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# Supervision of Banking in the Republic of Kazakhstan

Timur Kibatullin†

*The Republic of Kazakhstan's newly-formed banking system is described, focusing on the role of the National Bank as the central banking authority. The article outlines the system of statutes and regulations that govern Kazakhstan's banks, setting out the rules and procedures that banks must follow to operate in the Republic. Also, the author describes the scope of the National Bank's powers, offers various criticisms of the National Bank's extraordinarily broad discretion, and suggests proposals for future legislation.*

## PREFACE

The creation of an independent Republic of Kazakhstan after the dissolution of the former Soviet Union has opened new opportunities for foreign banks. Freed from the constraints of strict central planning, Kazakhstan is developing a system of private commercial banking. Within the last few years, a number of foreign banks have opened offices in Alma-Ata, the capital, and several leading foreign banks have moved to establish Kazakhstan-based subsidiaries. Citibank, Chase Manhattan and ABN Amro, among others, are in the forefront of the foreign banks doing business in Kazakhstan. Such banks, as well as other western companies and investors, have been attracted to Kazakhstan by its relative political stability, rich natural resources and industrious, well-educated people. Companies such as Chevron and Philip Morris have undertaken large projects in Kazakhstan, which have created many opportunities for supporting businesses and services. These business opportunities, in turn, have created more demand for investment and bank financing.

This article examines the structure of Kazakhstan's banking system. After outlining the governing legislative acts and regulations, the article focuses on the role and powers of Kazakhstan's central banking authority, the National Bank. The procedures for establishing a new bank are explained, including the grounds

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on which the National Bank may refuse to permit the opening of a new bank. The process that existing banks must follow in order to be licensed to conduct certain types of business, especially foreign currency transactions, is also reviewed.

The next section considers the National Bank's use of inspections and reporting requirements to monitor and to supervise the banks after they have opened. Finally, the paper examines the National Bank's broad enforcement powers. Throughout the paper, the author offers proposals that may improve banking in Kazakhstan, such as limiting the enormous scope of the National Bank's powers and developing a deposit insurance program.

#### HISTORY OF KAZAKHSTAN'S BANKING LAWS

The first banking law of the Republic of Kazakhstan, the Banks and Banking Activity Act, was passed by the Supreme Soviet of Kazakhstan in December 1990.<sup>1</sup> That act was progressive, even revolutionary, simply because it permitted private banks to exist.<sup>2</sup> In a state where only government-owned banks had been allowed to operate, that step alone was significant. The Banks and Banking Activity Act also established many important standards which continue to dominate the structure of Kazakhstan's banking system. For example, the Act created a central banking authority, defined the status of commercial banks, and established limits on the types of transactions that banks can conduct.<sup>3</sup>

The Banks and Banking Act governed both the central banking authority and the commercial banks, and it created two large government-owned banks, the Savings Bank<sup>4</sup> and the Bank for Foreign Economic Activity.<sup>5</sup> Despite the Act's important contributions to Kazakhstan's banking system, it rapidly proved inadequate and was replaced in 1992, only two years later, with two separate statutes, the National Bank Act<sup>6</sup> and the Banks Act.<sup>7</sup> These statutes created the

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1. *Zakon Kazakhskoi SSR "O bankakh i bankovskoi deyatel'nosti v Kazakhskoi SSR"*, 50 *Vedomosti Verkhovnogo Soveta KazSSR*, Item 475 (1990) [Banks and Banking Activity Act]. Note that Kazakhstan did not declare its independence from the USSR until December 16, 1991. Therefore, the Banks and Banking Activity Act was passed by the Supreme Soviet of the Kazakh Soviet Socialist Republic. The Republic of Kazakhstan's Constitution was not adopted until January 28, 1993. Nevertheless, laws adopted before independence or before the adoption of the Constitution, remain effective unless specifically repealed or amended by subsequent statutes. [Kazakhstan does not have a unified code of laws comparable to the U.S.C. In fact, many of its laws are only promulgated formally in the government-owned newspaper. Because of the lack of formal publications and because of the fluctuating structures of Kazakhstan's government since 1990, we have used citations based on the informal, English "working names" of the Kazakh statutes explored in this article. The reader should note, however, that most of these laws are *not* available in English. -Eds.]

2. *Id.* at art. 10.

3. See generally, *Id.*

4. *Id.* at art. 24.

5. *Id.* at art. 28.

6. *Zakon Respubliki Kazakhstan "O Natsional'nom Banke Respubliki Kazakhstan"*, 9 *Vedomosti Verkhovnogo Soveta Respubliki Kazakhstan*, Item 226 (1993) [National Bank Act].

7. *Zakon Respubliki Kazakhstan "O bankakh v Respubliki Kazakhstan"*, (1993) *Sovety Kazakstana*, May 18, 1993 [Banks Act].

National Bank<sup>8</sup> and represent the birth of Kazakhstan's current banking system. In 1994, the legislature adopted a series of amendments to the National Bank Act.<sup>9</sup> Most of the changes were minor, e.g., the word "ruble" was replaced by "tenge" to reflect the recent adoption of the new national currency.<sup>10</sup> Most importantly, the amendments gave the National Bank plenary power to regulate certain types of transactions and to license the private banks to perform those transactions.<sup>11</sup>

Another vital statute in Kazakhstan's banking system is the Currency Regulation Act.<sup>12</sup> As initially enacted in 1991, that act established basic principles of foreign exchange and created two government agencies, the Control Chamber of Kazakhstan and the Bank of Foreign Economic Activity, to supervise foreign currency transactions.<sup>13</sup> But the Bank of Foreign Economic Activity was soon denationalized and transformed into a semi-private banking corporation with the government participating as a shareholder.<sup>14</sup> In response to that transformation, the Currency Regulation Act was substantially revised in 1993.<sup>15</sup> The amended act shifted the responsibility for foreign exchange control to the National Bank thereby consolidating all banking supervision duties in that agency.<sup>16</sup>

In addition to the banking statutes, there are agency-created regulations that shape Kazakhstan's banking system. There are two sources of banking regulations: the National Bank is the principal source, and the Ministry of Finance has issued a few regulations as well.<sup>17</sup> Regulations by the National Bank and the Ministry of Finance cover a wide range of bank-related activities, including accounting procedures, foreign exchange control, monetary control, and other banking activities. Perhaps the most significant regulations promulgated by the National Bank are the Rules of Conducting Currency Transactions (the "Currency Rules").<sup>18</sup>

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8. Id. at art. 3; National Bank Act, *supra* note 6, art. 1.

9. Zakon Respubliki Kazakhstan "O viiesenii izmeneniy i dopolneniy v Zakon Respubliki Kazakhstan," "O Natsional 'nom banke Respubliki Kazakstan (TRANSLATION) (1994).

10. Id. at arts. 3, 12, 20, 22, 25, and 28.

11. Id. at arts. 3 and 4.

12. Zakon Kazakhskoi SSR "O valyutnom regulirovanii v Kazakhskoi SSR." 25 Vedomosti Verkhovnogo Soveta KazSSR, Item 310 (1991) [Currency Regulation Act].

13. Id. at art. 16.

14. The Foreign Economic Activity was denationalized and turned into Alembank Kazakhstan by the Decree of the cabinet of Ministers of the Republic of Kazakhstan N. 710 of August 28, 1992. Postanovleniye Kabineta Ministrov Respublik Kazakhstan N. 710 "O pereimenovanii Kozvneshekombanka V Alembank Kazakhstan," item 515 (1992).

15. Zakon Respubliki Kazakhstan "P valyutnom reguliro vanii" 10 vedomosti verkhov nogo Soveta, Item 240 (1993), *translated* in 4 Russia and Common Wealth Business Law Journal Report, No. 10 (1993).

16. Currency Regulation Act, *supra* note 12, art. 1, § 13; art. 3, §§ 2 and 3.

17. See, e.g., Instruksiya O poryadke vedeniya bukhgalterskogo uchheta valyutnykh operatsyi (Vremennye Metodologicheskiye Rekomendatsii Ministerstva Finansov Respubliki Kazakhstan N F-10-4/113), 2 Informatsionnyi Biulleten' Ministerstva Finansov Respubliki Kazakhstan 11 (1994) [Temporary Rules of Accounting in Foreign Currency Transactions].

18. Pravila provedeniya valyutnykh operatsyi v Respubliki Kazakhstan, 2 Informatsionnyi Biulleten' Ministerstva Finansov Respubliki Kazakhstan 19 (1994) [Currency Rules].

The National Bank has issued many other regulations to fill some of the nascent statutory system's gaps. For example, on May 12, 1992 the National Bank promulgated the Basic Regulation of Foreign Currency Transactions.<sup>19</sup> That regulation was, in turn, supplemented by the Rules of Conducting Foreign Currency Transactions,<sup>20</sup> which the National Bank adopted in December of 1993. Another example is the Temporary Regulation of Payments,<sup>21</sup> which governs the system of payments in Kazakhstan.<sup>22</sup>

Kazakhstan's banks are also subject to the Republic's corporate laws. For example, the Partnerships, Joint Stock Associations and Companies Act (the "Companies Act") governs the internal corporate management of a bank.<sup>23</sup> As a corporate entity, a bank in Kazakhstan must have articles of incorporation<sup>24</sup> and must establish a code of conduct for its officers, which must be ratified at the bank's shareholders meeting.<sup>25</sup> Once ratified, the code of conduct is binding upon all officers and directors of the bank.

#### THE CENTRAL BANKING AUTHORITY: THE NATIONAL BANK

In 1992, the National Bank Act created the National Bank as the central banking authority of Kazakhstan.<sup>26</sup> Article 4 of the National Bank Act establishes most of the National Bank's rights and responsibilities. It gives the National Bank power to:

- approve the establishment of new banks;
- issue licenses to permit a bank to conduct certain transactions (such as foreign currency transactions);
- examine banks and their branches;
- penalize banks for violating Kazakhstan's banking laws and regulations;
- promulgate rules, regulations and instructions for the banks; and,
- help establish accounting forms and other reporting requirements for the banks.<sup>27</sup>

Article 31 of the National Bank Act also helps to define the scope of the National Bank's authority. That article not only repeats some of the powers

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19. Osnovnye polozheniya o regularovanii valyutnykh operatsyi na territorii Respubliki Kazakhstan, Resolution of the National Bank No. 18 (1992) [Basic Regulation of Foreign Currency Transactions].

20. Currency Rules, *supra* note 19.

21. Vremennoye polozheniye o beznalichnykh raschetakh v Respubliki Kazakhstan, 7 Biblioteka bukhgaltera i predprinimatel'ya (1994) [Temporary Regulation of Payments].

22. The current system of payments in Kazakhstan is not very sophisticated. Money orders are the most commonly used type of transactional payment. Very few payments are made by check and there are no wire transfers.

23. Zakon Kazakhskoi SSR "O khozyaistvennykh tovarishestvakh i aktsionemykh obshchestvakh", 26 Vedomosti Verkhovnogo Soveta KazSSR Item 343 (1991) *amended by* Zakon Respubliki Kazakhstan "O vnosenii izmeneniy i dopolneniy v Zakon Kazakhskoi SSR", "O khozyaistvennykh tovarishchestvakh i aktsionemykh obshchestvakh", 9 Vedomosti Verkhovnogo Soveta, Item 216 (1993) [Companies Act].

24. *Id.* at art. 67, § 4.

25. *Id.* at art. 70, § 2.

26. National Bank Act, *supra* note 6.

27. *Id.* at art. 4.

listed in Article 4, but also empowers the National Bank to: (a) promulgate rules, regulations, directives, and instructions for the banks' clients; (b) establish licensing procedures and guidelines; and (c) examine the banks, either by on-site inspection of the banks' documents or by reviewing reports submitted by the banks.<sup>28</sup>

### *National Deposit Insurance*

Kazakhstan does not have a deposit insurance system, but there appears to be a growing consensus among National Bank officials that deposit insurance is needed.<sup>29</sup> To date, few banks have failed in Kazakhstan.<sup>30</sup> Because there has been no public outcry for deposit insurance, it is unlikely that the national legislature will create such a system. This tension—between the National Bank's perception of the need for deposit insurance and the national legislature's failure to see such a need—is likely to be mooted by the National Bank unilaterally creating a deposit insurance system by regulation sometime in the near future.<sup>31</sup>

It would, however, be unfortunate if the deposit insurance function were vested in the National Bank, because this function carries potentially great risk. The National Bank already bears the risks involved with its reserve and clearing functions. The responsibility for deposit insurance—involving large insurance payments when a bank fails—would substantially increase the total risks facing the National Bank. These risks could threaten the stability of Kazakhstan's banking system; therefore, the legislature should act to create a separate agency to provide deposit insurance, dividing the attendant risks and responsibilities.

### REQUIREMENTS FOR OPENING A BANK

To establish a bank in the Republic, one must first obtain permission from the National Bank.<sup>32</sup> The National Bank requires the following: (1) a formal application; (2) a statement of economic substantiation (usually a statement indicating how the opening of the bank will benefit the Republic); (3) a business plan, including two- or three-year forecasts of the bank's growth; (4) the professional backgrounds of the president and chief accountant; (5) the articles of incorporation, organizational minutes, bylaws, and any agreements among shareholders (such as pre-formation agreements); (6) an auditor's report on the financial reliability of the initial shareholders of the bank; and (7) a receipt indi-

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28. *Id.* at art. 31.

29. This proposition is based on the author's conversations and working relationship with many National Bank officials.

30. Mr. Grigory Marchenko, Deputy Chairman of the National Bank, says that there have been approximately fifteen bank failures, most of which involved very small banks.

31. Again, this proposition is based on the author's observations, experience, and conversations with National Bank officials.

32. Banks Act, *supra* note 7, art. 1.

cating the amount of the bank's initial funds.<sup>33</sup> The National Bank may take up to three months to complete its examination of the documents.<sup>34</sup>

During the examination, the National Bank's in-house counsel looks closely at the prospective bank's articles of incorporation.<sup>35</sup> If the articles of incorporation do not comply with current legislation, the National Bank will not allow the bank to open.<sup>36</sup>

The National Bank also pays close attention to the "proper qualifications" of the individuals who will serve as officers of the bank.<sup>37</sup> Prospective banks should provide the National Bank with their officers' professional biographies and documentation of their training and education, including academic degrees and certificates of study.<sup>38</sup> Although the Banks Act does not precisely define "proper qualifications," the rule of thumb is that the president, the chief accountant, and other members of the bank's executive committee each must have at least two years of banking experience.<sup>39</sup> If the top management does not have a satisfactory educational and professional background, the National Bank may refuse to permit the bank to open.<sup>40</sup>

The National Bank may refuse to allow a bank to open for several other reasons. For example, permission will be denied if any of the initial shareholders or senior management personnel have been convicted of any crime for a "mercenary purpose."<sup>41</sup> Such mercenary crimes probably include fraud and embezzlement, and might include simple robbery as well, although crimes such as simple assault would apparently not disqualify the bank.<sup>42</sup> Other grounds for refusing to allow a bank to open are: (1) the financial instability of the initial shareholders; (2) the bank's failure to put the minimum required amount of capital into a reserve fund held by the National Bank; (3) the National Bank's determination that the bank will be unable to support itself during its first two years of operation; or (4) the lack of appropriate facilities or technical expertise.<sup>43</sup>

Perhaps the most important of these requirements is that the National Bank may refuse to allow a bank to open because of the financial instability of the initial shareholders.<sup>44</sup> This is an important requirement because initial share-

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33. *Id.* at art. 17.

34. *Id.* at art. 19.

35. Rules of Opening Banks, Licensing Conducted Transactions, Changing the Articles of Incorporations, and Procedure of Winding Up Banks of November 22, 1993, adopted by the Resolution of the National Bank N23, § 9. This Rule was sent out to agencies and banks in Kazakhstan.

36. Banks Act, *supra* note 7, art. 20.

37. *Id.* at art. 17.

38. *Id.*

39. There is no special provision in the law that establishes this requirement: it is a custom.

40. Banks Act, *supra* note 7, art. 20.

41. *Id.*

42. The uncertainty about what crimes will disqualify the bank stems from the relative newness of the requirement. Also, the category of crimes committed for a "mercenary" purpose has not been explained or construed by the legislature or the courts.

43. Banks Act, *supra* note 7, art. 20.

44. *Id.*

holders may defer part of the payment for the shares issued to them.<sup>45</sup> Since the initial shareholders, in effect, may have bought part of the banking corporation on credit, their financial stability is a legitimate concern. If the initial shareholders fail to pay their full share, the bank's initial capitalization will be jeopardized. The National Bank has the right, but not the obligation, to verify the financial condition of initial shareholders by obtaining credit references from credit reporting agencies and financial institutions.

#### *Extra Requirements for Foreign Shareholders*

The Banks Act allows banks to be wholly- or partially-owned by foreign-bank shareholders,<sup>46</sup> but there are additional requirements for establishing such a bank. The foreign shareholder must provide: (1) the shareholder's articles of incorporation (or similar documentation); (2) resolutions from the shareholder's board of directors approving participation in the new bank; and (3) a written statement from a "supervising authority" in the foreign shareholder's home country permitting the shareholder to establish a bank in Kazakhstan; if the home country does not require its banks to obtain permission before investing in foreign banks, then a written statement to that effect from an "authoritative legal service" is sufficient.<sup>47</sup>

One of the most difficult and unsettled issues about opening a bank wholly- or partially-owned by non-residents is discerning what suffices as proof from "an authoritative legal service" that a shareholder's home country does not require the shareholder to get permission before investing in a foreign bank.<sup>48</sup> Experience indicates that the best course to pursue is to obtain a statement from a government agency in the shareholder's home country that no specific permission is needed.<sup>49</sup>

For example, a bank based in the United States may get a written statement from the Federal Reserve Board or the Department of Commerce that no official authorization is required. In that case, the Federal Reserve Board or the Department of Commerce would be acting as "an authoritative legal service." It is advisable to get such a statement from one of the home country's government agencies because Kazakh officials traditionally give more deference to reports from government agencies than those from private sources. It is doubtful whether a lawyer or law firm representing the foreign bank would be regarded as an "authoritative legal service" whose reports would satisfy the requirement.

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45. Companies Act, *supra* note 23, art. 49, § 2.

46. Banks Act, *supra* note 7, art. 18.

47. *Id.* at art. 18.

48. *Id.*

49. No written law exists to support this proposition. The only available authority is that of experience. In other words, U.S. banks that have opened branches in Kazakhstan have managed to convince the National Bank, by using this strategy, that they do not need U.S. permission to do business in Kazakhstan. Because there have been so few bank openings, there really is no customary practice that one can rely on. Nevertheless, several banks have managed to pass this requirement by working with the National Bank and its agents to come to a satisfactory, workable solution to this problem.



Nevertheless, official attitudes in Kazakhstan have started to change toward favoring the validity of private law firms' determinations of whether home countries would invalidate the deal without official permission.<sup>50</sup>

At the present time, a few foreign banks, primarily Turkish, German and American, have established joint ventures with several of Kazakhstan's banks. Additionally, several foreign banks have moved to establish wholly-owned subsidiaries without the participation of a local bank or partner. While some of the issues surrounding the approval process for foreign-owned banks are ill-defined, others are well settled. For instance, with respect to assessing the financial stability of a foreign shareholder, it is now established that the foreign shareholder may present verification of his financial stability from a first-class bank.<sup>51</sup> It also appears wise to provide a charter with the articles of incorporation.<sup>52</sup>

Finally, it should be noted that all documents submitted to the National Bank should be in English with a Russian translation.<sup>53</sup> Recently, due to the government's state language policy, the National Bank may also require a translation of the documents into Kazakh as well.<sup>54</sup>

#### *Limitations on the Banks' Activities and Special Licensing Requirements*

When the National Bank allows a bank to do business in the Republic, there are substantial limitations on the types of business that the bank may conduct. There are several types of activities from which banks are completely prohibited, others which banks may conduct only on a limited basis, and some activities which the banks may conduct only after obtaining special licenses from the National Bank. For example, banks are generally forbidden to engage in securities trading.<sup>55</sup> However, even though they may not trade securities for their own accounts, the banks may trade securities when done in trust for the

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50. Again, the support for this proposition is based on experience. For example, now that several U.S. banks have opened branches in Kazakhstan, there is, in an informal sense, a precedent for National Bank officials to rely on when approving new bank openings. Law firms that have worked with the National Bank in previous openings have established valuable relationships with National Bank officials and have established a reputation for professional competence. In the future, U.S. banks that open in Kazakhstan will probably have an easier time as the National Bank becomes more comfortable with its approval power and more settled in the procedures it requires.

51. Again, there is no formal source to cite to for this proposition. Nevertheless, it is an established rule of practice in Kazakhstan. Because the Republic is still in a formative stage, many procedures are not defined by statute, regulation, or any sort of case law.

52. See the previous footnote.

53. Item 8 of the Preamble of the Constitution provides that the "Kazakh language shall be a state language." In the same Item, Russian was declared the "language of interethnic communication." Discrimination based on the ability to speak either the "state" or "interethnic" language is prohibited.

54. At present, no special rule requires translation into Kazakh, but it is considered politically prudent. Russian is, however, the common business, financial, and legal language in the Republic. About 95% of the population of the Republic speak Russian.

55. Banks Act, *supra* note 7, art. 4. The present provision prohibits participation in "registered capital," which includes buying shares of a legal entity (a corporation or a Limited Liability Partnership).

account of a customer.<sup>56</sup> It should be noted that a bank remains subject to restrictions even though it has general permission to trade securities for the accounts of clients, i.e., it must employ a specialist who is licensed by the Ministry of Finance.<sup>57</sup>

Banks are also prohibited, as a general matter, from participating as shareholders or promoters in the creation of other corporations.<sup>58</sup> Also, banks are prohibited from engaging in non-banking ventures such as material production, commodity trading, and insurance.<sup>59</sup> On the other hand, all banks are permitted to insure monetary and credit risks.<sup>60</sup>

#### *Licenses to Conduct Foreign Currency Transactions*

One of the most important elements of banking in Kazakhstan is the ability to conduct foreign currency transactions.<sup>61</sup> Because there is substantial growth of cross-border trade and investments in Kazakhstan, this function is vital to banks because it enables them to provide a wide range of banking services to domestic and foreign companies. Banks are not, however, automatically entitled to offer that service.<sup>62</sup> To provide the service, a bank must obtain a license from the National Bank.

There are three types of licenses that give banks authority to conduct foreign currency transactions: a "special" license, an "internal" license, and a "general" license. A special license permits a bank to carry out one particular transaction. An internal license entitles a bank to purchase and sell currencies for its own account and for the accounts of its customers.<sup>63</sup> A general license allows banks to engage in *any* lawful foreign currency transaction.<sup>64</sup> Generally, banks obtain an internal license before obtaining a general license. A general license is vital to a bank because it allows the bank to establish closer relationships with foreign banks and to offer a broad range of banking services to its clients.

Article 15 of the Currency Regulation Act establishes the National Bank's right to grant both internal and general licenses.<sup>65</sup> It is interesting to note, however, that the statute relies on the National Bank's own regulations, the Currency

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56. *Id.*

57. *Vremennaya instruktsiya O poryadke vydachi razresheniya na pravo vedeniya posrednicheskoi deyatelnosti na rynke tsennykh bumag*, adopted by the Ministry of Finance of the Republic, 3 *Informatsionnyi Biulleten' Ministerstva Finansov Respubliki Kazakhstan* (1994) [Temporary Procedure of Licensing Intermediary Services on Securities Market].

58. Banks Act, *supra* note 7, art. 4.

59. *Id.*

60. *Id.*

61. The term "foreign currency transactions" includes all transactions involving foreign currency as a means of payment (export and import) or as an object of bargain (exchange of one currency for another).

62. Banks Act, *supra* note 7, art. 4.

63. Currency Regulation Act, *supra* note 12, art. 15.

64. *Id.*

65. Currency Regulation Act, *supra* note 12, art. 15.

Rules, in defining the licensing requirements.<sup>66</sup> Therefore, there are no legislative limits imposed on the National Bank in this area; rather, the National Bank is able to redefine the licensing requirements at will by changing the relevant sections of its Currency Rules.

Sections 6.02 and 6.03 of the Currency Rules define the qualifications and technical expertise that the personnel of the banks' foreign currency transaction departments must have, along with other requirements that banks must meet in order to be licensed to engage in foreign currency transactions.<sup>67</sup> The personnel must be familiar with Kazakhstan's foreign exchange laws and regulations, and must have knowledge of currency markets and international communication facilities.<sup>68</sup> They must also be able to communicate in English and be familiar with Kazakhstan's foreign currency reporting forms and printing facilities.<sup>69</sup>

As presently written, the Currency Rules contain a classic "catch-22" in its requirements for obtaining a license. To obtain a license, a bank must hold some foreign currency in its accounts.<sup>70</sup> However, a bank is supposed to have a license authorizing it to hold foreign currency before it does so.<sup>71</sup> To date the National Bank has taken no steps toward remedying this paradoxical requirement and, because several banks have managed to obtain the licenses, it appears that this problem is not insurmountable. This situation is representative of the reality of doing business in Kazakhstan. The "rule of law" is not firmly established and in many cases, authorization is obtained by negotiation with authorities rather than by formal adherence to rules and procedures.

Nevertheless, there are several procedures which *are* well-established and which must be followed. For example, in applying for a license to engage in foreign currency transactions, banks must submit several documents to the National Bank, including: (1) an application form; (2) a curriculum vitae describing the professional background of the officer who will be in charge of the bank's foreign currency transactions, including evidence of a degree in economics; (3) a description of the proposed foreign currency transactions department showing the personnel's qualifications and the appropriate technical facilities; (4) copies of letters from foreign banks willing to establish correspondent relationships with the bank; and (5) all the other documents required to open a bank discussed above.<sup>72</sup>

### *The Role of Banks in Foreign Exchange Control*

Article 3 of the Currency Regulation Act makes the National Bank the principal supervisory authority of foreign exchange.<sup>73</sup> That statute characterizes the

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66. *Id.*

67. Currency Rules, *supra* note 19, §§ 6.02, 6.03.

68. *Id.*

69. *Id.*

70. *Id.* at § 6.03.

71. Banks Act, *supra* note 7, art. 4.

72. Currency Rules, *supra* note 19, § 6.04.

73. Currency Regulation Act, *supra* note 12, art. 3.

National Bank as the "basic body of foreign exchange control" and no other supervisory authority is established.<sup>74</sup> But the National Bank has delegated its duties in this field to the banks. By delegating its supervisory duties to the banks, the National Bank appears to have violated the legislative intent underlying Kazakhstan's statutory scheme, which involves painstakingly privatizing the banks and establishing separate government agencies for enforcement. Moreover, one of the general doctrines of the Republic's constitution is that public and private institutions should be kept distinct.<sup>75</sup> Therefore, it is unconstitutional for the National Bank to assign its duties and powers to private banks; nevertheless, that is exactly what the National Bank has done.

Section 7.05 of the Currency Rules provides that banks permitted to conduct foreign currency transactions are "agents of currency control."<sup>76</sup> Section 4.36 states that banks, as agents of exchange control, shall supervise the legality of transactions made on the accounts of non-residents (both legal entities and individuals).<sup>77</sup> That is, banks are responsible for determining if their customers' transactions comply with the Currency Rules.

The National Bank imposes these supervisory duties as a condition on the banks' licenses to conduct foreign currency transactions.<sup>78</sup> Article 16 of the Currency Regulation Act provides that such licenses may be revoked if the bank "does not execute the terms on which the license was granted."<sup>79</sup> Because those licenses are vital to the banks, banks are effectively coerced to accept the duty to act as agents of currency control.

The duty to supervise transactions has placed banks in an awkward position in dealing with their clients. The banks' administrative, public duties will sometimes conflict with their private duties to their customers. If clients cannot predict how the banks will resolve these conflicts and if they fear that they will not have adequate control over their funds, they may prefer to leave their funds with foreign banks, slowing the growth of Kazakhstan's banking system.

Moreover, in the actual exercise of their supervisory power, banks lack effective enforcement capability. This consideration may undercut the conflict of duties concerns raised in the last paragraphs, but it also presents the more serious problem that if banks are incapable or unwilling to act as agents of currency control, there will be no effective foreign exchange control in Kazakhstan. In part, these problems may be related; that is, the banks may purposefully hesitate to enforce currency control thereby minimizing possible conflicts in order to attract and keep clients.

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74. *Id.*

75. The Preamble to the Republic's Constitution establishes that no private organization or person can be given the right to execute a state power. Constitution of the Republic of Kazakhstan, Preamble, § 4, *translated in* Constitutions of the Countries of the World (1994). Therefore, it seems unconstitutional for the National Bank to "deputize" the banks, delegating the state's power to supervise exchange to those private entities.

76. Currency Rules, *supra* note 19, § 7.05.

77. *Id.* at § 4.36.

78. *Id.* at § 7.05.

79. Currency Regulation Act, *supra* note 12, art. 16.

The National Bank has recognized the possibility for conflict between the banks and their customers in Section 7.09 of the Currency Rules, which creates a complaint procedure by which resident customers can appeal to the National Bank about a bank's exchange control actions.<sup>80</sup> Although this regulation at least recognizes the potential for conflict between banks and their customers, the customers may find themselves without a remedy because the regulations do not establish any procedures for resolving these complaints.<sup>81</sup>

In short, the current system of exchange control is mired in a dilemma. Without enforcement powers, banks cannot act as effective agents of currency control. On the other hand, the private nature of banks in Kazakhstan would be compromised if Kazakhstan's laws gave banks more enforcement powers. The best way to resolve this problem might be to have banks initiate action against a violator by filing a complaint, but then to leave the investigation of the complaint to the National Bank. In that case, it would be clear where the banks' obligation to be agents of foreign exchange control starts and ends.

#### *Enforcement of the Bank's Duties as Agents of Foreign Currency Control*

The National Bank has delegated power to independent investigative and prosecutorial agencies to enforce the banks' duties as agents of foreign exchange control.<sup>82</sup> These agencies are the Prosecution Agency, an investigative department of the State Police, and the Investigations Department of the National Security Committee. They are solely responsible for investigating and prosecuting foreign exchange control crimes and other banking violations.<sup>83</sup>

There are few limits on these watchdog agencies' investigative powers over the banks. The National Bank's delegation of supervisory powers to these autonomous agencies, without specific guidelines to limit the scope of their powers, is unwise in a country with a history of governmental investigations that "fish" for problems, i.e., investigate without cause.

Not only is the National Bank's delegation of power to these agencies unwise, it is also constitutionally unsound. First, there is no statute which authorizes the National Bank to delegate power to enforce the foreign exchange control laws.<sup>84</sup> The only authority for the National Bank's actions is in the Currency Rules, which are, of course, promulgated by the National Bank itself. Also, the laws of Kazakhstan do not grant any general power to the National Bank to assign powers to independent state agencies. These functions are reserved for the legislature.

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80. Currency Rules, *supra* note 19, § 7.09.

81. See *Id.*

82. Currency Rules, *supra* note 19, § 7.04.

83. Zakon Respubliki Kazakhstan "Ob organakh natsional'noi bezopasnosti v Republike Kazakhstan," 11 Vedomosti Verkhovnogo Soveta, Item 286, art. 14 (1992) [the National Security Body Act].

84. See, National Bank Act, *supra* note 6, art. 25.

### EXAMINATIONS OF EXISTING BANKS

The National Bank may examine the activity of any bank at any time.<sup>85</sup> Article 31 of the National Bank Act provides three methods which the National Bank can use to examine the banks and their branches: (1) direct on-site examinations by the National Bank; (2) on-site examination by a private auditing firm; and, (3) off-site review by means of reports submitted to the National Bank.<sup>86</sup> These examinations allow the National Bank to monitor and supervise the Republic's banks.

Direct on-site examination by the National Bank is the most frequently used method of examination.<sup>87</sup> The National Bank has several departments specifically established to conduct bank examinations.<sup>88</sup> Off-site review of reports submitted to the National Bank is also widely used. The National Bank requires many different documents and reports from the banks, especially in the sphere of foreign exchange.<sup>89</sup> Foremost among the required documents are a bank's balance sheet and income statement.<sup>90</sup>

The National Bank rarely hires outside auditing firms to conduct on-site examinations, partly because there only a few qualified firms. Very few Kazakh auditing firms presently have the expertise to conduct bank examinations and international firms, such as Arthur Anderson or Ernst & Young, are not well-suited to the task because Kazakhstan's auditing forms differ from international standards. Moreover, it appears that outside firms are used sparingly simply because the National Bank's officials disapprove of that method and prefer to conduct bank examinations themselves, thereby retaining tighter control over the banks.

#### *Examination Procedures*

No statute, rule or regulation presently defines specific procedures for the National Bank to follow when examining banks. This has not, however, impeded the National Bank; in fact, such examinations are carried out routinely. Because the National Bank's power to examine the banks' records is not limited by any particular procedures, the power may be subject to abuse, but at this time there seems to be little official incentive to limit the National Bank's power to examine the banks.<sup>91</sup>

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85. Banks Act, *supra* note 7, art. 28.

86. *Id.*

87. As counsel for KRAMDS-Bank, the author has often advised officers of the Bank regarding what to do during examination.

88. Berik Abuov, senior legal counsel of the National Bank, has informed me that the departments were established by the resolutions of the Supervisory Council of the National Bank. These resolutions were not published.

89. National Bank Act, *supra* note 6, art. 4.

90. Banks Act, *supra* note 7, art. 28.

91. *E.g.* in a recent draft of the National Bank Act, which the author received in January 1992, no provision limited the National Bank's scope of power with regards to examination and enforcement.

## REPORTING REQUIREMENTS

Kazakhstan's banks, and their customers, are subject to several different types of reporting requirements, i.e., they must submit information to the National Bank about certain transactions and accounts. In the sphere of foreign currency transactions, Article 13 of the Currency Regulation Act empowers the National Bank to obtain any information relating to the movement of foreign currency if that information is "necessary for defending the interest of the Republic of Kazakhstan."<sup>92</sup> Neither the Currency Regulation Act nor any other law or regulation provides guidance as to when such information is "necessary." Therefore, customers cannot be certain of when their confidential information must be disclosed to the National Bank. Moreover, the statutes fail to specify the purposes for which the information will be used.

The National Bank also has very broad power in obtaining reports from banks about purely local transactions and accounts. Article 25 of the National Bank Act allows the National Bank to develop and promulgate accounting, reporting, bookkeeping and statistical forms.<sup>93</sup> Additionally, the National Bank has the authority to establish reporting procedures and the terms of reporting.<sup>94</sup>

The banks' customers are also subject to various reporting requirements. Article 17 of the Currency Regulation Act requires all persons in Kazakhstan to supply their bank and the National Bank with information that establishes their compliance with the Currency Regulation Act.<sup>95</sup> No other governmental or non-governmental entity is legally entitled to such information.<sup>96</sup> The National Bank decides what types of information and documentation is necessary to fulfill this requirement.<sup>97</sup>

*Problems with Disclosure of Confidential Information*

All of Kazakhstan's reporting requirements create problems for banks and their customers by creating the potential for improper disclosure of confidential information. First, the National Bank has been given unbridled discretion in deciding what information must be disclosed to it. Second, the Currency Regulation Act does not establish standards of confidentiality nor specify any penalties for wrongful disclosure of confidential information by public or private officials.

Yet another problem in this area is that the Currency Regulation Act does not define "confidential information." Looking to other sources of law for guidance provides little assistance. For example, the Private Entrepreneurship Pro-

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92. Currency Regulation Act, *supra* note 12, art. 13.

93. National Bank Act, *supra* note 6, art. 25.

94. *Id.*

95. Currency Regulation Act, *supra* note 12, art. 17.

96. There are exceptions to this rule. Prosecutorial and investigative bodies may require information relating to persons and matters being investigated. The Taxation Service may also obtain this type of information about a specified person.

97. Currency Regulation Act, *supra* note 12, art. 17.

tection Act gives a hopelessly inadequate definition of confidential information as "information which is not required to be published."<sup>98</sup>

Protecting confidential information about customers' foreign currency transactions would be a worthwhile objective of Kazakhstan's banking laws. It would foster customer confidence in the government if banks knew that their information would be used only by specific entities for specific purposes. Also, subjecting state officials to penalties for wrongful disclosure would reinforce a sense of responsibility for protecting confidential information. Without legal assurance that confidential information will be properly protected, many citizens and corporations will be wary of using the banks. Again, this is especially true in light of the Republic's history of overintrusive government. Additionally, it bears repeating that the likely effect of these potential customers' fears is that less capital will enter Kazakhstan, and that the available capital will be less efficiently available to help the economy's growth.

As a practical matter, many sensitive issues arise in day-to-day banking transactions. When it is not clear what information will be deemed confidential, foreign investors may be deterred from using Kazakhstan's banks. This problem could be solved if the National Bank adopted a protective policy for information disclosed in the course of preparing and reviewing the required reporting forms. Any such "Banking and Commercial Secrecy Act" should provide an exclusive list of officials allowed to have access to the information and specify procedures for obtaining, keeping, and releasing such information. This approach would create protection for the banks against the National Bank, and allow customers to assess what information would be divulged. Setting these principles in a statute would create predictability and stability in this sensitive area.

#### ENFORCEMENT POWERS OF THE NATIONAL BANK

##### *Hierarchy of Sources of Law*

Before analyzing the enforcement powers of the National Bank, a brief overview of the hierarchy of legal authorities in Kazakhstan may be helpful. The Constitution of the Republic of Kazakhstan states that it is the supreme law of the land.<sup>99</sup> In case of a conflict between a statute and the Constitution, the Constitution must prevail.<sup>100</sup> The Constitution also provides that if it is amended, previously passed statutes must be amended to conform to the amended Constitution.<sup>101</sup> The second level of legal authority is comprised of statutes enacted by the national legislature; the third level is comprised of regulations and directives issued by governmental agencies such as the National Bank. These regulations and directives must be consistent with the constitution and statutes of the Republic.

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98. Zakon Respubliki Kazakhstan "O zashite i podderzhke tchastnogo predprinimatel'stva," Kazakhstanskaya Pravda, July 4, 1992, [Private Entrepreneurship Protection Act].

99. Constitution of the Republic of Kazakhstan, supra note 78.

100. Id. at arts. 101, 127, and 131.

101. Id. at art. 129.



In theory, this three-level hierarchy of legal authority is clearly established. However, because of several structural and cultural influences that have shaped Kazakhstan's legal system, the established three-tier theory does not always determine the outcome of actual disputes.

One of the structural problems affecting the implementation of the three-tier hierarchy of legal authority is that, according to Kazakhstan's constitution, the national legislature is the final interpreter of the Constitution,<sup>102</sup> and the courts have a very limited role in construing and interpreting the laws. Kazakhstan does not have a common law tradition of judge-made law, but rather has a civil law tradition modified by 70 years of Soviet rule, under which courts were not allowed to create or interpret the law.<sup>103</sup>

This structure makes incremental changes on a case-by-case basis unusual, if not impossible. Because the national legislature itself must act before a law is supplemented or changed, changes are unlikely unless the problems arising under the law are large enough to draw national attention. Therefore, even when regulations arguably contradict the Constitution or statutes, they are likely to be enforced. This is because they offer specific directives for judges to implement and because the courts are not empowered to alter those regulations by "construing" them in accordance with the constitution. In fact, such an idea is almost entirely foreign to Kazakhstan's judges.

Another structural problem is that, more often than not, a complainant's only avenue for recourse is through administrative proceedings conducted by the agency with whom the complaint arose. In Kazakhstan, administrative proceedings are the default procedure for handling complaints with government agencies; recourse to the courts is only allowed if specifically authorized by law. Moreover, the administrative proceedings do not necessarily involve any kind of hearing; they may consist solely of the agency's review of reports. In short, Kazakhstan does not offer its citizens or corporations anything similar to the United States' right to due process.

When making certain types of complaints, however, the banks are allowed to file complaints directly with a court, instead of with the National Bank.<sup>104</sup> But even in those cases, the banks have the burden of proving that they did not violate the law, i.e., they are presumed guilty until proven innocent.<sup>105</sup> Thus, as a practical matter, it is very difficult to challenge the regulations and directives of the National Bank.

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102. The "Supreme Soviet shall give an official interpretation of laws of the Republic." Constitution of the Republic of Kazakhstan, *supra* note 7, art. 64, 3.

103. The Supreme Court of the Soviet Union was given a very limited power; it was only allowed to give "recommendations" on particular questions, amounting to little more than advisory opinions that could be ignored by the Supreme Soviet.

104. Banks Act, *supra* note 7, art. 42.

105. There is no special provision of law allocating the burden of proof. The general principle is "an asserting party shall carry out the burden of proof unless otherwise is provided by law."

*General Framework of the National Bank's Enforcement Powers*

The National Bank Act and the Banks Act provide the general framework for the National Bank's enforcement powers. Article 33 of the National Bank Act, for instance, specifies the grounds upon which the National Bank can refuse to permit a bank to open or to grant licenses to conduct particular transactions.<sup>106</sup> Article 35 of the act describes various violations of the law and the corresponding penalties.<sup>107</sup> Ignorance of the violations is no defense.<sup>108</sup>

It is interesting to note that Article 35 of the National Banks Act, which establishes penalties, refers to Article 34 of the same act, which establishes a procedure for the dissolution of a bank.<sup>109</sup> By incorporating the procedure for bank dissolution into the list of penalties for banking law violations, it appears that the legislature has created a corporate "death penalty." This sanction has yet to be exercised, and it remains unclear when this sanction is intended to be used.<sup>110</sup>

The penalty provisions of the National Bank Act are reinforced by the Banks Act. Article 22 of the Banks Act repeats Article 33 of the National Bank Act in its entirety.<sup>111</sup> Similarly, Article 29 of the Banks Act mostly repeats Article 35 of the National Bank Act,<sup>112</sup> and authorizes the National Bank to enforce its directives and the banking laws in the following ways:

- (a) imposing fines on the banks or their officials;
- (b) deducting funds directly from the bank's reserve fund, which is held by the National Bank;
- (c) assuming temporary control of the bank;
- (d) revoking licenses to conduct certain types of business;
- (e) confiscating monies obtained by illegal banking activities; and
- (f) issuing mandatory instructions (similar to an injunction).<sup>113</sup>

*Specific Penalties in Foreign Exchange Control*

Besides the general provisions, there are other statutes and regulations that empower the National Bank to enforce particular aspects of its control over banks. For instance, the Currency Regulation Act and the Currency Rules not only serve as substantive sources of law regarding foreign exchange control, but also provide penalties for violations of those provisions. Article 16 of the Currency Regulation Act grants the National Bank power to limit or revoke a bank's

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106. National Bank Act, *supra* note 6, art. 33.

107. *Id.* at art. 35.

108. Banks Act, *supra* note 7, art. 31.

109. *Id.* at arts. 35 and 34.

110. This provision conflicts with the general corporate laws, which provide that a corporation may be dissolved only with shareholders' consent, or upon judicial determination in bankruptcy proceedings, or when the corporation was created for a limited period. Companies Act, *supra* note 24, art. 23.

111. Compare Banks Act, *supra* note 7, art. 22 with National Bank Act, *supra* note 6, art. 33.

112. Compare Banks Act, *supra* note 7, art. 29 with National Bank Act, *supra* note 6, art. 35.

113. Banks Act, *supra* note 7, art. 29.

license to engage in foreign currency transactions.<sup>114</sup> Sections 7.11 and 7.12 of the Currency Rules specify other penalties that can be assessed against resident banks and other persons that violate the foreign exchange laws.<sup>115</sup>

Section 7.12 of the Currency Rules provides fines for those who do not comply with the National Bank's reporting, accounting, and bookkeeping requirements.<sup>116</sup> Section 7.11, however, is much more potent. It provides that those who make illegal, voidable transactions are subject to having their funds forfeited and confiscated.<sup>117</sup> The Currency Rules do not specifically limit this forfeiture to the funds that were actually involved in the illegal transactions.<sup>118</sup> Therefore, it is conceivable that *all* of a bank's funds may be forfeited and confiscated if it is involved in any voidable or illegal transactions. Such a severe penalty would ordinarily be unfair to the bank and its innocent customers, but the decision whether or not to impose that drastic penalty appears to sit with the National Bank. This is another area where the legislature should try to provide some guidance as to the National Bank's discretion.

In addition to corporate penalties, both civil and criminal penalties may apply to individuals involved in a violation of the foreign exchange laws. For example, under Article 18 of the Currency Regulation Act, officers of resident corporations, or any other individuals violating the foreign exchange laws, are subject to both civil and criminal sanctions.<sup>119</sup>

### *Enforcement Procedures*

Absent any statutorily defined procedures for assessing penalties against banks, the National Bank uses administrative proceedings. However, Kazakhstan does not have anything like the United States' Administrative Procedure Act to specify what procedures should be followed in the administrative proceedings.

One example of the summary nature of the National Bank's decisions and the limited availability of judicial review is found in Article 34 of the National Bank Act:

If a decision is made to revoke the permission to open a bank, the National Bank will notify the Bank of said decision.

Upon receipt of the National Bank's decision to revoke a bank's license to operate, the operational management of the bank is temporarily transferred to an administrator appointed by the National Bank until a liquidation commission can be appointed to protect the interest of the creditors and clientele.

Liquidation of the bank is carried out in accordance with the prevailing legislation.<sup>120</sup>

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114. Currency Regulation Act, *supra* note 12, art. 16.

115. Currency Rules, *supra* note 19, §§ 7.11 and 7.12.

116. *Id.* at § 7.12.

117. *Id.* at § 7.11.

118. *Id.*

119. Currency Regulation Act, *supra* note 12, art. 18.

120. Banks Act, *supra* note 7, art. 23.

If the bank's management disagrees with the National Bank's decision to revoke permission to open the bank, it can appeal to a court of arbitration within ten days.<sup>121</sup>

No clue is given as to how the National Bank arrives at its decision or whether the bank has the right to a hearing before the decision is made. The bank is given only ten days to raise its appeal and no provision is made for a stay of the National Bank's order while the bank appeals. Therefore, the temporary administrator will likely take immediate control of the bank, potentially causing irreparable damages.

#### *Statutory Limitations on the National Bank's Actions*

Article 26 of the Banks Act offers the banks some specific protection against possible overreaching by the National Bank, but this protection is rather weak. Article 26 provides that "the National Bank is not allowed to interfere in an operational activity of the bank, except for the cases provided by law."<sup>122</sup>

Whatever protection Article 26 was intended to provide has been greatly diminished by the Article's vague language. First, the Banks Act does not define what constitutes "an operational activity." Furthermore, the reference to "exceptions provided by law" is ambiguous. It is unclear which laws were to be incorporated by this reference. If it incorporates the regulations created by the National Bank itself, then the protection offered by Article 26 against the National Bank's overreaching is a sham.

The absence of clear, statutory protection from the National Bank's possible over-interference means that banks are vulnerable to possible abuse or misuse of the National Bank's discretionary enforcement powers. Discretion over questions of interpretation and enforcement of laws rests with the National Bank's officials, and in practice the regulatory system often depends less on legal rules and procedures than on a bank's socio-bureaucratic relationship with the National Bank.

#### CONCLUSION

Kazakhstan's newly-formed banking system is remarkably effective given the almost complete lack of modern private banks in the country until four years ago. Nevertheless, there are several flaws in the current system. Most significantly, the extensive and exclusive reliance on regulations promulgated by the National Bank as supplements to the major banking statutes is disturbing because the National Bank is given wide latitude to interpret the scope of its legislatively-derived powers. To date, the National Bank has consistently used that latitude to increase its power.

The broad discretionary power vested in the National Bank, the uncertainties surrounding the meaning of various provisions in the banking laws, and the

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121. National Bank Act, *supra* note 6, art. 34.

122. Banks Act, *supra* note 7, art. 26.

lack of due process protections for banks and their customers all pose business and legal risks. Those risks will cause the banks which operate in the Republic to charge more for their banking services than is necessary—costs ultimately borne by Kazakhstan’s citizens and corporations. Other banks will be deterred from operating in Kazakhstan, thus slowing down the growth of Kazakhstan’s fledgling banking industry. To avoid these problems, the Republic’s lawmakers should limit the National Bank’s powers, establish specific statutory procedures and requirements for banks to follow, and create protections and remedies for banks and their customers against improper action by the National Bank.