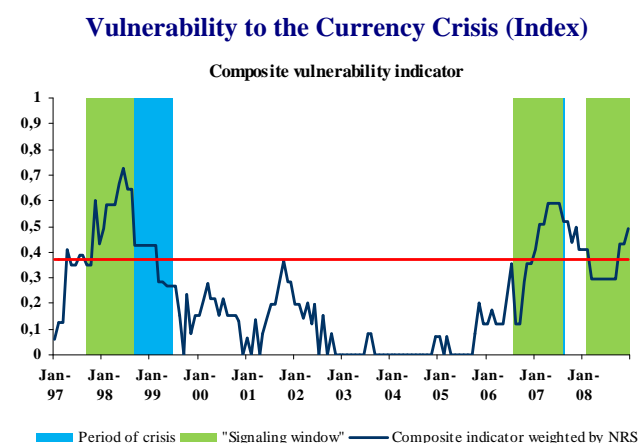


## I. General Conclusions

The evaluation of factors that determined financial stability of Kazakhstan in 2008 (Kazakhstan Financial Stability Report for 2008) has specifically focused on the following risk factors which will form economic conditions in 2009:

- 1) Exacerbation of risks of the slowdown in the economic growth in Kazakhstan in the environment of the slowdown in the global economy and instability in the global financial and commodity markets;
- 2) Increased burden on the country's international reserves as a result of increased risks in the balance of payments;
- 3) The importance of retaining the confidence of bank clients in the environment where traditional funding sources of the financial system are limited;
- 4) Retained low pricing levels in the real estate sector;
- 5) The need in increasing the bank capitalization in the environment where expenses on provisions grow as a result of anticipated slowdown in the economic growth and deterioration of financial performance of enterprises;
- 6) The need to move from the supporting policy to the policy oriented on the structural adjustment of vulnerability factors;
- 7) The need to develop the government intervention mechanisms on the principles of adequacy of resolution's cost distribution by the parties of the financial system to risks assumed by shareholders earlier.

The 2009 performance proved the adequacy of estimates made. The situation in 2009 showed that the combination of different risk factors may have a substantial destabilization nature and may require from the Government a large-scale financial and regulatory intervention to support financial stability.



Note: Green area- preceding 12 months area when signals should occur.

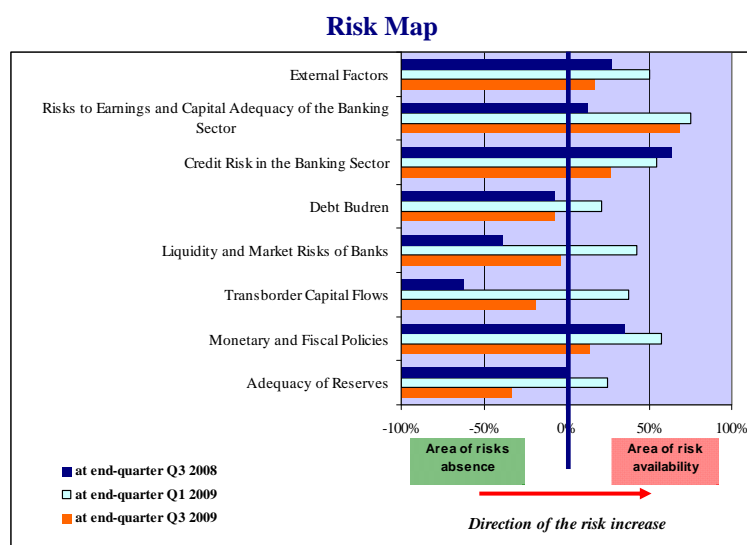
Source: NBRK

Specifically, as the result of decreased world prices and the devaluation of currencies of the countries – major trading partners of Kazakhstan – parameters of the real effective exchange rate of the Tenge deteriorated significantly, the extent of the economic activity slowdown increased and the inflow of foreign currency from exports reduced significantly. As a result, composite indicator showing the extent of vulnerability of the economy against the crisis<sup>1</sup> calculated on the basis of a set of economic indicators of financial and macroeconomic sustainability exceeded its threshold already in November 2008, thus demonstrating the increased probability of substantial pressure in the foreign exchange market in the near-term.

Factors that contributed to the increased vulnerability at the end of the previous year were different from those in 2007 in that the stable inflow of foreign currency from foreign trade operations and

<sup>1</sup> The composite indicator includes: real exchange rate, exports of goods and services, current account to GDP, oil price, gross external debt to GDP, real GDP, differential between deposit and credit interest rates, real interest rate, and money supply. The methodology is provided in the Financial Stability Report of Kazakhstan for 2007. The Methodology was improved to include the calculation of parameters specific for Kazakhstan that determine the ability of macroeconomic variables to predict crisis, as part of the joint project with the IFO, Munich (Annex 2).

real growth of the economy, against the favorable pricing environment, at that time allowed absorbing the impact of risks accumulated in the period of the credit growth and excessive money supply.



Source: NBRK

half of the year.

Generally, despite the fact that a number of parameters in the risk map continue to remain in the risk zone<sup>2</sup>, a significant decrease on virtually all vulnerability aspects was observed at end-2009 as compared to the situation in Q1 2009 when the decision to change the exchange rate policy was made. Moreover, the situation with liquidity, balance of payments, total debt burden and adequacy of the country's international reserves improved considerably.

A certain increase in the solvency risk and liquidity risk in the public sector should be mentioned. The increased debt exerts the major pressure on the solvency while liquidity is affected by the expenditures on debt servicing in the environment of decreased state budget non-oil revenues.

Despite the fact that inflation remains low in the near-term, a great role of a fiscal component determines the inflation potential in the mid-term. Accordingly, an excessive growth of expenditures and the expansion of non-oil budget deficit need to be limited.

The correction in the exchange rate policy allowed maintaining profitability of exporters, minimizing devaluation expectations and, coupled with the low domestic demand, limited the increase in imports. Despite the fact that the current account deficit will be about 3% of GDP for 2009 as a whole, according to current estimates, it is anticipated to be financed with a significant capital inflow from direct investments. Further recovery of the external demand and prices for resources in 2010 allows suggesting the activation of foreign economic operations and the building up of an insignificant profit on the current account operations. Also high volumes of direct investments inflows will remain.

Additionally, there is a reason to believe that the foreign market will not be completely closed for financial institutions and the strongest banks will be able to enter the capital markets. The past year showed that despite problems in some banks, the system as a whole is capable of sustaining the

<sup>2</sup> The risk map is based on the system of 69 indicators of financial and macroeconomic sustainability in different sectors and segments. The method is based on the analysis of historic dynamics and evaluation of the fluctuations magnitude and the extent of deviations. The method is provided in a greater detail in the Financial Stability Report of Kazakhstan for 2007 in the Special Research Section

external shocks and meet its domestic and foreign commitments in due time. At the same time, the success of entry to the market of financial institutions depends on liquidity of the global money markets and capital markets, the extent of curtailment of the governmental financial support as part of their anti-crisis programs and a high potential competition among the borrowers, both sovereign and private ones, from the emerging economies, all of those altogether determining the attractiveness of pricing parameters for raising foreign borrowings.

As a whole, the expansion of the economic growth base and its sustainability, given that the link “world prices – risks of private borrowers – capital inflow – crediting of non-primary industries” common for the upward phase has been broken, is dependent, first of all, on the ability of the government of not only replacing the sources of financial resources but also encouraging the increase of private savings and investments. An important aspect of financial stability here is the sustainability of external debt of the non-financial sector in the environment of uncertainty in the commodity markets in the event if investments are funded mainly from the growth of debt.

Based on the performance for 9 months of 2009 one may see that there was no net outflow of deposits from the system that could be an undesirable outcome of the devaluation and the measures for stabilization of the banking system. On the contrary, deposits of individuals increased by more than 20%. Alongside with that the depositor flight was observed only in a few banks and not in the banking system as a whole. Specifically, with the average level of the deposit re-distribution among banks at 4-5% during 2 years, in Q1 and Q2 2009 about 8-11% of deposits migrated within the banking system in the search for a safe harbor or more attractive terms.

The increased business activity fuels the demand for credit resources from the banking sector which, by virtue of the retained conservative approach of banks to liquidity management and borrower risks, is not balanced with the adequate supply of credit resources. As a result, a growth in deposits is not fully transformed in the expansion of credits to the real sector which determines high liquidity of the banking system. Banks are not eager to place their resources both in the financial and the credit markets due to their reluctance to assume risk and prefer to keep them on accounts with the NBRK. Largely, the situation is determined by uncompleted restructuring of liabilities of 2 Kazakh banks<sup>3</sup> that would result in significant minimization of the uncertainty factor.

The increased liquidity in the time of high market volatility and unstable expectations of the market participants may contribute to the growth of speculative moods in the foreign exchange market and may have a significant destabilization impact. Under these circumstances, the choice in favor of stabilization of the exchange rate fluctuations and establishment of clear exchange rate benchmarks will be rather justified. In future, stabilization of expectations in the near-term and flexible exchange rate policy in the mid-term depending on the fundamental factors will become the top priorities in the exchange rate policy of the National Bank.

Revaluation of the borrowers' foreign currency liabilities as a result of changes in the exchange rate policy, especially in the sectors oriented on the domestic market and having no significant sources of foreign exchange proceeds increased the burden on the quality of credit portfolios of banks. At the same time, the devaluation effect on the increase in non-performing loans cannot be overestimated since both the population and enterprises experienced the decline in revenues and cash proceeds as well as financial resources from banks as a result of a lower domestic and external demand and the slowdown in the crediting of the economy. In particular, the comparison of the portion of foreign currency loans, FX position of borrowers with the dynamics of non-performing loans by sectors and segments of lending in 2009 doesn't show a significant dependency of the extent of the credit portfolio deterioration from a higher level of dollarization of a sector or

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<sup>3</sup> On November 23, 2009 Temirbank where BTA Bank is a shareholder, also announced that it started to restructure its liabilities. As a result by the end of November 3 banks are in process of dialogue with creditors about restructuring of the liabilities obligations.

segment. By itself, the fact of high sectoral dollarization of liabilities remains a substantial risk factor, primarily for the quality of the bank loan portfolio.

A wide use of the instruments of the loan portfolio restructuring allows banks controlling the deterioration in the quality of a loan portfolio. Thus, according to the information provided by banks, they changed the lending terms in respect of about 12% of their loan portfolio with the view to improve the customer creditworthiness. The efficiency of these arrangements to a great extent depends on the pace and scale of the economic recovery based on a favorable external pricing environment.

The slowdown in the economic growth and domestic demand inflicted the biggest blow on small businesses in those industries which are oriented on a domestic consumer of goods and services. Specifically, an increased number of non-operating and non-active enterprises may bear the risk of increased failures if the base for the restoration of economic growth is not expanded at the expense of non-primary industries of the economy. The decline and growth phases of cycle, objectively, with some lag have effect on financial sustainability of enterprises. In this case one can anticipate that high sectoral risks and the pressure on the quality of loan portfolio of banks will still be in place in 2009.

In general, in spite of a significant deterioration in the quality of credit portfolio, a share of loans charged off the balance sheet remains rather low, thus not corresponding to the current environment and showing that the banks are reluctant to recognize their losses. A number of factors contribute to the situation, such as limited capital to cover losses, a hope that financial condition of borrowers would improve, but also unresolved situation with the taxation of revenues from restored provisions.

As the economy recovers gradually and sectoral and individual risks of borrowers go down, the trend for reduced rates in the credit market will start to develop. Under these circumstances the banks will need, in the near-term, to give a special attention to the regulation of interest rate risk, especially when the term exceeds one year, specifically to those institutions that used to pursue an aggressive borrowing strategy in respect of financial resources in the environment of limited opportunities for efficient placement of those resources.

Despite a notable decline, from the financial stability standpoint, the level of foreign debt of the banking sector remains high. Only the availability of reliable and stable domestic sources of funding may ensure a further seamless reduction in the volumes of foreign funding of the banks.

Given the limited funding sources, the role of capital increases, which must actually both contribute to the absorption of losses from the credit portfolio and serve as a cushion for a sustainable credit growth, in the mid-term.

At present, despite an active growth in the number of banks with foreign participation during the last two years and their increased role, their share doesn't pose a threat to financial stability in the mid-term and doesn't require an administrative intervention on the part of the government. Alongside with that, as part of implementation of the Concept for the financial sector development in the post-crisis period, the government will clearly determine the optimal percentage of foreign participation which, on the one hand, will promote the interests of the country's economic security and, on the other hand, will be a financing cushion supporting the lending activity in the event if the crisis situations develop.

The priorities set by the financial regulator with regard to the requirements to provisioning, the structure of the investment portfolio and capital adequately identify the risk zones requiring

increased attention on the part of banks. Particularly, the risks associated with the currency mismatch on the asset and liability side of the borrower's balance sheet, risks of the portfolio rebalancing, of derivatives and structured financial instruments, capital adequacy risks in realization of both anticipated and hidden (latent) risk, require a higher quality assessment. In doing so, it is important to avoid procyclicality and the forced tightening of regulatory requirements.

The experience of the past economic cycle showed the importance of establishing an efficient system of macro-prudential regulation with the focus on counter-cyclicality and efficiency of the instruments for the prevention of imbalances in the markets of financial and real assets. The effectiveness of coordinated measures of macro- and micro-prudential regulation depends on the efficient assessment of risk transformations in the near- and long-term and their impact on financial stability. One of the key instruments must be the introduction of automatic regulators of capitalization and liquidity depending on the business cycle phases, timely identification and response to systemic risks arising both inside and outside the financial system. New regulatory tools must be introduced as the upward phase of the economic evolution cycle develops.

Macro-prudential regulation measures must be oriented on the financial system stability as a whole, on prevention of the imbalances formation and the increase in systemic risks and should be synchronized with the monetary and fiscal policy objectives and macro-prudential regulation measures. As part of the macro-prudential regulation, a focus will be made on an adequate assessment and control of risks and the quality of risk management systems in banks. The regulation system should be in optimal balance with the tightening of requirements to financial organizations and keeping the opportunities for diversification of the sources of profit generation.

On the whole, maximal efficiency of macro-prudential regulation could be attained only if it is implemented as an integral part of the overall macroeconomic policy. In these purposes the role of the National Bank as a central authority responsible for ensuring financial stability and implementation of macro-prudential regulation is strengthened.