failure considered to have systemic implications to the financial system and the use of public funds authorized by the Ministry of Finance, the DIF could still make payments toward the cost of a restructuring transaction that involves a transfer of insured deposits even if the least cost test is not met, provided that the resources of the DIF used for this purpose do not exceed the amount that would be necessary for the reimbursement of insured deposits in liquidation, net of expected recoveries.

Emergency Liquidity Assistance framework

39. A legally-grounded lender-of-last-resort framework is a necessary component of the financial safety net, alongside strong supervision, timely resolution, and effective deposit protection. The current NBT law already entrusts the central bank with such a function.

40. However, given the increasing dependency of the banking system on central bank refinancing, particularly for public banks, and its potentially adverse impact on the autonomy of the monetary policy, there would need to establish a proper emergency liquidity assistance (ELA) framework. Most importantly, such a reform should better disentangle the conduct of monetary policy operations and the provision of ELA, aimed at preserving financial stability through the handling of banks' idiosyncratic refinancing difficulties. To this end, the law should explicitly state that such ELA can be provided at the NBT's sole discretion only under very limited circumstances and toward banks that meet predetermined preconditions.

41. Based on this clarified mandate, the NBT should set up a formalized, comprehensive ELA policy. This policy would aim to operationalize the detailed criteria that trigger eligibility to ELA, as well as the related processes, terms and conditions, and disclosure requirements applicable to ELA. Going forward, the NBT should also be encouraged to upgrade its operational preparedness by requiring banks to be prepositioned to ensure that collateral can be accessed quickly and reliably.

The insolvency framework

42. As evidenced by the track record in banks' NPL recovery processes, an important step towards improving the efficiency of the financial system would also include the modernization of the bankruptcy law and the solvency regime. As a general rule, poor asset quality requires prompt workout and/or restructuring of NPLs. This needs to be supported by a legal framework that protects the rights of lenders and borrowers, and which allows out-of-court settlements. When banks fail to recover their delinquent assets in the early stages of their past-due status, they should be given more flexibility to compromise with the troubled borrowers (at least with the most creditworthy of them) before initiating collection lawsuits. The development of arbitration with such borrowers should provide banks with a last-ditch possibility to optimize the trade-offs between the amount, timing, and cost of their recoveries, i.e., maximize the present value of their assets. When the borrowers are not deemed eligible to such workout procedures or the latter has failed, banks should, of course, keep the right to go to court. But these courts should be specialized, so that commercial and/or banking considerations may be better taken into consideration in judicial decisions and delays of judicial proceedings can be reduced. This revision of the legal framework should mostly aim to reduce the current bias toward the borrowers' rights, to speed up the court proceedings, and to reduce the cost of enforcing judicial decisions. This revision of bankruptcy law should be carried out in the context of a broader overhaul of legislation, with a view to improving the enforceability of contractual and property rights, particularly in relation to collateral realization and foreclosure.

Addressing the legacy of high NPLs

43. Benefiting from a regulation that is both upgraded—as described above—and enforced, the NBT would be better equipped to address the legacy of high NPLs across the system, notably by setting ambitious NPL workout objectives to banks' Board members and senior managers. Individual, time-bound plans could be assigned to banks, with operational targets to implement NPL workout processes, which would trigger early intervention measures or resolution actions in case these targets are not met. The banks' boards members and senior managers should be responsible for the implementation of these NPL workout plans, articulated on specific and verifiable measures and milestones designed to improve the identification, measurement, management and write-off of NPLs or foreclosed assets. The follow-up of these plans should be subjected to the on-going monitoring of the off-site supervision division, with on-site examinations being targeted on problem banks or those presenting delays.

44. In order to leverage the individual NPL reduction plans, system-wide schemes could be explored, with the aim to facilitate the spin-off between performing and non-performing assets and accordingly to better match the operational banks' capacities and needs. Two different splitting strategies are however conceivable in this respect, the selection of which should depend on the banks' sustainability and the implied cost for the taxpayers.

45. The first approach would entail a transfer of all non-performing and non-earning assets of those banks saddled with legacy NPLs to a winding down non-banking entity, called

hereunder Asset Management Company (AMC). The aim would be to carry out a comprehensive clean-up of these banks, required to be viable after such asset sales, but without any transfer of their deposits. As to the AMC, it would need significant long-term funding, but only little capital. The cost-effectiveness of this 'AMC approach' could be assessed based on the following advantages and drawbacks:

Advantages	Disadvantages
• Cleans up the banks' balance sheets • Breaks the links between the banks and their debtors (especially related parties) and thus potentially improves the collectability of loans • Allows banks to focus on their core business (lending) • Safeguards banks' brands • Serves as a vehicle for getting NPLs out of any troubled banks, based on uniform valuation criteria, centralizing ownership of collateral, thus providing more leverage over debtors • Could allow some payoff as impaired assets could be sold over time when market conditions are more favorable	• Leaves banks with the contingent liabilities likely to arise from the specific transfer to assets to the AMC or from the non-transferred business lines • Loses the banks' informational advantage (knowledge of the borrowers by the relationship managers) and operational advantage (possibility to provide additional financing which can facilitate debt restructuring) • Usually becomes bloated, depending increasingly on government funds or government guaranteed bonds, thus easily becomes black hole for wasted taxpayer money • May lessen the incentive on the banks for improving their recovery processes and, more broadly, their risk management • Unless a sound governance framework is in place, the creation of the AMC may lead to a general deterioration of payment discipline, and further deterioration of asset values. This supports moral hazard and facilitates corruption • It may also be difficult to insulate the AMC against external pressure from insiders and/or related parties.

46. An alternative approach would aim at transferring the good assets of banks with legacy NPLs and some of their liabilities (including, but not necessarily limited to the insured deposits) to another bank, leaving the remaining assets and liabilities in the transferor banks, the license of which would then be revoked before liquidation. This approach would be envisaged under a closed basis only, meaning that the license of the transferor banks would be revoked in order to leave contingent liabilities behind in the liquidation. In the absence of banks financially able to assume the cost of such 'purchases and assumptions', it could be envisaged to carry out this transfer to a 'bridge bank' established for this purpose. The latter would be temporarily owned, wholly or partially by the Government with the aim of privatizing it later. The advantages and drawbacks of this approach could be summarized as follows:

Advantages	Disadvantages
• Maintains the value of performing assets by transferring them immediately to a healthy bank, which facilitates the sale thereof to a buyer that is not interested in the entire failed bank • Immunizes the bridge bank (and the subsequent buyer) against contingent liabilities, which are left in the banks under liquidation • Minimizes disruption to banks' customers, in particular to insured depositors and maybe to other depositors by providing them access to the bridge bank	• May feed the perception by other banks of unfair competition in case of, whole or partial, state ownership of the bridge bank and special/different prudential requirements • May result in excessive time in the state hands and risk of political interference • May raise cost overruns with respect to the original estimate in case of unexpected deterioration of the good assets after their transfer • May lead to a reduction of the deposit base leading to a potential loss in franchise value

47. The most relevant benefits associated with the bridge bank approach relate to the possibility of insulating performing assets and bona fide liabilities in a separate entity. Further, in this approach under a "closed basis", the bridge bank (and the subsequent buyer) is not liable for contingent liabilities, which can be substantial and which are left in the banks under liquidation. In contrast, the liabilities to insider or related parties receive the proceeds of the liquidation of the transferor banks net of the cost of any contingent liabilities, mostly out of the non-performing loans or non-earning assets. The result of the liquidation process will then be tantamount to bailing-in the liabilities to insider or related parties, thereby alleviating unrelated depositors' losses.

48. In both approaches, attention must be paid not only to the immediate improvement of the asset quality in the banking system, but also to the potential for upgrading the risk management instruments. Once the non-performing assets have been cleared, the rehabilitated banks must strictly comply with all prudential standards and financial discipline. This requires the drafting of a rehabilitation strategy and an action plan for further monitoring its implementation for the next few years.

49. In both approaches, too, a fundamental prerequisite is the availability of a fair, prudent and realistic economic value of the banks' assets and liabilities (whether transferred or not). Not only does this valuation help ensure a fair treatment of both transferor and transferee of assets and liabilities, this valuation is also required for the purpose of determining whether the banks' shareholders and/or creditors would have received better treatment if the banks had entered into normal liquidation. Benchmarking this economic value (in resolution) against the gone-concern value (in liquidation) will be the basis of the 'No Creditors Worse Off' (NCWO) test[19], whereby "creditors should have a right to compensation where they do not receive at a minimum what they would have received in a liquidation of the firm under the applicable insolvency regime".

50. The cost-effectiveness of these alternative approaches would need to be assessed in line with the best international practices, in particular the Key Attributes of Effective Resolution Regimes for Financial Institutions. Against this background, the "least cost test" (minimization of the cost to taxpayers) is a key criterion to be considered. The main components of this cost typically include the capital injection in the transferee structure (AMC or bridge bank), and the cost of funding the transferred assets over their expected recovery process.

C. The Way Forward

51. The low levels of financial development and financial stability that currently prevail in Tajikistan weigh significantly on the country's macro-economic outlook. Not only does the underdeveloped banking sector fail to finance growth through sound lending policies, but also its high vulnerability and instability stifle depositor confidence and hinder its capacity to mobilize savings.

52. There is a strong case for breaking this vicious circle, provided the authorities commit to setting and implementing a comprehensive, ambitious and outcome-oriented strategy. This note aims to identify the desirable pillars of such a strategy, namely a set of policies designed to (i) enable proper market discipline, (ii) upgrade the institutional environment, and (iii) strengthen the individual players through a clean-up of their legacy problem assets. By definition, such a strategy can only be initiated and monitored from a top-down perspective, with only a few authorities potentially able to drive the process – such as the Ministry of Finance and the Central Bank – and preferably within a clearly articulated and publicly communicated policy framework.

[19] This test is one of the key safeguards established by the Key Attributes of Effective Resolution Regimes for Financial Institutions (Financial Stability Board – 15 October 2014).

AN ASSESSMENT OF STATE-OWNED ENTERPRISES IN TAJIKISTAN[1]

This paper assesses the performance of the 24 largest State-Owned Enterprises (SOEs) in Tajikistan and discusses the fiscal risks these enterprises pose. The study shows that although SOEs are important contributors to the economic growth and development in Tajikistan, their poor financial and operational performance continues to impose serious fiscal costs and risks. Against the backdrop of revenue shortfalls and rising fiscal risks in recent years, fiscal space is becoming limited. To ensure fiscal stability and debt sustainability, the government should fast-track reforms to ensure that SOEs are governed properly to improve service delivery and minimize fiscal risks.

A. Introduction

1. **Although there has been privatization of several SOEs, Tajikistan still has many enterprises.** In 1991, Tajikistan implemented a privatization program of state enterprises, which focused on small-scale enterprises operating in the agriculture, trade and services sectors. Although more than twelve thousand enterprises had been privatized by 2015, there has been a considerable slowdown in the number of enterprises privatized in recent years. The reason for fewer enterprises being privatized is that the remaining SOEs lack privatization potential. In light of this, it is unclear if a large share of the remaining SOEs can be privatized.

2. **SOEs are an integral part of Tajikistan's economy and play an important role in promoting economic development.** The SOE sector has contributions to growth, fiscal revenues and services. In particular, during 2013-2015, SOEs accounted for an average of 14 percent of total economic activity. SOEs also provide revenues to the government from dividends and other tax payments. Further, SOEs provide a range of essential infrastructure and services that are critical to Tajikistan's economic development. For instance, SOEs are responsible for important production items such as energy, metal processing and water resources; and they provide services in transport, telecommunications, banking and insurance. In addition, SOEs play an important role in the labor market.

3. **However, while SOEs play a pivotal role in the economy, their current performance pose significant fiscal and financial stability risks.** The economic and financial performance of SOEs has deteriorated in recent years and as a result, the government has been providing financial support to some SOEs in the form of sub-loans or direct credits from the budget. As a number of SOEs are loss making, some of them are unable to repay the government, thus the SOE sector has been a consistent fiscal drain on the government's budgetary resources. The poor performance of

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[1] This SIP was prepared by Keyra Primus and Zuhro Qurbonova. We are grateful for helpful discussions and comments from Marco Rossi, Paul Ross, Inutu Lukonga, Abdurauf Zuchurov and Vladimir Krivenkov.

some SOEs also translates into nonperforming loans. Preliminary information shows that SOEs account for a significant share of NPLs in the banking sector.

4. Against this backdrop, this paper assesses the financial and operational performance of SOEs in Tajikistan and evaluates the fiscal risks they pose to the economy. The paper also offers suggestions on how the government can mitigate the fiscal costs of SOEs to ensure fiscal and debt sustainability. To conduct the analysis, we use data for the 24 largest SOEs that are monitored by the SOE Monitoring Department (SOEMD). The conclusions emerging from the review are that although SOEs are important contributors to the economic growth and development in Tajikistan, against the backdrop of revenue shortfalls and dwindling fiscal space, the SOEs' poor financial and operational performance imposes substantial fiscal costs.

5. The remainder of this paper is organized as follows. Section B provides an overview of the structure of SOEs in Tajikistan. Section C discusses the performance of the 24 largest SOEs, whereas Section D assesses the fiscal risks posed by SOEs. The final section concludes and suggests measures to improve oversight and mitigate the risks from SOEs.

B. Structure of the SOE Sector

6. The corporate structure of the SOE sector comprises different types of enterprises (Table 1). SOEs include State Unitary Enterprises (SUEs), Open or Closed Joint Stock Companies (JSCs), and Limited Liability Companies. Most of the SOEs, 88 percent, are SUEs, whereas 11 percent are Open JSCs. The SUEs and Open JSCs are fully owned either by the central or local government. The Closed JSC and Limited Liability Company (LLC) are only owned by the central government. Majority of the enterprises operate in the non-financial sector (about 99 percent), while a few entities are in the financial industry.

Table 1. Tajikistan: Types of State-Owned Enterprises

	Total	Owned by central Govt.	Owned by local Govt.
Enterprises with state ownership of ≥ 50%	**908**	**716**	**192**
Grouped by sector:			
• Non-financial sector	898		
• Financial sector	10		
Grouped by type			
• SUEs	797	608	189
• open JSC	104	101	3
• closed JSC	6	6	
• LLC	1	1	

Source: Republic of Tajikistan, 2016.

C. Performance of SOEs and Developments in the SOE Sector

7. In recent years, the profitability of some of the large SOEs has deteriorated. In 2016, the gross income of the 24 largest SOEs declined to TJS 5.3 billion (9.7 percent of GDP) from TJS 6.4 billion (13.2 percent of GDP) the previous year. The five largest SOEs—Amonat Bank, Barki Tajik (electricity company), Tajik Rail Road, Tajik Air Company, and Tajikistan Aluminum Company (TALCO)—contributed over 75 percent of the gross income (Table 2). Meanwhile, expenditures declined by 16.5 percent in 2016 compared to the previous year. Overall, net losses decreased from TJS 2.6 billion (5.4 percent of GDP) in 2015 to TJS 2.2 billion (4.0 percent of GDP) in 2016. An analysis of the data shows that about 99 percent of these losses can be attributed to the two largest SOEs: Barki Tajik and TALCO. Continued losses by Barki Tajik and TALCO, if not contained, can threaten fiscal and debt sustainability.

Table 2. Tajikistan: Income and Expenditures of State-Owned Enterprises (2015-2016)

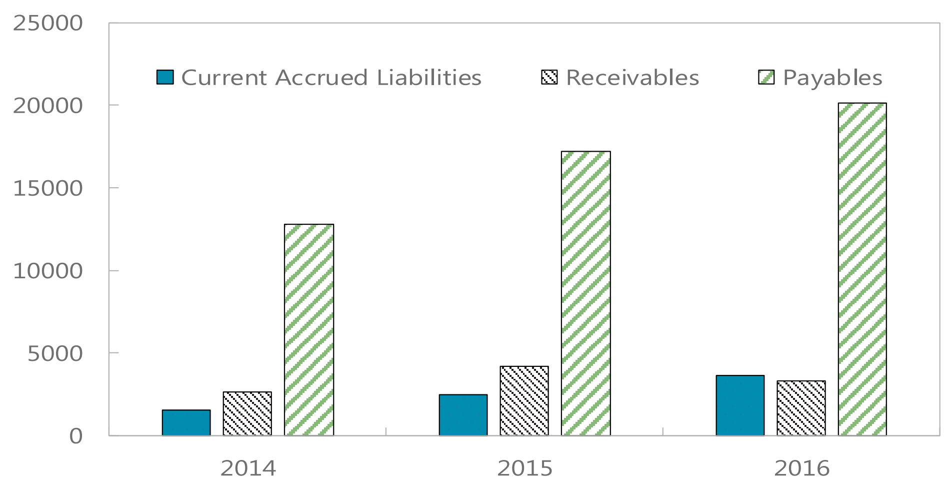
	Somoni (millions)							
	Gross Income		Expenditure		Profit/Loss before Tax		Profit/Loss after Tax	
State-Owned Enterprise	**2015**	**2016**	**2015**	**2016**	**2015**	**2016**	**2015**	**2016**
Aeronavigation	70.7	75.2	38.9	40.7	31.8	34.4	24.2	26.2
Dushanbe Airport	301.3	345.7	215.2	267.3	86.1	78.5	65.4	59.6
Khujand Airport	91.1	116.4	54.8	64.4	36.3	52.0	27.6	38.9
Kurgan-Tyube Airport	6.3	6.2	5.5	5.7	0.8	0.5	0.6	0.4
Kulyab Airport	36.7	22.8	24.7	17.5	12.0	5.3	9.1	4.0
Tajik Air Company	408.2	463.8	403.5	462.3	4.7	1.5	0.6	-3.1
Barki Tajik	1,700.6	1,846.1	4,384.0	3,966.9	-2,683.4	-2,120.7	-2,701.1	-2,142.4
Tajik Rail Road	555.6	594.4	529.7	565.7	25.9	28.7	19.7	21.8
Aluminum Sokhtmon	29.2	15.5	31.0	20.0	-1.8	-4.4	-2.3	-4.6
TALCO	927.8	464.2	1,003.4	708.5	-75.6	-244.3	-80.4	-256.3
Vostok Redmet	9.5	10.3	9.5	10.4	0.0	-0.1	0.0	-0.1
Tajik Cement	192.6	154.1	133.4	128.3	59.2	25.7	45.0	22.1
Tajik Trans Gas	2.4	1.4	10.5	8.8	-8.1	-7.4	-8.0	-7.3
Fuel Gas Supply Corporation	10.1	4.1	11.5	4.6	-1.4	-0.5	1.8	-0.5
Canning plant of Isfara city	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Water and sewerage supply of Dushanbe city	45.1	45.5	53.1	48.8	-8.0	-3.3	-8.5	-3.7
Water canal of Hujand city	16.5	16.4	21.9	18.7	-5.4	-2.4	5.5	-2.5
Housing & Communal Services Department	115.0	120.8	117.0	121.7	-2.0	-0.8	-2.1	-0.8
Amonat Bank	1,659.3	671.3	1,610.4	657.2	48.9	14.1	29.9	2.8
Tajik Telecom	114.9	190.3	110.0	184.8	4.9	5.5	3.7	4.2
Tajik Post Office	7.1	7.0	7.1	7.3	0.0	-0.3	0.0	-0.3
TV Radio Company	36.3	36.2	35.7	34.6	0.6	1.5	0.4	1.2
Tajik Invest	7.3	5.2	7.0	4.5	0.3	0.7	0.3	0.5
Tajik Insurance	63.3	63.9	58.9	59.7	4.4	4.1	3.3	3.2
Total	**6,406.9**	**5,276.8**	**8,876.7**	**7,408.5**	**-2,469.8**	**-2,131.7**	**-2,565.3**	**-2,236.9**

Source: IMF staff calculations based on data from the SOEMD, Ministry of Finance.

8. **The accumulated liabilities of SOEs are a source of fiscal risks**. Current accrued liabilities of the 24 largest SOEs have increased substantially by over 30 percent annually between 2014-16 (Figure 1). At end 2016, current accrued liabilities of the 24 largest SOEs were TJS 3.6 billion (6.6 percent of GDP). These liabilities include borrowing directly from the government's budget, borrowing from domestic banks and other non-bank financial institutions, payments to suppliers for goods received, unpaid taxes and unpaid wages.

Figure 1. Tajikistan: SOEs: Current Accrued Liabilities, Accounts Receivable and Accounts Payable

(In millions of somoni)



Source: IMF staff calculations based on data from the SOEMD, Ministry of Finance.
Note: For accounts payable, estimates are tentative as the payment status is unclear. 2016 reflects data for Q1–Q3.

9. **The latest data revealed that SOEs' contribution of dividends paid to the budget increased.** Dividends paid by state enterprises increased by almost 30 percent in 2015 – from TJS 13.7 million in 2014 to TJS 17.8 million in 2015 (Table 3). Notably, although there was a decline in dividends paid by some SOEs in 2014-2015, this was fully offset by the increase in the number of SOEs paying dividends in 2015. It is important to note that, because compliance with the policy is poor, not all profitable enterprises transfer dividends to the budget. Therefore, revenues from dividends are lower than what the government should receive.

Table 3. Tajikistan: Dividends Paid to the Budget by SOEs
(In millions of somoni)

Name	2014	2015
Dushanbe Airport	3.80	4.01
Amonat bank	2.70	2.50
Khujand Airport	2.10	1.00
Aeronavigation	1.10	1.90
Kulyab Airport	0.90	0.97
Tajik Air Company	2.30	1.76
Tajisugurta	0.80	0.23
Tajiksarmoyaguzor	-	0.01
Tajik Rail Road	-	0.30
Tajik Cement	-	4.87
Tajik Telecom	-	0.13
Teleradiocom	-	0.03
Housing and Public Utilities	-	0.06
Total	**13.70**	**17.77**

Source: Fiscal Risks Reports 2014–15, Ministry of Finance.

10. **SOE oversight has been strengthened but fiscal risks remain.** Over the years, the government has made progress in trying to assess and manage fiscal risks. Despite the government's efforts, losses in SOEs continue to mount rapidly creating fiscal risks and costs. This underscores the need for fast-tracking reforms to improve fiscal risk management. Some of the key achievements of the government in this area include:

- **Establishing and operationalizing an SOEMD in the Ministry of Finance in 2008.** Initially, the SOEMD monitored the financial performance of the 10 largest SOEs. The scope of monitoring was further expanded to 16 SOEs as a result of Tajik Air being split into six individual SOEs, and then to 24 SOEs in 2013.

- **Preparing and publishing statements of fiscal risks as part of the budget documentation since 2013**. The statement on fiscal risks includes:

    - Explicit direct liabilities from on-lending arrangement;
    - Sub-loans from the state budget.
    - Direct loans to SOEs from state budget;
    - Contingent liabilities from guaranteed loans;
    - The materialization of risks;
    - Legal disputes against SOEs;
    - Quasi-fiscal activities by the SOEs;

  - Statistics on direct subsidies;
  - Statistics on dividends transferred by the SOEs to the state budget, and
  - General recommendations to mitigate and manage risks.

- **Introducing a dividends policy in 2013 and expanding the policy in 2016 to cover additional large SOEs that are majority-owned by the government**.

- **Developing and approving a strategy for managing fiscal risks in 2016.**

D. Fiscal Risks of SOEs

11. A key concern is the growing indebtedness of some SOEs. Loss-making enterprises are a persistent drag on public finances because they need continuous financial assistance from the government. Liquidity problems, increasing indebtedness and operating losses of SOEs are absorbed by accumulating arrears, subsidized loans, direct credits from the budget and debt write-offs. Although these measures can provide some temporary financial relief to SOEs, they create fiscal costs and can threaten fiscal stability. Further, these measures are unable to offset SOEs rising fiscal costs that translate into NPLs in the banking system.

12. Moreover, the government is also exposed to significant fiscal risks when they on-lend funds to SOEs. As summarized in Figure 2, the government of Tajikistan borrows funds from International Financial Institutions (IFIs) and then on-lends the money to SOEs for important projects. Because these loan agreements are between the Ministry of Finance and the IFIs, the government is obligated to repay the loans to the foreign lenders if the SOEs are unable to service their debt. The decline in profitability of some of the largest SOEs has made it difficult for them to fulfill their financial obligations. During 2013-2016, sub-loans to SOEs have been rising significantly (Figure 3). At the end of 2016, outstanding sub-loans, including interests and penalties, were TJS 13.3 billion (24.4 percent of GDP). Barki Tajik accounts for approximately 95 percent of total on-lent funds (sub-loans).

Figure 2. Tajikistan: The On-Lending Arrangement

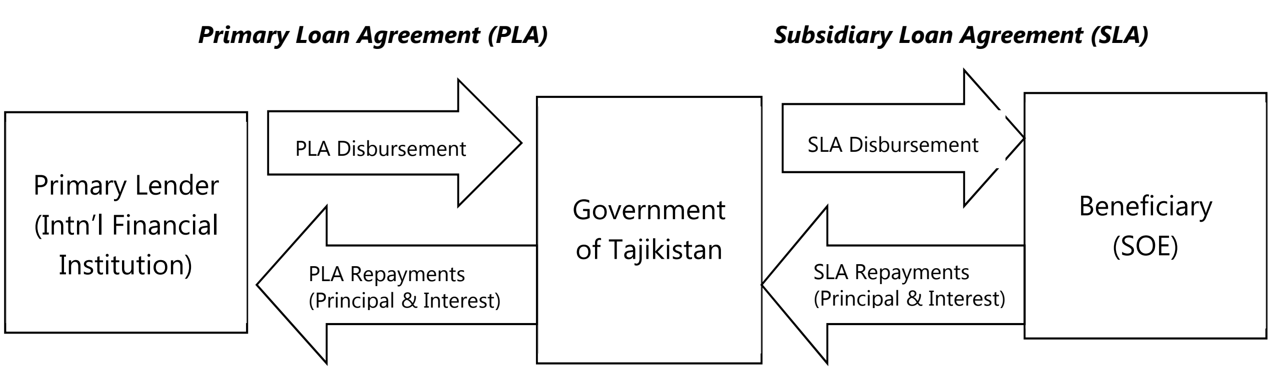
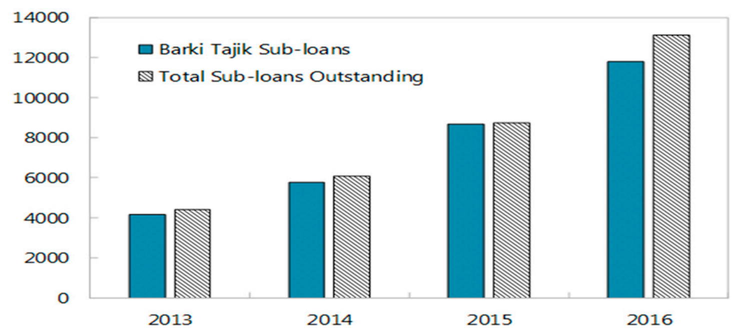


Figure 3. Tajikistan: Outstanding Balances on Government Sub-Loans

(In millions of somoni)



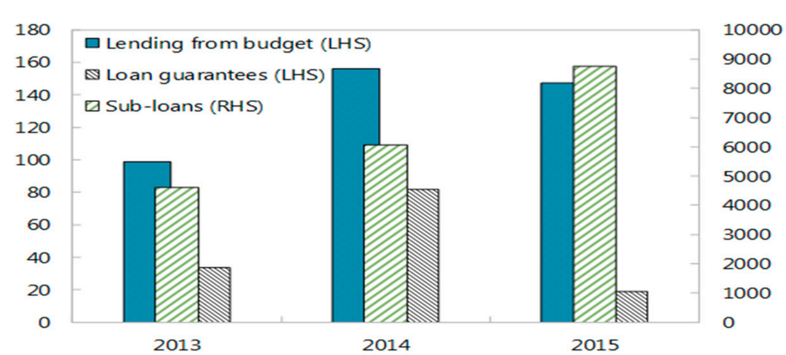
Source: IMF staff calculations based on data from the SOEMD, Ministry of Finance.

13. **The government provides credits from the budget to large enterprises, creating a strain on the fiscal accounts.** In 2014 and 2015, direct lending from the budget to SOEs was TJS 155.9 million and TJS 147.1 million, respectively (Figure 4). Data show that those credits were given to two SOEs – Barki Tajik (which received about 90 percent of the credits) and Tajik Trans Gas. Preliminary information indicates that majority of these loans are still outstanding.

14. **The state provides direct guarantees for loans made by SOEs in exceptional cases**. Over the period 2013-2015 the government guaranteed TJS 44.6 million loans on average (Figure 4). By law, the loans guaranteed by the government in a calendar year should not exceed 20 percent of the loans approved by the state for the year (Republic of Tajikistan, 2016). There are potential fiscal costs associated with government guarantees because they are a form of contingent liabilities. It is therefore important for the government to carefully manage guarantees.

Figure 4. Tajikistan: Direct Lending from Budget, Loan Guarantees and Sub-loans

(In millions of somoni)



Source: Fiscal Risks Reports 2013-15, Ministry of Finance.

15. SOEs have accumulated losses by engaging in quasi-fiscal activities. In Tajikistan, the main quasi-fiscal activities include: the use of below cost prices for energy, utilities, and other services; provision of noncommercial services; soft budget constraints; barter and offset arrangements; subsidized lending; and bailouts (The World Bank, 2014). Quasi-fiscal activities could generate liabilities that can easily accumulate overtime, undermining public debt sustainability.

16. Contingent liabilities can accentuate pressure on the budget and complicate fiscal planning, especially during difficult times. Given the deteriorating economic performance of SOEs and the current banking crisis, it is possible that a large number of contingent liabilities can emerge from SOEs and banks – creating substantial unforeseen costs to the government. In Tajikistan, considering the current accrued liabilities of the 24 largest SOEs and the guarantee of deposits in Amonat bank – which is state-owned and its deposits are not insured by the deposit insurance fund – contingent liabilities are estimated to be about 7-8 percent of GDP in 2016. This is close to estimates obtained for other countries. For instance, in a recent study, Bova et. al. (2016) found contingent liabilities realizations, which are likely to coincide with banking crises, are about 6 percent of GDP on average.

E. Conclusion and Recommendations

17. SOEs play a pivotal role in Tajikistan's economy but they create fiscal risks. SOEs account for a substantial share of total economic activity and they provide essential services. However, the SOEs have been a consistent fiscal drain, and their financial position has been deteriorating. The fiscal risks from SOEs are compounded by a lack of transparency and capacity to manage and monitor these risks. To mitigate costly shocks to public finances from SOEs, the government would need to strengthen fiscal risk management and improve governance. Some of the key reforms the government of Tajikistan should undertake to improve transparency and limit fiscal risks are outlined below.

- The government should phase out and end quasi-fiscal activities of SOEs. Notably, SOEs that engage in quasi-fiscal activities directed by the government should be compensated. This recommendation is in line with a paper by IMF (2016b) which pointed out that successful oversight requires quasi-fiscal activities to be fully funded in the budget and disclosed in financial reports prepared by the government and SOEs.

- Contingent liabilities realizations can be a major source of fiscal distress to Tajikistan's economy. The government recently indicated their intention to establish a budgetary reserve fund as a buffer against contingent liabilities. Although this can help mitigate fiscal risks from contingent liabilities, given the shortfalls in revenues in recent years, there may not be enough budgetary resources to establish this fund. It is important for the government to put a transparent framework in place to monitor, assess and disclose fiscal risks from contingent liabilities.

- All large SOEs should comply with the requirement to publish their audited financial statements on an annual basis. Medium and small SOEs should be required to publish summarized financial data annually.

- Some SOEs have been consistently failing to achieve adequate profitability. As a result, those SOEs continue to be a net drain on the government budget. It is therefore important for the government to assess SOEs viability to earmark those for restructuring, privatization and winding-up.

- The Statement of Fiscal Risks which is included in the budget should be expanded to include information on SOEs' accumulated arrears to domestic banks. This information is important to monitor the viability of banks in the current economic environment.

- The establishment of the SOE Monitoring Department (SOEMD) in the Ministry of Finance is positive but capacity of the department needs to be strengthened. At present, the SOEMD includes two units consisting of nine employees. Therefore, the capacity of the staff to conduct detailed monitoring of the financial performance of SOEs is limited. The government should enhance capacity to manage and monitor fiscal risks.

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