

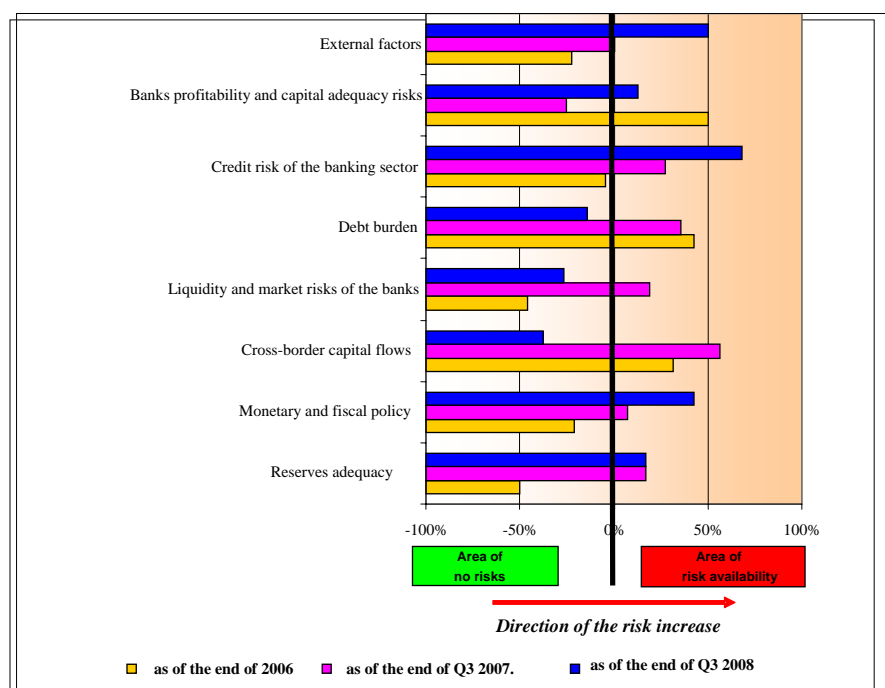
I. General Conclusions

The results of analysis of the factors that ensure financial stability show the adequacy of assessments of the Kazakhstan Financial Stability Report made in December 2007 regarding the parameters of further development, namely:

- increase of the risks of credit portfolio quality aggravation in the background of the problems of major corporate borrowers, adjustment on the real estate market and burden of the accumulated debt on a financial position of the households as well as inflation costs;
- higher requirements for the banks' profitability in the conditions of liquidity reduction and tightening of the credit policy;
- deterrent effect of reduction in the banks credit activity on the economic growth dynamics;
- assessment of banks capacities of external liabilities redemption and adequacy of the reserves for increasing the banking system liquidity;
- need in revision of the development strategy by the banks.

These conditions were directly reflected in the snapshot of risks to financial stability at the end of the third quarter 2008. In particular, the most essential factor of vulnerability is currently a growth of credit risks, accumulation of the reserves to cover which is putting pressure on profitability and future capitalization of the banking system.

Map of Risks



The favorable condition of the world commodity markets and the underestimated effect of import deceleration in the conditions of lower domestic demand contributed to essential improvement of the balance of cross-border flows and allowed retaining the country's reserves without resorting to considerable interventions. At the same time, the degree of reserves adequacy was not evaluated to a full extent under the influence of the unfavorable external factors.

In the perspective, in the conditions of the world economy deceleration, recession of the large economic powers, and instability of the world financial institutions, an unfavorable condition of not only financial but commodity market may result in worsening the risks of further economic growth deceleration in Kazakhstan and financing deficit of the balance of payment which will increase a potential burden on the country's international reserves.

In the background of a decrease in the contribution of traditional factors of economic growth, compensation of private investments and consumption reduction becomes the main goal of the stimulating policy of fiscal expenses. At the same time, in the conditions of budget deficit growth due to the announced increase of the volumes of economy support up to 20% of GDP, **Kazakhstan Financial Stability Report, December 2008**

utilization of the National Fund assets and reduction of the potential of the real sector of economy to ensure a steady growth of tax proceeds, the likeliness of rise in sovereign risks is high. Accordingly, the ability of the state to ensure a balance between the sustainable growth rates of state expenses and the need in promoting the economic growth becomes of primary importance.

In spite of the real growth deceleration, the indicators of activity of the real sector, in particular, employment and enterprises profitability have not shown a growth of tension over 9 months of 2008 in the background of a favorable pricing environment. In the conditions of the economic growth deceleration they are likely to be delaying and underestimating the actual adjustment amplitude in the real sector. Reduction of income of the households and enterprises will manifest in full in the conditions of the world prices drop that will additionally intensify a negative effect of the price shock on the export, balance of payment current account and real economic growth in 2009. Also, the growth of competition on the international capital markets between borrowers in the conditions of more moderate supply of financial resources adds to the likeliness of aggravation of new borrowing parameters (term, cost) and the external debt structure.

High liquidity of corporate clients in the foreign exchange and retention of the capabilities of external liabilities refinancing by some banks allowed the banks to maintain their currency liquidity and to sell a foreign currency surplus on the stock exchange. Under these circumstances, the currency market liquidity remained fairly high, and some major transactions of speculative nature could not essentially affect the market behavior. In turn, this allowed the NBK to minimize costs of restricting volatility of a tenge exchange rate by gradually compensating the last year losses at the expense of increase in gold and foreign exchange reserves. High foreign exchange liquidity of customers and supply of dollars by them have also allowed moderating the payment burden with regard to banks external liabilities on the money market rates in the foreign currency. This situation and NBK operations have on the whole stabilized the overall liquidity level on the financial market.

At the same time, in the conditions of constraints of traditional sources of funding, special importance is given to keeping confidence of bank clients and increasing the role of interbank market in order to re-distribute the financial flows. The use of state guarantee mechanisms that are widely used in all the countries can play a determining role in this.

The analysis of reaction of different population groups also shows that small savers whose deposits are subject to guaranteeing are more sensitive to the change in banking sector risks assessment. At the same time, their reaction is evenly distributed in relation to all banks regardless of risk specifics of each separately taken bank. On the contrary, big depositors pay much attention to specific risks of the banks and are sensitive to assessment of risks and scope of state support for separate financial institutions. Accordingly, in the crisis conditions, maximally wide distribution of deposit guarantees can stabilize the reaction of major depositors and deposit base of the banks. In the long-term perspective, the guarantee system shall take into consideration the need in creating incentives for qualified evaluation of separate banks and the overall banking system made by the population.

Inflexibility of the behavior of all market participants determining the situation in the real estate segment creates an uncertainty and lack of clear price guidelines. The reduction of personal income in real terms and crediting volumes on the part of banks, on the one hand, creates pressure of the demand factors on further price reduction. On the other hand, lack of essential additional supply of mortgaged apartments by the banks that do not wish to fix losses, and reduction of the new construction profitability build an essential line of resistance on price levels close to the current ones. Besides, reduction of risks of banks insolvency due to state guarantees in the background of real estate market non-transparency makes unlikely the choice in favor of investments in real estate as an alternative to banking instruments with fixed return. Thus, in view of combination of the

factors in the short-term perspective it is logical to expect retention of low price levels (some possible reduction of the prices in Almaty) and commencement of a gradual recovery of the prices not earlier than the end of the next year. Further on, completion of the construction of the facilities that were started and financed at the expense of state resources, and lack of new projects will move to the forefront a deficit of housing, i.e. the factors of a limited supply.

The price indices reduction of corporate securities of Kazakhstani issuers on the foreign market determined the fall in the main parameters of the Kazakhstani stock market which could not become for the corporate sector an alternative to the bank financing market. The reduction in the value of securities occurred in the entire spectrum of securities, and this reflects an effect of referring by investors of all Kazakhstani assets to one group of risk and 'flight into quality'.

In the background of decline in market capitalization of the banks, the growth of costs for creating provisions due to aggravating quality of the credit portfolio and decrease in the credit activity contribute to reduction in the profitability which puts an additional pressure on the capital adequacy, thereby restricting the banks capability of absorbing potential losses. The reduction of the share of interest income and increase of non-interest expenses did not allow to the banks to fulfill the potential of maintaining profitability at the expense of increasing the interest spread. In spite of the controlled direct FX risk of the banking system, a short position in the foreign currency of bank borrowers bears an essential indirect FX risk (credit risk) depending upon fluctuations of the tenge exchange rate.

A credit risk of the banking system is considerably increasing. At the same time, in spite of the growth of volume of provisions, their real adequacy has not yet been tested because the banks actively pursued the policy on credit restructuring. The economic growth deceleration and financial ratios aggravation of the enterprises of a wider spectrum of the economy sectors will in this background put an additional burden on revenues of the banks. Under their restricted capabilities for expenses optimization, this requires to maintain a higher level of capitalization.

As a result of depreciation of financial instruments that are in the portfolio of the Kazakhstani accumulation pension funds and a negative net income in the second half of 2008, the rate of return of pension assets has essentially reduced which increases a risk of safeguard of pension savings and potential loading on the state budget as to compensation of depositor's losses.

The reduction of internal demand, increase of the assets quality risks and potential threats of the banking system capital adequacy, need in supporting confidence in the domestic financial system set priorities of the anti-crisis program of the Government, NBK and AFN.

In the exceptional conditions of instability, in determining the mechanisms of overcoming the crisis, the state must take into consideration a number of dilemmas, particularly:

- 1) focus on solving the structural problems, or maintaining the current conditions that ensure financial stability;
- 2) accept fairness of the various assets price levels being formed, or their assessment as price distortions that weakly reflect fundamental factors;
- 3) implement a mechanism of equal costs distribution between all the participants, or maximum state support with acknowledgement of a probability of moral hazard;
- 4) minimize the state costs, or maximize potential benefits in the medium-term perspective.

The elements of the anti-crisis program of Kazakhstan show the combination of different priorities:

- measures on stabilization of the economy and financial sphere have until recently been of primarily short-term supporting character and have not been focused on solution of long-term structural factors of vulnerability;

- despite this, the measures turned out to be fairly effective and allowed mitigating a negative impact of the world financial crisis with minimum costs, and this was encouraged by a strong position of the state budget with high oil prices and banks capability of refinancing an essential part of external liabilities;
- if the NBK's policy in terms of discounting the cost of security on refinancing operations was fairly liberal, which conforms to the current world practice, then an expected state's entering the banks capital on the price levels of the stock market, close to minimum, testifies to the fact that the Government considers the current risk assessment to be fair;
- fixation of the minimum price levels of the market of shares for the Government to enter the banks capital supposes equal distribution of costs with the existing shareholders. At the same time, adequacy of costs distribution to risks taken earlier by the existing shareholders ('appetite for risk') depends upon the form, conditions and price parameters for entering the banks capital. Similarly, the issues of buyout by the Stress Assets Fund of the banks problem assets and restructuring issues should be worked over in a maximally effective manner in order to exclude the unjustified competitive advantages of the banks that used the most risky strategy, and to exclude the strife for deliberate default by borrowers for the purpose of getting a possibility of restructuring their liabilities;
- in the conditions of lack of clear benchmarks, correction depth and costs scope, a special attention should be paid to the effectiveness of utilizing state resources, especially by taking into consideration reduction of the budget capabilities and using an 'safety pillow' in the form of NFK.

International experts have acknowledged that in the conditions of instability it is not necessary to speculate too much on the topic of moral hazard. Along with that, it is important to take into consideration the need in minimizing this hazard in the long-term perspective which supposes elaboration of the most effective model of solution of the sector structural problems and subsequent exit of the state out of the system. In addition, the state policy must create sufficient incentives for using the internal sources of the financial system growth.