

### III. Institutes of Financial Intermediation

#### 4. Role of Financial Sector in the Economy

##### 4.1 The Level of Development of Financial Relations

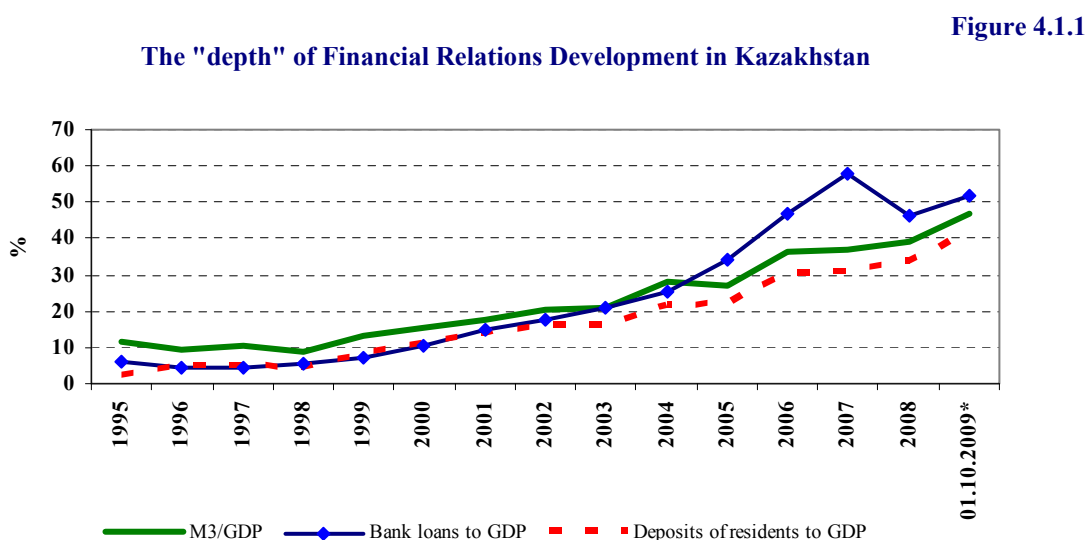
*During the two years of the global financial crisis development the function of financial intermediation in the country has undergone significant changes. The reallocation of resources to the economy was achieved due to active governmental support of financial institutions.*

The loss of the former funding sources redounded upon inability of banks to fulfill their function of financial intermediation and that forced the state to interfere in order to ensure stable functioning of the country's economy. However, resources allocated as part of the government anti-crisis measures appeared to be insufficient for satisfying the need in credit resources on the part of economic entities, and negative indicators of economic growth represent logical implication of the process.

As of the third quarter end of 2009 the ratio of credits to the economy to GDP increased to 52% as compared to 46% at the end of 2008 (Figure 4.1.1.). The growth is mainly caused by the revaluation of loan portfolio denominated in foreign currency as the result of devaluation occurred in February 2009 and the value of the indicator itself continues to be lower than that of the pre-crisis level.

The extent of confidence in the banking system remains – the ratio of deposits to GDP continues growing. At the end of Q3 2009 it was 42% versus 34% in 2008.

More moderate lending rates allowed contracting the gap between the rates of credits to the economy versus growth of savings among the population. The lack of opportunity to raise resources from foreign markets considerably increased attractiveness of deposits as a potential resource base.



Note: the GDP data are annualized  
Source: SARK, NBRK calculations

## 4.2 The Structure of Financial Sector

*The degree of services concentration in the financial sector remains high despite significant contraction of business of its key segments in the environment of financial and economic instability. The growth of competition on the part of banks with foreign participation, in terms of the level of penetration of foreign capital in the banking sector currently doesn't pose any threat for financial stability.*

A wide range of factors influenced the number of market players in various segments of financial services, both of regulatory and economic nature. In particular, increased minimum capital requirements of banks and professional players of the securities market, tightened prudential regulation of mortgage companies and stricter requirements to transfer and cash operations conducted by non-bank financial institutions contributed to the fact that a part of financial institutions left the market (Table 4.2.1). In the segments of mortgage companies and securities market overall slowdown in economic activity in the stock market and real estate market as a result of the current crisis caused additional increasing effect of regulatory actions.

**Table 4.2.1**

### Institutional Structure of the Financial Sector (number of financial institutes)

Financial Institutes	01.01.2006	01.01.2007	01.01.2008	01.10.2008	01.01.2009	01.10.2009
Banks	34	33	35	36	37	37
Insurance companies	37	40	41	44	44	43
Insurance actuaries	30	33	44	49	56	63
Professional participants of the SM *, including:	130	147	208	217	212	180
<i>Brokers-dealers</i>	62	70	106	106	103	86
<i>Registrars</i>	18	16	17	15	15	12
<i>Pension asset management companies</i>	11	13	11	13	13	14
<i>Investment portfolio manager</i>	28	37	61	68	66	54
<i>Custodians</i>	11	9	10	11	11	11
<i>Transfer agents</i>	0	2	3	4	4	3
Trade organizers	1	1	1	1	1	1
Accumulation pension funds	14	14	14	14	14	14
Mortgage companies	7	10	12	12	12	7
Institutions performing certain types of banking operations	32	16	23	23	22	10
including investment companies	0	1	4	4	4	3

*Note: number of licenses granted*

*Source: FSA*

On the other hand, favorable prospects of the country's economic development in the long-term and rich natural resources ensure attractiveness of the most capacious segments of the financial market for foreign players which tend to take advantages of available funding in the environment of limited resource base among large Kazakh banks. In particular, such new players as JSC "Shinkhan Bank Kazakhstan" (South Korea), bank subsidiary VTB Bank (Russian Federation) appeared in the banking market, a number of foreign investors expressed their interest in entering the market soon.

Generally, a growing share of foreign capital in the financial sector is currently at an acceptable level from the standpoint of financial stability. In addition, the level of foreign participation in respect of entities of the insurance sector and pension services sector is mainly determined by foreign parent companies of the Kazakh banks with foreign participation (Table 4.2.2).

Table 4.2.2

### Foreign Participation in the Financial Services Sectors, %

	Foreign participation in the authorized capital of financial organizations					Share of financial organizations with foreign participation in total assets				
	01.01.06	01.01.07	01.01.08	01.01.09	01.10.09	01.01.06	01.01.07	01.01.08	01.01.09	01.10.09
Banking sector	10,5	5.6	15.4	17.9	16.7	7.3	5.9	15.8	15.8	23.8
Insurance sector*	6.2	8.9	21.5	15.5	14.9	12.5	28.7	20.6	30.9	33.2
Sector of pension services*	3.5	2.6	17.7	10.6	17.5	18.1	17.6	20.1	17.0	20.3

Note: including indirect ownership

Source: FSA

In general, despite some reduction versus 2007 level on lending segments, high level of financial services concentration remains in the banking sector, in the loan portfolio concentration. So, nearly 85% of loans provided to the economy sectors fall on the top five Kazakh banks, where such industries as construction and trade (Table 4.2.3) are dominating. The most significant reduction of concentration can be observed in the segment of lending to natural persons and primarily in the consumer lending. Medium- and small-size banks could use the opportunities to expand their involvement in the segment to the maximum, given the change in priorities among large players.

Table 4.2.3

### Concentration of Financial Sector Segments (share of 5 top financial organizations of each segment)

Item	1.01.2008	1.01.2009	1.10.2009
<b>Banks in lending:</b>			
to legal entities	86.66	84.40	84.54
construction	87.31	87.85	87.92
trade	84.47	79.18	80.49
to individuals	67.97	66.46	61.37
consumer loans to individuals	73.77	73.05	56.29
for construction and purchase of housing by individuals	64.32	63.14	62.30
mortgage residential loans of individuals	75.18	63.96	62.72
<b>Insurance (reinsurance) organizations in the following sectors:</b>			
General insurance	54.84	57.16	56.19
Life insurance	86.47	83.04	86.07
<b>Accumulation pension funds</b>			
On attracted pension assets	80.10	78.12	76.48

Source: FSA

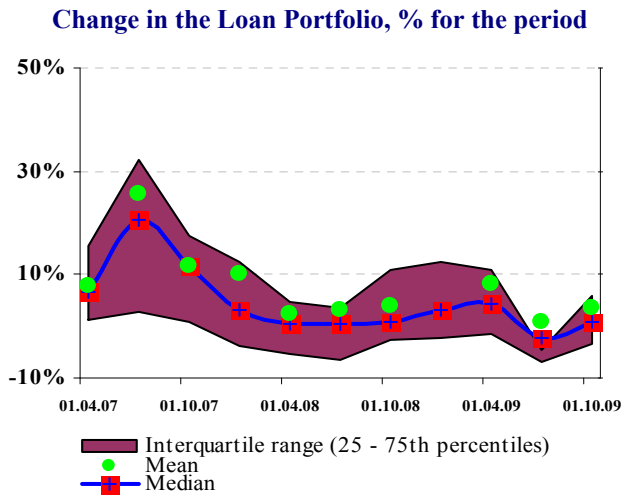
## 5. Banking Sector

### 5.1 Credit Risks

*The quality of loan portfolio of the Kazakh banks deteriorated virtually in relation to all sectors of the economy alongside with the slowdown of economic activity. As a result, lending activity of banks remain low due to the objective lending conservatism driven by such main factors as current losses and remaining assessments of high credit risks of the domestic borrowers.*

As of October 1, 2009 the volume of total loan portfolio of the Kazakh banks in absolute terms amounted to KZT 10 138.3 bln. having increased by 9.7% since the beginning of the year. Despite the fact that only 2.5% growth was observed for the respective period of the last year, the main effect on the growth dynamics this year was from the revaluation of portfolio of foreign currency loans as a result of the Tenge devaluation, whose share in the loan portfolio increased from 52 to 60% over 2009. Regardless of the devaluation effect, the change in the loan portfolio is insignificant.

**Figure 5.1.1**



Source: FSA, NBRK calculations

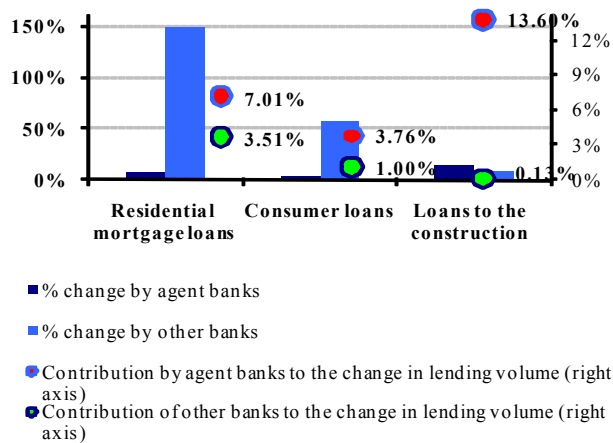
As a whole, the lending conservatism in 2009 was pertinent to the majority of banks – the spread in values of quarterly changes in the bank loan portfolios and, hence, inhomogeneous strategy of banks in the credit market – has noticeably reduced (Figure 5.1.1).

The implementation of anti-crisis measures for stabilization of the economy and the financial sector while having not changed significantly the overall lending volume, nonetheless allowed maintaining lending activity and provided refinancing to a large part of the existing borrowers, especially in the construction sector and in mortgage lending. Specifically, residential mortgage lending and lending to the construction sector

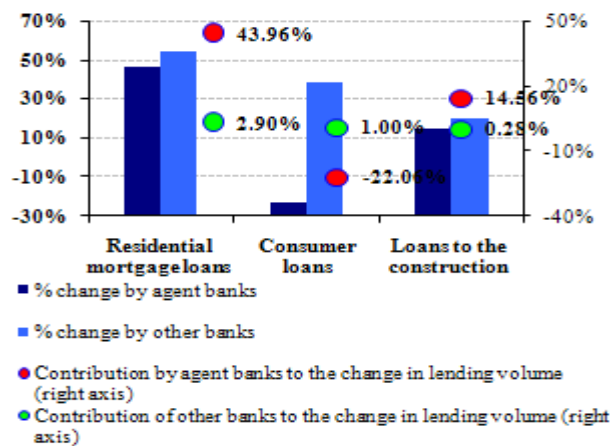
in 2009 was mainly provided by banks – agents of the government program<sup>41</sup> (Figure 5.1.2).

**Figure 5.1.2**

**The Change in the Loan Portfolio by Segments, Relative to the Same Period of the Previous Year As of Oct 1, 2008**



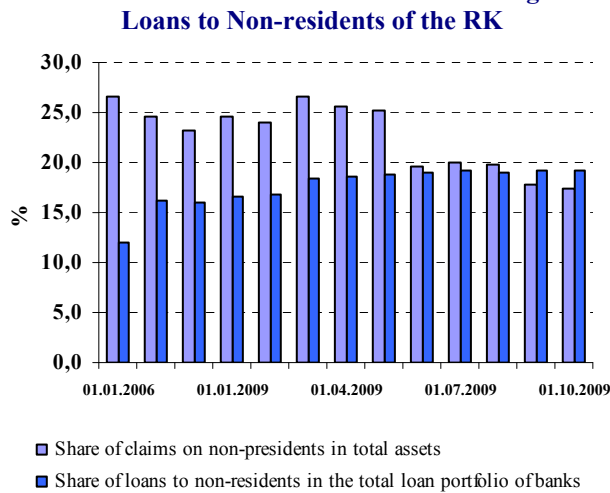
Source: FSA, NBRK calculations



At the same time the banks which do not participate in the program, despite a considerably lower contribution to the overall lending volumes were able to increase their loan portfolios from their internal resources in the segments of mortgage lending and lending to the construction sector comparable with agent banks. Moreover, in the environment where consumer lending market has contracted dramatically, the banks which do not participate in the government program not only built up their consumer loan portfolio but also increased their market share in the environment of weak competition on the part of large and medium-size banks in this market segment.

<sup>41</sup> As part of the joint efforts by the Government, the National Bank and the Agency on Regulation and Supervision of the Financial Market and Financial Organizations for the stabilization of the economy and financial system for 2009 – 2010 aimed at stabilization of the financial sector, development of the real estate sector and support of the small-and medium-size enterprises, resources were allocated from the National Fund and distributed among the following Kazakh banks: BTA Bank, Halyk Bank, Kazcomertsbank, Alliance Bank, Bank CenterCredit, Eurasian Bank», Kaspi Bank, ATF Bank, Tsesnabank, Nurbank, Temir Bank, Bank Subsidiary of the Russian Sberbank, and Astana-Finance Bank.

Figure 5.1.3



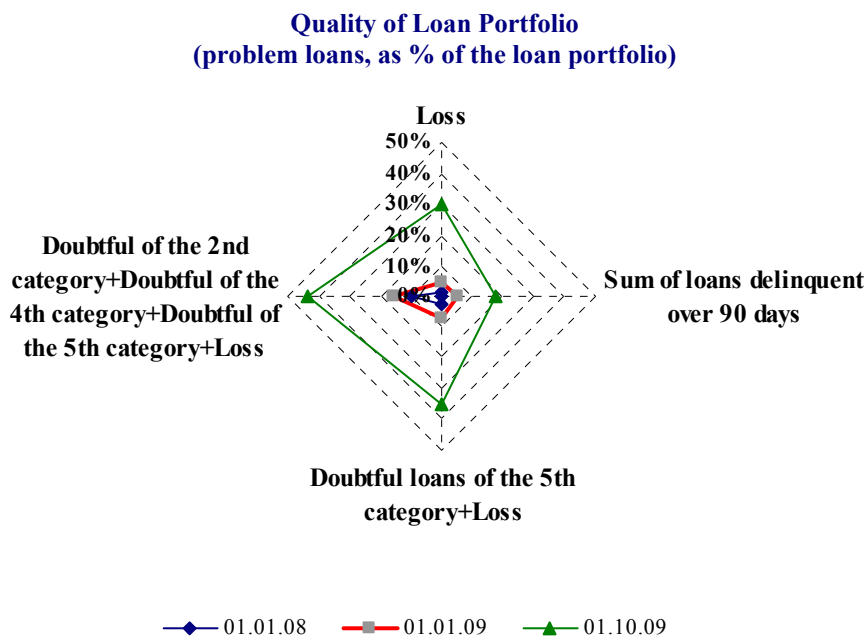
Source: FSA

On the other hand, alongside with the slowdown in lending to the domestic economy sectors, in 2009 loans to non-residents continued growing (including if the effect of evaluation as a result of the Tenge devaluation is excluded), increasing from 16.6 to 19.3% in the total loan portfolio (Figure 5.1.3).

*The numbers of the portion of non-performing loans (NPLs) were well above the internationally accepted permissible values. The analysis of quality of the aggregate loan portfolio of the banking system excluding those banks that undergo the restructuring of their foreign liabilities, shows relatively more moderate credit risks and their inhomogeneous distribution across the economic sectors. Also, from an objective point of view, one cannot overestimate the extent of the effect of the Tenge devaluation on the growth in problem assets, since both the population and enterprises irrespective of their sector experienced the decrease in earnings and cash inflows, as well as financial resources from banks as a result of a lower domestic and external demand and the slowdown in the crediting to the economy.*

Doubtful loans of the 5 category and bad loans including provisions for homogenous loans (NPLs under the FSA’s methodology) showed over 4.5 fold increase over 9 months of 2009 and accounted for about 35% of the total loan portfolio. NPLs calculated under the international methodology as loans with delinquency over 90 days have increased over the same period by more than 3.5 times and amounted to 17.5% of the loan portfolio (Figure 5.1.4).

Figure 5.1.4



Source: FSA

**Table 5.1.1**  
**Transfer Matrix on the Share of Loans in the Loan Portfolio with Delinquency over 90 days**

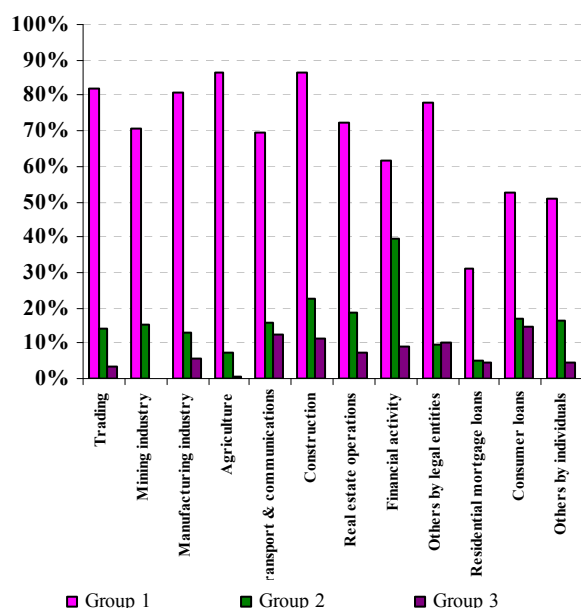
as of 01.10.2008	as of 01.10.2009			
	Quartile 1	Quartile 2	Quartile 3	Quartile 4
Quartile 1	7	1	0	1
Quartile 2	1	5	1	1
Quartile 3	0	2	3	3
Quartile 4	1	0	4	4

Note: numeric values in the matrix reflect the number of banks  
Source: FSA, NBRK calculations

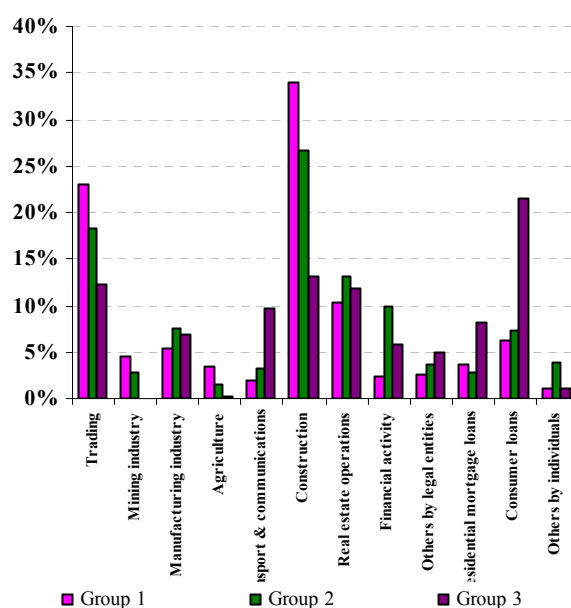
The general tendency of the deteriorated quality of loan portfolio was distributed among banks unevenly (Table 5.1.1). Particularly, the majority of banks with a lower share of loans with delinquency over 90 days in 2008 have retained a relatively high asset quality and in 2009 (14 out of 17 banks within the first half of the list on the share of problem loans in 2008, remained in the same group in 2009). That group was mainly presented by medium and small banks that are either subsidiaries of foreign banks or have significantly built up their loan portfolio

over the reviewed period. In the group with a relatively lower quality of loan portfolio the situation is not homogenous – against the backdrop of the overall deterioration in the loan quality some banks were more capable of efficiently controlling the growth in delinquent loans as compared to others. The practice of restructuring widely used by large and medium banks enables financial organizations to partially limit the growth of NPLs while expecting a further restoration of financial condition of those the borrowers which face temporary difficulties (Box 5). At the same time, reassessment of the quality of loan portfolio of the banks under restructuring which materially affected the overall picture for the system in many ways reflected a low quality of risk-management and low efficiency of the borrower selection system. In particular, low quality of the risk management system resulted in that the level of problem loans at those banks varies, by industries, from 62% to 82% of the loan portfolio of those banks to legal entities and from 31% to 52% in segments of lending to individuals (Figure 5.1.5).

**Share of Problem Loans by Industry in the Total Loan Portfolio Broken Down by Bank Groups, as of 01.10.2009**



**Figure 5.1.5**  
**Share of Problem Loans by Industry in the Total Volume of Problem Loans Broken Down by Bank Groups, as of 01.10.2009**



Note: 1) Group 1 of banks includes: Alliance Bank and Temir Bank, the rest of the groups are divided based on the share of assets in the market: more than 2% - Group 2, less than 2% - Group 3;

2) Problem loans consist of doubtful loans of category 5 and loss loans.

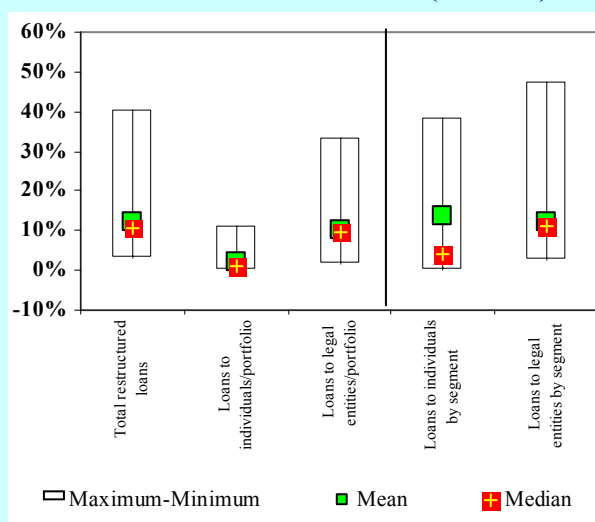
Source: FSA, NBRK calculations

## Processes of Restructuring and Refinancing at the Banks

In the environment where the financial condition of corporate borrowers and the population deteriorated, banks were quite active in their loan restructuring efforts. Based on the information from the banks\*, from January to September 2009 about 12% of all bank loans have been restructured on average. Banks almost equally restructured both loans to individuals and non-financial organizations – on average 13.7% and 12.3% of loans to the respective range of borrowers (Figure 1). The spread in values is quite high, with the maximum reaching 40% of the loan portfolio and individual lending segments.

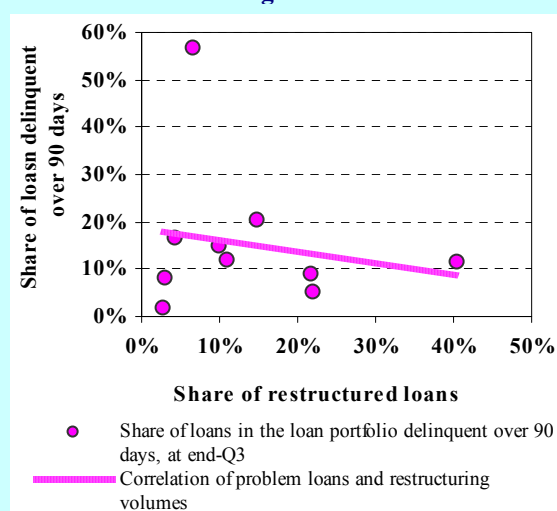
As for individuals, mortgage loans fell under restructuring in a greater degree. Also, given that the devaluation increased the burden on those borrowers whose loans are denominated in foreign currency, one may place it on record that restructuring of those loans was relatively more common than restructuring of loans in the domestic currency.

**Figure 1**  
Share of Restructured Loans (residents)



Source: Banks, NBRK calculations

**Figure 2**  
The Restructuring and Problem Loans



Source: Banks, NBRK calculations

Generally, it might be mentioned that the restructuring of a loan portfolio allows controlling the quality of a loan portfolio in a more efficient manner, although the correlation with the NPLs level is not always obvious. At the same time its efficiency depends to a great extent on the sustainability and the pace with which the economy recovers based on a favorable external pricing environment.

Note:

1. Used here is the information on the restructuring and refinancing volumes for 9 months of 2009 provided by ten top and medium banks at a special request from the NBRK.
2. The question posed to the banks assumed that the restructuring shall mean the change in the lending conditions aimed to reduce the debt burden on a client (i.e. reducing the amounts of lump sum payment on a loan with a view to improve a client's creditworthiness): loan roll-over, reducing interest rates on the loan, writing off the past due amounts (excluding writing off a fine), etc. Hence, restructuring in this sense represents a set of measures aimed to improve the quality of a loan. Also, refinancing of one liability by another under more favorable terms and conditions shall not be included in the report. Therefore, said numbers may be considered as those enabling to determine the share of restructured non-performing loans with sufficient accuracy.
3. A bank which provided the report shall be responsible for reliability of information provided.

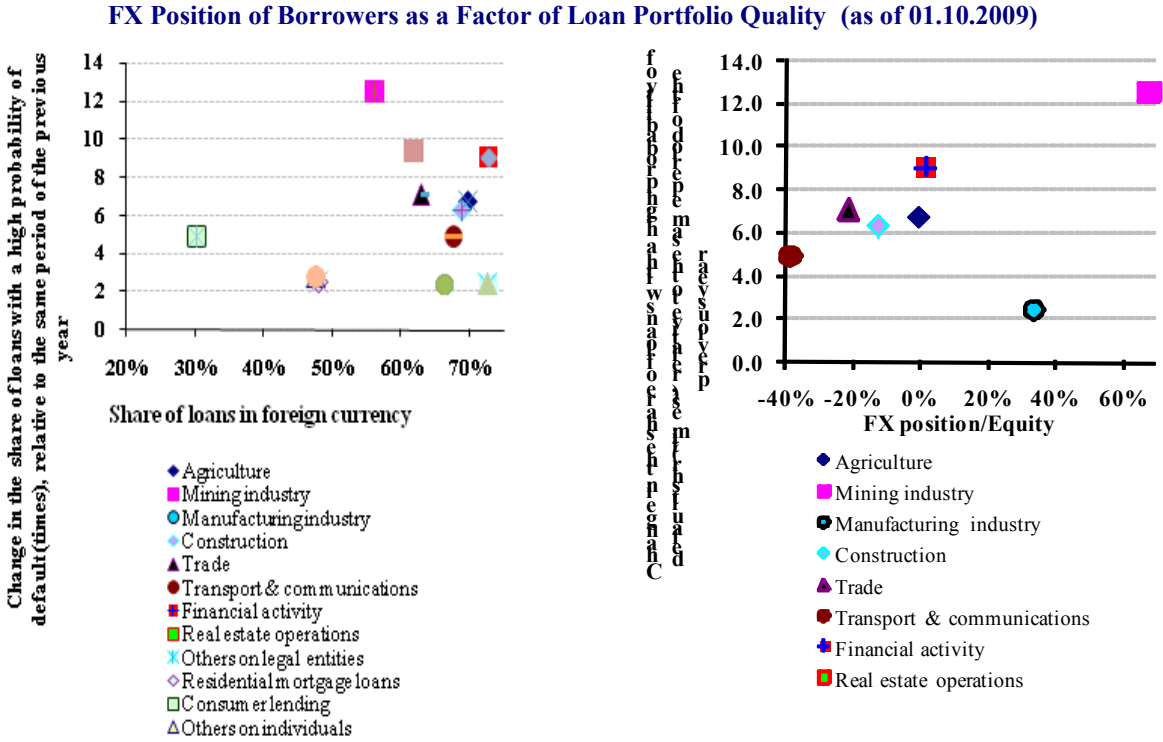


This group of banks considerably distorts the picture of overall sectoral risks. If small banks and bank undergoing restructuring<sup>42</sup> are excluded, on average the volume of problem loans by industries and segments of lending will make up 16.6% at the end of nine months of 2009. The largest concentration of problem loans falls on industries such as financial activity (40% of loans), construction (23%), real estate transactions (18%) and consumer lending (17%). It is also notable that the share of problem loans in the loan portfolio went down in 2009 in the trading and construction sector that happened partially due to the refinancing of liabilities by the borrowers as part of the government anti-crisis program. Without this financing program an overall level of problem loans could have been significantly higher, given the dominating portion of loans in the trading and construction sectors. Also, a relatively higher portion of problem consumer loans in total loans of small banks is worth mentioning, and this is adequate to their lending priorities in the recent years.

The devaluation of the Tenge that was implemented in February objectively increased the burden of the servicing of borrowers' debt where the main currency of earnings does not correspond to the currency of liabilities to banks. At the same time, comparing the share of foreign currency loans and FX position of borrowers with the increase in loans with a high degree of probability of default (doubtful loans of the 5<sup>th</sup> category plus bad loans) by industries and segments of lending doesn't show a significant dependency of the scale of the change in the portfolio quality on the extent of dollarization of economic activity in the industry / segment (Figure 5.1.6).

In general, high sectoral risks and a significant portion of non-performing loans in the bank balance sheets continue having a negative impact on the pricing and non-pricing parameters of loans, thus retaining high unrealized demand for credit resources on the part of the real sector of the economy (Box 6).

Figure 5.1.6



Note: FX position – difference between financial assets and liabilities in foreign currency by large and medium-size enterprises adjusted by the cash receipts from operating activity in foreign currency (in annual terms);  
Equity – equity owners of large and medium-size enterprises.

Source: SARK, FSA, NBRK calculations

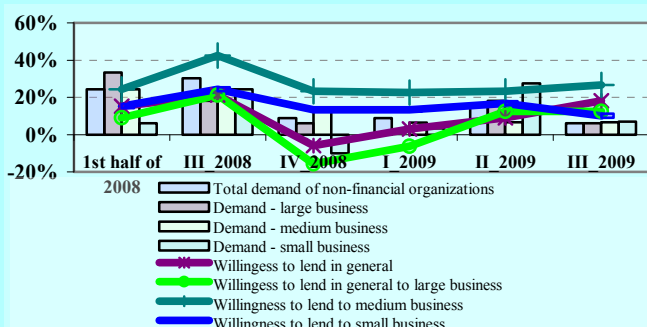
<sup>42</sup> In addition to BTA Bank and Alliance Bank, Temirbank (where BTA Bank is a shareholder) was included in the group which also announced about the initiation of the restructuring process on November 23, 2009.



### Quality Parameters of Credit Risk

Figure 1

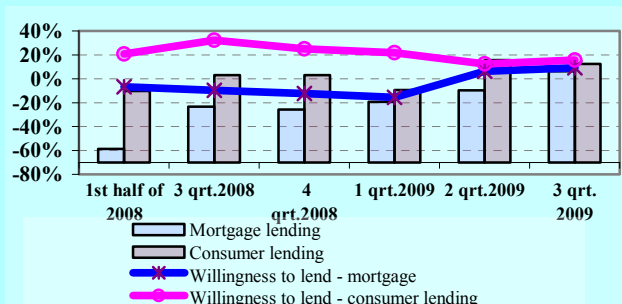
Change in the Demand for Credit Resources, % Respondents (Corporate Sector)



Source: Banks, NBRK calculations

Figure 2

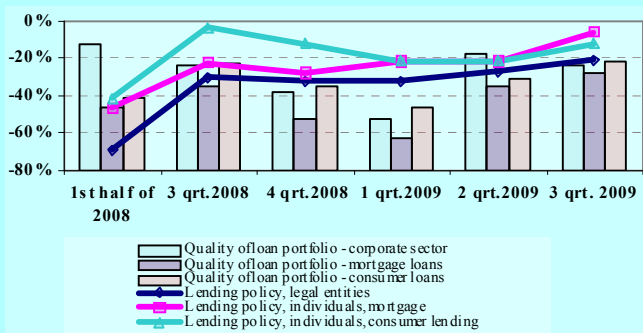
Change in the Demand for Credit Resources (Market of Loans to Individuals), % of Respondents



Source: Banks, NBRK calculations

Figure 3

Change in the Lending Policy and the Quality of Loan Portfolio



Source: Banks, NBRK calculations

During 9 months of 2009 based on banks' evaluation there prevailed a trend of limited demand for credit resources from nonfinancial organizations (Figure 1)\*. The terms of providing credit resources by the banks limit their demand on the part of non-financial organizations. This demand is mainly directed at satisfying the existing need in financing the working capital and restructuring of the current debts.

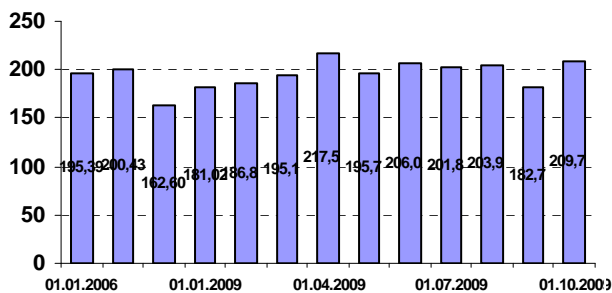
At the same time in 2009 the retail sector displayed positive tendencies in the demand for consumer lending (Figure 2). Banks explain this tendency by the quick turnover of the invested capital in the consumer segment of lending, which has a positive affect on revenues. In the 3<sup>rd</sup> quarter of 2009 for the first time since 2008 the demand for mortgage lending was positive. According to the banks' estimates one of the main reasons for this is the fact, that the real estate market has almost reached its "bottom", and real estate can soon be viewed as the object of long-term investments.

As far as lending terms are concerned, in the current year the banks pursued a tight lending policy (Figure 3). The most significant influence on the tight lending policy was made by the present trends in economic development, increased proportion of the high-risk loans and changes of risk portfolios in major industries.

Banks expect certain recovery of the lending market by the year end. 45% of respondents expect minor increase in demand for credit resources in corporate lending and 44% of responders - in consumer lending. The prevalent portion of responders predicts the lending policy to remain on the same level both in the corporate segment and consumer lending. This is supported by the growing number of the banks declaring the slowing of deterioration and even certain stabilization of the quality of the loan portfolio.

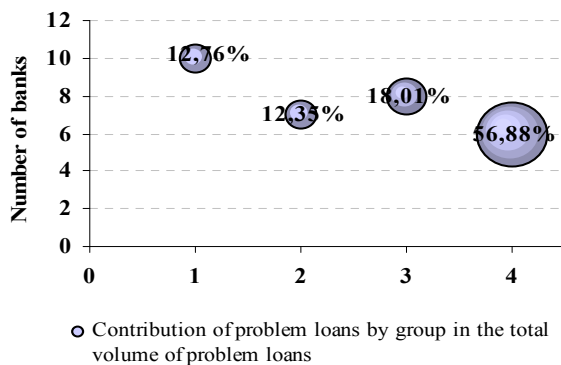
Note: hereinafter the results are shown as net percentage change, which is calculated as a difference between the % of respondents, who registered the increase/easing of a parameter, and the % of the respondents, who registered the decrease/tightening of a parameter.

**Figure 5.1.7**  
**Coverage of Loan Portfolio by the Value of Collateral and Provisions (in per cent)**



The source: FSA

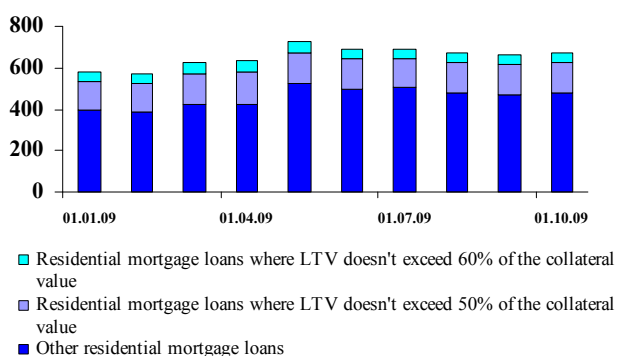
**Figure 5.1.8**  
**Distribution of Banks by LTV and the Share of Problem Loans in the Total Volume of Problem Loans, as of 01.10.2009**



Notes: 1) problem loans - loans with delinquency over 90 days;  
 2) BTA Bank was excluded from the selections;  
 3) Quartile groups:  
 The 1st – less than 0,44      The 3rd – from 0,55 to 0,75  
 The 2nd – from 0,44 up to 0,55      The 4th – exceeding 0,75

Source: FSA, NBRK calculations

**Figure 5.1.9**  
**Structure of Residential Mortgage Loans by LTV**



Source: FSA

*In general the increase of reserves is associated with the dynamics of deterioration of the quality of assets. At the same time, in spite of significant decrease of the credit portfolio quality, banks continue to be reluctant to recognize their losses.*

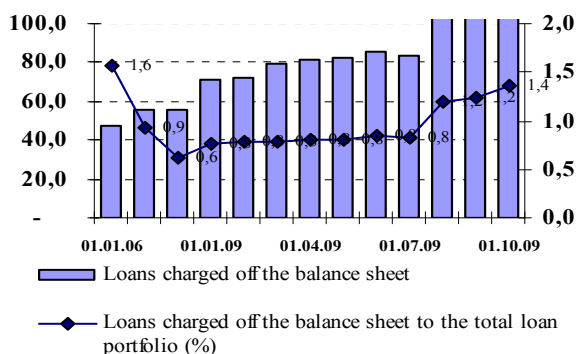
Adequately reacting to external environment, the banks continued to direct their operating income to create provisions, which as of 01.10.2009 totaled 36.4% of the total credit portfolio (excluding BTA Bank and Alliance Bank – 17.6%) as compared to 11.1% at the beginning of the year. Loan coverage ratio of loans with delinquency over 90 days by the provisions created for them (coverage ratio) was 0.79 versus 0.69 at the beginning of 2009. Due to the increase in reserves, the amount of coverage including collateral and provisions on the whole is comparable with the period prior to the crisis, and the level of reserve coverage is higher than similar indicators in the majority of developed and developing countries (Figure 5.1.7).

Distribution of banks by the proportion of loan value to collateral value (LTV) displays a sharp increase in the proportion of loans with delinquency over 90 days in the overall loan information from the banks whose LTV exceeds 0.75<sup>43</sup> (the number corresponding to that in the 3<sup>rd</sup> quartile). The group of banks of the 4<sup>th</sup> distribution quartile has more than 50% of all loans with delinquency over 90 days randomly selected (Figure 5.1.8). Respectively the LTV level within 0.70-0.75 can be considered optimal as concerns the risks of collateralized lending. At the same time, when analyzing distribution of mortgage residential loans by the proportion of loan value to collateral value, one can notice the significant prevalence of loans with high value of LTV, which presents major risk of losses in case of necessity to sell the collateral in the environment of low prices in the real estate market (Figure 5.1.9)

<sup>43</sup> The cumulative selection doesn't include BTA Bank due to the fact that a high proportion of problem loans, being the result of lending to off-shore companies and companies related to the former shareholders of the bank, does not allow isolating the role of LTV as a factor of the increase in problem loans.

On the whole in spite of the significant decrease of the loan portfolio quality, the portion of

**Figure 5.1.10**  
**Loans Written off the Balance Sheet to the Total Loan Portfolio**



Source: FSA

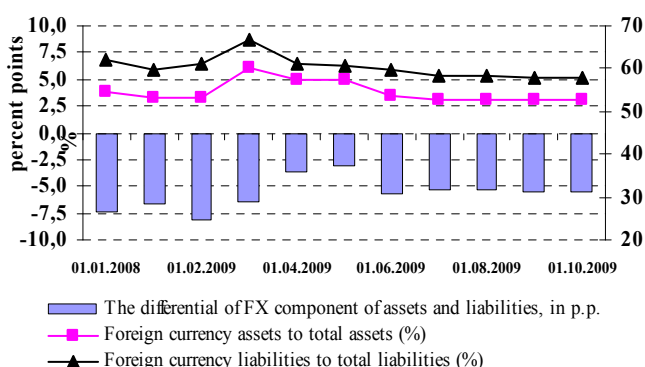
the loans written off the balance sheet remains reasonably low irrespective of the current conditions. This proves that banks are reluctant to recognize their losses (Figure 5.1.10).

The contributing factors are inadequacy of the capital to cover losses, hopes for restoration of the financial condition of borrowers, as well as unresolved issues of taxation of the revenues arising from restoration of provisions.

## 5.2 Market Risks

*High level of dollarization of liabilities of the banking system makes the banks keep a substantial part of their assets in foreign currency for the purpose of adjusting their currency position. Given the trend to reduce interest rates when allocating assets in the internal market, the banks whose attraction of long-term high interest rates resources led to the accumulation of liquidity, are facing the increase of interest rate risks.*

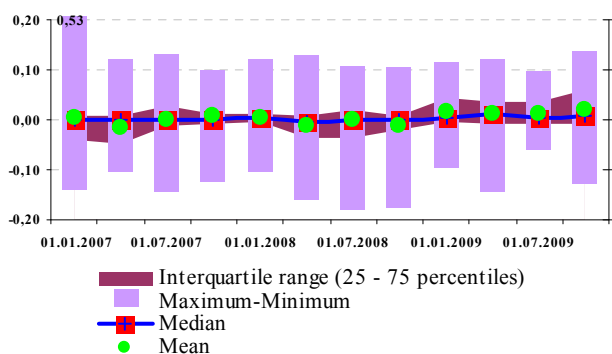
**Figure 5.2.1**  
**Foreign Currency Assets and Liabilities in Total Assets and Liabilities**



Source: FSA

In spite of devaluation of the Tenge and short-term structural changes of the balance sheet, by the middle of the year the banks have brought the proportion of foreign currency assets and liabilities to the level of the recent years. As of 01.10.2009 the portion of the foreign currency holdings in the total assets of the local banks was 53.0%, and in the foreign currency liabilities was 58.1%. Negative difference between foreign currency assets and liabilities from the beginning of 2009 was within 3.1-8.1 % (Figure 5.2.1).

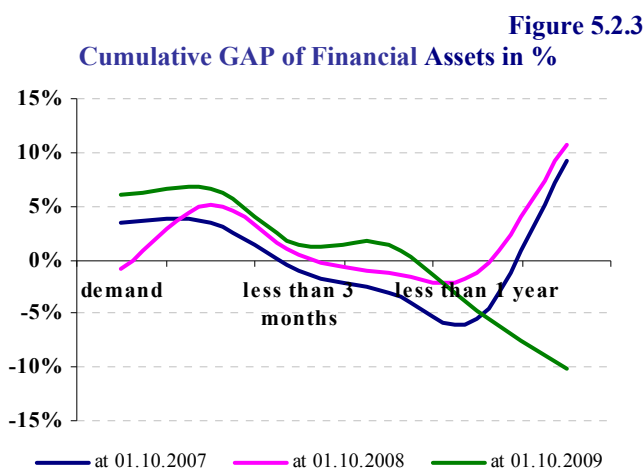
**Figure 5.2.2**  
**Net FX USD Position to the Equity of Banks**



Note: BTA Bank, Temirbank and Alliance Bank have been excluded from the sample because of the negative equity value.

Source: FSA, NBRK calculations

On the whole the foreign exchange position of the banks has been generated within the standard values, excluding the banks with the negative capital. It is important to mention that expected devaluation at the end of 2008 stimulated the banks with the negative position to reduce it in order to minimize direct losses caused by potential change of the foreign exchange rate (Figure 5.2.2). The situation of adjusting the currency of assets and liabilities as well as a tendency towards the increase of a long position in the USD was present throughout all 9 months of 2009.



Source: FSA, NBRK calculations

between financial assets and liabilities. This increases the interest rate risks for the banks, which have been actively attracting expensive resources at the time of the formation of the long-term trend of decreasing the interest rates on the market.

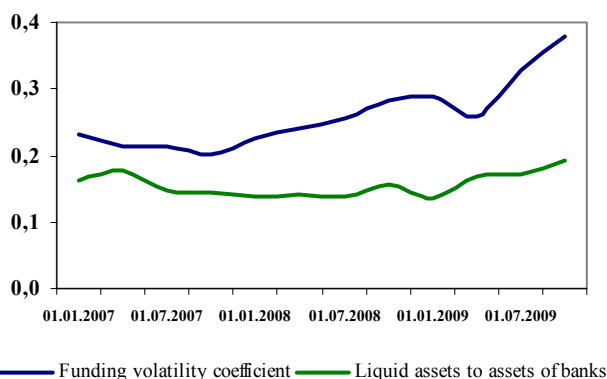
### 5.3 Liquidity Risks and Funding Sources of the Banks

*In order to compensate for the volatility of funding in the uncertain environment the banks preferred to invest money in liquid and low risk financial instruments instead of crediting to the economy with its prevailing of high sectoral and individual borrowers. In addition to this, the lack of confidence in the interbank credit market limits the possibility of redistribution of resources among the banks with excessive and inadequate liquidity.*

*High growth of deposits as compared to the increase in bank loans helps reducing dependency but does not fully replace external funding. The determining factors of the increase of the deposit base were the assets allocated by the government as part of the program to support the financial and real sectors of the economy.*

**Figure 5.3.1**

**Share of Highly Liquid Assets and Funding Volatility Coefficient \***



Note: Funding volatility coefficient is calculated as the ratio of the difference between the deposits and liquid assets to the difference between total assets and liquid assets.

Source: FSA

among market players in the financial system in order to reduce the unpredictability of the resource base.

In the environment of the increase of general economic risks and volatility of funding starting from 2007, the banks consistently increased the portion of their short-term claims on similar liabilities by cutting down long-term assets.

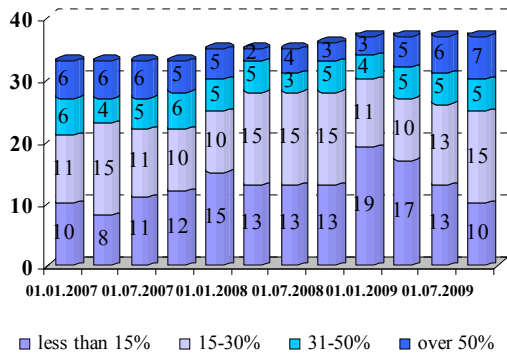
As of 01.10.2009 a positive GAP was registered on financial instruments with the maturity of 6 months (Figure 5.2.3).

Accordingly, in case of fluctuation of the short-term interest rates the banks are guaranteed against losses on the most liquid financial instruments. At the same time in contrast to the previous years a significant gap of more than one year appeared in 2009

At the beginning of the current year there started a steady trend of the increase in the share of highly liquid assets in the total assets of the financial institutions. This can be explained by expanding operations of the National Bank in the unstable environment aimed at supporting liquidity of the banking system and by the objective conservatism of the banks themselves (Figure 5.3.1).

From October last year the share of highly liquid assets in the total assets of the banks was about 14% -19%. At the same time the significance of deposits compared with other funding sources outpaces the increase of liquid assets. This increases the volatility of funding and requires setting up clear time limits of the state policy of financial support of the economy and increasing confidence

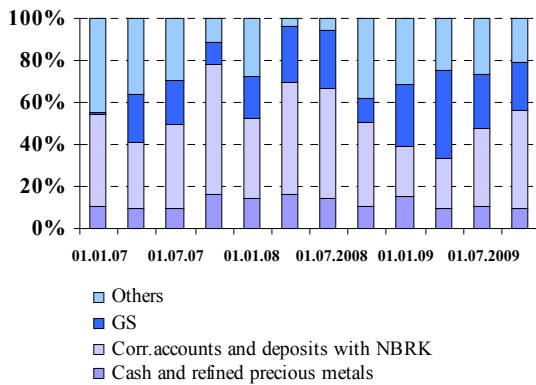
**Figure 5.3.2**  
**Distribution of Banks by Intervals\* of the Liquidity Level (Number of the Banks)**



Note: \* by share of liquid assets in assets of banks, as %  
 Source: FSA

**Figure 5.3.3**

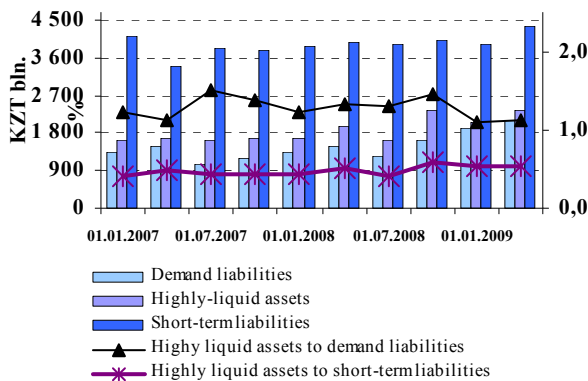
**Structure of Highly-liquid Assets**



Source: FSA

**Figure 5.3.4**

**Coverage by Highly-liquid Assets of Demand Liabilities and Short-term Liabilities (Less Than One Year)**



Source: FSA

In the process of distributing banks by the groups based on the level of highly liquid assets, there is a trend of noticeable reduction in the number of banks belonging to the group with a relatively high liquidity risk or with a level of highly liquid assets below 15%. This being said, the overwhelming number of the banks still have a share of highly liquid assets within 15% - 30%. Since the beginning of 2009 the number of banks with a significant portion of highly liquid assets (above 50%) increased more than twice (Figure 5.3.2).

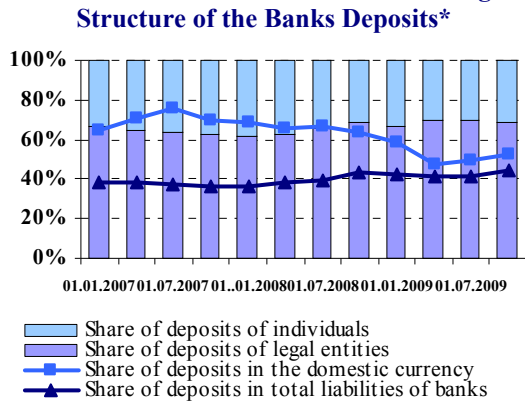
Since the beginning of the current year the structural changes in the highly liquid assets are characterized by the significant increase of the share of balances on correspondent accounts and on deposits with the National Bank (this portion during 9 months of 2009 was within 22.9% - 46.3%, the average being 32.4%) and reduction of the portion of government securities (23.6% - 42.2%, the average being 30.5%) and cash and precious metals (9.5% - 15.7%, 11.4% respectively) (Figure 5.3.3).

On the whole the total amount of highly liquid assets exceeds the total amount of demand liabilities. As for the short-term bank liabilities (up to one year), highly liquid assets cover only half of them (Figure 5.3.4).

In the environment of economic instability the increase of the deposit base supported not only banks' liquidity, but their resource potential too. The increase of the clients' deposits (excluding deposits of special purpose subsidiaries) from the beginning of the current year was a little over 30%, which was due to the 35% increase of deposits of legal entities, primarily through placing these deposits in the framework of the government program (Figure 5.3.5).



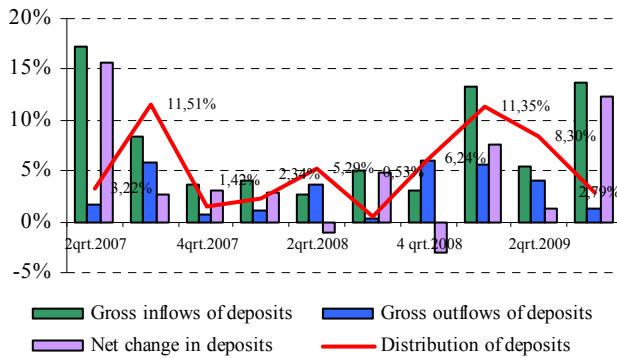
Figure 5.3.5



Note: Deposits excluding nonresidents  
Source: FSA

Figure 5.3.6

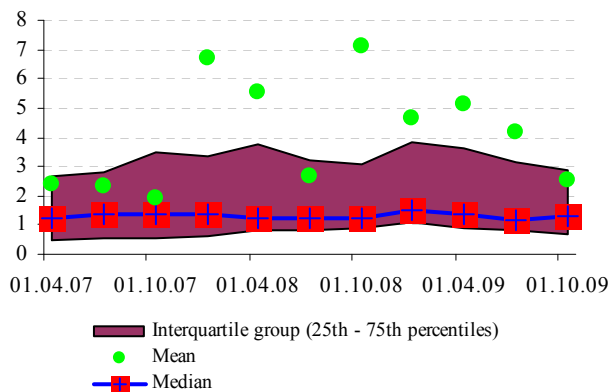
The Extent of Deposit Re-distribution in the Banking System



Source: KDIF, NBRK calculations

Figure 5.3.7

Ratio of Loans to Deposits (by the Beginning of the Period)



Notes: loans and deposits between banks, repos and deposits of SPV have been excluded.  
Source: FSA, NBRK calculations

It is important, that despite the destabilized situation in some banks, on the whole the confidence of the public in the banking sector has not failed. The results of 9 months activity showed that there was no net deposit outflow from the system, which might be the least desirable result of the devaluation and forced change of the management in two banks (Figure 5.3.6). There was a run of depositors from some banks, but not from the banking system in general. In particular, with level of redistribution of deposits<sup>44</sup> among the banks around 4-5% in the course of 2 years, in the 1<sup>st</sup> and 2<sup>nd</sup> quarters of 2009 about 8%-11% of deposits, mainly deposits for the amount over KZT 5 mln. (the amount guaranteed by the state), migrated inside the banking system searching for a "quiet harbor" or more attractive terms.

In general, high rate of deposit growth as compared to the growth of the banks' assets strengthened the potential of deposits as a source of credits to the economy (Figure 5.3.7). As of 01.10.2009 the ratio of loans to deposits was 1.6, which is close to the optimal level of 1.5 from the point of view of funding risks. At the same time there is a significant difference in the indicators of the banks – as of 01.10.2009 only 22 banks met the criterion of 1.5 (18 banks by the beginning of the crisis in the middle of 2007).

Steady reduction of the ratio of loans to deposits in 2009 took place at the background of decrease in the volume of external debts of the banks down to 37% as of October 1, 2009 (Figure 5.3.8). Due to the lack of possibility for refinancing in foreign markets for the majority of banks, maintaining the inflow of people's deposits and increase in the deposits of legal entities together with the reduction in credits to the economy were the most important sources of paying off the banks' external debts.

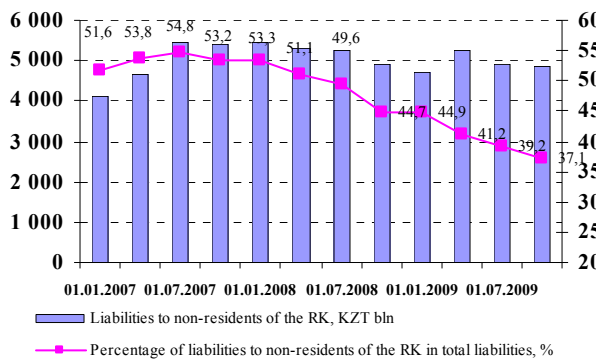
<sup>44</sup> Flows during the  $t$  period for a bank  $i$  is calculated as follows ( $I$  is the bank's deposits):

$$POS / NEG \text{ flows} = \sum_i^N |g_{it}| * \left( \frac{(I_{i,t-1} + I_{i,t}) / 2}{\sum_{i=1}^N I_{i,t-1}} \right)$$

Where  $g$  is a weighted rate of deposits change by the bank's share in the total deposits, compared to the previous year. The net flow is calculated as a difference between positive and negative flows. The redistribution flows are calculated as a sum of positive and negative flows minus the net flow by the module.



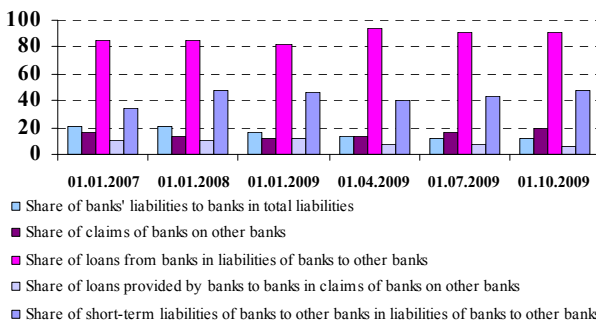
**Figure 5.3.8**  
**Liabilities of Banks to Non-residents, (%)**



Source: FSA

funding sources and closed external markets for the banks of Kazakhstan, the potential of the domestic interbank financing as a funding source for the banks remains low. During the crisis this reduced the volume of losses due to the distribution effect (contagion). At the same time as the financial system recovers, further development of the interbank market becomes critical in order to diversify the resources of the local banks and redistribute the excess of the financial resources (Figure 5.3.9).

**Figure 5.3.9**  
**Dynamics in the Development of Bank Relationships (%)**

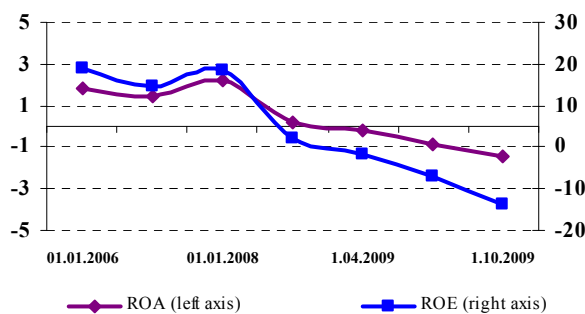


Source: FSA

## 5.4 Performance of the Banks and Capital Adequacy

*The observed trend of the reduction of the banks' yield during the analyzed period transformed into their losses due to the deterioration of the credit portfolio quality of the banks and significant decrease of their credit activity. High credit risks are the objective sign of the weakness of the banking system, which creates pressure on the bank capital and impedes reconstruction of the balanced rate of crediting to the economy.*

**Figure 5.4.1**  
**Dynamics of ROA, ROE in Annual Term (in %)**



Note: Starting from April 1, 2009 the data is presented without 2 banks, which are undergoing the restructuring of their external debts

Source: FSA

In the forthcoming 12 months the banks are planning to replace a portion of the external debts to be repaid by their internal liabilities (22%). Another way to repay the external debts is through reduction of domestic and foreign assets (around 20%). Apart from this, an important role is given to restructuring of the foreign debts of two banks. In case of its success, the burden of servicing foreign obligations of the whole system in the year to come will be reduced by 50%.

Due to the contraction of the main funding sources and closed external markets for the banks of Kazakhstan, the potential of the domestic interbank financing as a funding source for the banks remains low. During the crisis this reduced the volume of losses due to the distribution effect (contagion). At the same time as the financial system recovers, further development of the interbank market becomes critical in order to diversify the resources of the local banks and redistribute the excess of the financial resources (Figure 5.3.9).

The downward trend in the earnings from the banking business, which started in 2008, led to the formation of the negative indicators of the return on assets and equity as a whole in the system, excluding BTA Bank and Alliance Bank, which as of October 1, 2009 are in the process of restructuring their foreign debts. (Figure 5.4.1).

High sensitivity of the banking system of Kazakhstan to the crisis can be explained by the following structural problems: (1) non-diversified sources of financing of the economy, (2) underdeveloped capital market, (3) segmented real sector of the economy, (4)

high level of dollarization of the economy and the banking system, (5) high level of the sectoral concentration of a credit risk and (6) ineffective systems of risk management due to the aggressive growth rates of banking expansion.

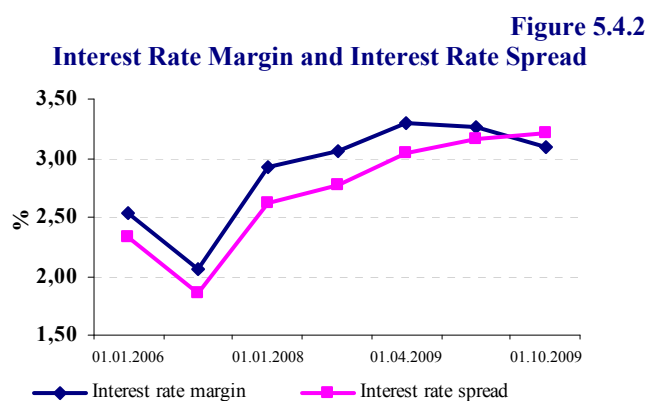
Similar systemic weaknesses exist in other countries oriented at building the market economy. Their banking sector displayed comparable and even bigger scale of adjustment (Table 5.4.1)

**Table 5.4.1**

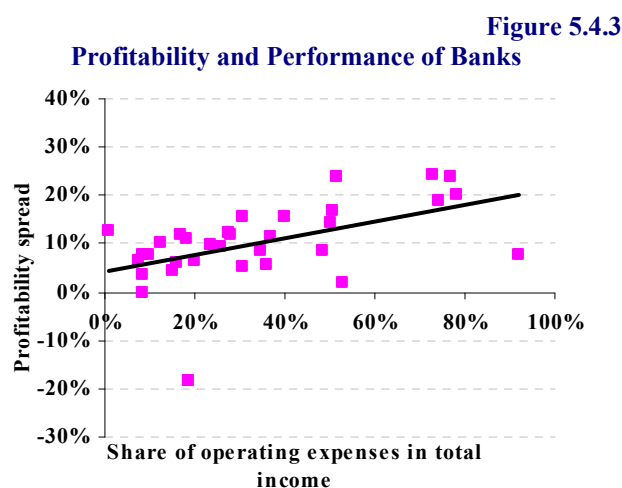
	2003		2004		2005		2006		2007		2008		2009	
	ROA	ROE	ROA	ROE	ROA	ROE	ROA	ROE	ROA	ROE	ROA	ROE	ROA	ROE
Bulgaria	2.4	22.7	2.1	19.6	2.0	21.4	2.2	25.0	2.4	24.8	2.1	23.1	1.6	15.7
Czech Republic	1.2	23.8	1.3	24.6	1.4	26.4	1.2	23.4	1.3	25.4	1.2	21.7	1.3	23.4
Hungary	1.5	19.3	2	25.3	2	24.7	1.8	24	1.4	18.1	1.1	11.6	1.1	15.3
Latvia	1.4	16.7	1.7	21.4	2.1	27.1	2.1	25.6	2.0	24.3	0.3	4.6	-1.6	-19.7
Lithuania	1.2	11.4	1.3	13.4	1.1	13.8	1.5	21.4	2.0	27.3	1.2	16.1	-0.1	-1.0
Russia	2.6	17.8	2.9	20.3	3.2	24.2	3.3	26.3	3.0	22.7	1.8	13.3	0.5	3.6
Ukraine	1.0	7.6	1.1	8.4	1.3	10.4	1.6	13.5	1.5	12.7	1.0	8.5	-3.3	-24.5
Poland	0.5	5.8	1.4	16.9	1.6	20.6	1.7	22.5	1.7	22.4	1.5	20.7	1.1	15.6

Note: The data covers the period of March-June depending on the country.

Source: IMF, GFSR, October, 2009.



Source: FSA



Note: the sample is represented by banks which are not limited by any individual segments of the economy;

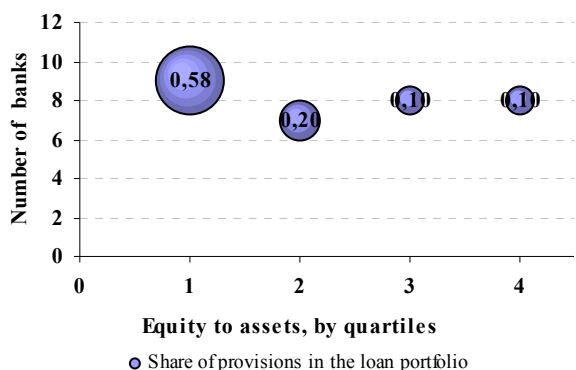
Source: FSA, NBRK calculations

Starting from 2007, the banks tried to partially compensate high credit risks and increase of the non-interest expenses by consistent increase of the interest margin and spread of profitability, which in 2009 varied within 3.06%-3.29%.(Figure 5.4.2).

At the same time limited funding and impossibility to increase interest rates in the situation of the falling inflation and requirements of the government program of financing urged the banks to optimize their operating expenses. The portion of the operating expenses in the banks' revenues averaged 34%, whereas the value of the spread<sup>45</sup> based on 9 months of 2009 varied within 0.08 and 0.21, (Figure 5.4.3). There is a noticeable correlation between the profitability spread and operating expenses, which together with the funding structure and credit risks are important factors of the resource costs at the market for the end borrowers.

<sup>45</sup> A spread is calculated as a difference between loan and deposit interest rates. Interest rates on loans are calculated by dividing the interest income on loans for a period by an average lending position for the same period. The interest rates on deposits are calculated by dividing the accrued interest costs on deposits for a period by an average position on deposits for the same period. Credits and deposits between banks are excluded.

**Figure 5.4.4**  
**Distribution of Burden on Provisioning and Its Impact on Capitalization, as of 01.10.2009**



Note: Banks based on capitalization to assets are distributed as follows:

The 1<sup>st</sup> group - up to 0,10    The 3<sup>rd</sup> group- from 0,19 to 0,40  
 The 2<sup>nd</sup> group -from 0,10 to 0,19    The 4<sup>th</sup> group - over 0,40

Source: FSA, NBRK calculations

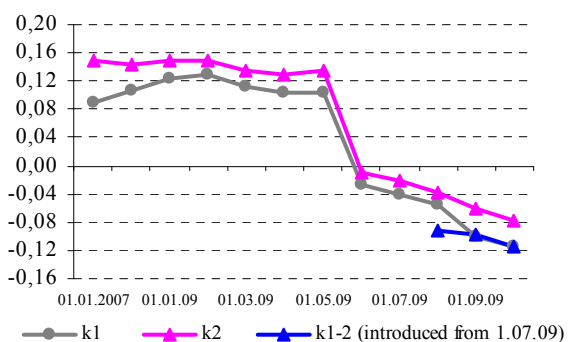
evaluation of the influence of extreme but possible events on the capital adequacy of the banking system (results of stress-tests).

On the whole, noticeably reduced credit activity of the banks and deterioration of the loan portfolio quality in 2009 ensured the pressure of the created specific provisions and, in turn, bank losses on the capital - the banks with higher level of provisions in the credit portfolio had the lowest capital adequacy ratio (Figure 5.4.4).

As a result the total equity (rated) of the Kazakh banks as of 01.10.2009 represented a negative value. Excluding BTA Bank and Alliance Bank, which as of 01.10.09 were undergoing the restructuring process, the capital adequacy ratios in the banking sector remain acceptable from the financial regulator's point of view (Figure 5.4.5).

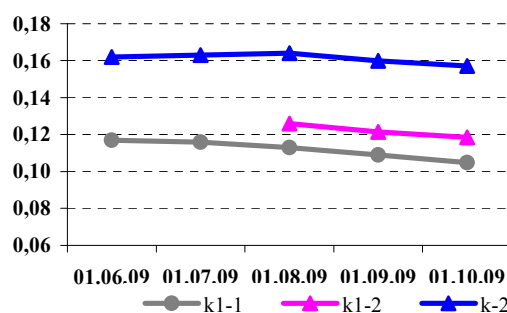
Boxes 7 and 8 represent additional comprehensive analysis of all risk factors and

**Capital Adequacy Ratios**



Source: FSA

**Figure 5.4.5**  
**Capital Adequacy Ratios (excluding 2 Banks)**



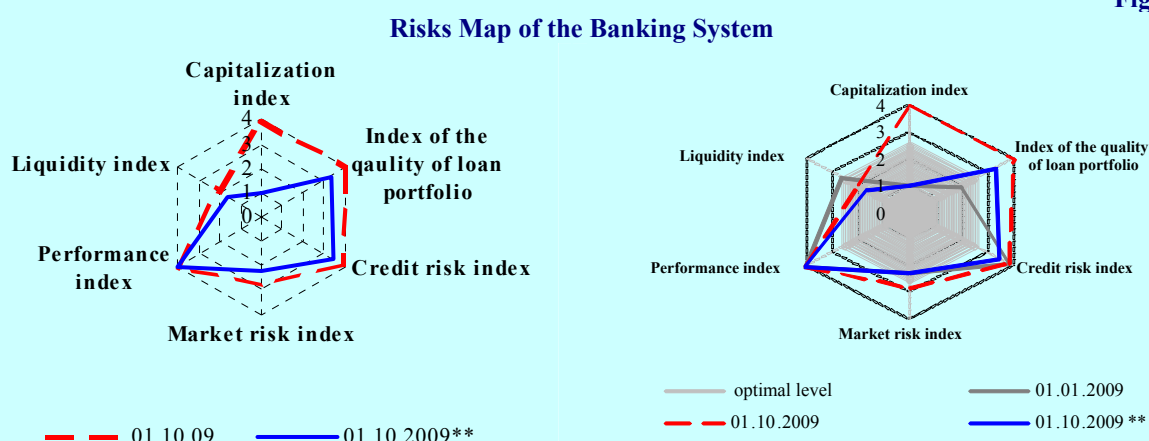
Note: excluding BTA Bank and Alliance Bank  
 Source: FSA

### Evaluation of the Stability of the Banking System Based on the Aggregate Financial Stability Index (AFSI)\*

The AIFS value at the beginning of 2009 was 2.60, which characterized the situation of the banking system as satisfactory with extremely high level of risks. But the increase of internal risks due to the continuing deterioration of the general economic environment, devaluation of the national currency and declared in the 2<sup>nd</sup> quarter of the current year suspension of recurrent payments on foreign debts by two banks and their subsequent restructuring, had a major impact on the evaluation of the financial situation of the banking system.

The AIFS indicator increased from 2.60 at the beginning of 2009 up to 3.43 as of 01.10.2009. This allows assessing the position of the banking system as unstable according to the existing classification. Occupying the borderline position and being the most sensitive to the value of the aggregate index are capitalization level (4.00), credit portfolio quality (4.00), and performance (4.00). This is caused by the progressing reduction of the banks' credit portfolio quality and increase of the provisions levels. At the same time the value of this index without the data of two banks, whose foreign debts are being restructured from 01.10.2009, was 2.59, which allows evaluating the position of the banking system as satisfactory (with extremely high risk levels), at the adequate value of capitalization index equal of 1.00, liquidity index equal of 1.67 and the market risk equal of 2.20. (Figure 1). At the same time high level of credit risk and low credit portfolio quality remain the weak points.

Figure 1



Data of the classification of the banks by their financial stability show a relatively stable situation for the overwhelming majority of the banks. According to this classification a significant number of the banks (27) have the index value between 1.5 and 2.5 (that is within the optimal level of financial stability), though their number fell from 31 at the beginning of 2009. The position of five banks is classified as satisfactory with the extremely high risk levels (Table 1).

Table 1

#### Aggregated Index of Financial Stability on Banks

Evaluation of Financial Stability	Stable	Normal (moderate risk level)	Satisfactory (tendency for increase of risks)	Satisfactory (with extremely high risk levels)	Unstable	Critical
AFSI Value	from 1 to 1.5	From 1.5 to 2	from 2 to 2.5	from 2.5 to 3	from 3 to 3.5	above 3.5
	number of banks					
01.04.2008	4	17	10	4	0	0
01.07.2008	4	13	14	4	0	0
01.10.2008	3	16	12	5	0	0
01.01.2009	2	18	13	2	1	0
01.04.2009	5	18	6	5	3	0
01.07.2009	5	17	8	4	3	0
01.10.2009***	2	14	13	5	0	0

Source: FSA

\* The methodology of calculating the AIFS was offered by the FSA in its Report on Financial Stability for 2008.

\*\* The data without 2 banks, which are in the process of restructuring at present.

\*\*\*Without 3 banks (2 are in the process of restructuring and 1 is reorganized due to the changes of its organizational and legal status.)

### Results of Stress Testing of the Banking System as of 01.10.09

In order to test the banking system for stability the FSA periodically implements sensitivity analysis, which defines the maximum influence of the negative factors on the banking sector. The following factors are taken into consideration: foreign exchange rate, real estate prices and deterioration of the loan portfolio quality.

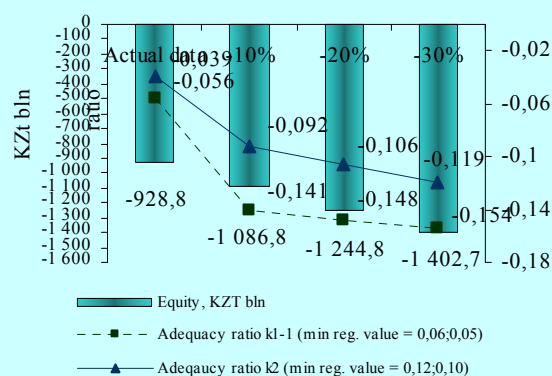
Stress testing was done on the whole of the banking system and excluding three banks – the JSC “BTA Bank”, the JSC “Alliance Bank” and a subsidiary of the JSC “BTA Bank” the JSC “TEMIRBANK” (these banks have violated the capital adequacy ratios at the date of the review).

#### Scenario of Changing the Foreign Exchange Rate

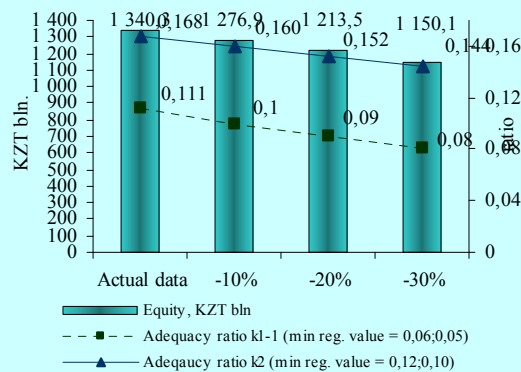
In the structure of foreign currency claims and liabilities of the banks the largest unit weight belongs to the claims and liabilities in the USD. As of 01.10.2009 the shares of these indicators were 84.2% and 80.7% respectively. Due to this, the stress testing was done on the basis of the open FX position of the USD.

Figure 1

Stress-testing as of October 1, 2009 (Devaluation of Tenge against USD) on All Banks



Stress-testing as of October 1, 2009 (Devaluation of Tenge against USD) Excluding 3 Banks

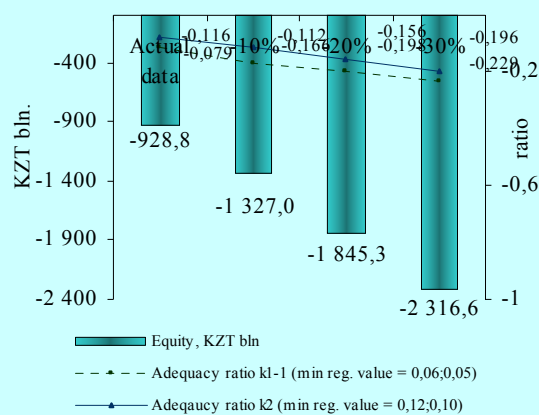


Source: FSA

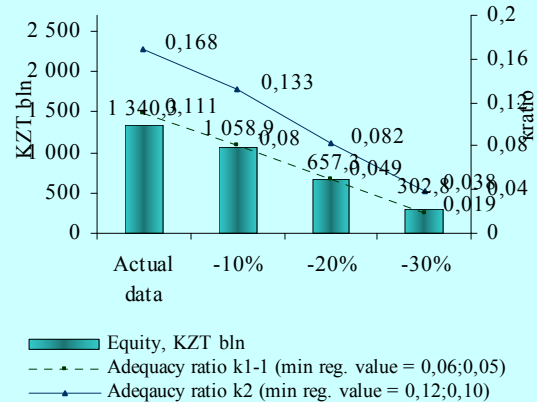
The scenarios under consideration analyzed 10%, 20% and 30% increase of the foreign exchange rate of the KZT/USD. If on 01.10.2009 the foreign exchange rate of the KZT/USD was 150.95, then the scenarios implied its increase up to 166.0, 181.1 and 196.2. In addition to this, due to the changes of the credit risk, the provisions increased by 20% from the difference between the actual amount of assets and the amount received as the result of calculations.

Figure 2

Stress-testing as of October 1, 2009 (Impairment of Real Estate) on All Banks



Stress-testing as of October 1, 2009 (Impairment of Real Estate) Excluding 3 Banks



Source: FSA

The results of stress testing showed that the increase of the foreign exchange rate of the USD by 10% of the capital adequacy ratios will be fulfilled by all the banks (excluding three banks). In case of increasing the foreign exchange rate by 20%, the  $\kappa_2$  ratio will be violated additionally by 1 bank, by 30%,

the  $\kappa 1$  ratio is violated additionally by 3 banks.

### Scenario of Changing Real Estate Prices

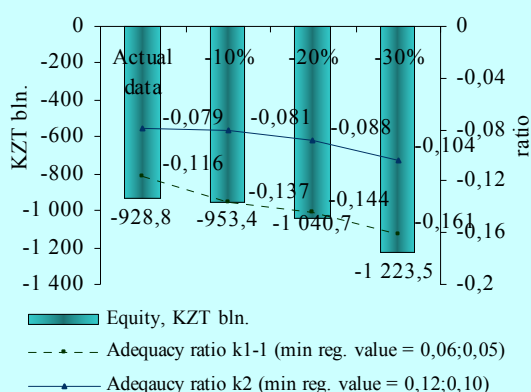
When evaluating the financial situation of the banking sector, the considered scenario assumed real estate devaluation by 10-30%. The calculation took into consideration mortgages (secured by the real estate), which as of 1.10.2009 comprised 39.3% of the total loan portfolio of the banks. In case of devaluation of the real estate on mortgages by certain percent, banks are assumed to add provisions in the amount of devaluation.

As the result of devaluation of real estate by 10-30% on mortgage loans secured by the real estate will have a significant impact on the financial condition of the banking sector. Violation of the capital adequacy ratios at the time of real estate devaluation by 10% was registered in 4 banks, by 20% - in 8 banks, by 30% – in 11 banks (excluding 3 banks).

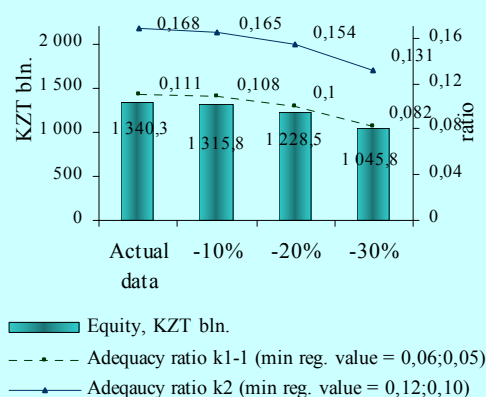
### Scenario of the Loan Portfolio Quality Deterioration by the Sectors of Economy

Based on the credit structure of the economy and the share of bad loans in each sector of the economy, the stress-testing was done in construction, trade and industry. When conducting a stress-test, the loan provision in a corresponding sector of economy was increased by 10 – 30%. The most significant impact on the change of the equity of the banking sector is made by deterioration of the loan quality in the trade sector.

**Stress-testing as of October 1, 2009 (Deterioration in Quality of Loans to Construction Sector, Trade and Industry) on All Banks**



**Figure 3  
Stress-testing as of October 1, 2009 (Deterioration in Quality of Loans to Construction Sector, Trade and Industry) Excluding 3 Banks**



Source: FSA

It is important to point out, that deterioration of the loan portfolio separately in industry and construction will not influence significantly the financial condition of the banks, the capital adequacy ratios will not be violated by these banks (excluding 3 banks). In the trade sector with the increase of the provisions by 20%, the violation of the ratio was registered in 2 banks, and by 30% - in 4 banks.

At the same time in the scenario of simultaneous increase of the provisions in the loan portfolios of construction, trade and industry in the banking sector (3 banks are excluded from this statistics) up to 10 percentage points, there were no violations of the capital adequacy ratios, with the increase up to 20 percentage points, there were violations of the capital adequacy ratios in 5 banks, and up to 30 percentage points – in 9 banks.

On the whole, in view of the continuing impact of the crisis on the world economy and devaluation of the Tenge in February 2009, conducting stress testing proved that the situation of the banking system significantly deteriorated as compared with the same period of 2008. At the same time, taking into consideration the restructuring of foreign debts in 2 major banks, the results, shown above, can not be compared with the results of stress tests of the previous years.



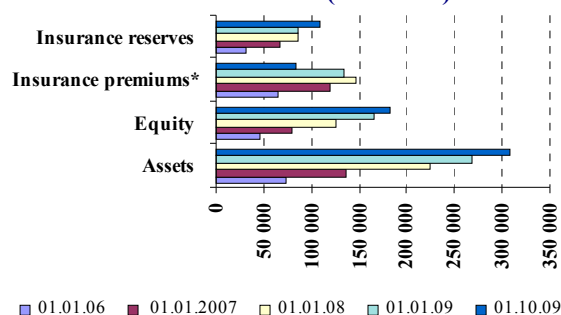
## 6. Other Financial Institutions

### 6.1 Insurance Sector

*Recession in the economy has slowed down a little the growth rate of key indicators in this financial sector segment; however, its dynamics still remains positive. Lower sensitivity of the insurance sector to macroeconomic shocks is explained by a stable growth in premiums written in obligatory types of insurance; high capitalization level achieved in previous years; conservative investment policy and much less aggressive growth rates of development in comparison with other segments of the financial sector.*

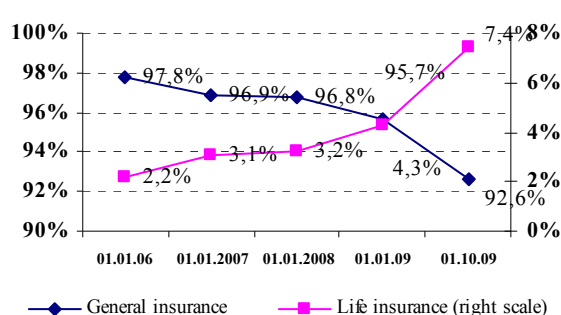
*Current recessionary phenomena have also contributed to certain adjustment of the size of market of “captive” insurance services and preservation of moderate concentration level in the insurance sector, which provide conditions for its qualitative and effective growth in perspective.*

**Figure 6.1.1**  
Key Indicators of Insurance Market of the Republic of Kazakhstan (KZT mln)



Note: \* insurance premiums written under insurance contracts  
Source: FSA

**Figure 6.1.2**  
Distribution of Insurance Premiums by Types of Insurance



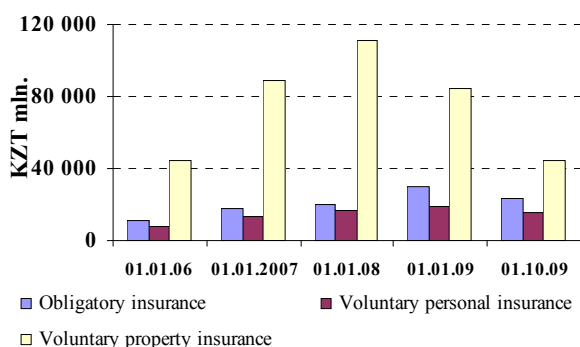
Source: FSA

Worsening of general economic conditions and problems in the banking system have caused certain slowdown in the rates of the insurance sector growth. Thus, the total assets of the insurance organizations increased by 9.1% for the period from the 4<sup>th</sup> quarter of 2008 till 3<sup>rd</sup> quarter of 2009 and amounted to KZT 307.2 bln. as compared to the assets available as of 1 October 2009. The total equity, having increased by 12.5% since last October, amounted to KZT 182.3 bln. in absolute terms. Insurance reserves were KZT 109.2 bln., which is more by 12.5% than the amount of reserves formed as of 1 October 2008. Cutback in the real economy lending by the banks had extremely negative impact on the amount of the insurance premiums written, which dropped by KZT 25 bln. or 23% on tear-on-year basis (Figure 6.1.1).

In the pattern of the insurance premium distribution among different types of insurance certain increase has been noted in the share of insurance premiums in the life insurance segment; however, the share of this type of insurance in the insurance market structure still remains insignificant (7.4% as at the end of 3<sup>rd</sup> quarter) (Figure 6.1.2).

The amount of premiums for voluntary property insurance has decreased due to significant cutback in the bank lending, and, accordingly, drop in premiums for insurance policies against other financial losses, though in pre-crisis period this type of insurance demonstrated high rates of growth. At the same time, one can observe the low sensitivity of the obligatory insurance and personal insurance segments to unfavorable economic conditions; these segments have demonstrated growth at the account of expansion of the obligatory insurance and increase of the insurance rates (Figure 6.1.3). A great reduction in insurance payouts had taken place as well. In such a case, one can observe the largest decrease of the voluntary property insurance segment in the structure of total insurance payouts (by 82.7%, from KZT 38.7 bln. as of 01.01.2009 to KZT 6.7 bln. as of 01.10.2009) (Figure 6.1.4).

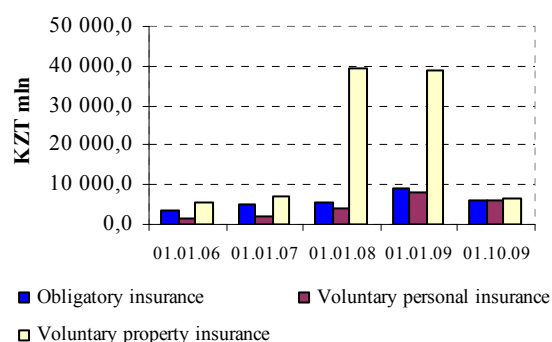
**Figure 6.1.3**  
**Structure of Insurance Premiums Written\***



Note: \* insurance premiums written under insurance and reinsurance contracts

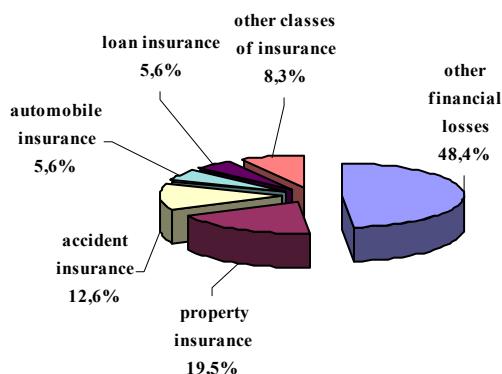
Source: FSA

**Figure 6.1.4**  
**Structure of Insurance Payouts**



Source: AFN

**Figure 6.1.5**  
**Distribution of Insurance Premiums under Banking Risk Insurance Contracts with Breakdown for Classes of Insurance**



Source: FSA

Risks associated with banking operations are covered by insurance policies against other financial risks; property insurance (except for insurance of transport and cargo); insurance of motor vehicles; third party liability insurance (except for automobile third party liability insurance); insurance of loans, guarantees and sureties. In such a case insurance against other financial losses accounts for a major portion (48.4%), and is followed by the property insurance (19.5%) and accident insurance (12.6%) (Figure 6.1.5).

The total amount of the insurance premiums for banking insurance has dropped by KZT 5.8 bln. or 44.6% on year-on-year basis.

Worsening of the financial condition of the banks and bank conglomerates against the background of financial instability has resulted in decrease of the captive insurance level that stayed high in the pre-crisis period (Table 6.1.1).

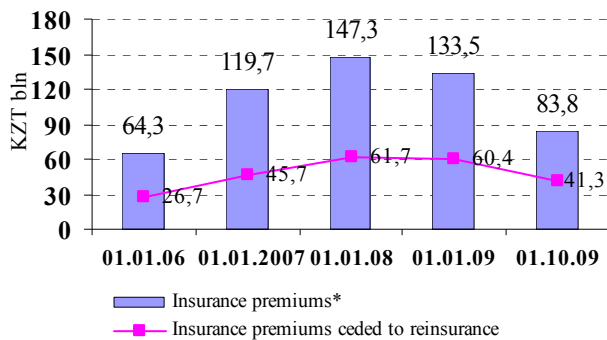
**Table 6.1.1**

**Concentration of Insurance Companies, in which Banks are Large Participants (%)**

	Share of assets of insurance (reinsurance) companies, wherein banks are large participants, in total assets of insurance sector, %	Share of premiums of insurance (reinsurance) companies, wherein banks are large participants, in total insurance premiums, %
01.01.2006	70.3	64.8
01.01.2007	67.5	58.3
01.01.2008	62.5	59.7
01.10.2008	57.0	53.2
01.01.2009	35.7	43.9
01.04.2009	32.2	30.7
01.07.2009	30.9	30.4
01.10.2009	31.5	31.1

Source: FSA

**Figure 6.1.6**  
**Amount of Insurance Premiums Written and Ceded to Reinsurance**

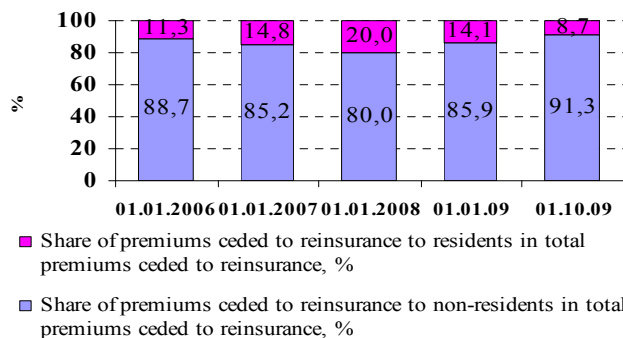


Note: \* insurance premiums under insurance and reinsurance contracts

Source: FSA

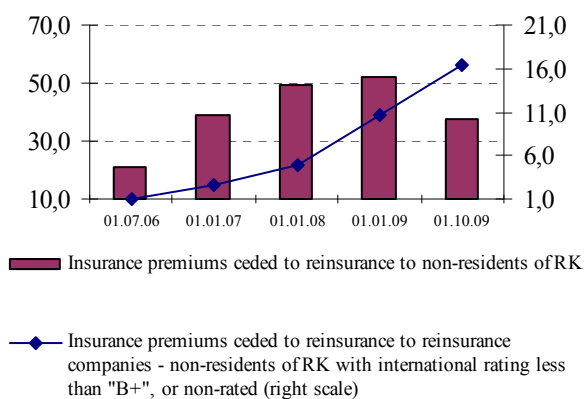
Despite the general trend towards decrease of reinsurance cover, still observed is growth in

**Figure 6.1.7**  
**Insurance premiums ceded to reinsurance**



Source: FSA

**Figure 6.1.8**  
**“Non-rated” External Reinsurance (KZT bln.)**

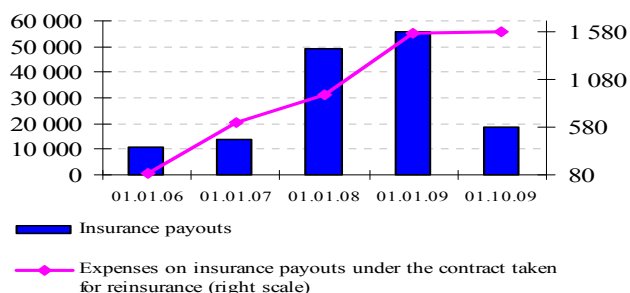


Source: FSA

The amount of insurance premiums ceded to reinsurance as of 1 October 2009 dropped by 21.5% as compared to one as of 1 October 2008 and equaled to KZT 41.3 bln. (49.3% of the total amount of insurance premiums written). One cannot but note a large portion of premiums ceded to reinsurance to non-residents – 91.3% of the total amount of premiums ceded. (Figures 6.1.6 - 6.1.7). In the pattern of premiums ceded to reinsurance to non-residents the Russian Federation accounts for a major part – 52.1% (34.6% as of 1 January 2009) and is followed by Great Britain - 17.8% (15.9% as of 1 January 2009).

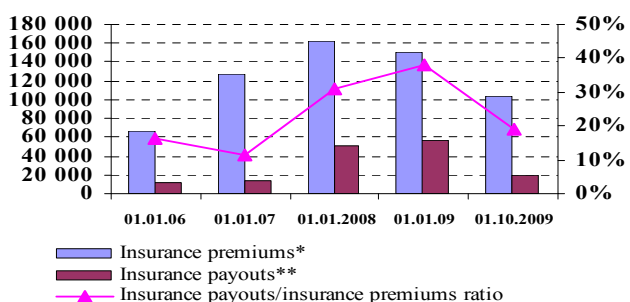
Despite the general trend towards decrease of reinsurance cover, still observed is growth in the share of “non-rated” external reinsurance (i.e. reinsurance of risks with reinsurers that do not have the regulatory required credit rating). Thus, the amount of insurance premiums ceded to non-resident reinsurers having international rating below “B+”, or non-rated has increased by 1.5 times from the beginning of the current year, which contributed to growth of the “non-rated” external reinsurance in the total share of external reinsurance up to 43.5% (as of the beginning of current year this indicator was 20.7%). This fact is explained, to a large extent, by general lowering of ratings of the international financial institutions, including reinsurance companies, as a result of the risk re-assessment (Figure 6.1.8). In turn, a slight growth of 8.6% is observed in reinsurance payouts as of 1 October 2009 (2.1% in the same period of 2008) due to materialization of the insurers’ risks associated with instability (Figure 6.1.9).

**Figure 6.1.9**  
**Amount of Insurance Indemnities Paid, Including those under Contracts Taken for Reinsurance (KZT mln.)**



Source: FSA

**Figure 6.1.10**  
**Insurance Payouts/Insurance Premium Ratio in Insurance Market**

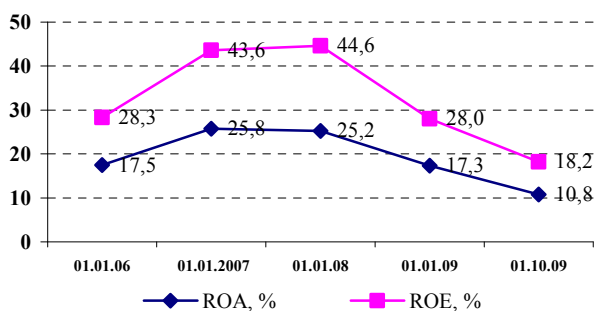


Notes: \*insurance premiums written under insurance and reinsurance contracts

\*\*payouts under insurance and reinsurance contracts

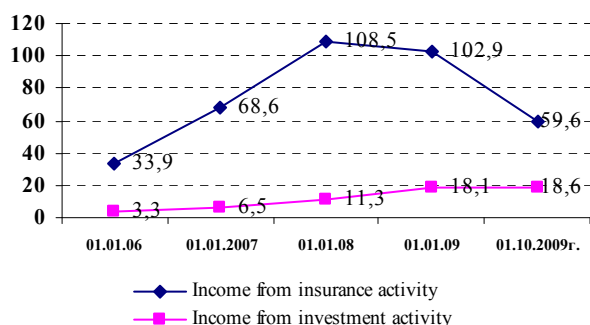
Source: FSA

**Figure 6.1.11**  
**Return on Assets and Return on Capital**



Source: FSA

**Figure 6.1.12**  
**Income from Insurance and Investment Activities (KZT bln)**



Source: FSA

Rates of decrease in the insurance indemnities paid were much higher than those in the insurance premiums written. Thus, the ration of insurance indemnities paid to insurance premiums written in the insurance market has dropped from 38.3% to 19.3% for nine months of the current year: in relative terms the insurance payouts have decreased by 65.1% from the beginning of the year, while insurance premiums have decreased by 30.6% only (Figure 6.1.10)

Loss ratios for different types of insurance as of the end of the third quarter of the current year are practically at the same level and range from 40.4% for obligatory insurance to 42.0% for voluntary personal insurance. In this case, the loss ratios for the obligatory insurance and voluntary personal insurance have decreased insignificantly from the beginning of the period, while the loss ratio for the voluntary property insurance has increased from 16.8% to 40.7%, which is explained by shrinking of the amount of premiums for this type of insurance and materialization of the risks due to worsening of general economic environment in the country.

Against the background of decrease in the insurance premiums written, still preserved is dynamics in decrease of the net profit of the insurance companies, which has dropped by 28.1% from the beginning of the year and amounted to KZT 30.1 bln. as of the end of the 3<sup>rd</sup> quarter of 2009. Return on capital and return on assets of the insurance companies were 18.2% and 10.8%, respectively, as of 1 October 2009.

Sufficiently high return of the insurance companies is due to low susceptibility of their financial condition to external and internal factors because of small share of income generated from the investing activity and appropriate adjustment of the investment policy under current circumstances (Figure 6.1.11). Thus, the operating income has dropped by 42%, while the investment income has demonstrated a minor growth (Figure 6.1.12).

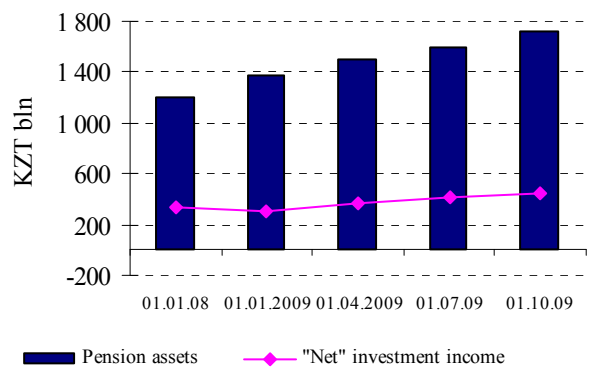
Portfolio composition of the insurance companies evidences that the

insurance companies pursue a conservative investment policy. Thus, deposits in the banks and investments in non-state securities of the RK issuers still prevail in the investment portfolios of the insurance companies. At that a share of deposits in the banks has dropped from 39.9% to 34.2% as compared to the beginning of the year, while a share of investments in the RK securities has increased from 9.6% to 18.3%.

**6.2 Accumulation Pension System**

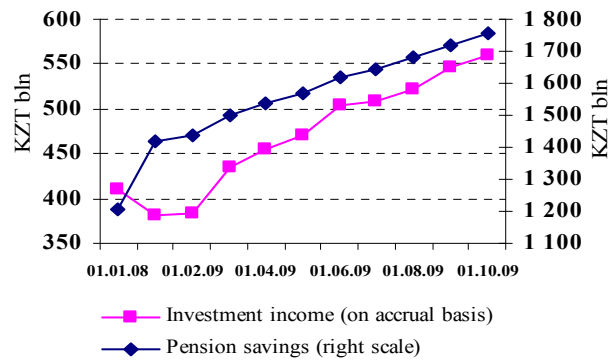
*Unfavorable general economic situation has caused change in the investment policy and strategy of the accumulation pension funds towards higher risk mitigation and increased share of low-risk instruments in the investment portfolios. Moreover, a set of the regulator’s measures aimed at safeguarding of pension savings has served as an additional incentive for risk mitigation.*

**Figure 6.2.1**  
**Dynamics in Changes of Invested Pension Assets and “Net” Investment Income**



Source: FSA

**Figure 6.2.2**  
**APF Pension Accumulations and Investment Income**



Source: FSA

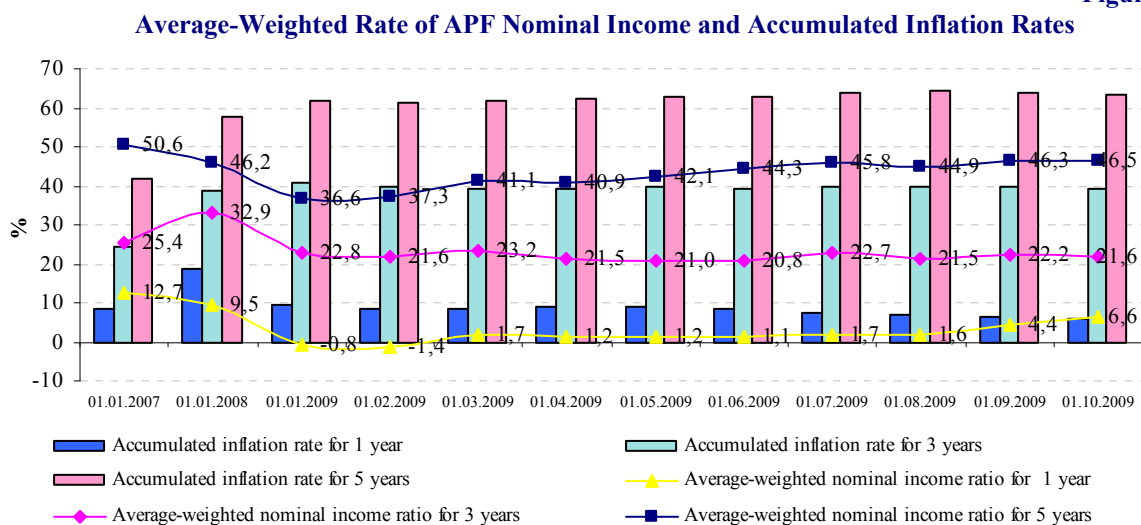
14 accumulation pension funds were operating in Kazakhstan as of 1 October 2009. Pension assets increased by 27.3% during the period from October 2008 till September 2009 and amounted to KZT 1,754.4 bln.. Pension savings/GDP ratio increased by 1.8% as compared to last October and amounted to 11% as of the end of September of this year. APF assets have been growing primarily at the expense of monthly pension contributions (Figure 6.2.1).

Starting February this year, a positive trend has been observed in the dynamics of APF investment income, which resulted in increase of the share of “net” investment income in the total amount of pension savings of the contributors (recipients) from 21.6% beginning of the year till 25.8% as of 1 October 2009. In this case, a sharp increase of the “net” investment income by KZT 43.1 bln.(14.0%) during February 2009 has been due to revaluation of financial instruments denominated in foreign currency (Figure 6.2.2).

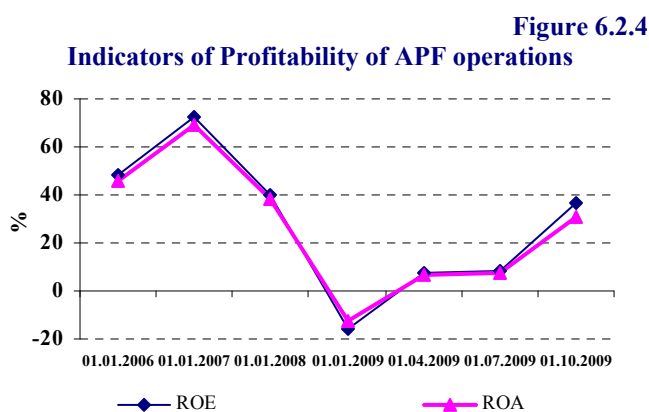
The average-weighted rates of nominal income on APF pension assets started to stabilize after devaluation of the national

currency in this February. As of 1 October 2009, the average-weighted rate of nominal income for the year exceeded the accumulated inflation rates per year by 1.1 times, while the accumulated inflation rates for 3 years and 5 years exceeded the average-weighted rates of nominal income for the same period by 1.8 times and 1.4 times, respectively (Figures 6.2.3 – 6.2.4).

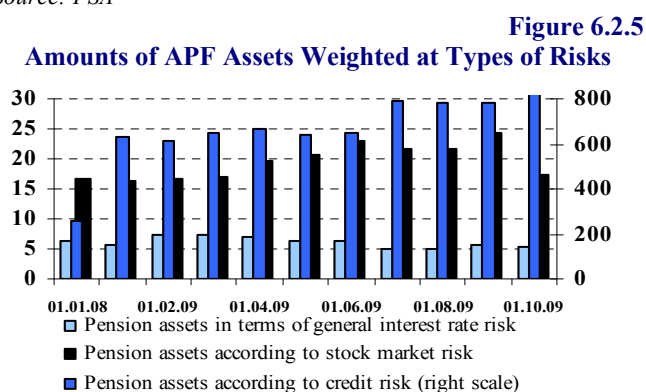
Figure 6.2.3



Source: FSA



Source: FSA



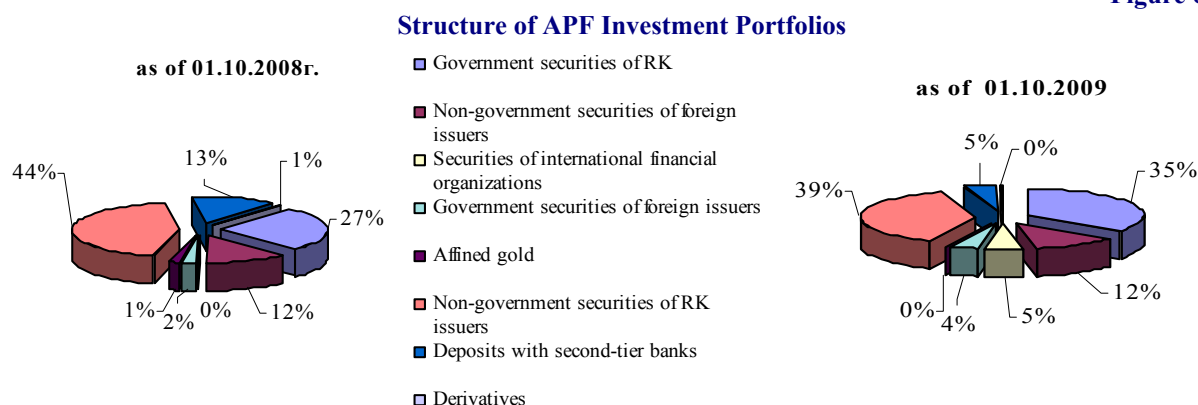
Source: FSA

Significant increase in the APF credit risk-weighted assets observed starting the beginning of the second half of this year has been due to growth in the number of defaults in servicing of liabilities in the corporate debt securities market, while reduction in the amount of APF assets weighted at the stock market risk has been stipulated by certain stabilization of situation both in the global markets and domestic stock market (Figure 6.2.5).

Structural changes in the investment portfolios of pension funds as of 1 October 2009 have been oriented at increase of a share of low-risk financial instruments in the portfolios, such as securities of foreign issuers and securities issued by international financial organizations, and reduction of a share of investments in non-state securities issued (Figure 6.2.6).



Figure 6.2.6



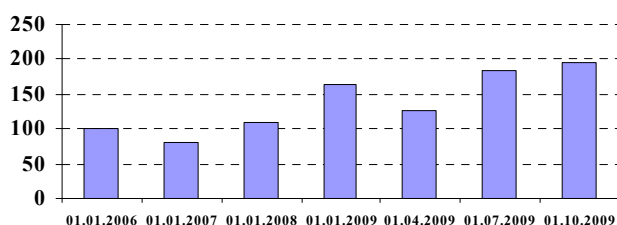
Source: FSA

### 6.3 Financial Situation of Non-Banking Organizations

*Due to objective macroeconomic reasons the operations of the non-banking sector in 2009 have been characterized, in general, by low return and impairment of the asset quality. Moreover, withdrawal of the non-banking organizations with state participation out of financial regulation has resulted in decrease of a share of loans extended to the non-banking organizations in the structure of assets.*

#### Organizations engaged in certain types of banking operations

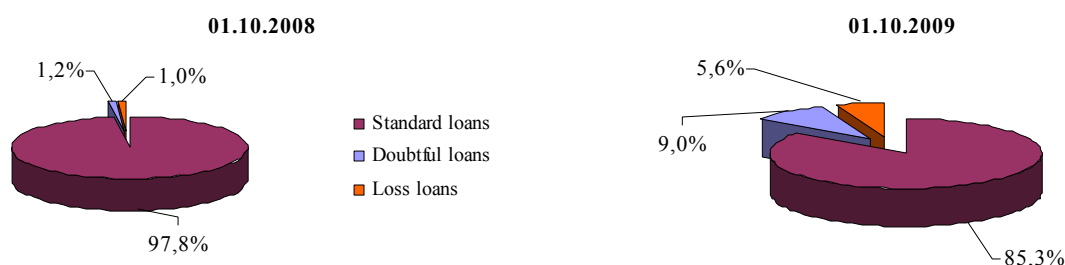
**Figure 6.3.1**  
Loans Extended by Organizations Engaged in Certain Types of Banking Operations to Legal Entities and Individuals (KZT bln.)



Source: FSA

From the beginning of this year the loans extended by the organizations engaged in certain types of banking operations have grown by 20.6% or KZT 33.4 bln. and amounted to KZT 195.8 bln. as at the end of the 3<sup>rd</sup> quarter (Figure 6.3.1). Lending profile of the non-banking organizations in the current year has been characterized by significant drop in the share of loans extended to financial organizations, which has been stipulated, in a greater degree, by withdrawal of a large

**Figure 6.3.2**  
Quality of Loan Portfolio of Organizations Engaged in Certain Types of Banking Operations

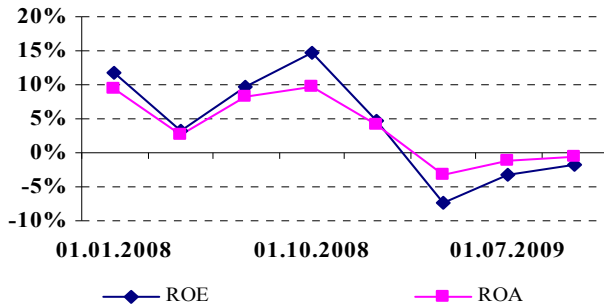


Source: FSA

number of non-banking organizations with state participation out of financial regulation. A share of loans granted to individuals has also decreased by more than 3 times up to 10.3%, which decrease has been stipulated by conservatism still preserved against the background of worsened economic

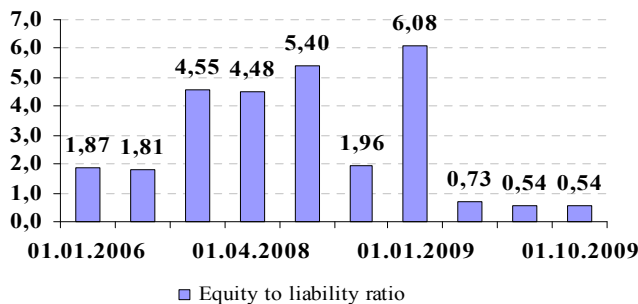
conditions. Similar to the banking sector, impairment of the loan portfolio quality has been observed in the segment of organizations engaged in certain types of banking operations. Thus, within the period from October 2008 till September 2009 a share of loss loans increased from 1.0% to 6.0% and a share of doubtful loans increased from 1.2% to 9.0% (Figure 6.3.2).

**Figure 6.3.3**  
**Rates of Return of Organizations Engaged in Certain Types of Banking Operations**



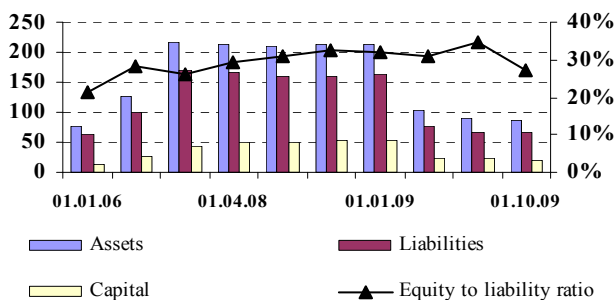
Source: FSA

**Figure 6.3.4**  
**Financial Solvency Risks of Non-banking Organizations**



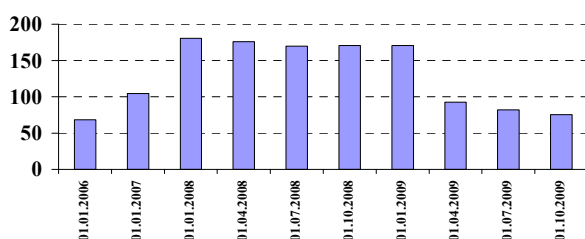
Source: FSA

**Figure 6.3.5**  
**Data on Assets, Liabilities and Equity of Mortgage Companies (KZT bln)**



Source: FSA

**Figure 6.3.6**  
**Dynamics in Loan Portfolios of Mortgage Companies (KZT bln)**



Source: FSA

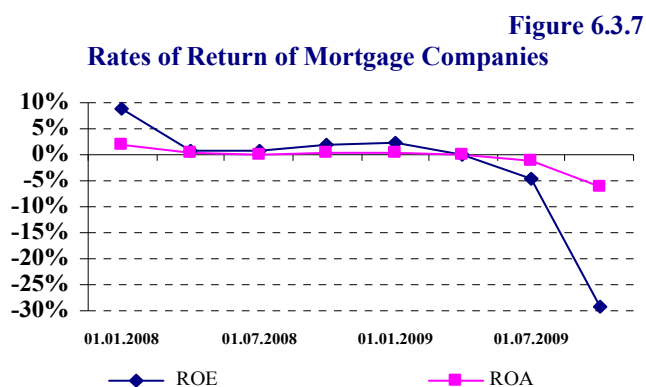
Starting from the 2<sup>nd</sup> quarter of this year the rates of return of the non-banking organizations have demonstrated a negative result; however, their dynamics bears evidence of the gradual recovery trend (Figure 6.3.3).

Degree of cover (equity/liabilities of the non-banking organizations ratio) at the end of the 3<sup>rd</sup> quarter of current year amounted to 0.54 as against 1.96 as of 1 October 2008 (Figure 6.3.4).

### Mortgage Companies

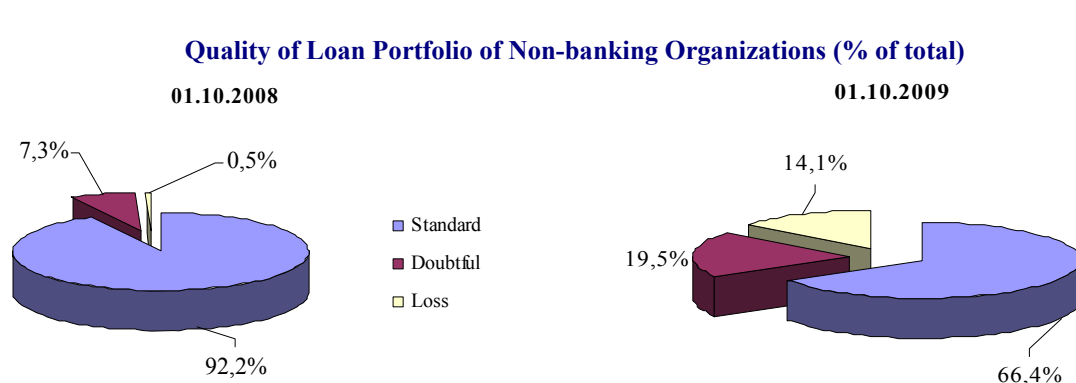
From the beginning of this year the dynamics of assets and liabilities of the mortgage companies has demonstrated reduction thereof by 59.9% and 58.3%, respectively. Equity of mortgage companies for the period under review decreased by 64.8%; at that the level of capital cover of the mortgage companies has been decreasing starting from the second half of this year (Figure 6.3.5). Loan portfolio of the mortgage companies from the beginning of this year has shrunk from KZT 170.4 bln. to KZT 75.4 bln. (55.8%) (Figure 6.3.6).

Profitability of mortgage companies in the current year has kept decreasing under the negative impact caused by significant impairment of the loan portfolio quality in conditions when credit risks and currency risks remain rather high (Figure 6.3.7).



Source: FSA

Quality of the loan portfolios of mortgage companies has suffered significant changes. Starting last October a share of loss loans in the structure of loan portfolios of mortgage companies has increased from 0.5% to 14.1%, while a share of doubtful loans has grown from 7.3% to 19.5% (Figure 6.3.8).



Source: FSA

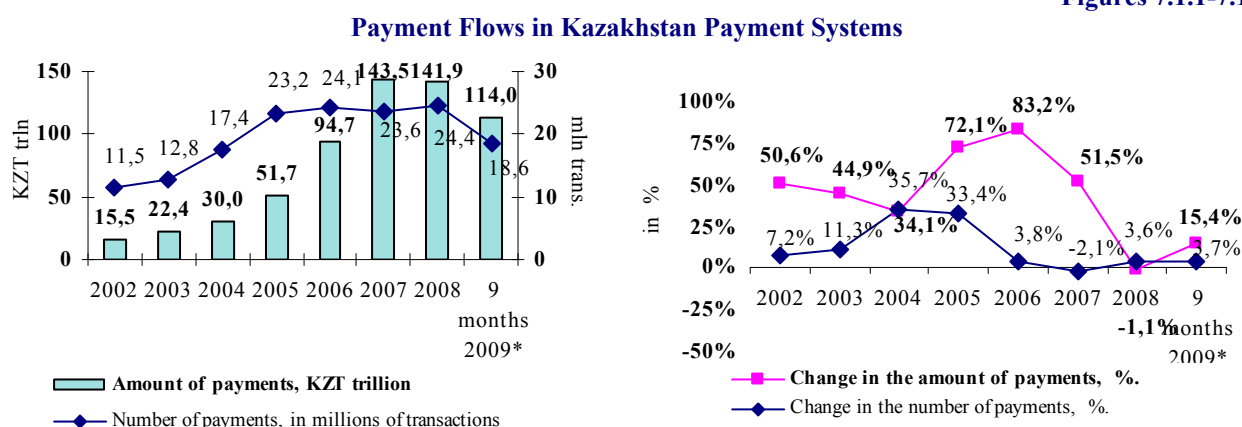
## 7. Payment Systems

*As a part of measures affected for stabilization of Kazakhstan's economy, one of the major remaining objectives is to maintain sustainable and effective operation of payments systems. Measures taken by the Government to support the banks made possible to mitigate the liquidity problems in the banking sector and promoted the growth of amounts of payments in Kazakhstan payment systems.*

### 7.1 Development of Payment Systems in Kazakhstan

In general, 2009 has witnessed the increase in a number and amounts of payments in Kazakhstan payment systems (Figures 7.1.1.-7.1.2). 18.6 mln. transactions for KZT 114.0 trln. were made through Kazakhstan's payment systems for 9 months of 2009. A number of payments in the payment systems increased by 3.7% (or 668.5 ths. transactions) on year-on-year basis, while the amount of payments increased by 15.4% (KZT 15.2 trln.).

Figures 7.1.1-7.1.2



In the Interbank System of Money Transfer (ISMT), a systemically significant payment system of Kazakhstan, for 9 months of 2009 there were made 98.3% of the total amount of non-cash payments in Kazakhstan and 38.6% of the total number of transactions (7.2 mln. transactions for the amount of KZT 112.0 trln.), which gives evidence that ISMT has fulfilled its mission – to make the largest and high-priority payments.

The Interbank Clearing System (ICS) has processed more than a half of all non-cash payments in Kazakhstan – 61.4% and 1.7% of its total amount (11.4 mln. documents for the amount of KZT 1,934.2 bln.), which also demonstrates that ICS has fulfilled its mission – to make a large amount of retail payments for small amounts.

Financial sector transactions account for the major volume of payments in Kazakhstan payment systems: these include trading of securities and bills issued by residents of the Republic of Kazakhstan (42.6% of the total volume of payments); inter-bank deposits and transfers of the banks' own funds and funds of their customers (28.3%) and foreign currency transactions (11.9%).

One should note that the financial sector entities demonstrate the highest activity in transfers/withdrawals of funds placed on the deposit accounts with the banks.

Thus, the volume of transactions related to transfer of inter-bank deposits, banks' own funds and funds of their customers for 9 months of 2009 has increased by KZT 13.3 trln. (or 70.1%) on year-on-year basis.

In this case the volumes of payments for goods and services for 9 months 2009 have amounted to 7.5% of the total amount of payments in Kazakhstan, having decreased by 7.5% on the year-on-year basis (Table 7.1.1).

**Table 7.1.1**

**Volumes of Payments by Types of Payment Purposes**

Indicator	9 months of 2008		9 months of 2009		Change	
	KZT bln	% to total volume	KZT bln	% to total volume	KZT bln	%
Transactions with foreign currency and precious metals	19 656,9	19,9%	13 542,2	11,9%	-6 114,7	-31,1%
Deposits	18 998,3	19,2%	32 307,1	28,3%	13 308,8	70,1%
Borrowings	1 686,6	1,7%	1 145,1	1,0%	-541,5	-32,1%
Securities, bills and deposit certificates issued by non-residents of RK	572,3	0,6%	1 187,7	1,0%	615,4	107,5%
Securities and bills issued by residents of RK	39 896,3	40,4%	48 586,3	42,6%	8 690,0	21,8%
Goods and intangible assets	5 077,2	5,1%	4 252,3	3,7%	-824,9	-16,2%
Services	4 163,4	4,2%	4 292,2	3,8%	128,8	3,1%
Other payments <sup>46</sup>	8 710,2	8,8%	8 654,6	7,6%	-55,6	-0,6%
<b>Total</b>	<b>98 761,2</b>	<b>100,0%</b>	<b>113 967,3</b>	<b>100,0%</b>	<b>15 206,2</b>	<b>15,4%</b>

Source: NBRK

## 7.2 Liquidity Risk and System Risk

In 2009 the emphasis has been put on the issue, if the users of payment systems have adequate liquidity to meet the undertaken liabilities to make payments. With a view to manager the liquidity risk<sup>47</sup> and system risk<sup>48</sup>, which may influence significantly the country's financial system stability, the National Bank and users of the payment systems carry out monitoring and control of position of users in the systems on a regular basis.

To manage said risks ISMT uses mechanisms of queue management (which set priorities in execution of payment documents and change the priority of payment documents) and makes additional transfers of funds from a user's correspondent account to its position in the system.

In such a case, ensuring of compliance of the annual average liquidity ratio (MLR)<sup>49</sup> and money turnover ratio (MTR)<sup>50</sup> to the values, when the system risk is considered as minimal, promotes mitigation of default risks due to insufficient liquidity<sup>51</sup>. For 9 months of 2009 the average daily MLR in ISMT was 1.09 and MTR was 1.07 and no overrun of established limits was observed.

In whole, certain improved of situation with the users' liquidity in ISMT has been observed in 2009. Thus, for 9 months of 2009, the average daily liquidity volume of the system users (opening balance in ISMT<sup>52</sup>, at the account of which the users make payments) was as high as KZT 569.7 bln., having increased by 7.3% on the year-on-year basis (Figure 7.2.1). The share of the National Bank's opening balance of the total amount of the system liquidity equaled to 52.7%. The National Bank's funds excluded, the average daily amount of liquidity of certain system users for 9 months of 2009 was equal to KZT 269.7 bln. (57.6% of the average daily amount of turnover of

<sup>46</sup> Include pension payments and allowances, special-purpose transfers, payments to and out of budget.

<sup>47</sup> Liquidity risk is a payer's risk caused by its inability to fulfill the money transfer liabilities.

<sup>48</sup> System risk is a risk that a failure of one user of a payment system to meet its money transfer liabilities would entail failures of other user (users) of a payment system to fulfill their money transfer liabilities.

<sup>49</sup> Money Liquidity Ratio (MLR) is a ratio of the systems liquidity (opening balances of all users) to the sum of debit turnover in ISMT and rejected (recalled) payments in ISMT.

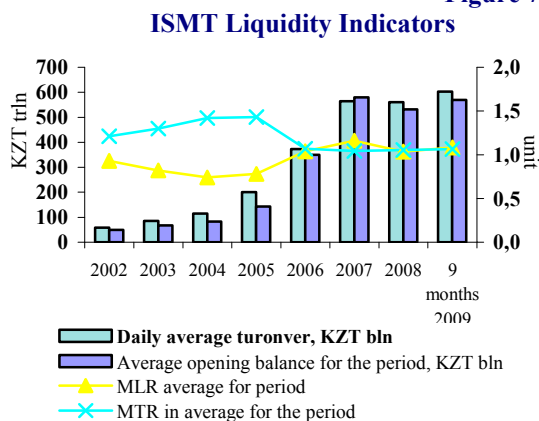
<sup>50</sup> Money Turnover Ratio (MTR) is a ratio of debit turnover in ISMT to the system liquidity.

<sup>51</sup> To manage the liquidity risk in the system the following margins for MLR and MTR limits have been set in the system: upper bound  $MLR > 1.5$  at  $MTR < 0.5$ , lower bound  $MLR < 0.5$  at  $MTR > 1.5$ .

<sup>52</sup> User's opening balance is a cash amount that a user transfers from its correspondent account to the position in the system.

said users). Therefore, about half of payments in the system are processed at the account of payments received from other users.

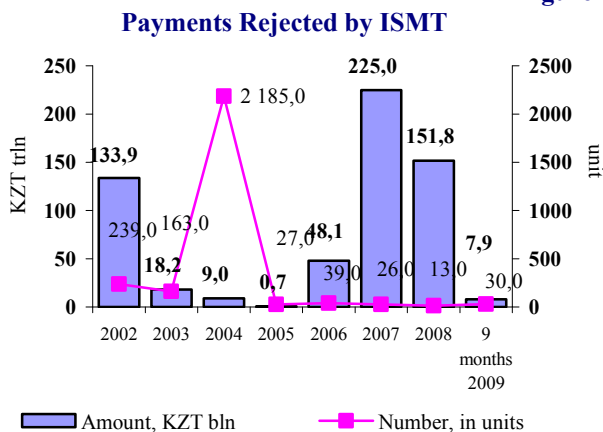
Figure 7.2.1



Source: NBRK

have been provided for and priorities of making payments depending of the types thereof have been set.

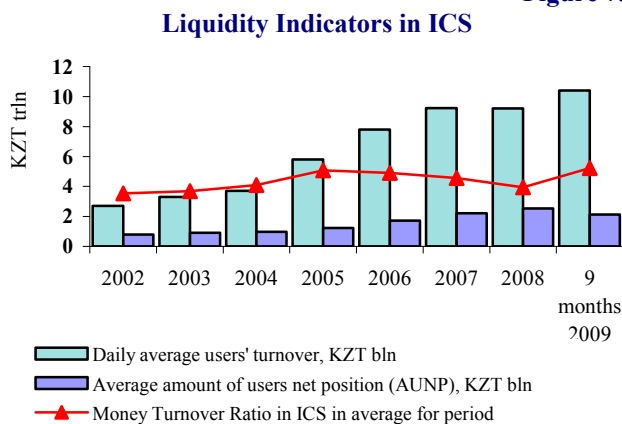
Figure 7.2.2



Source: NBRK

totally 13 payments for KZT 151.8 mln. were rejected due to lack of liquidity. All rejected or recalled payment documents were executed by ISMT users at the same day or again during the following business days.

Figure 7.2.3



Source: NBRK

7.2.3), while for the same period of 2008 this indicator was equal to 3.87. At that the average daily amount of the users' net position based on the clearing results amounted to KZT 2.1 bln. and

In addition, the daily analysis of payment documents that were in queue during the ISMT business day and were recalled by the users and rejected due to insufficient liquidity is performed also to manage liquidity risk and system risks. At that monitoring by the banks of payment documents priority promoted decrease in the amount of rejected payments. Thus, for 9 months of 2009, in ISMT 30 payments for KZT 7.9 bln. were rejected (recalled) due to insufficient liquidity (Figure 7.2.2), while in 2008

For the purpose of liquidity risk and system risk management, the Interbank Clearing System uses a mechanism of a queue "unwinding", when payment documents for the deficient amount having lower priority are annulled. In addition, MTR (money turnover ratio in ICS) is calculated, which shows how many times the payments in the system have been made at the expense of cash counterflow as well as analysis of the amount of the user's net position.

For 9 months of 2009 the average daily MTR amounted to 5.23 (Figure



decreased by 15% on year-on-year basis. A share of the user's net position amount to the sum of average daily turnover of the users in ISMT<sup>53</sup> is insignificant (0.4% for 9 months 2009), which promotes mitigation of liquidity risk when calculating the net positions through ISMT.

At the same time, for 9 months of 2009, in the Interbank Clearing System 1,057 payments documents for the amount of KZT 178.0 mln. were rejected due to insufficient liquidity.

### **7.3 Operating and Technical Risks**

Uninterrupted and reliable operation of the payment systems depends, to a great extent, on the mechanisms used for management of technical risk, which is associated with possible shortcomings in errors of hardware and telecommunication facilities, and of operating risk associated with possibility of errors on the part of the user's personnel and payment system operator in the course of discharge of their duties.

To manage the operating risk the payment system operator – “Kazakhstan Center of Interbank Settlements of the National Bank of the Republic of Kazakhstan” State Enterprise – carries out on a regular basis the works for raising the personnel qualification and uses mechanism for separation of the personnel operations in accordance with their functions.

To increase the operation reliability and production efficiency of payment systems and to manage technical risk the following methods are applied: use of a backup centre, check up of users and ongoing monitoring of the payment system hardware and software. In 2009 the works on update of technical infrastructure of the payments systems continue (transfer to anew technical platform and putting into commercial operation of ISMT-2, ICS-2 and BMES-4).

The works also continued on construction of a new backup center in Astana, which will ensure uninterrupted operations of the National Bank in case of contingencies and emergency situations in the location of the main center.

One of the indicators of effective development of the payments systems is the maintenance of high coefficient of uninterrupted operation (operability)<sup>54</sup> of payments systems, which ensure timely payments in the territory of RK. According to the international standards the payment system's operability coefficient should not be less than 90%. For 9 months of 2009 the average monthly operability coefficient of ISMT was 99.78% and that of ICS – 99.93%. Therefore, the operability coefficients of Kazakhstan payment systems demonstrate high effectiveness of their operations.

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<sup>53</sup> The average sum of net debit position of users correlates to the average daily amount of turnover in ISMT as net position of clearing users is calculated at the account of users' funds available in ISMT.

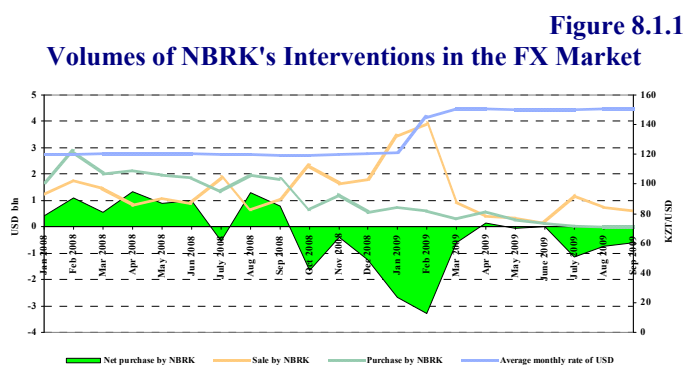
<sup>54</sup> Payment system's operability coefficient for year is calculated as the ratio of real time of operations (period of time from opening of a business day till closing of a payment system's business day, less the time when a payment system was suspended) to the total time of operation of a payment system (period of time from opening of the payment system business day till closing of its business day).

## 8. Financial System Regulation and Risk Management

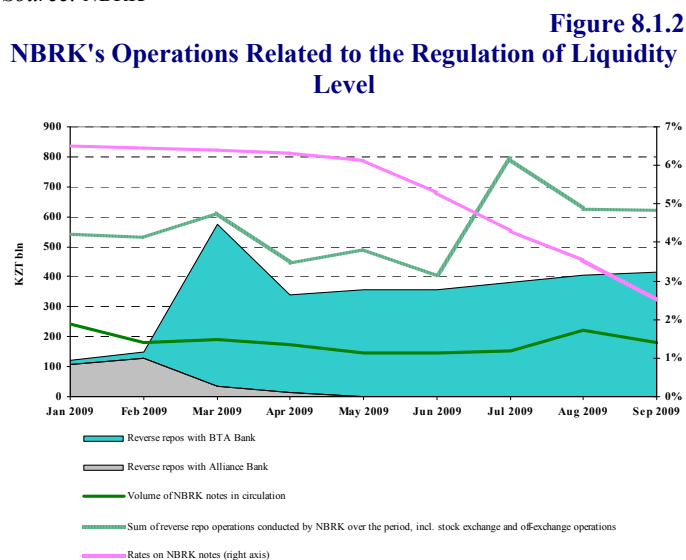
*The effect of the implementation of the anti-crisis package of measures adopted in the end of 2008 implied overcoming the lack of financing the real sector of economy as a result of drastic reduction in the banks' lending activity and deficit of funding in the banking system. Currently the main objective of the regulatory policy is to encourage lending activity of banks which prefer to limit investing their funds in the economy while maintaining a high liquidity level.*

### 8.1 Actions taken by the National Bank to maintain the financial system stability

In the environment of high level of speculative pressure on the market in October 2008 – January 2009 the NBRK had to maintain the exchange rate stability by intensive interventions in the foreign exchange market. During the period the volume of USD sales by the NBRK exceeded purchases volume by approximately USD 6 bln. As a result, the decision was made about the Tenge devaluation that was implemented on February 4, 2009 and to introduce a new foreign exchange band – KZT 150±5 per 1 USD. The speculative pressure in the market was observed throughout the first quarter: in February-March the NBRK had spent about USD 4 bln. of its reserves while intervening in the foreign exchange market. The situation had normalized by April, however, in July the NBRK had to turn to some increase in the intervention volumes in order to counteract the



Source: NBRK



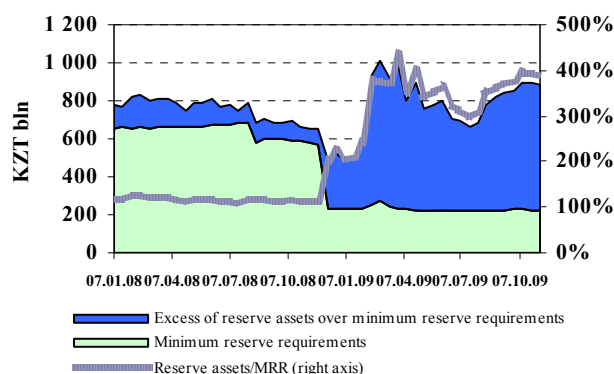
Source: NBRK

speculative spurs observed in the market during that month against the backdrop of irrational devaluation expectations of the market players. The speculative pressure was felt in the foreign exchange market during the entire third quarter, however, its intensity was notably less than in the first quarter (Figure 8.1.1).

The main purpose of the NBRK's participation in the money market was to create conditions for stable functioning of the money market and to smooth the shock effect. The most critical objective of this aspect of the NBRK's operations was to ensure that the liquidity of Alliance Bank and BTA Bank experiencing serious difficulties since the beginning of the year was maintained at an acceptable level. So, transactions with the two banks account for 61% of the total transaction turnover for Q3 2009.

In addition, to increase the banking system liquidity, the minimum reserve requirements (MRR) were reduced from March 3, 2009 (from 2% to 1.5% on domestic liabilities of banks and from 3% to 2.5% on foreign and other liabilities of banks).

**Figure 8.1.3**  
**Reserve Assets and Minimum Reserve Requirements**



Источник: НБРК

didn't facilitate the growth in lending activity of banks which prefer to maintain high liquidity level and limit the volumes of their investments in credits to the economy. Thus, by the end of Q3 reserve assets showed almost a four-fold increase over the level of MRR (Figure 8.1.3). Banks do not strive for assuming risks of the real sector of the economy and prefer to invest in more liquid and less risky assets including with the NBRK's accounts. The volume of time deposits of banks with the NBRK grew up from KZT 33 bln. in the end of 2008 to KZT 546 bln. in the end of Q3 2009, despite significant decrease in the deposits interest rates undertaken in order to discourage deposit placements by banks with the NBRK. So, the deposit-taking rates have been lowered – to 0.5% for 7-day deposits and 1.0% - for one-month deposits as of December 1, 2009.

## 8.2 Regulatory measures undertaken by the Agency on Regulation and Supervision of the Financial Market and Financial Organizations

In Q4 2008 – Q3 2009 the FSA had undertaken a set of prudential regulation measures aimed to mitigate risks and increase the banking system sustainability:

**1. Increasing minimum amount of banks' equity.** In order to strengthen the banking sector's potential and increase its competitiveness, the requirements to a minimum amount of equity of existing and newly established banks have been increased from October 1, 2009 up to KZT 5 bln., and from July 1, 2011 – up to KZT 10 bln. The minimum amount of equity for regional banks where a major amount of services is provided in the regions of Kazakhstan except for the cities of Almaty and Astana, amounted to KZT 2 bln. from October 1, 2009 (subject to compliance with certain conditions); from July 1, 2011 it will amount to KZT 4 bln.

**2. Changing the framework for the regulatory capital calculations.** From January 1, 2010 preferred stock of banks previously included in the calculation of the Tier 2 capital will be included in the calculation of the Tier 1 capital. This measure is of a countercyclical nature since, in effect, its introduction would result in the increased values of calculated capital adequacy ratios of Banks. In addition, with the view of improving the quality of regulatory capital, from July 1, 2011 perpetual financial instruments will be excluded from the calculation of the Tier 1 capital and will be used in the calculation of the Tier 2 capital.

**3. Changing the capital adequacy ratios.** Under the Standards of the Basel Committee on Banking Supervision a new capital adequacy ratio was introduced –  $\kappa_{1-2}$  (ratio of Tier 1 capital to the sum of risk-weighted assets and liabilities):

- for a bank in which a bank holding company or a parent bank has a participation interest, which have a certain rating assigned by one of the rating agencies, the capital adequacy ratio  $\kappa_{1-2}$  should be at least 0.05, and from July 1, 2011 – at least 0.08;

- for a bank without a large participant – an individual  $\kappa_{1-2}$  should be at least 0.07, and from July 1, 2011 this ratio should be at least 0.10;
- for other banks and those banks in which over 50% of distributed shares are owned by the Government, the capital adequacy ratio  $\kappa_{1-2}$  should be at least 0.06, and from July 1, 2011 this ratio should be at least 0.09.

**4. Changing the ratios that limit the level of liabilities to non-residents.** To enhance financial sustainability of the banking sector, the maximum value of  $\kappa_9$  ratio (liabilities to non-residents to equity) was increased from 2 to 3 from July 1, 2009. In addition, to take account of the specifics in the operations of banks with foreign participation, subordinated debt to a non-resident parent bank and liabilities of a bank subsidiary in the Republic of Kazakhstan to a non-resident parent bank on received loans were excluded from the calculation of  $\kappa_8$  and  $\kappa_9$  ratios.

From October 1, 2009, as part of the calculation of bank capitalization to liabilities to non-residents ratios  $\kappa_7$ ,  $\kappa_8$  and  $\kappa_9$ , non-invested balances accepted by a bank under a custodial agreement were excluded from the amount of liabilities to non-residents of the Republic of Kazakhstan. From the same date, unsecured guarantees and sureties of a bank started to be included in liabilities to non-residents when calculating the bank capitalization ratios  $\kappa_8$  and  $\kappa_9$  for the purposes of limiting foreign borrowings through bank affiliates.

**5. Changing the liquidity ratios.** To enhance financial sustainability of the country's banking sector and protect bank depositors, a current liquidity ratio  $k_4$  (average monthly highly liquid assets of a bank to average monthly demand liabilities) was introduced, the regulatory value of which is equal to 0.3.

From October 1, 2009 unsecured guarantees and sureties of a bank issued when bank subsidiaries, legal entities affiliated to the bank raise foreign borrowings and also as part of bank securitizations with the creditor's right to demand early repayment of liabilities, were included in the algorithm for calculating the current liquidity ratio  $k_4$  as part of demand liabilities. The majority of banks were well above the established ratios; therefore this didn't have a material impact on the bank liquidity.

**6. Tightening the provisioning requirements in respect of certain types of loans.** For the purposes of credit risk regulation, requirements were tightened in relation to provisioning against loans provided in foreign currency to those borrowers which do not have appropriate foreign exchange proceeds and /or whose foreign exchange risks are not covered by the relevant hedging instruments on behalf of a borrower.

Besides, from January 1, 2010, the classification category of a loan provided to a borrower (debtor, co-borrower) that is an entity registered in the off-shore zone or is an associate or subsidiary of the entity registered in the offshore zone, will be initially defined as "loss" (provisioning at 100%).

**7. Revising the factors which are used by the FSA to identify the reduced sustainability level of Banks:**

- critical values of reduced capital adequacy ratios and liquidity ratios were revised;
- the definition of "non-performing loans" was specified ("non-performing loans" were replaced by "loans where delinquency on the principal and/or interest is 90 days or more");
- when identifying risks associated with lending to the construction sector, only those loans that were provided for the purchase and construction of commercial and residential real estate and residential mortgage loans have been taken into account.

**8. Regulating the functioning of problem banks.** The Law passed on July 11, 2009 "On amendments to some legislative acts of the Republic of Kazakhstan regarding improvements of the laws of the Republic of Kazakhstan on payments and money transfers, accounting and financial reporting by financial institutions, banking activity and activity of the National Bank of the Republic of Kazakhstan" has governed the procedure for the restructuring of bank liabilities and establishment of a bridge bank.

Pursuant to the Law, a decision to restructure financial institutions shall be made by a specialized court. The status of an entity under restructuring shall provide for the suspension of the execution of creditors' claims on a financial institution where liabilities of the institution to the creditors are expected to be restructured, should such claims be lodged before the court's decision comes into effect in the period of restructuring of the financial institution.

A bridge bank is established upon the regulator's resolution when a problem bank is under conservatorship, in doing so assets and liabilities of a problem bank are transferred provided there are sufficient assets to cover the transferred liabilities. In future a bridge bank may transfer assets and liabilities to a beneficiary bank, followed by the termination of the bridge bank's operation.

### 8.3 Measures for direct support and recovery of the banking sector

Insufficient funding which banks begin to perceive after the closure of foreign capital markets resulted in a material contraction of their lending activity which appeared to be a very urgent problem in 2009. The absence of new loans with the deteriorating quality of the existing portfolio resulted in a certain "shrinkage" of the credit portfolio (mainly due to large amounts of provisions accrued).

Largely, the shrinking effect of the portfolio was over passed owing to the support measures for the banking sector taken by the NWF as part of implementation of the Joint Plan of Actions of the Government, NBRK and FSA for stabilization of economy for 2009 – 2010<sup>55</sup>.

The total volume of additional funding in 2009 exceeded KZT 922.7 bln, of which KZT 308 bln. were used for the Government's stepping in the equity of 3 strategic banks (BTA, Halyk Bank, and KKB) and additional KZT 24 bln. was deposited with Alliance Bank against the pledge of its shares. The capitalization volume of BTA Bank, where problems with liquidity and asset quality had aggravated dramatically by the beginning of this year, through the repurchase of its common stock amounted to KZT 212.1 bln. (75.1% of voting common stock). Thus, the government has become a major owner of BTA Bank (Table 8.3.1).

**Table 8.3.1**

#### Volumes of Additional Capitalization of Strategic Banks in the 1<sup>st</sup> half of 2009

Bank	Capitalization mechanism	Amount, KZT bln.	Equity holding of the NWF
BTA Bank	Repurchase of common stock	212,1	75,1%
Alliance Bank	Deposit placement	24,0	-
Kazcommertsbank	Repurchase of common stock	36,0	18,33%
Halyk Bank	Repurchase of common stock	27,0	27,95%
	Repurchase of preferred stock	33,0	

*Note: The participation interest of the NWF in the banks' capital is provided based on the information officially published by the banks.*

*Source: NWF*

Additional funding to banks was also provided through the measures for the support of the real sector of the economy. Thus, at the end of Q3 2009 as part of the programs for the support of key sectors of the economy (construction and real estate market, SME, agro-industrial complex) the

<sup>55</sup> The Joint Plan of Actions of the Government, National Bank and the Agency for regulation and Supervision of the Financial Market and Financial Organizations of the Republic of Kazakhstan for stabilization of the economy and financial sector for 2009 – 2010 was adopted on November 25, 2008. Financial security of the Plan suggested the use of assets of the National Fund of the Republic of Kazakhstan in the amount of KZT 1 200 bln (approximately USD 10 bln. at the exchanger rate at the date when the Plan was adopted). Under the Plan, these assets should have been used to achieve the following goals:

- 1) Financial sector stabilization – USD 4 bln. (KZT 480 bln.);
- 2) Residential sector development – USD 3 bln. (KZT 360 bln.);
- 3) Support of the medium and small business – USD 1 bln. (KZT 120 bln.);
- 4) Agro-industrial complex development – USD 1 bln. (KZT 120 bln.);
- 5) Implementation of infrastructure projects and break-through projects – USD 1 bln. (KZT 120 bln.);

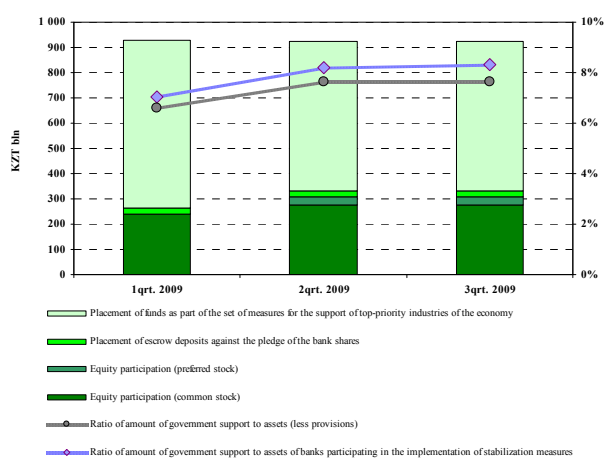
By now these funds were disbursed and drawn down in full in line with the Plan (with some minor corrections).

size of bank liabilities against the funds received for implementation of measures for the support of the real sector of the economy amounted to KZT 590 bln. Therefore, the total share of the NWF in the funding<sup>56</sup> of the banking system amounted to 7.7% as of end-September 2009 (Figure 8.3.1).

It should be noted that about 80% of the additional funding on the part of the NWF falls on 4 largest banks: Alliance Bank, BTA Bank, Halyk Bank and KKB. The NWF's share in the funding of these banks exceeded 10% at the end of Q3, and the NWF's funding share in the BTA Bank's liabilities accounted for 15.6% (Figure 8.3.2).

Besides, in September of this year the decision was made to use the assets of The Distressed Assets Fund (the Fund's total equity is KZT 70 bln.) established in the end of 2008 to support the priority sectors of the economy including the manufacturing industry through the banking sector.

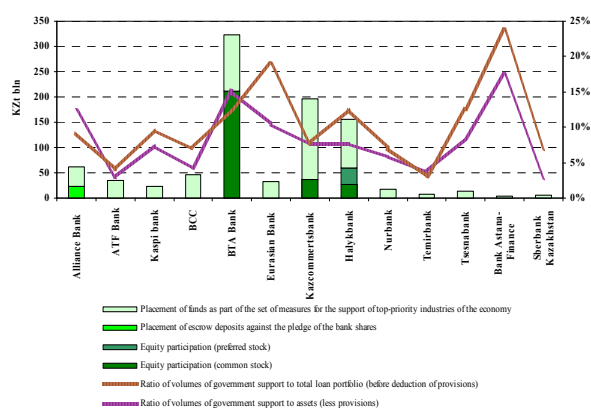
**Figure 8.3.1**  
**Coverage by the Government of the Deficit of Funding of the Banking System**



Note: The volume of funding on the part of the government is estimated as the amount of liabilities to NWF from provision of funds as part of the anti-crisis program, at end-period, and volumes of funds provided by NWF when stepping up in the banks' equity.

Source: NWF, FSA, NBRK calculations

**Figure 8.3.2**  
**Funding of the Banking System Broken Down by Banks as of the end of Q3 2009**



Note: The volume of funding on the part of the government is estimated as the amount of liabilities to NWF from provision of funds as part of the anti-crisis program, at end-period, and volumes of funds provided by NWF when stepping up in the banks' equity.

Source: NWF, FSA, NBRK calculations

## 8.4 The process for restructuring of foreign liabilities of Alliance Bank and BTA Bank<sup>57</sup>

A separate block of problem issues in the stabilization of the financial sector is to normalize the situation around BTA Bank and Alliance Bank which undergo the process of their foreign debt restructuring. The problems of these banks to a large extent enhance the uncertainty of expectations among the financial market players in respect of the future of the Kazakhstan's financial system, therefore the stability of the country's banking sector and the coming up of the post-crisis phase of economic revival will to a great extent depend on the success of the restructuring process of the two banks.

**Restructuring of BTA Bank.** This April two large creditors - Nomura and Morgan Stanley – lodged a claim on BTA Bank for early repayment of the Bank's debt to the creditors in the amount of USD 550 mln. The ground for this claim were the covenants under the borrowing agreement based on which the Bank's creditors had an opportunity to demand early debt repayment in the event the Bank ownership changes.

<sup>56</sup> Hereinafter the additional funding means the amount of liabilities to the NWF incurred from provisions of funds as part of the anti-crisis program, at end-period, and the amounts provided by the NWF when stepping up in the banks' equity.

<sup>57</sup> The information is provided by the NWF



Creditors' claims regarding early repayment resulted in suspended repayments on the principal from April 2009 and on interest – from July 2009.

On September 3, 2009 BTA Bank signed two important agreements with the Creditors Committee:

- Agreement on the main principles of restructuring that is a proof of the fact that the Creditors committee members agree to cooperate with BTA Bank in the process of foreign liabilities restructuring.
- Agreement on the appointment of the Creditors Committee which confirms the consent of each of the 13 institutions – BTA's creditors – to present the interests of all creditors and investors of the Bank as the Creditors Committee in the course of restructuring.

After signing the Agreement on the appointment of the Creditors Committee, the management of BTA Bank arranged a detailed presentation for the creditors characterizing the bank's condition. On September 4, 2009 KPMG provided an independent report with the credit portfolio analysis of the bank and the Bank management provided a detailed business-plan and more detailed information on the proposed restructuring options.

On September 18, 2009 the Standstill Memorandum was signed with the Creditors Committee and also an additional memorandum of Understanding signed between the Bank and the Fund regarding the drafting of the final restructuring plan which was presented to the Agency of the Republic of Kazakhstan on regulation and Supervision of the Financial Market and Financial Organizations ("the FSA"). The FSA in its turn approved the restructuring plan and determined the deadline for signing the final agreement on the terms and conditions of the restructuring December 7, 2009.

On October 23, 2009 a specialized financial court of Almaty approved the Bank's application for the restructuring<sup>58</sup>. As a result of this, from the date of the court's approval and during the restructuring period the Bank's property is protected from law suits on foreclosure of the Bank's assets against debt repayments. This, in its turn, enables the Bank to implement restructuring while maximally complying with the principle of equality for all creditors.

The signing of the final agreement on the terms and conditions of restructuring with the Creditors Committee is scheduled for this December. In the Bank's opinion, its foreign debt has to be reduced from US\$ 12 to US\$ 4 bln. in order to normalize its own equity volumes; however, the creditors believe that the charge off amount should be much less.

***Restructuring of the JSC "Alliance Bank"***. On April 17, 2009 the Creditors Committee was established comprising 9 international financial institutions such as: Asian Development Bank, Calyon, Commerzbank Aktiengesellschaft, DEG Deutsche Investitions- und Entwicklungsgesellschaft mbH, JP Morgan Chase Bank, N.A., Sumitomo Mitsui Banking Corporation Europe Limited, Wachovia N.A., ING Asia Private Bank Limited and HSBC plc.

As a result of a number of negotiations and meetings held in London and in Almaty during April-July of this year, on July 6, 2009 the Creditors Committee has signed the Memorandum of Understanding ("the Memorandum"). The Memorandum represents the principal approval of creditors to restructure the Bank's foreign debt.

The next important step in the restructuring process was the signing of the Agreement of Intentions between "Samruk-Kazyna" and the Bank. The Agreement contains the intention of "Samruk-Kazyna" to purchase a controlling block of common stock worth KZT 24 bln. and preferred stock worth KZT 105 bln. after the successful completion of the restructuring process. The signing of this Agreement was an important pre-requisite for going on with the constructive

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<sup>58</sup> Under the provisions of the Law passed on July 11, 2009 "On amendments to some legislative acts of the Republic of Kazakhstan regarding improvements of the laws of the Republic of Kazakhstan on payments and money transfers, accounting and financial reporting by financial institutions, banking activity and activity of the National Bank of the Republic of Kazakhstan".

negotiation process with the bank's creditors since "Samruk-Kazyna" involvement would allow bringing the Bank's equity in line with the prudential normatives.

On July 14, 2009 the bank provided its plan for restructuring and recapitalization which was approved by the FSA on July 21, 2009.

On October 5, 2009 the Bank has signed the Agreement on the restructuring of the Bank's liabilities with the Creditors Committee and the Fund. Under the terms and conditions of the restructuring process the Bank's debt will be reduced from the current USD 4.3 bln. to 1 bln. The creditors meeting will be the next step in the restructuring process of borrowings of Alliance Bank. In the course of the meeting which is expected to be held before mid-December the creditors will vote for the final approval of the Restructuring Plan. In order to get the Plan approved, the Bank will need to have the consent on the part of creditors whose claims comprise at least two thirds of the Bank's total liabilities subject to restructuring.

### **8.5 Measures for support of the real sector of the economy as part of the Plain of Joint Actions by the Government, National Bank and the Agency on Regulation and Supervision of the Financial Market and Financial Organizations of the Republic of Kazakhstan for stabilization of the economy and financial sector for 2009 – 2010<sup>59</sup>**

The Joint Plan of Actions of the Government, NBRK and FSA for stabilization of the economy for 2009 – 2010 approved on November 25, 2009 suggested five areas for stabilization of the economy and financial sphere and overcoming the consequences of the crisis. The first area out of the five (measures for stabilization of the financial sector) provides for direct support of the banking system through additional capitalization of banks. The other four include measures for stimulation of the real sector of the economy, while the measures for the support of top-priority sectors (construction and real estate, agro-industrial complex and agriculture, and SME) are comprehensive performance-oriented, since they suggested both bank funding and provision of financing to entities in the real sector. The fifth area – implementation of infrastructure and breakthrough projects – is aimed to develop and diversify the economy.

It should be noted that the measures for the development of the residential real estate sector, agro-industrial complex and SME appeared to be a logical continuation of measures on the government incentives for the economy whose implementation was taking place before the crisis.

**1. Measures for the development of the housing sector.** To resolve the problems in the real estate market a set of measures was used including the funding of uncompleted residential facilities in Almaty and Astana, refinancing of mortgage loans of individuals and repurchase of apartments in new built residential blocks in Astana.

During 2009 KZT 39 bln. was allocated to finish uncompleted residential buildings in Astana (30 facilities in total). In Almaty in 2008 – 2009 about KZT 23 bln. was allocated through banks to complete the construction of residential complexes. In addition, KZT 41 bln. was allocated to repurchase 6203 apartments in 46 uncompleted facilities in Astana.

KZT 120 bln. was provided to refinance mortgage loans through Banks to 11 banks<sup>60</sup>. Agreements with 31 thousand borrowers were re-concluded for the total amount of KZT 120.5 bln.

Five banks take part in the facility providing for the repurchase of apartments in the residential buildings under construction by making bank mortgage loans – ATF Bank, Eurasian Bank, Tsesnabank, Temirbank and Alliance Bank. These banks are expected to finance the repurchase of apartments by the stakeholders in 13 uncompleted construction facilities, including 11 facilities in Astana and 2 – in Almaty. The total cost of those facilities amounts to KZT 19.5 bln.

**2. Measures for the SME support.** KZT 120 bln. was allocated from the National Fund of the Republic of Kazakhstan for the support of SMEs, of which KZT 117 bln. was used to implement the 3<sup>rd</sup> tranche of the Stabilization Program. The allocated resources were distributed among 12 partner banks in February 2009. The conditions of the program for the SME funding also

<sup>59</sup> According to the data by NWF, MoF, MEBP

<sup>60</sup> BTA Bank, KKB, Halyk Bank, Alliance Bank, BCC, ATF Bank, Temir Bank, Kaspi Bank, Tsesnabank, Eurasian Bank, Nurbank

provided for involvement of partner banks in the program with their own resources. However, only ATF Bank initially provided resources of KZT 10 bln. Thus, the overall funding pool under the Program amounted to KZT 127.0 bln. Loans were provided on the following conditions under the 3<sup>rd</sup> tranche:

- Maximum loan amount – up to KZT 750 mln;
- terms – up to 84 months;
- annual effective interest rate – not more than 12.5%;
- currency of the loan – Tenge;
- refinancing of the existing loans of SMEs with the limit of 70% of the portfolio built up from the NWF's resources;
- grace period for the principal amount repayment on loans provided for the replenishment of the working capital – up to 6 months, and in respect of loans provided for other purposes - up to 12 months;
- SME must start the drawdown of a loan within 2 months from the date when a bank loan agreement was concluded.

The drawdown was finalized by the end of the 1<sup>st</sup> half of 2009. Partner banks financed 2 565 borrowers for the amount of KZT 123.1 bln. The average interest rate of funds placement with banks – 7.8%, effective interest rate for the end-borrower – 12.2% pa.

In the sectoral break-down over 70% of funds were directed in the area of trade and services which was caused, in its turn, by established sectoral structure of small and medium-size business in the country. In the regional breakdown the largest amounts were provided in Almaty – KZT 40.9 bln. (453 borrowers) and in Astana – KZT 20.6 bln. (304 borrowers). As a result of the Program implementation 9 765 working places were created.

**3. Measures for the support of the agro-industrial complex.** Initially it was intended to provide KZT 120 bln. to finance the agricultural sector including for planting and harvesting. Financing was implemented with the involvement of the national holding company KazAgro. As of October 15, 2009 the total volume of funding provided to the agro-industrial complex was KZT 68,4 bln.

**4. Implementation of innovation, industrial and infrastructure projects.** The NWF has built up a pool of investment projects as part of the anti-crisis program for the amount: the development institutes comprising the NWF have approved 212 projects in different industries, of which 160 are already being funded. At the end of the first half of the year the NWF's investments in the area amounted to USD 1.4 bln. accounting for 12% of the total investment volumes in Kazakhstan over the period.