



QAZAQSTAN ULTTYQ BANKI

# FINANCIAL STABILITY REPORT OF KAZAKHSTAN

2018 – 1H2019

ALMATY, 2020



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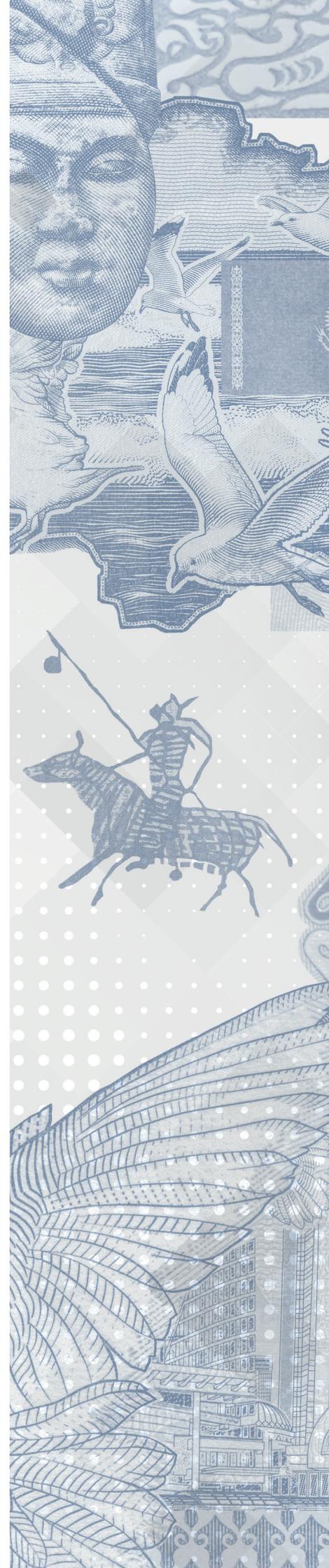
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**LIST OF ABBREVIATIONS AND ACRONYMS:**

|                 |  |
|-----------------|--|
| <b>AFS</b>      | Agency for Financial Supervision of the Republic of Kazakhstan                                   |
| <b>AQR</b>      | Asset Quality Review   |
| <b>Bail-in</b>  | Liabilities restructuring  |
| <b>BCBS</b>     | Basel Committee on Banking Supervision   |
| <b>BL</b>       | by-law   |
| <b>CFS</b>      | Council on Financial Stability and Development of Financial Market of the Republic of Kazakhstan |
| <b>CPI</b>      | consumer price index   |
| <b>CSD</b>      | JSC "Central Securities Depository"  |
| <b>DA</b>       | domestic assets  |
| <b>DFIs</b>     | derivative financial instruments   |
| <b>DO</b>       | domestic obligations   |
| <b>FCC</b>      | freely convertible currency  |
| <b>FDIs</b>     | foreign direct investments   |
| <b>FLB</b>      | federal loan bonds   |
| <b>FRS</b>      | U.S. Federal Reserve System  |
| <b>GDP</b>      | gross domestic product   |
| <b>GFER</b>     | Gold and foreign exchange assets   |
| <b>GP</b>       | government programs  |
| <b>GS</b>       | government securities  |
| <b>HHI</b>      | Herfindahl-Hirschman index   |
| <b>HLA</b>      | highly liquid assets   |
| <b>IAMS</b>     | A bank subsidiary that acquires impaired or stressed assets of the parent bank                   |
| <b>IC</b>       | insurance company  |
| <b>IDA</b>      | rate of banking investments in domestic assets   |
| <b>IFOs</b>     | international financial organizations  |
| <b>IMF</b>      | International Monetary Fund  |
| <b>JSC</b>      | joint-stock company  |
| <b>KDIF</b>     | JSC Kazakhstan Deposit Insurance Fund  |
| <b>KMG</b>      | JSC "NC "KazMunayGas"  |
| <b>KSE/KASE</b> | Kazakhstan stock exchange  |
| <b>LB</b>       | large business   |
| <b>LCR</b>      | liquidity coverage ratio   |
| <b>LE</b>       | Legal entities   |
| <b>LEA</b>      | local executive authority  |
| <b>LIBOR</b>    | London Interbank Offered Rate  |
| <b>LRL</b>      | last resort loans  |
| <b>LTV</b>      | Loan-to-value ratio  |
| <b>MCI</b>      | monthly calculation index  |
| <b>MCO</b>      | microcredit organization   |
| <b>MF RK</b>    | Ministry of Finance of the Republic of Kazakhstan  |
| <b>MO</b>       | mortgage organization  |
| <b>MP</b>       | monetary policy  |



|                       |   |
|-----------------------|---|
| <b>MRR</b>            | minimum reserve requirements  |
| <b>NBRK/NBK/</b>      | National Bank of the Republic of Kazakhstan   |
| <b>NC</b>             | national company  |
| <b>NDF</b>            | non-deliverable forward   |
| <b>NF RK</b>          | National Fund of the Republic of Kazakhstan   |
| <b>NPISH</b>          | Non-profit institutions serving households  |
| <b>NPL/NPL 90+</b>    | Loans with overdue principal debt and/or accrued remuneration of over 90 days (non-performing loan) |
| <b>NP<sub>s</sub></b> | Natural persons/individuals   |
| <b>NSFR</b>           | net stable funding ratio  |
| <b>OCP</b>            | open currency position  |
| <b>OECD</b>           | Organization for Economic Co-operation and Development  |
| <b>P&amp;A</b>        | transfer of insolvent bank's assets and liabilities to another bank                                 |
| <b>PD</b>             | principal debt  |
| <b>PF</b>             | Pension Fund  |
| <b>PLF</b>            | JSC "Problem Loans Fund"  |
| <b>PQPS</b>           | public and quasi-public sector  |
| <b>QPS</b>            | quasi-public sector   |
| <b>RB</b>             | republican budget   |
| <b>RML</b>            | residential mortgage loan   |
| <b>ROAA</b>           | return on average assets  |
| <b>SC MNE RK</b>      | Statistics Committee of the Ministry of National Economy of the Republic of Kazakhstan              |
| <b>SE</b>             | small enterprises   |
| <b>SF</b>             | Salary fund   |
| <b>SME</b>            | small and medium enterprises  |
| <b>SRC MF RK</b>      | State Revenue Committee of the Ministry of Finance of the Republic of Kazakhstan                    |
| <b>SREP</b>           | Supervisory review and evaluation process   |
| <b>SSIF</b>           | JSC "State Social Insurance Fund"   |
| <b>STB</b>            | second tier bank  |
| <b>UAPF</b>           | JSC "Unified Accumulative Pension Fund"   |
| <b>ZhSSBK</b>         | JSC "Zhilstroyberbank"  |
| <b>\$/bbl.</b>        | USD/barrel of oil   |
| <b>bln.</b>           | billions  |
| <b>mln.</b>           | millions  |
| <b>pp</b>             | percentage point  |
| <b>ppl.</b>           | people  |
| <b>sq.m.</b>          | square meter  |
| <b>thou.</b>          | thousand  |
| <b>tln.</b>           | trillions   |
| <b>y/y</b>            | year on year  |

# OVERVIEW

## MACROECONOMIC POLICY

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Kazakhstan remains dependent on oil prices but enhanced macroeconomic stability in recent years and reduced cyclical volatility as a result of transition to a floating exchange rate enabled more effective economic response to external shocks. The ongoing reforms in macroeconomic policy have laid a foundation for cutting dependence and for a more sustainable development. Further enhancement of sustainability will require the adoption of more counter-cyclical and predictable fiscal policy and structural reforms.

The economy continued to grow at 3.9-4.1% per year in pursuit of long-term government targets, significantly outstripping the global economy. Growth was largely driven by government and quasi-government spending that advanced the economic growth. The contribution of non-tradable sector to GDP has increased and secured three-quarters of total growth in the first half of 2019. Capital investments remain limited, especially in the tradable non-oil sector. The bulk of investment was in oil and gas sector, where projects have moved from the investment to the production phase.

Inflation gradually decreased and at the end of 1H 2019 amounted to 5.4%, but inflation volatility remains high, especially among its components, and tail risks prompt the need in more conservative interest rate policy. The base rate as an indicator of monetary policy responded flexibly to projections and inflation prospects, including those associated with external shocks. The base rate and inflation projection spread was maintained at the level of 3.0-3.5 percentage points, slightly below the economic growth rate.

The interest and credit channels of the monetary policy remained insensitive to the interest rate policy. To enhance the effect of the interest rate channel, a more liquid and efficient market of tenge government securities (GS) is needed. On the demand side, it requires a reduced concentration of institutional investors and decreased role of capital investors, and

on the supply side, rationalization of public debt raising policy. The transfer of some pension assets to private management companies scheduled for 2020 can help boost the liquidity of the government securities market. A transfer through a credit channel was restrained by lack of creditworthy demand required to issue a quality loan.

The exchange rate channel remained the main transmission channel of the monetary policy. Decreased USDKZT volatility in 2H2018 and 1Q2019 has boosted the growth by the end of 1H2019, demonstrating an unshakable commitment to the floating rate policy. The foreign exchange market continues to be relatively small, and its flows concentration is extremely high. Pricing efficiency is constrained by poor willingness and ability of market actors to take open positions and smooth out market impulses that are difficult to predict and too massive for potential market makers.

Inflation risks associated with the leaking of the exchange rate and subsequent consolidation of price expectations remain moderate, but to further boost confidence in tenge, they shall be commitment to maintain the floating rate policy and a relevant risk premium for tenge assets holders.

Kazakhstan's fiscal position in 2018 improved markedly: non-oil deficit fell from 12.7% to 7.6% of GDP. Government assets in 1H 2019 grew and stabilized at 60 billion USD. Long-term macroeconomic risks were mainly associated with outstripping growth of budget expenditures (13% per year on average over past three years and 19% in 2019). To enhance the efficiency of government spending and weaken Kazakhstan's economic dependence on commodity cycle, real exchange rate should be stabilized at a competitive level; it necessitates a more disciplined and counter-cyclical fiscal policy as the most significant factor in developing the aggregate demand.

## CREDIT TO THE ECONOMY AND ABSORPTION CAPACITY

Credit to the economy grew slightly in absolute terms and contracted relative to GDP. Loan portfolio has stagnated amid compressed corporate portfolio and the rapid growth of households loans. Corporate portfolio compressed as a result of write-offs or retreat from the loan system of insolvent and bad faith borrowers from the system and was not associated with termination of lending to operating businesses. The growth in household lending was secured by mortgages with government support, and consumer lending.

Loans to businesses, with the exception of forced refinancing, was growing over past three years, but growth has been concentrated in well-capitalized banks. The heterogeneity of banks in terms of capital adequacy, not recorded in the financial statements, decreased, but remained high.

In addition to economic capital adequacy, the growth of quality credit is constrained by lack of equity in borrowing enterprises. In 2018, 39% of enterprises in SME sector had low or negative capital. In 2018, financially unstable enterprises accounted for 79% of SME debt to banks, as in 2015–2017. The ability of such enterprises to service their

obligations is extremely low, and extension of loan to them carries unjustified risks for the banks. A persistently high share of insolvent enterprises is associated with structural (low competitiveness), cyclical (falling oil prices at the turn of 2014–2015) and institutional factors (poor quality of bank underwriting, inefficiency of corporate bankruptcy procedures).

Activity in the residential real estate market in 2018-1H2019 boosted and in 1H2019, for the first time in three years, prices rose. The housing market has become increasingly dependent on government subsidized housing finance programs that replace market lending and undermine pricing but increase housing affordability and support construction.

Risks of consumer loans remained moderate but increasing consumer credit penetration and household debt burden without a more conservative approach to assessing borrower's solvency can grow into systemic. In 2019, debt burden requirements were augmented, the range of households lending regulation was expanded, and government support was extended to certain household groups to reduce their debt burden.

## CREDIT RISK

During 2018 and 1H2019, credit risk of banks' loan portfolio continued to decline both as a result of reduction of a historically problem portfolio and improved quality of credit decisions. Just as before 2018, the quality of banks' loan portfolio has improved, mainly due to the redemption of problem loans by the government and due to equity or lenders in some cases. The decrease of the size of the problem portfolio occurred thanks to recognition of loan losses, including as part of the Bank Sustainability Program, write-offs of loans; sales of loans to the government and specialized companies, and retreat of insolvent banks from the system.

The quality of the corporate portfolio remained significantly lower than that of the retail portfolio. High corporate loan risks manifest a higher concentration of loans, frequent cases of affiliation, high rate of borrowing, and depression of non-tradable sector they represent. The creditworthy demand of the corporate sector remains limited amid structural changes caused by worsening trading conditions for non-tradable sector and a low base in the tradeable sector. The role of the government programs has increased, both in corporate and retail lending. Subsidized products supplanted market credits. The quality of corporate loans issued under government programs remains low, but higher than the quality of market loans.

In the retail portfolio, credit risks were mainly concentrated in large secured loans that implied affiliation. The volume of such loans in 2018 fell sharply due to liquidated banks

but remains high. The quality of retail mortgages and car loans, which are increasingly dependent on government programs, remained relatively high.

Improving the quality of the loan portfolio improved as reliability of financial statements was enhancing. Further progress here is constrained by banks' limited loss absorption capacity. Some banks with lacking absorption capacity still actively manage their overdue status by modifying the repayment schedule, remuneration capitalization, and various combinations of refinancing to minimize loss recognition. Improving the quality of reporting to the level that is needed to ensure financial stability and functionality of the banking sector will require further improvement of the quality and motivation of regulatory opinion and relentless supervision of the entire financial reporting chain.

The transition to risk-based supervision from 2019 eliminated most serious violations in banking practice and strengthened requirements for internal risk management systems. The completion of independent asset quality review of 2019 will help diagnose the quality of bank loan portfolios and enhance the credibility of supervisory judgments in identifying and resolving unviable banks. Further improvement of asset quality will require banks to continue improving the quality of credit decisions and enhancing responsibility of bank management and shareholders, auditors and appraisers.

## FUNDING RISKS

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Liquidity risks of financially sound banks remained moderately low. Most stable banks maintain a significant stock of highly liquid income-generating assets. They make account for more a third of the total assets of the system. The National Bank continues to absorb excess liquidity with short-term notes and standing facilities to keep money market rates within the interest rate range of the base rate. Stability of interest rates, access to borrowed primary liquidity on predictable conditions and excessive volume of high-quality collateral enable banks to economize balances of reserve assets without being exposed to liquidity risk.

High dollarization of liabilities still remains the main funding risk, as it widens the currency gap on the banks' balance sheets and forces banks to choose between currency risk and liquidity risk. In case of massive actualization of this risk, the National Bank may be required to act as a seller of long-term currency swaps. To minimize this risk and further reduce dollarization, a convincing macroeconomic policy will be required,

including a commitment to the floating rate and interest rate policies as well as countercyclical fiscal policies.

Direct forex risks remain insignificant. However indirect forex risks associated with unrecognized losses on forex loans, despite the reduced share of forex loans from 27% to 19%, remain high.

Poor funding sustainability continues to be an important factor of banks' vulnerability. It manifests itself in high concentration of lenders, especially the public sector, and a low share of term funding. To set up a derivatives market for deposits in 2018, a new mechanism of marginal rates for households deposits was introduced based on rates and reference to the market benchmark.

Further enhancing the funding sustainability will require a more adequate accounting of risks in prudential liquidity ratios (LCR, NSFR), improved quality of interest rate risk reporting, and wider application of supervisory assessment measures under requirements of the Basel Committee on Banking Supervision (Pillar 2).

## FINANCIAL SECTOR CONCENTRATION

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In 2018, concentration of the banking sector continued to rise as a result of reorganization and liquidation of insolvent banks. Amid increased concentration, classification of the banks as backbone banks and prevention of a merger of less than well capitalized banks without capital adequacy issue resolved and efficiency of problem banks identification and

settlement mechanisms enhanced in the first place have become increasingly relevant.

Consolidation of insurance companies continued to grow steadily and reached the level of the banks. The concentration of management companies also remains extremely high and limits the functional development of the financial sector.

## RISK-BASED SUPERVISION AND BANKS REGULATION

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In 2018, legislative reform was introduced to strengthen the supervisory mandate of the National Bank with the launch of risk-based supervision and the principles of supervisory judgement. The principle of proportional supervision was introduced, which envisages application of measures based on size, significance, complexity and risks of financial institutions. A phased approach to application of supervisory measures, starting from recommendation measures and their

subsequent tightening in case of identified risks still remain, is set out in the legislation. The notion of presumed affiliation was introduced to identify related parties to the banks based on economic characteristics, not limited to formal legal criteria.

A new mechanism was introduced for insolvent banks identification and resolution based on minimization of systemic implications and government losses.

The process of problem bank identification and resolution and their classification by financial situation is regulated. As far as the law is concerned, the triggers and the term for capital increase of such banks are defined. This enabled the separation of supervisory measures and resolution measures as well as enhancement of efficiency of decision-making on insolvent banks.

The regulator is provided with a full set of resolution tools, including mandatory bail-in restructuring. Resolution is carried out without the need for coordination with shareholders and creditors, taking into account the hierarchical priority of creditors and mandatory independent valuation of bank's property. In addition, restrictions on government's participation

comes into force only if bank's liquidation carries systemic risks. The grounds were introduced for the regulator to invalidate, by the court, the transactions with suspected asset stripping and priority retreat of individual creditors shortly before bank's failure.

The key stage in full transition to a new supervision regime is independent asset quality review of 2019. It will make it possible to diagnose the real situation at the banks, provide reasons for regulatory requirements for capitalization and take necessary measures to improve the banking sector.

## **CORPORATE BANKRUPTCY**

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Ineffective corporate bankruptcy institution constrains financial stability. It inhibits the engagement of resources of insolvent borrowers in economic turnover, creates facilitates value loss, enhances banks' credit risks and restrains business development.

To note, rehabilitation and bankruptcy procedures are not launched, controlled or done in the collective interests of the creditors. They are launched late, are delayed, become unreasonably expensive, opaque, and facilitate asset stripping. Legislation and enforcement practice are incompliant with the principles of protection of rights of secured creditors, especially during rehabilitation. The most primitive forms of resolution dominate. Elimination is more than 90% of cases. Restructuring under creditors' control has almost no options.

Creating conditions for the improvement of enterprises through more effective bankruptcy procedures is a priority task for ensuring financial stability. In 1H2019, legislation absolutely prioritized collateral lenders in the framework of bankruptcy, but most of the problems remained unresolved. The most obvious step on the reform agenda is to optimize bankruptcy procedures and deadlines, taking into account the interests of creditors, including secured creditors, fine-tuning of temporary administration mechanisms and enhancing responsibility and accountability of managers before creditors. In addition to legislative amendments, reforms should envisage the drafting of by-laws, advanced training for all parties to bankruptcy proceedings; development of law enforcement practice, including interpretations by the Supreme Court; development of guidelines and requirements for financial analysis by administrators, and binding reasoning of court decisions.

## **STRENGTHENING THE ROLE OF THE COUNCIL ON FINANCIAL STABILITY**

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In 2018 and 1H2019, the Council on Financial Stability and Development of the Financial Market of the Republic of Kazakhstan (CFS) was reviewing on a quarterly basis the most pressing issues of financial stability, reduction of systemic risks and development of financial sector. In the first half of 2019, legislative amendments were

drafted to reform the institutional regulatory model, which provide the separation of supervisory functions from the National Bank in 2020. In this regard, CFS's role as an interdepartmental collegial body on financial stability will be strengthened.

Section 1.



MACROECONOMIC  
CONDITIONS



Over the past year and a half, the global economy has been steadily deteriorating, and growth prospects and indicators of entrepreneurial confidence have been weakening in every quarter except for 2Q2019. Trade disagreements, which changed investors' expectations, have triggered growing economic uncertainty. Behind the episodes of periodic escalation of geopolitical risks, aggravated trade conflicts, growing populist sentiments is the increasing discrepancy between the economic policies of the developed countries and structural problems that they face. The growth observed in recent decades that was based on debt financing of aggregate demand has caused the household debt to reach sustainability threshold. The automation of ever more processes is a sign of further increase of unemployment rate and income inequality, a decrease in social mobility, a gap in economic growth rates and other imbalances that underlie the global slowdown.

Extremely soft monetary policy of the last decade has made it possible to mitigate associated risks, but demand stimulation potential through extremely low rates has practically been exhausted. The sustainable solution to these problems requires difficult decisions to be made and unpopular structural reforms to be implemented, and these still remain outside the economic policy discourse. Longer-term risks that are structural by their nature cannot be fully addressed through monetary policy instruments.

To stabilize the long-term growth path, it is obvious that structural reforms and increased level of infrastructure investments are required. Lack of fiscal policy support complicates the situation and emphasizes the importance of balanced economic policy that ensures coordination of monetary, fiscal and structural policies.

In Kazakhstan, oil and other export raw materials market remains to be the main channel manifesting the influence of global risks on domestic economy development.

In Kazakhstan, over past two and a half years, real GDP growth has remained at 4% per year. As part of the monetary policy, inflation has been steadily declining, reaching the level of 5.3% in 2018 and 5.4% in mid-2019 and remains within the target boundaries. Despite inflation slowdown in 2018, tail risks remain high in

2019-2020. In 2019, the NBK continued to gradually lower its inflation target. The base rate is still developed factoring for provisions at the actual rate of 3.0 - 3.5%. The presence of the NBK on forex market remained historically minimal. Decreased exchange rate volatility since the end of 2018 brought it closer to the 2014 level, and it partially recovered by the end of the first half of 2019.

Over the reporting period, the contribution of nontraded sector has been on the rise and secured over three quarters of GDP growth in the first half of 2019.

Organic growth of private sector was restrained by lack of enterprises' own equity that, in turn, cumbered potential extension of money to the economy without creating unjustified risk of unproductive loans.

As a result, Kazakhstan's high vulnerability to external shocks, economic activity's dependence on oil prices, and poor competitive ability of domestic production have remained.

Main investments are still raised by capital intensive extractive sectors. Despite improved trading conditions for tradable sector manufacturers in 2015, there is still a limited supply of capital investments in tradable non-oil sectors, thus manifesting the low sector base as well as still existing institutional and structural barriers to oil dependence reduction.

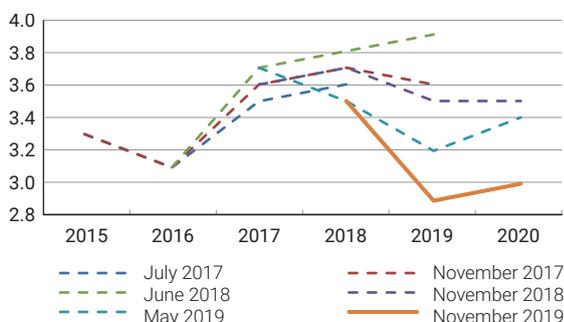
Despite Kazakhstan's improved fiscal position in 2018, when non-oil deficit decreased from 12.7% of GDP to 7.6% of GDP, and a significant buffer in the form of assets of the National Fund with more than 32% of GDP by the end of 2018, fiscal policy continues to significantly affect country's economy. Thus, the procyclical nature of government spending reduces macroeconomic stability and may cause the fiscal space to narrow, which, given the accelerated growth of government spending unsupported by productivity growth, necessitates fiscal reform. Despite the available net position on external assets, the absence of the rules, the structure and arbitrary decision-making on budget deficit financing create the risks of narrowing of fiscal space and an increase of a premium on external borrowings.

## 1.1. EXTERNAL CONDITIONS

Global slowdown and worsened growth prospects are caused by structural imbalances and contradictions that continue to rise. Soft monetary policy offers favorable conditions for funding and lending, but without fiscal policy support and deeper reforms, it may not solve the issue of growing income inequality and debt levels. In this context, increased protectionism and economic nationalism is a response, rather than a reason for global growth slowdown.

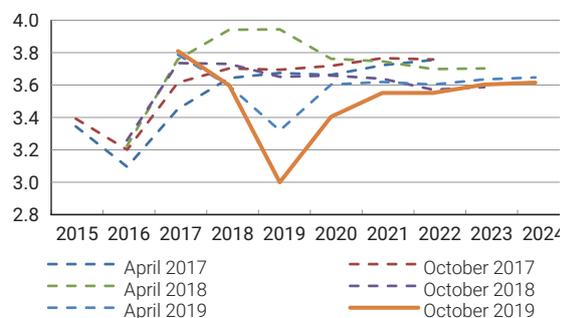
In 2019, global GDP growth continued to follow downward trend. According to world economic outlook, IMF and OECD project global growth slowdown. Thus,

**Chart 1.1 Rising Global Uncertainty**  
 OECD predicts global economic slowdown

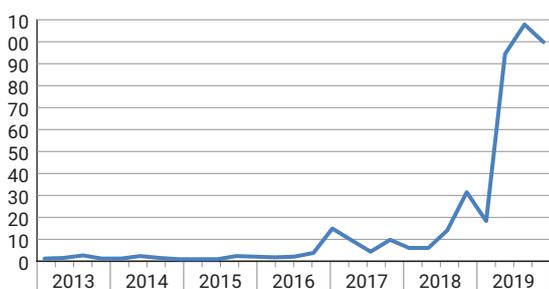


OECD estimates suggest that global GDP growth rate would stand at 2.9% in 2019 and at 3.0% in 2020, which is 0.5% lower than the 2018 forecast (**Chart 1.1**). Trade confrontation remains the main factor behind rising global risks and uncertainty. Thus, in 2019 trade uncertainty index reached its historical maximum, mainly due to trade war between the economies of the United States and China. At the same time, an expert survey conducted by ifo over five quarters demonstrates that both the assessment of current economic situation and expectations of global economy's further development have worsened.

**IMF also revised its forecast for world GDP growth for 2019-2020 downward**



**Rising Trade Uncertainty Index**

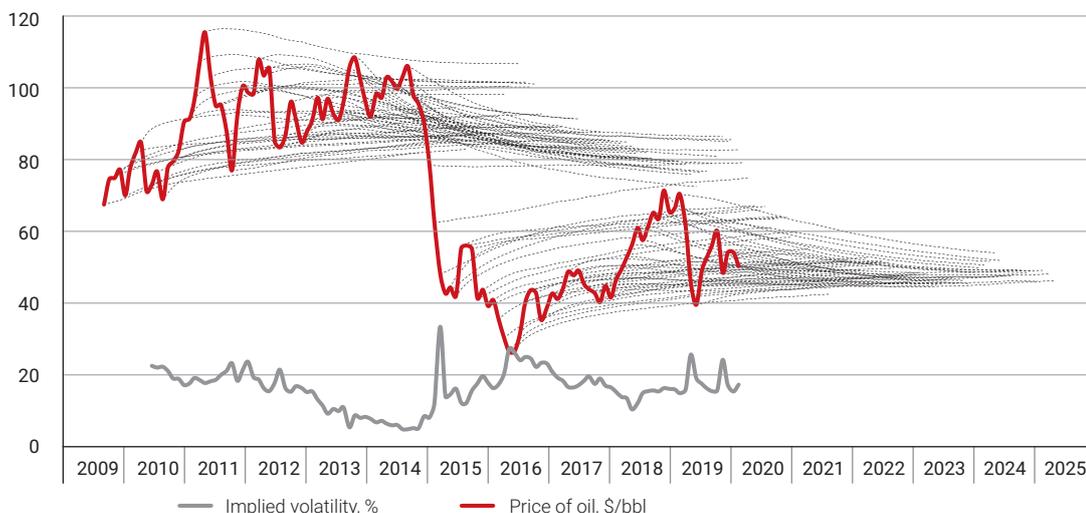


Source: IMF World Economic Outlook, OECD World Economic Outlook

After oil market's adjustment to new price level and significant price stagnation, the prices have recovered as expected, and in 2018 showed the whole range of prices anticipated in the medium term. Market expectations demonstrate the convergence of medium-term expectations in the range of \$50-60 per barrel of oil (**Chart 1.2**).

Geopolitical tensions continue to be a risk to the Eurasian region. The adoption of a new package of sanctions against the Russian Federation, one of Kazakhstan's largest trading partners, has weakened the ruble and the competitiveness of Russian trading partners. Expectations of further sanctions pressure caused an occasional increase in speculative activity on forex market.

**Chart 1.2 Medium-Term Expectations for Oil Prices Reflected by Oil Market Futures in the Range of 50-60 USD per Barrel**  
Brent Oil Futures



Source: Bloomberg

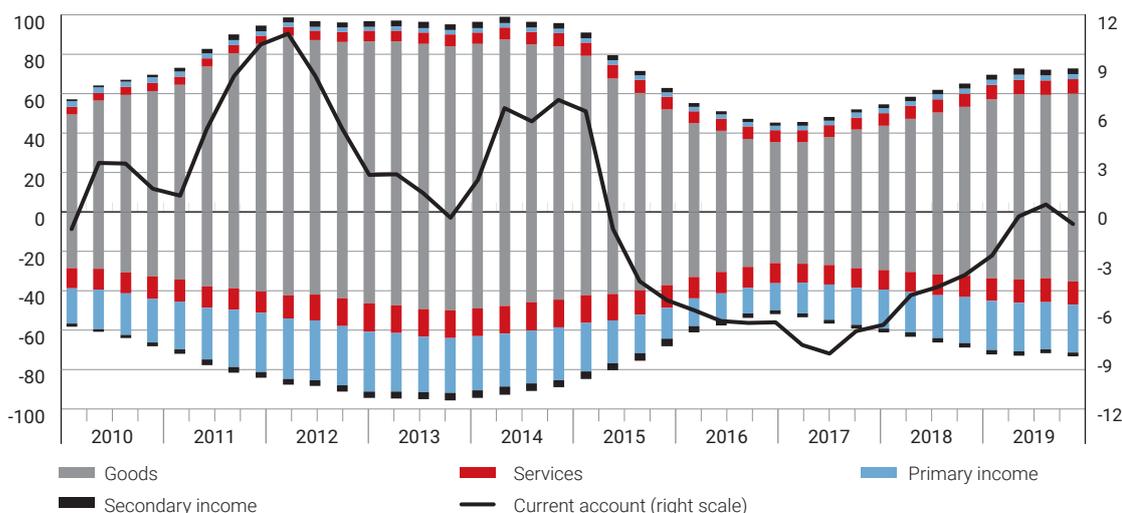
## 1.2. EXTERNAL ACCOUNTS

The decline in oil prices in the first half of 2019 caused a decrease in exports of goods, which together with increase in imports of goods, caused current account deficit of -\$1.4 billion in the first half of 2019.

end. Such dynamics was driven by increased oil prices, rise of oil production and stable demand for oil from trading partner countries. In particular, the average annual price of Brent crude oil in 2018 amounted to \$72 per barrel.

In 2018, the current account was almost balanced and accounted for -0.2% of GDP or -\$289 million by the year

**Chart 1.3 Current Account deterioration in 1H2019**  
Current account (+ debit, - credit), billion US dollars, amount for 4 quarters

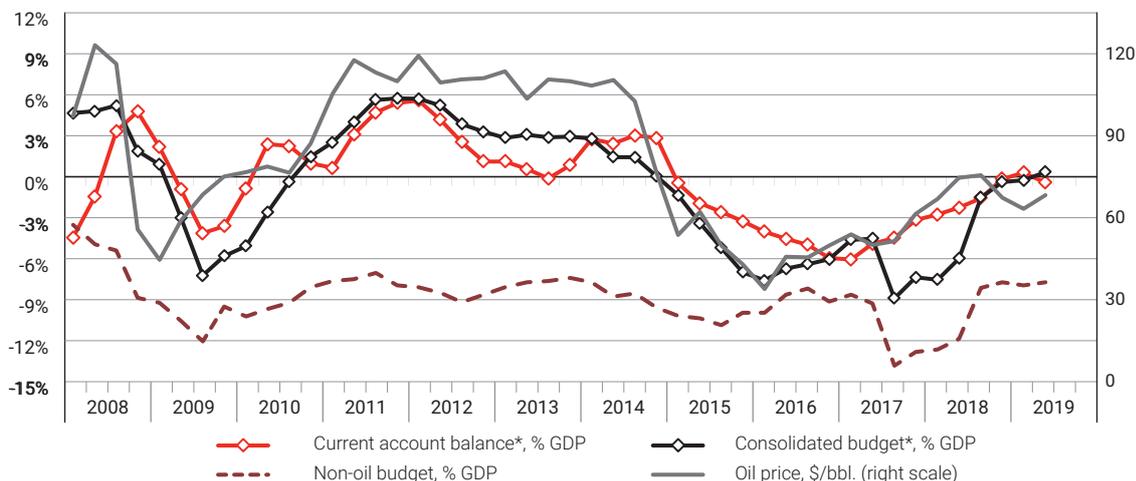


Source: National Bank

The formation of the current account is still influenced by export revenues, which determine external income. Foreign income of non-residents is transformed into imports of services and investment goods.

Residents' external incomes stabilize the current account, mainly through increased public sector spending, however, they enhance the procyclical nature of the fiscal policy (Chart 1.4, Chart 1.5).

**Chart 1.4 Double deficit contracts as oil price rises**  
Amount over 4 quarters to moving GDP over 4 quarters



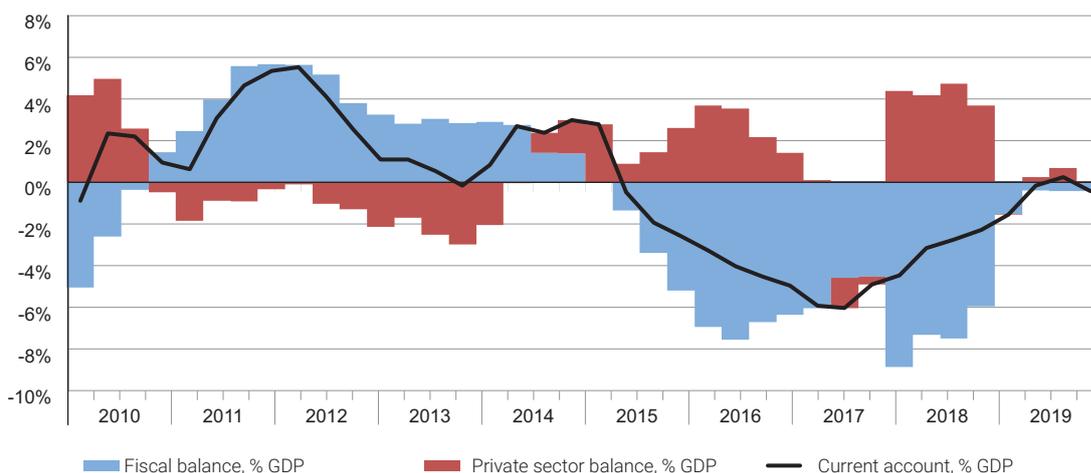
Source: Ministry of Finance of the Republic of Kazakhstan, National Bank, National Bank assessment

In particular, the growth in imported investment goods was associated with expansion and overhaul of oil recovery and refining production facilities.

demand. Outrunning growth of government expenditures that generate population's purchasing power, contributed to the growth of aggregate demand that with limited supply has increased double deficit of the budget and current account.

Government subsidy programs continued to significantly affect both investment and consumer

**Chart 1.5 Current account dynamics is mainly driven by Government Expenditures**



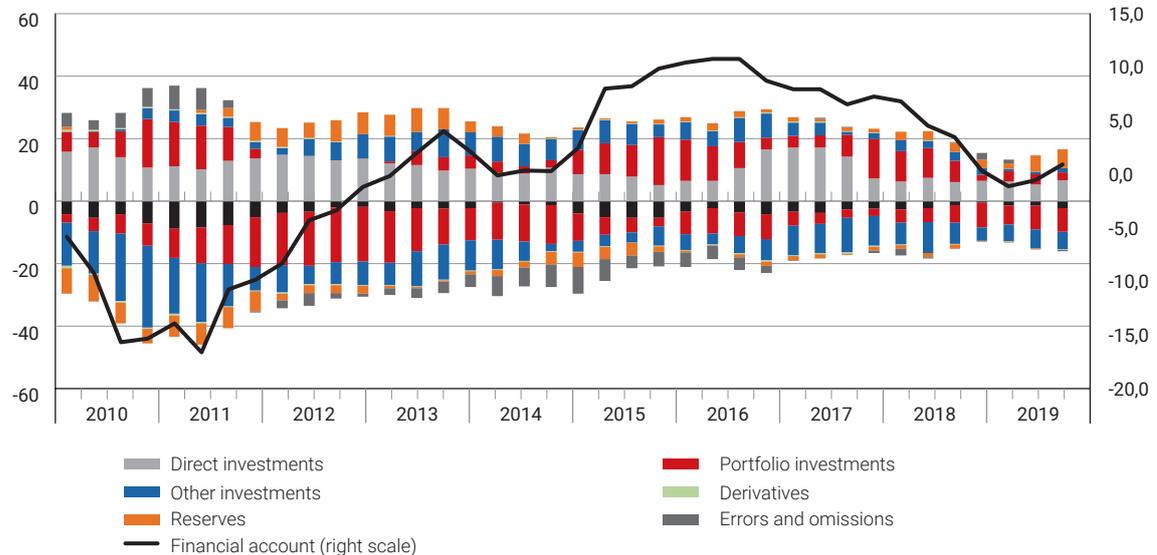
Source: Ministry of Finance of the Republic of Kazakhstan, National Bank  
Note: Balance of savings investment of the private sector (includes QSS) is calculated on the residual principle; all indicators are presented as the moving amount for 4 quarters to GDP's moving value

Fiscal and quasi-fiscal transactions were reflected in the financial account. In particular, redemption of KMG Eurobonds (in the amount of \$1.6 billion) and that of KazAgro (in the amount of \$1.1 billion) put extra pressure on balance of payments. In addition, in the first quarter

of 2018, JSC KazMunaiGas Exploration Production repurchased the shares and global depository receipts. This has resulted in the capital outflows of portfolio investments.

**Chart 1.6 Under Capital Outflow Current Account Deficit was Financed by the Reserves**

Financial account (+ inflows / - outflows), billion US dollars, amount for 4 quarters



Source: National Bank

Historically the inflow of foreign direct investments was a main source of current account financing, which enabled partial financing of current deficit and covered the demand of public and private sectors for foreign currency.

FDI inflows to Kazakhstan mainly come through reinvestments of direct foreign investors revenues

into the sectors indirectly or directly linked to mining. Unavailability of externally financed large-scale projects in Kazakhstan in the context of scheduled and early repayments of external liabilities explains the dynamics of foreign direct investments, which, after some growth period caused by high oil and metal prices, started to slow down.

**Chart 1.7 Slowdown in FDIs Inflow despite Rising Oil Prices**

Net inflow of FDIs, billion US dollars, amount for 4 quarters



Source: National Bank

### 1.3. ECONOMIC GROWTH

Over past few years, economic growth has continued to remain at 4% per annum. Fiscal stimulation became the main drive of growing nontraded sectors in the first half of 2019. Contribution of nontraded sectors remained steady amid decreased contribution of the traded sector. The supply of capital investments for traded non-oil sectors remained limited, and main investments were raised by capital intensive extractive industries.

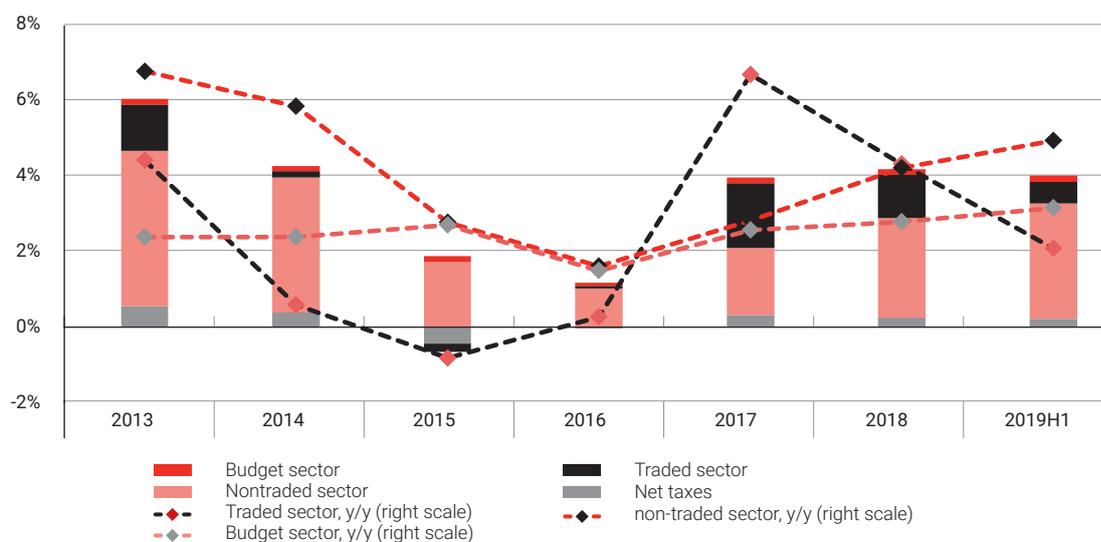
The transition to inflation targeting and a floating exchange rate helped to smooth out the effect of external factors on Kazakhstan's economy, however, it has not sufficed to ensure its growth adaptability and stability. Deteriorated terms of trade in 2015 enabled the strengthening of the role of traded sectors, however, fiscal stimulation of aggregate demand, including imports, restrained the restoration of local production competitiveness.

Over past two years, the growth of economy's tradable sectors have slowed amid accelerated growth of nontraded sector. In 2018, real growth was mainly driven by nontraded sectors (Chart 1.8), which escalated along rising global oil prices, expanding government spending and a reviving consumer market. This altogether to GDP growth at 4.1% in 2018.

At the same time, the growth of traded industries in 2018 slowed down to 4.3% compared to 6.6% in 2017. The slowdown of industrial production in the mining and manufacturing industries was the main growth-restraining factor.

In the first half of 2019, the slowdown in the growth of traded sector has continued, which, nevertheless, was offset by accelerated growth in the construction industry related to nontraded sector.

Chart 1.8 *Rising Prices on Commodity Markets was the Basis for Economic Growth*  
Contribution to GDP Growth



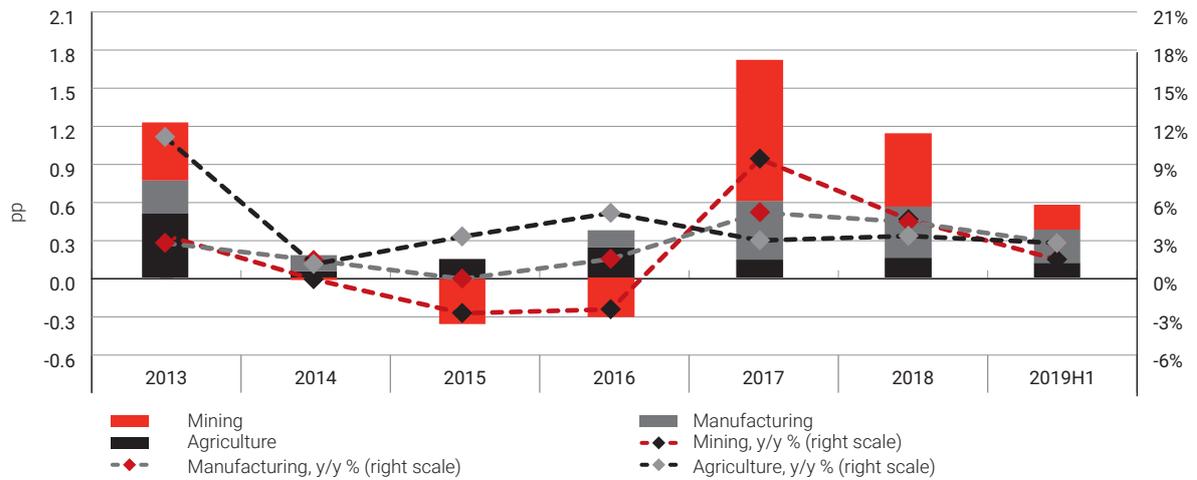
Source: SC MNE RK

Note: Traded sector includes agriculture, mining and manufacturing; Budget sector covers education, public administration and defense, compulsory social security and health care, as well as social services; Nontraded sector includes all other sectors not covered by traded and budget sectors. The contribution to GDP growth in the first half of 2019 is calculated in relation to the first half of 2018

In 2018, the growth of the mining industry slowed down, despite rising oil production that reached a maximum of 90 million tons (Chart 1.9). The reduction in external demand caused the production of non-ferrous metal ores to slow down from 7.6% a year earlier to 4.3%.

In the first half of 2019, the slowdown in the mining industry continued following decreased oil production due to technical work at the largest fields.

Chart 1.9 Slowdown in production of mining output

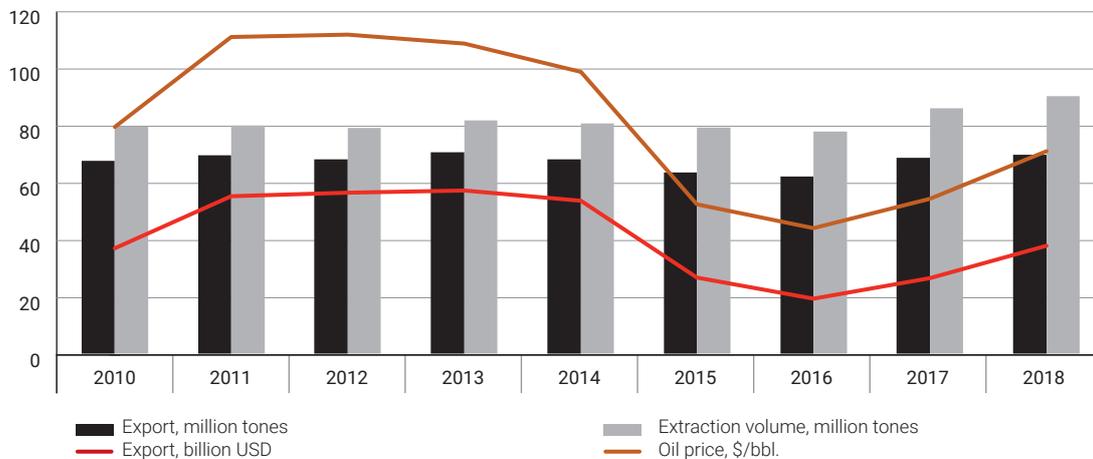


Source: SC MNE RK

Note: for the first half of 2019, growth is calculated to the corresponding period of 2018

In 2018, exports grew by 42.2%, mainly contributed by crude oil and gas export (Chart 1.10).

Chart 1.10 Kazakhstan Remains highly dependent on oil  
Crude oil export and production



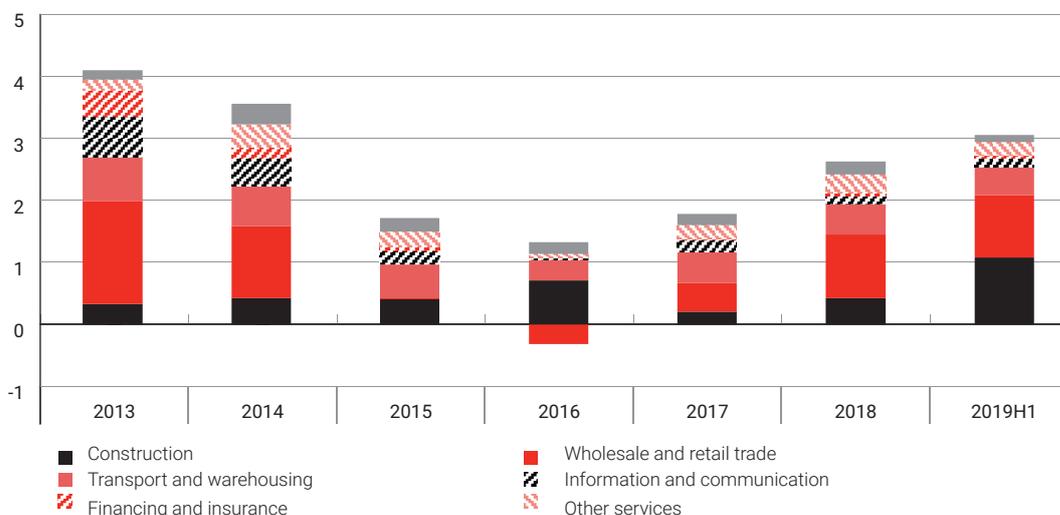
Source: SC MNE RK

Wholesale and retail trade contributed the most to the growth of the nontraded sector in 2018 (Chart 1.11). The expansion of consumer lending amid rising wages caused the retail sector to increase. In general, the trade growth in 2018 greatly outperformed the overall economic growth. The growth in sales of goods was contributed by wholesale trade, including by oil trade growth.

In the first half of 2019, fiscal stimulation, including through state housing programs, once again boosted the construction industry. The contribution of the construction sector to GDP growth exceeded one percent point, leaving wholesale and retail trade behind.

**Chart 1.11 Trade in Petroleum Products and Intensified Construction were the Major Contributors to GDP growth**

Contribution to GDP Growth



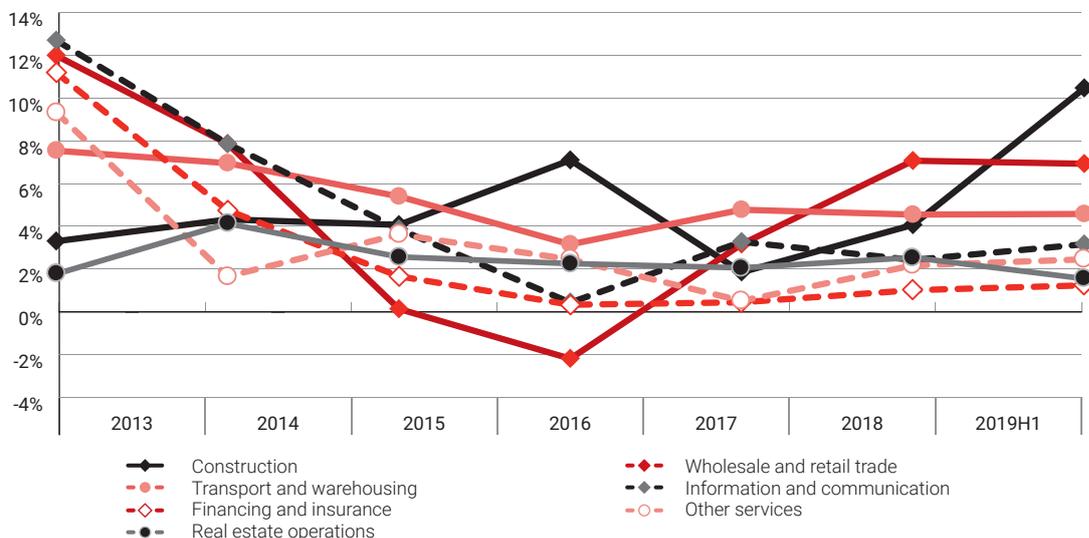
Source: SC MNE RK

Note: The contribution to GDP growth in the first half of 2019 is calculated in relation to the first half of 2018.

The construction industry in 2018 grew by 4.1% y/y twice as fast than the year before and twice as slow that in the first half of 2019 (Chart 1.12). Against this

background, the growth of real estate transactions has slowed down.

**Chart 1.12 Nontraded Sector Growth, y/y**



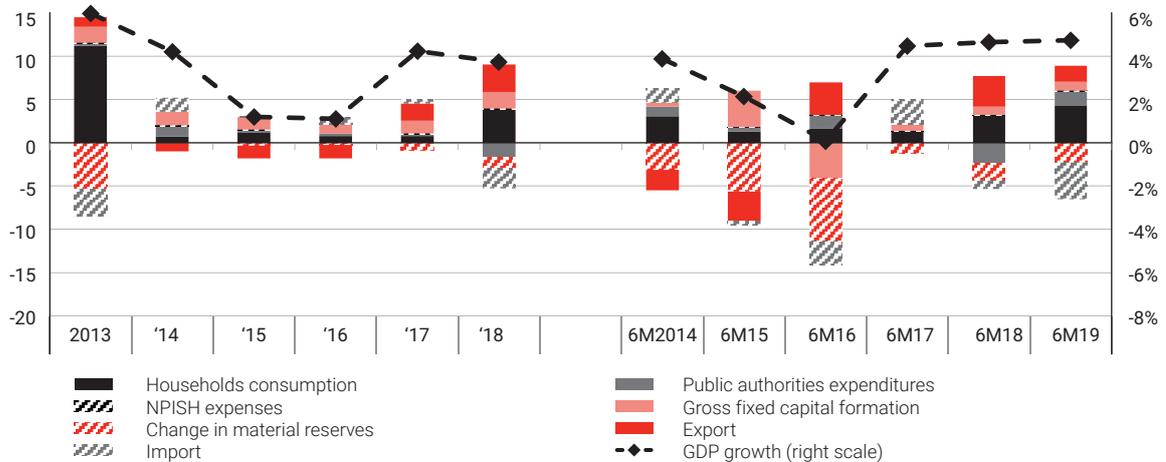
Source: SC MNE RK

In 2018, GDP at expenditure approach was growing thanks to enhanced consumer demand. The growth in household consumption was thus 6.1% (1.2% y/y in 2017). The household consumption contributed the most to GDP growth (Chart 1.13). One of the drivers behind growing consumer demand was the increase in real cash incomes of the population. In particular, in 2018, real wage growth amounted to 2.4% y/y against a decrease of -2.1% y/y in 2017. Along with consumer

demand, export growth positively contributed to growing GDP as end-user, largely owing to restored energy prices.

In the first half of 2019, aggregate demand was driven by growing household consumption and the government spending. Imports grew by 21% compared to the same period of the last year.

Chart 1.13 Contribution of Aggregate Demand Components to GDP Growth, y/y



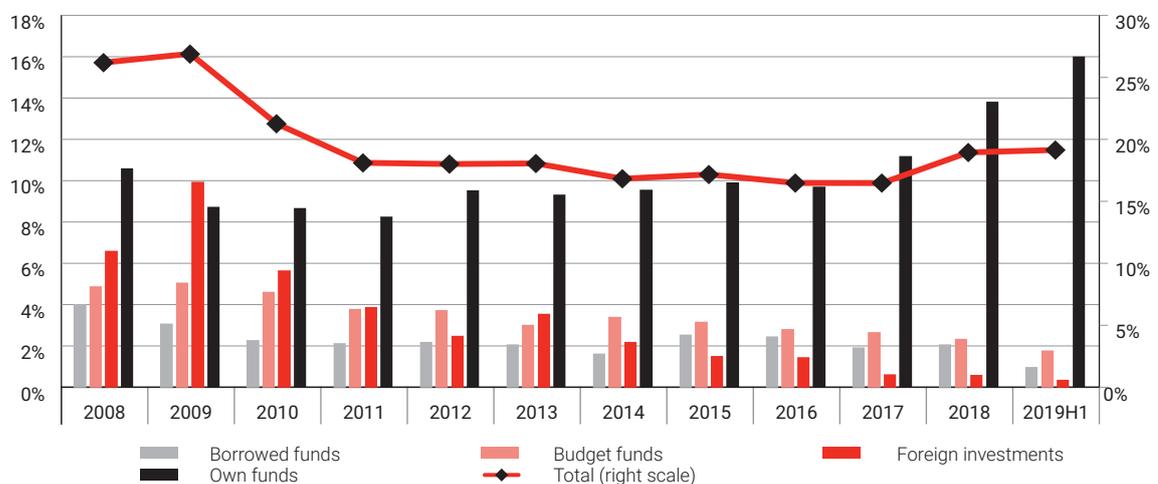
Source: SC MNERK

Since 2018, investment activity has been growing, and as results of the first half of the year showed the investments to GDP ratio of 19.2% (Chart 1.14). This is despite the fact that over past seven years, the average investment to GDP ratio stood at 17.4%. Such a significant increase in investments was underpinned by increased investments into other expenses by 101.6% y/y (0.3% y/y in 2017), a driver behind the increase in

their share from 14.0% to 23.4% in the total investment structure.

In addition, the financing of investments in fixed assets at the expense of the budget has a long-term downward trend that manifests a shift of the government spending from capital expenditures to current expenditures.

Chart 1.14 Structure of Fixed Capital Investment

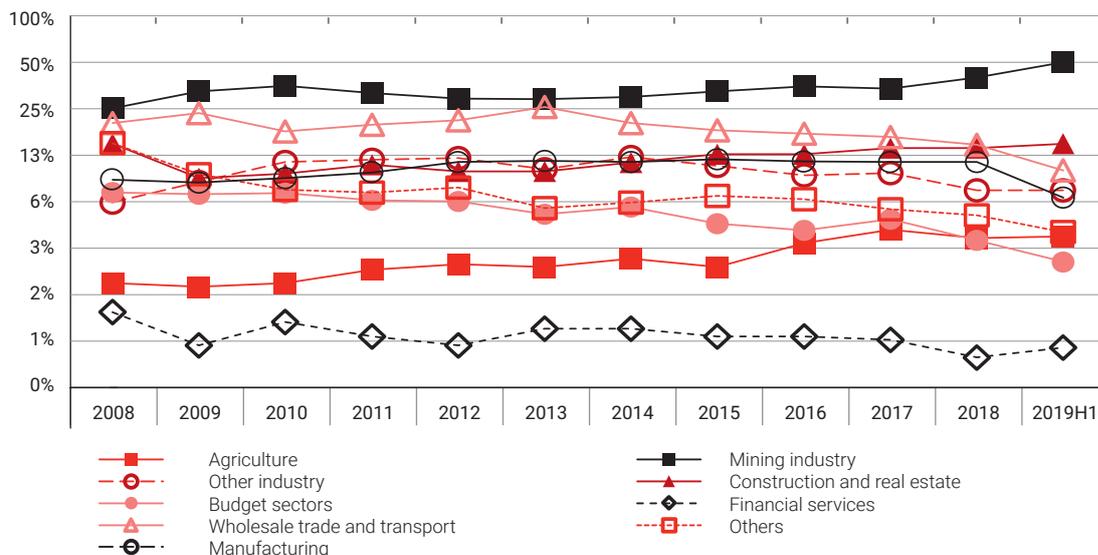


Source: SC MNERK

The growth of investments is a positive factor, however, it was mainly secured by the growth of investments in the oil industry, which is no solution to the issues related to enhancement of economic diversification. Mining industry remains a fixed assets investment leader. Investments to the sector grew 1.5 times in nominal terms, while the index of physical volume of investments grew by 40.4% y/y. Mining industry

accounted for 40.4% of the total investment structure by sectors of economy, with 85.4% of which invested in oil and gas production. In the first half of 2019, the share of investments in the mining industry exceeded the half, an implication of the transition of oil and gas projects from the investment to active production phase.

Chart 1.15 Fixed Capital Investment Areas



Source: SC MNE RK  
 Note: data are shown on a logarithmic scale.

In general, 2018 and the first half of 2019 were positive for Kazakhstan’s economy. The growth rates were maintained, mainly due to the growth of nontraded sectors of the economy, in particular, construction and

trade. The growth of these sectors was secured by rising oil prices and expansion of government spending, so sustainability of such growth remains an open question.

### 1.4. FISCAL POLICY

**Kazakhstan’s fiscal position in 2018 has improved. Non-oil deficit fell from 12.7% of GDP to 7.6% of GDP. Fiscal buffer in the form of assets of the National Fund at the end of 2018 exceeded 32% of GDP. Kazakhstan’s fiscal space still offers wide opportunities for growth stimulation at the expense of government spending and guarantees that usually have short-term and unsustainable effect on nontraded sector and overwhelming long-term effect on traded sector.**

**Economic stabilization in 2018 and 1H2019, secured mainly by growing oil revenues, masks the problems of non-oil sector and the need for a more disciplined and countercyclical fiscal policy.**

Kazakhstan is a classic example of a resource-based country that is highly dependent on oil market. Oil dependence puts significantly more pressure on

external and fiscal position amid decreasing oil prices and exacerbates the symptoms of the Dutch disease when the prices rise.

All this stimulates the need for the reform of the fiscal policy as to strengthen its role as a macroeconomic stabilizer, including its coordination with monetary policy.

Non-oil deficit has been growing by leaps and bounds the fiscal expansion from 2004 to 2009, when the government spending in dollar terms grew at an average of 39% per year. Over past 10 years, the level of non-oil deficit has stayed at the average level of 8.5%, with no signs of sustainable decrease (Chart 1.16). Official budget deficit in the context of fiscal position is of little information, as it covers only the deficit financed by the debt and excludes the financing by NFRK.

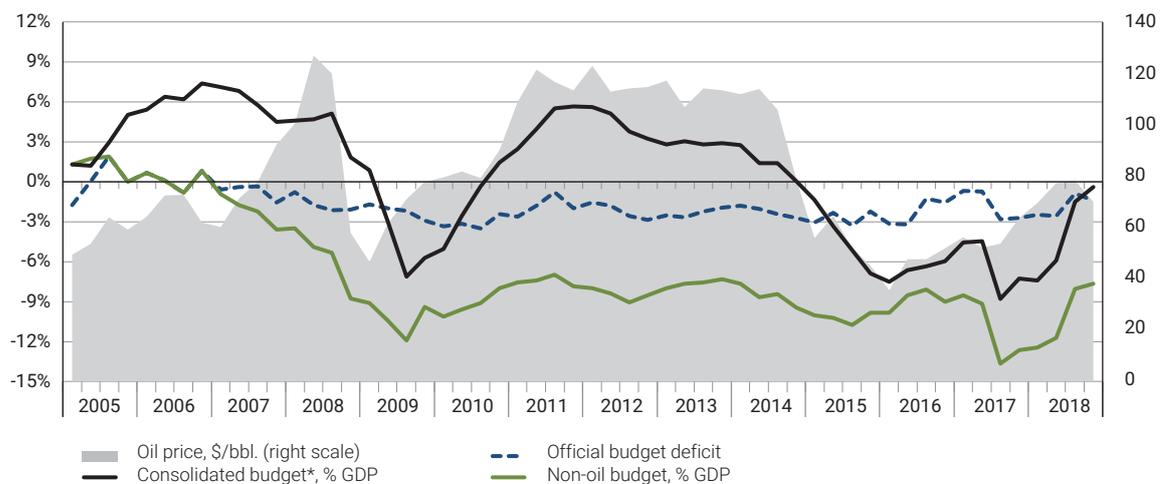
Consolidated budget balance that corresponds to the classical model of fiscal position improved greatly in 2018 and left the deficit zone in early 2019. In 2018, the decrease in the consolidated budget deficit was caused mainly by the growth of oil revenues to the NF of the Republic of Kazakhstan and decreased expenditures. The analysis of current expenses offers more information. One-off bailout expenditures for second-tier banks in 3Q2017 creates false picture of mass fiscal stimulus in 2017 and a sharp consolidation in 2018. With one-off costs excluded, the direction of fiscal policy towards deficit reduction is more visible:

consolidated budget deficit has been decreasing by 2,6 pp in 2017 and by 2,9 pp in 2018.

Despite improved fiscal balance and external position, fiscal stability risks associated with price drop remain high.

Currently, NFRK transfers play a role of a redistribution mechanism, but their effectiveness is restricted by poor countercyclicality of expenditures, low discipline of fiscal rules compliance and predominating focus on consumer demand and nontraded sector support.

**Chart 1.16 High non-oil deficit and insufficient countercyclicality of consolidated deficit**



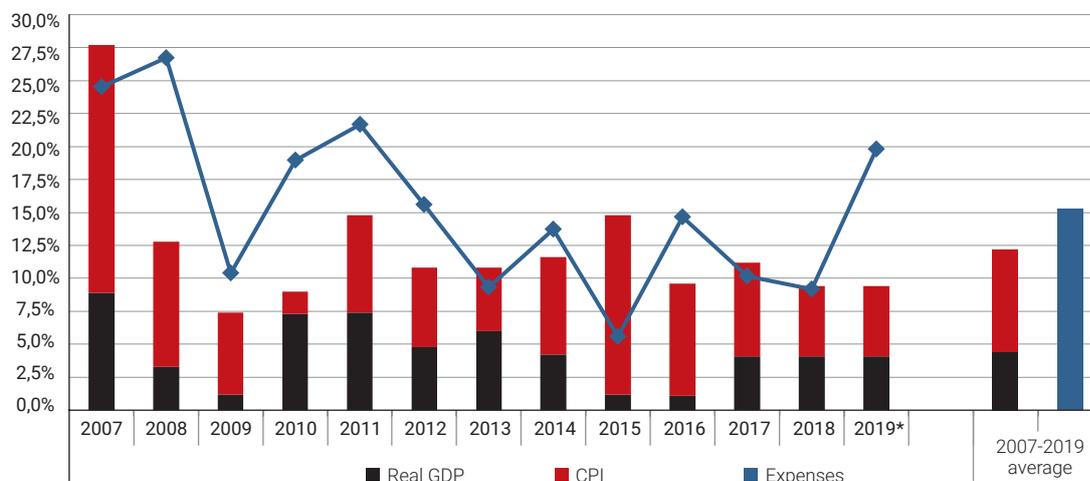
Source: Ministry of Finance of the Republic of Kazakhstan, National Bank, IMF, authors' calculations

In addition, the expenditures for the service and repayment of the government borrowings increased mainly due to the current structure of public debt. Over next three years, expenses related to public debt are expected to rise on the growing volume of principal debt repayment. To note, the costs of debt servicing and repayment are both in tenge and foreign currency. Tenge part of the debt presents no significant risks, while the forex part is exposed to forex risk, which may lead to a significant increase in debt servicing costs in case of tenge depreciation.

The comparison of the growth rate of the government spending and that of real GDP and inflation demonstrates a notable differential, especially at times of rising oil prices ([Chart 1.17](#)). This emphasizes the pro-cyclical nature of the government spending, which exerts pro-inflationary pressures. Government spending should be aligned with monetary policy's inflation reduction objectives. Therefore, the growth of the nominal level of the government spending should not exceed the growth of accumulated inflation and real GDP.

**Chart 1.17 Government spending rises faster than inflation and real GDP growth during periods of high oil prices**

Government spending growth, real GDP growth and inflation



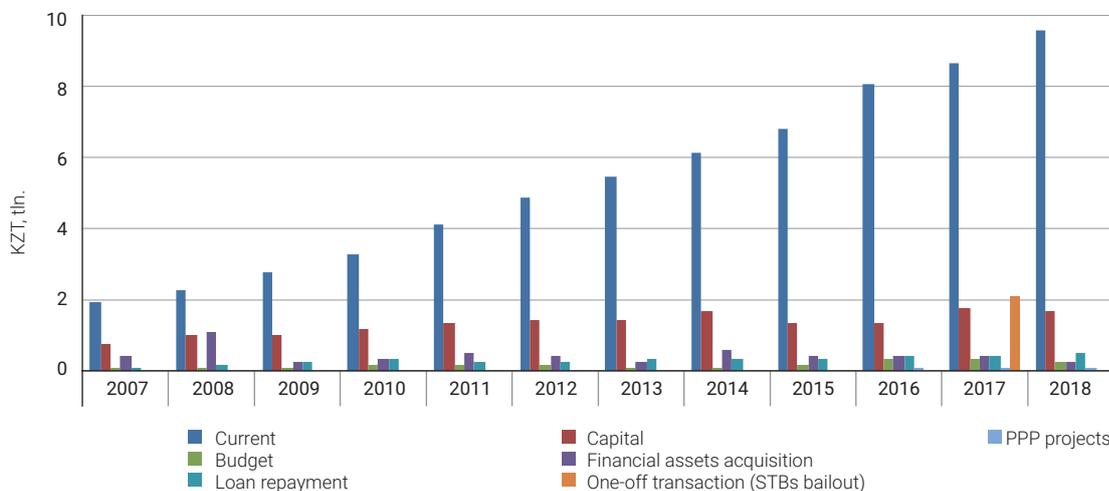
Source: Ministry of Finance of the Republic of Kazakhstan

Note: State budget expenditures are presented disregarding a one-off bailout transaction for STBs in 2017. \* The planned values of the adjusted budget for 2019 were used as the level of expenditures for 2019; inflation and real GDP growth was set at 2018 level.

The analysis of government spending by economic classification demonstrates a lack of capital expenditures that are in decline in favor of expanded

current spending. Although current spending helps stabilize current consumption, it creates no reserve for long-term economic growth.

**Chart 1.18 Capital expenditures are substituted by current expenditures in the structure of government spending**



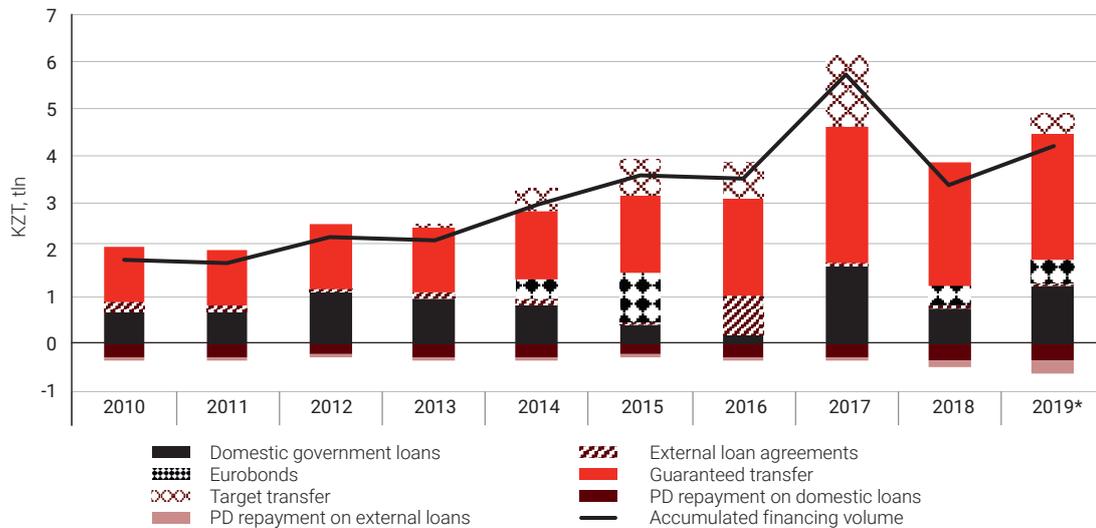
Source: Ministry of Finance of the Republic of Kazakhstan

The main source of consolidated deficit continues to be NFRK's transfer, while the share of domestic debt decreases (Chart 1.19). В 2018 правительство не использовало целевой трансферт, в отличие от 2017 года. In 2018, unlike in 2017, the government has not resorted to the targeted transfer. In 2019, to finance growing expenditures, the transfer was increased to

3.07 trillion tenge, including 370 billion tenge of targeted transfer.

Absent clear-cut rules of the transfer size, including the targeted transfer, weakens countercyclicality and sustainability of the fiscal policy.

Chart 1.19 NFRK Transfers Remain the Main Source of Deficit Financing



Source: Ministry of Finance of the Republic of Kazakhstan

Note: \* data on servicing internal and external debt are presented as of November 1, 2019

NFRK Concept<sup>1</sup> sets out three major fiscal rules: targeted levels of non-oil deficit, threshold size of NFRK transfers and minimal size of NFRK assets as GDP share.

These rules are called to smooth out the effect of oil revenues on budget expenditures as they are saved in foreign assets and sold in some amount for the budget use, but they are not sufficiently countercyclical. In particular, the existing rules are not tough enough to maintain the spending discipline with high oil prices, not flexible enough to finance the deficit with a temporary drop in oil prices, insufficiently adaptable to the permanent fall of oil prices, and not long enough to accommodate the planned oil production decline as reserves deplete.

Possible revision of long-term fiscal guidelines or alignment of short-term goals at the budget formation and performance stage takes the level of budget discipline down and increases the procyclicality of budget expenditures.

Initial plans of fiscal consolidation get softer. During the planning process, the non-oil deficit was set above the target level (2017, 2018), and in 2019 the target level itself was revised. In addition, the volume of transfers raised from NFRK had increased. The volume of transfers for 2019 was increased to the level of 2.7 trillion tenge from the initial level of 2.3 trillion. tenge,

while the 2020 transfer was increased to 2.7 trillion tenge from the initial level of 2 trillion tenge.

In aggregate, insufficient integration of restrictions set out in the Concept into the budget process and the elements of manual control in the form of targeted transfers reduce economy's adaptation capacity and increase the risks of accelerated utilization of NFRK assets. In the long term, a decrease in NFRK assets will bring the credibility of the fiscal policy down and significantly affect how external investors perceive the level of country risks.

The countercyclical fiscal policy is required, and it implies the introduction of an automatic budget expenditure adjustment mechanism linked to economic cycle and long-term oil prices that could become an integral part of the budget process.

Such a policy should take into account external shocks on fiscal revenues in order to stabilize expenditures in tenge terms, given the limited volume and structure of NFRK assets. So, government spending should be stabilized at such a level as to enable a competitive real exchange rate, and as a result, rather than the goal, the accumulation of funds with NFRK. Due to limited oil reserves, the planning horizon should include a depletion period.

To ensure the flexibility and adaptability of the rules in the long run, automatic mechanisms are needed to align deviations from the approved policies and from the forecast models prescribed at a regulatory level. In addition, the rules used to comply with the current

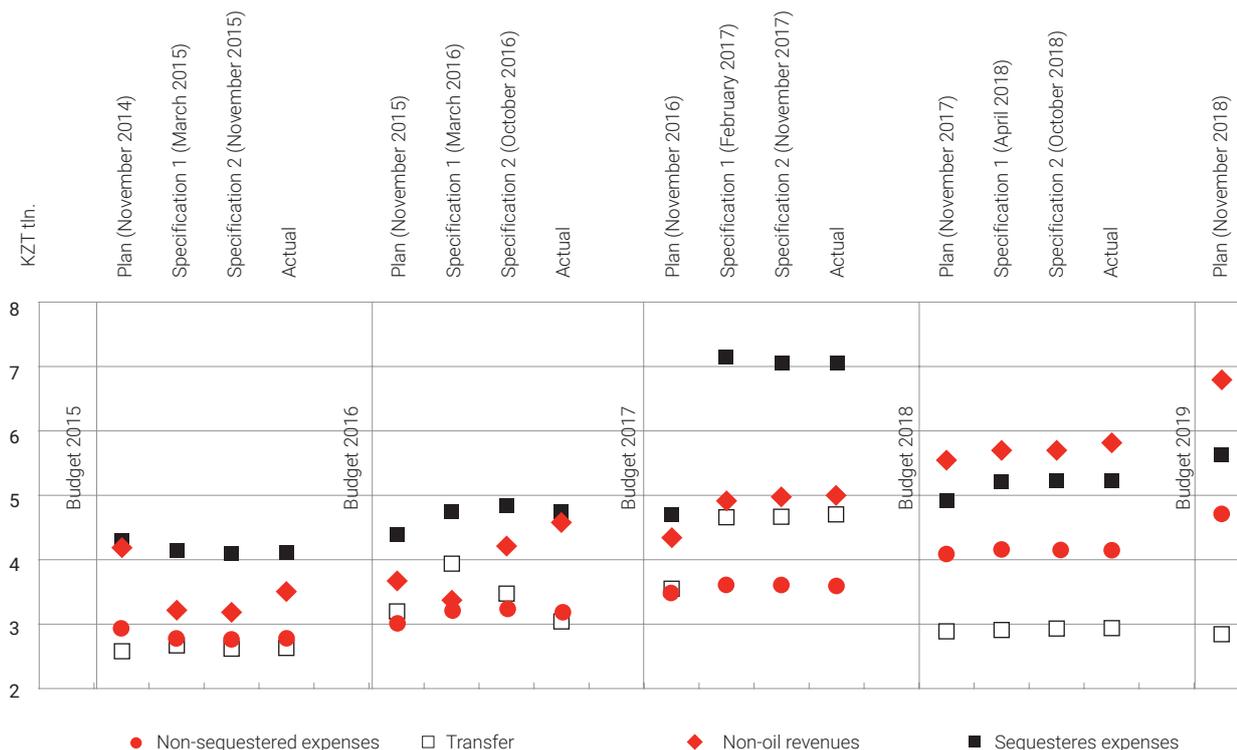
<sup>1</sup> Approved by the Degree No. 385 of the President of the Republic of Kazakhstan on December 8, 2016, "On the Concept of Formation and Utilization of the Funds from the National Fund of the Republic of Kazakhstan"

economic conditions must be validated in the medium-term, and be reviewed in case of structural changes or permanent shocks.

The lack of automatic adjustment mechanisms and the imperfection of the forecasting planning process entail the need for the budget adjustments (Chart 1.20). Between 2015 and 2017, there were significant

deviations from the parameters originally budgeted that were aligned during implementation. It is noteworthy that in 2018, the budget performance and subsequent adjustments showed the lowest rate of volatility compared to previous three years. The budget had practically no deviations from its performance approved in November 2017, following enhanced oil market volatility.

Chart 1.20 Budget Adjustments

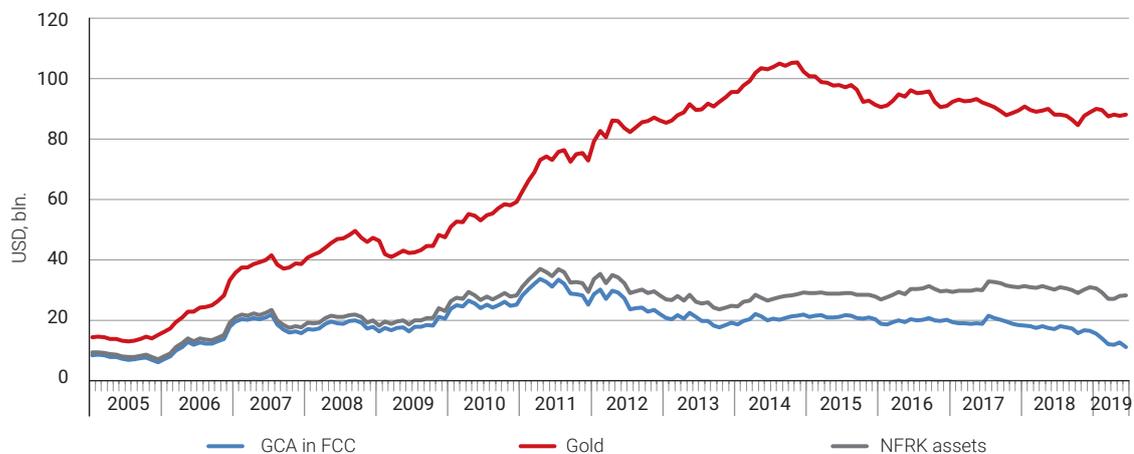


Source: Ministry of Finance of the Republic of Kazakhstan

Despite structural and institutional problems, substantial fiscal buffer enables to maintain Kazakhstan's rating at the investment level (Chart 1.21). However, the growing government spending financed by NFRK

transfers and postponing a decision on the reduction of the volume of transfers raised for the budget boosts the risks of narrowing the fiscal space and, as a result, enhancing long-term risks for macro-fiscal stability.

Chart 1.21 *Significant external assets help maintaining the sovereign rating at an investment grade level*  
Volume of GCA and NFRK assets, as accumulated



Source: National Bank

## 1.5. MONETARY POLICY AND FOREIGN EXCHANGE MARKET

In 2018 - 2019, NBK continued to pursue its monetary policy with the principles of inflation targeting and a floating exchange rate. Inflation continued to decrease to 5.3% in 2018 and to 5.4% at the end of 1Q 2019, but the pace of disinflation slowed down, while inflation components' volatility and tail risks remained high, calling for caution and maintenance of a minimal spread between the base rate and the inflation forecast at least at 3.0-3.5 percentage points.

The effect of monetary policy on accumulated demand through interest rate and credit channels was restrained by a number of institutional and structural factors. Potential demand expansion through credit channel is limited by high credit risk of the corporate sector that was historically presented by nontraded sector and had high debt burden and limited capability of the banks to absorb credit risk.

Over three and a half years of interest rate management, the sensitivity of risk-free yield curve against money market rates has improved at under a year periods, where NBK notes were the main instrument, the demand was generated by voluntary investors and the activity was relatively high, The rate of return on under a year period reflected the decisions on monetary policy: its smoothing until 1Q2018m its toughening in 2Q2018 and extension of medium maturity of NBK's tenge liabilities in summer of 2019. Despite enhanced transparency of the rate

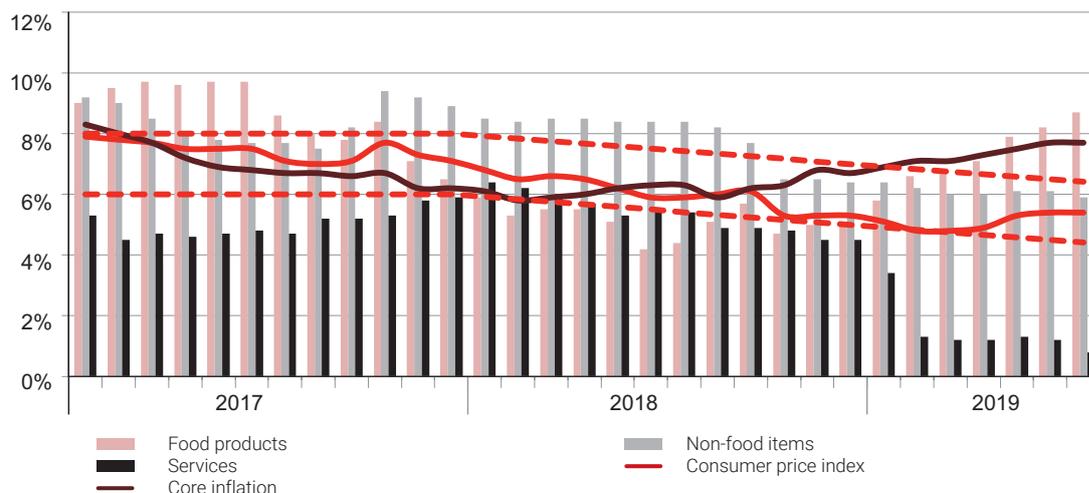
policy, the transmission of monetary market rates to futures market remains limited.

Amid sustainable credit to the economy, the fiscal policy, which was consolidated in 2017 and 2018 and smoothed in 2019, was the contributing factor to the generation of the aggregate demand and inflation.

NBK's main task was to maintain sustainable value of the national currency and the exchange rate channel as the main transmission channel of the interest rate policy, NBK remained dedicated to floating exchange rate policy, and its involvement in the foreign exchange market was minimal. USDKZT volatility declined in 2Q2018 and 1H2019, though partially re-emerged at the end of 1Q2019. However, foreign exchange market remains relatively shallow, its efficiency is low, and market participants readiness and capability to take open FX positions are limited.

In 2018, inflation dropped to 5.3%, almost evenly across all the components. In 1H2019, inflation remained within the target corridor (5.4% at the end of the first half of 2019), though the gap between the components was high: unregulated food prices have gone up, and the tariffs for regulated services went down abruptly. Starting from 4Q2018, the differential between the core inflation and the general inflation rate was growing and being indicative of inflationary pressure and the risk of accelerated inflation ([Chart 1.22](#)).

Chart 1.22 Risks of long-term proinflationary pressure



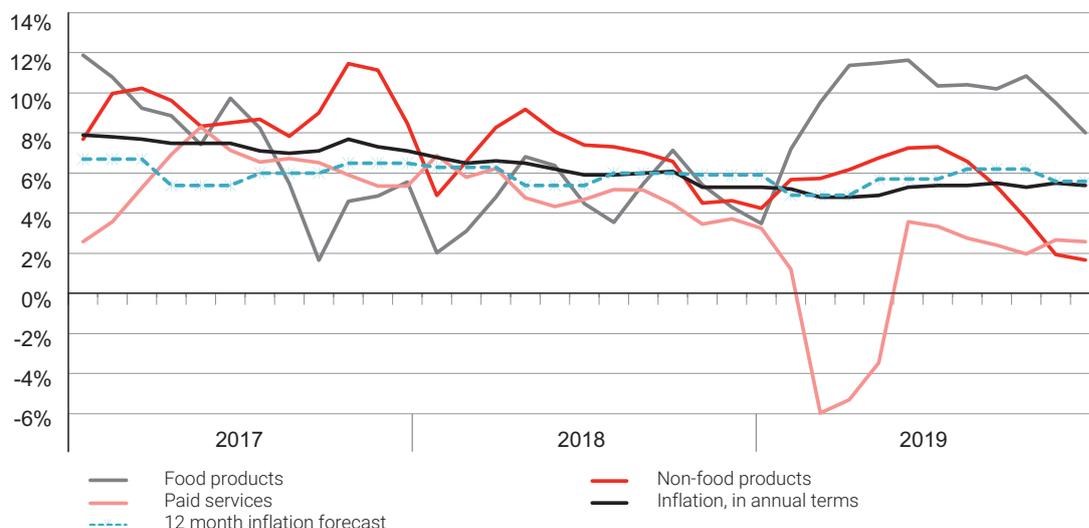
Source: SC MNE RK

Note: base inflation index is taken for core inflation, which excludes fruits and vegetables, utilities (regulated), rail transport, communications, gasoline, diesel and coal

In early 2019, inflation of food and non-food products accelerated (Chart 1.23). Lowering of prices for

regulated services had created a deferred inflation effect brought down in the second quarter of 2019.

Chart 1.23 The reserve created by lower prices for regulated services was exhausted in the second quarter of 2019



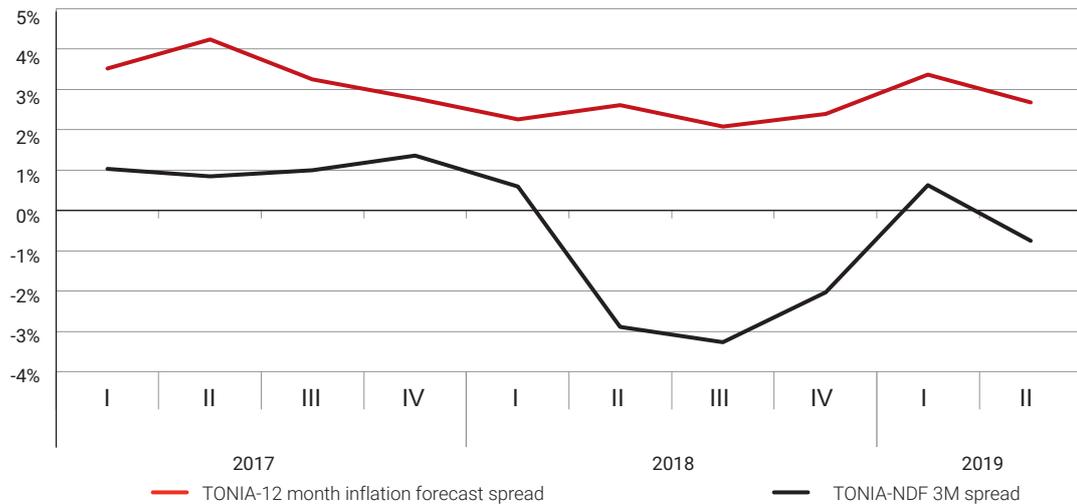
Source: SC MNE RK, National Bank assessment

Note: the graph shows annualized moving average values for 3 months of seasonally adjusted data on the consumer price index by component.

The exchange rate channel remained to be the main channel of monetary policy transmission due to the high import share in consumer basket. Tenge depreciation of 2018 put extra inflation pressure and increased the risk of speedy dollarization of STBs liabilities. In 2Q2018, the rate of USDKZT non-deliverable futures grew as a response to deteriorated global sentiment

and increased pressure on tenge (Chart 1.24). Tenge rate and forward rate spread became negative and indicative of tenge arbitrations, though wide demand and supply spreads on NDF market rendered the utility of short position in fact dubious. Nevertheless, the base rate was increased by 25 basis points to 9.25% in October 2018.

Chart 1.24 Risk Premium for Tenge Assets Holding

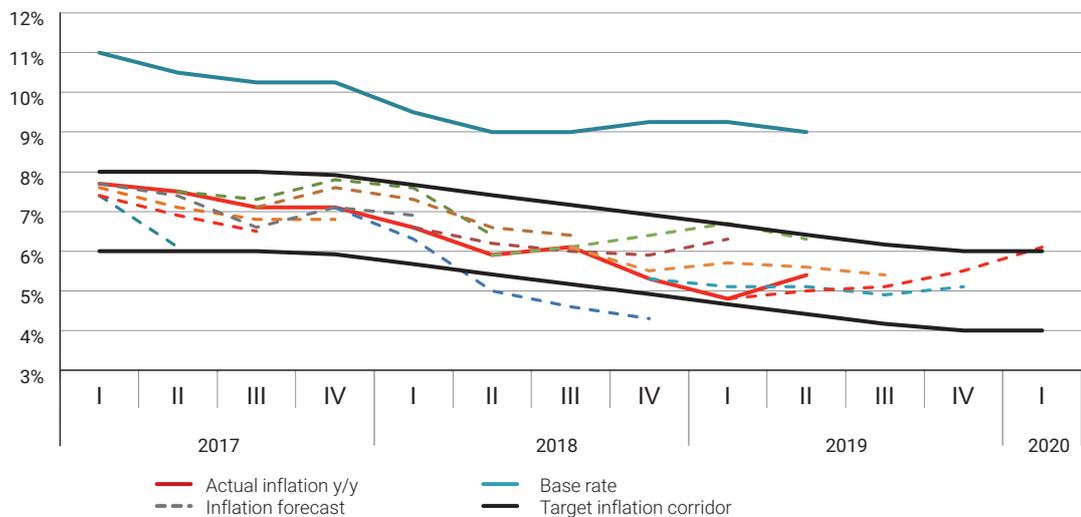


Source: KASE, Bloomberg

In 2018-2019, the base rate was set in view of the real rate reserves at the level of 3.0-3.5%. The inflation target

was taken from 6-8% down to 5-7% in 2018 and to 4-6% for 2019-2021 (Chart 1.25).

Chart 1.25 The NBK has lowered its inflation target for 2018-2019



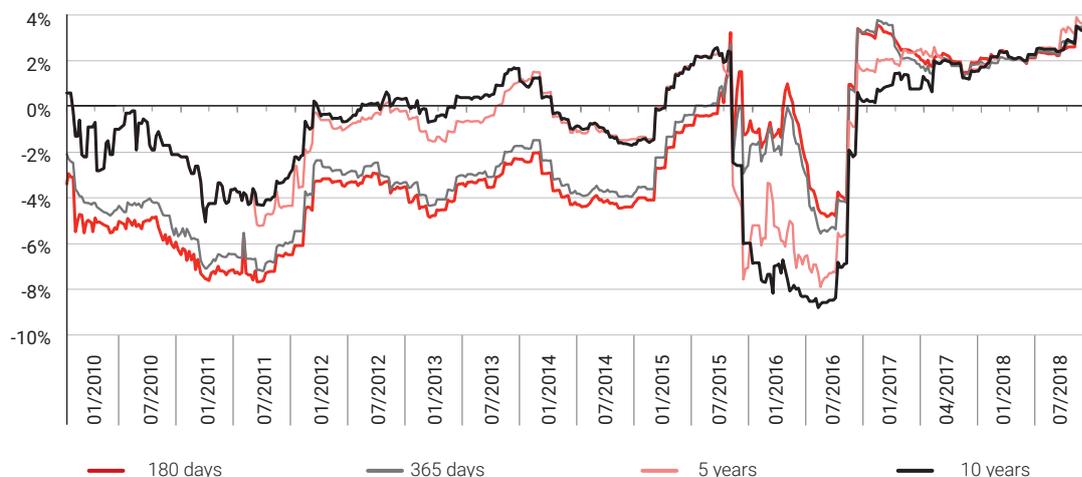
Source: National Bank

NBK's notes market continued to be relatively liquid in 2018-1H2019, and notes rates reflected voluntary demand of second-tier banks for risk-free tenge assets and their monetary policy expectations. Hence this market of long and medium government securities still remains low liquid and disable yield curve from being a price guide for tenge funds on under a year periods and restricts the efficiency of the interest rate channel.

Despite low information value, the yield on all the periods to maturity enables positive return in real terms.

Before the transition to the interest rate management policy, investors could get the return in real terms only at long maturity. The return on short maturity was negative. After the transition to inflation targeting, inflation rate was declining and the positive differential of real return was growing (Chart 1.26). Boosted activity on government securities market (for more details on GSM see Section II) and potential normalization of the yield curve shape will make long instruments more attractive.

**Chart 1.26 After the transition to the interest rate management regime, real yields rose at all maturities**  
 Real rates (inflation-adjusted nominal yields)



Source: KASE, National Bank, National Bank assessment

After a structural shift that occurred with the transition to a new monetary policy regime, nominal rate volatility was high, and the yield curve, prior to rate stabilization at a new level, was inverted. Due to low liquidity and enhanced uncertainty, the curve was not a reliable reflection of investor expectations. Market players generated their expectations for the cost of risk-free capital in isolation from rates of short-term repo market. After NBK began to target short-term rates, a short-term curve segment was generated to enable the market to form a yield curve based on NBK's bond rates (Chart 1.27).

Despite enhanced efficiency of the interest rate channel, in particular, the curve's enhanced sensitivity to changes in the base rate, its role is limited by the level of development of tenge government securities market. Current fiscal policy, in particular, suboptimal government debt management policy, has brought about the formation of non-optimal institutional and maturity structure of the government securities market, which imposes a number of restrictions.

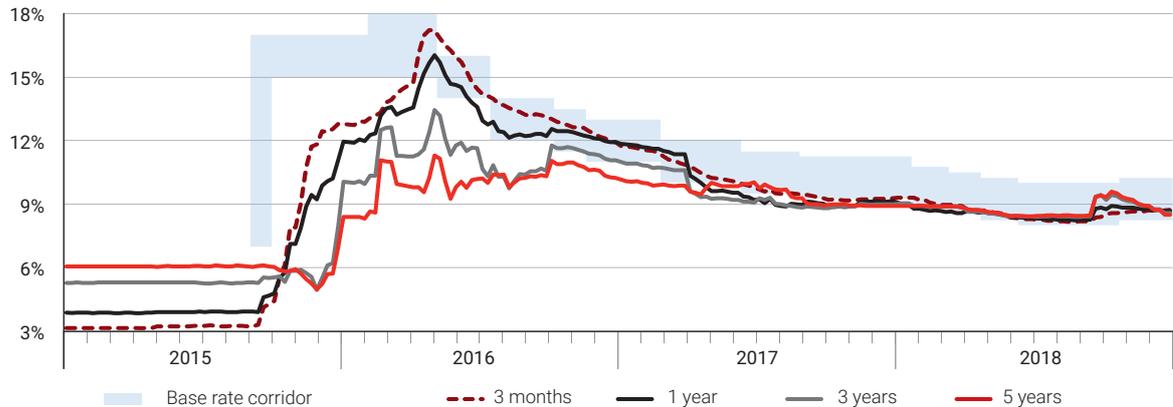
Firstly, for more efficient functioning of the transmission mechanism, more informative yield curve is required, which implies enhanced liquidity of the government securities market. Market segmentation is current, and liquidity is concentrated at the short end of the curve, which forces NBK to withdraw it by issuing short-term notes.

Secondly, current policy of budget deficit financing triggered by potential transfers from NFRK has no public debt focus. Conceptually, the part of liquidity concentrated in NBK notes can be reallocated into longer securities of the Ministry of Finance of the Republic of Kazakhstan. However, there are a number of problems covered in more detail in Government Securities Market section.

Despite these limitations, the level of transmission of decisions on base rate on corporate lending and funding market has risen. The cost of providing and raising capital of the corporate sector from that time on started to depend on a change in the base rate (Chart 1.28).

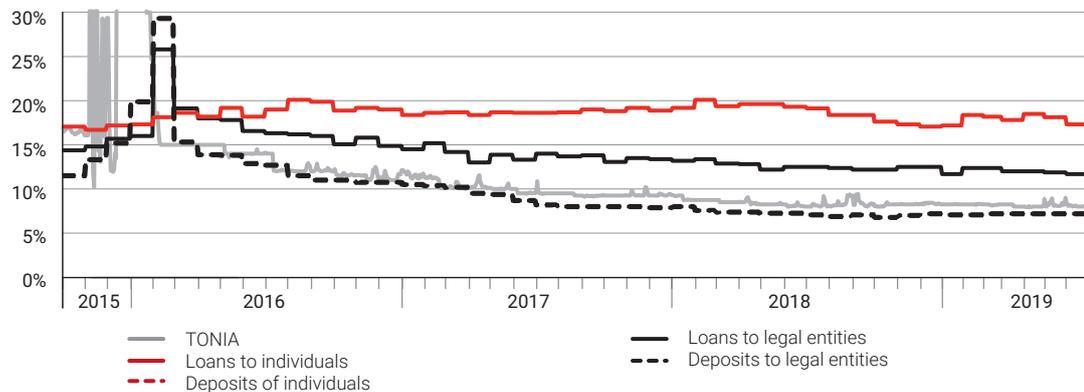
The picture in the retail sector slightly differed. In 2018, the rates started to approach the rate of a one-day repo, however, high debt burden on this market segment and low quality of the borrowers limited the enhancing sensitivity of retail lending. Also, the pricing on retail loan market is undermined by state programs for rate subsidization.

**Chart 1.27** After a change in the monetary policy regime, the rates along the yield curve are formed inside the prime rate corridor



Source: KASE, National Bank

**Chart 1.28** Retail Segment Less Sensitive to Base Rate Changes



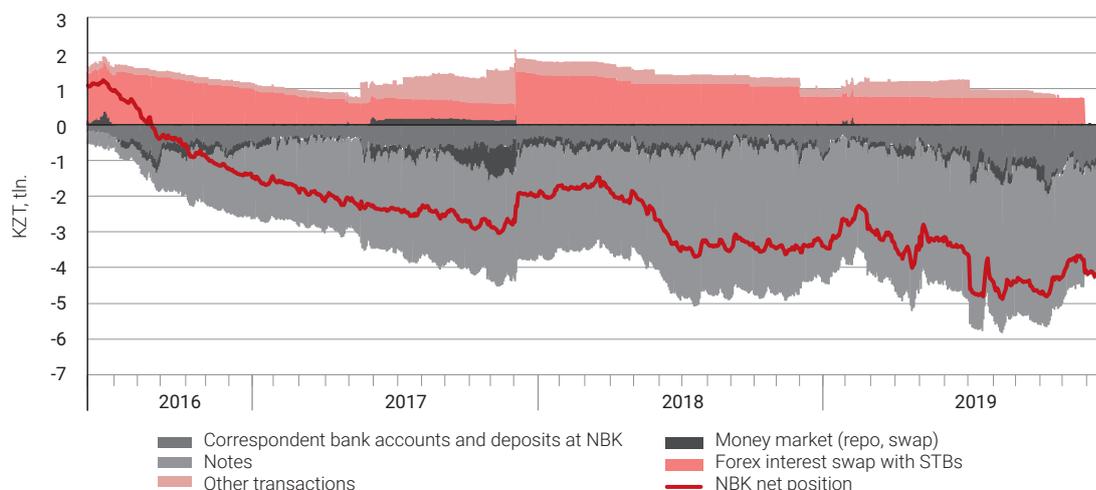
Source: National Bank, KASE

## Implementation of Monetary Policy

In 2018-2019, NBK continued to withdraw excessive liquidity to maintain interest rate within NBK target corridor ([Chart 1.29](#)). As of August 1, 2019, open position on NBK's transactions equaled 3.8 trillion tenge (without correspondent accounts), which is 19% of all money mass or 6% to GDP (2018).

NBK notes remained to be the main instrument of tenge liquidity withdrawal in 2018 and 2019. Also, major part of tenge liquidity was in correspondent accounts and deposits of NBK. In 2018 and 2019 forex and FX swaps between NBK and the banks were redeemed, thus decreasing tenge liquidity in circulation.

Chart 1.29 Starting from 2016, the NBK acts as a net buyer of tenge liquidity

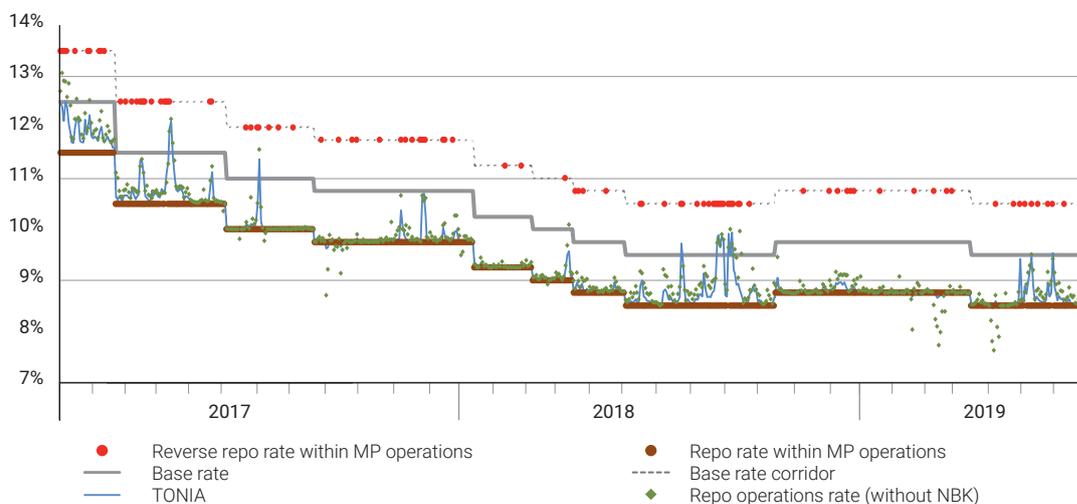


Source: National Bank

Over the analyzed period, NBK kept the targeted money market rate (TONIA) within the interest rate range of the base rate. Most of the time in 2018, TONIA was on the lower threshold of the corridor, with the exception of

the growth in rate in 3Q due to the increased demand for tenge liquidity. NBK also began to act as a liquidity seller that pushed TONIA from the lower threshold (Chart 1.30).

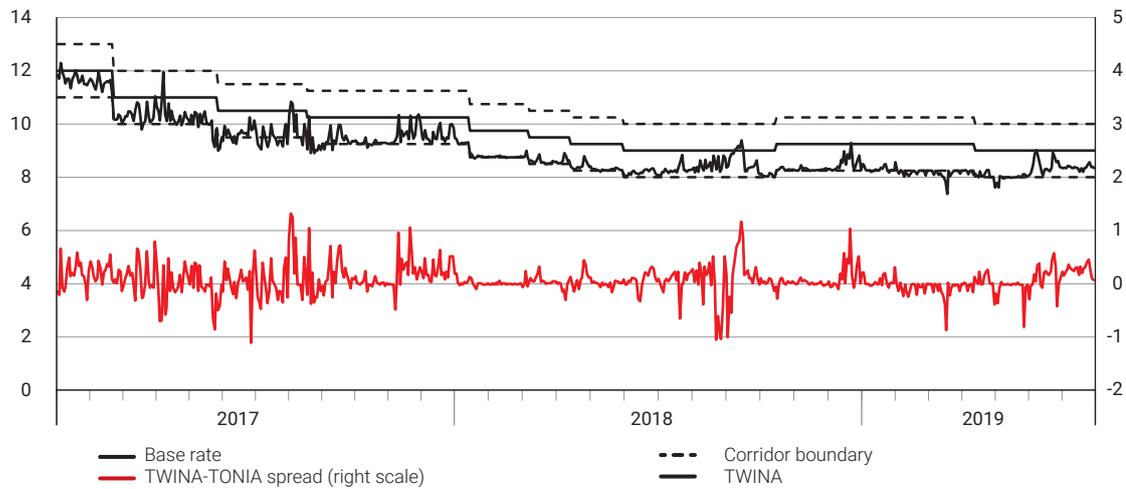
Chart 1.30 Volume-weighted rates on autorepo operations with overnight GSs and NBK participation



Source: KASE, National Bank assessment

Seven-day repo market rates that are not pushed by the NBK closely follow one-day repo rates (Chart 1.31). This indicates that market players mostly rely on one-day repo market rates as they generate expectations of short-term rate trajectory.

Chart 1.31 *The rates on the 1-day repo market serve as the main reference point for the formation of 7-day repo rates*



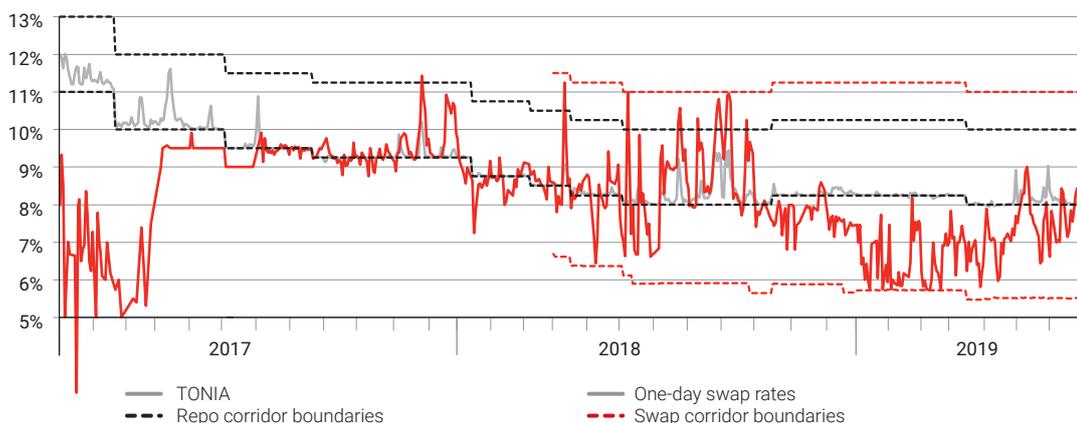
Source: KASE, National Bank

Short-term forex swaps are the alternative to the repo market; they enable the banks to borrow in tenge and to lend out on USD. In 2017 this market rates differed greatly from repo rates. To boost the efficiency of monetary policy's transmission mechanism, in April 2018 the NBK introduced a percentage corridor for one-day FX swaps, which value is pegged to the base rate (Chart 1.32). Thus, NBK began to act on the boundaries of the corridor within set limit for daily liquidity withdrawal volume of \$500 million. The corridor's upper threshold is set as the base rate plus 2%, and the lower threshold is pegged to one-day Libor and base rate spread:

$$(\text{Base rate}_t - 1\% - \text{Libor}_{t-1}) / (1 + \text{Libor}_t)$$

A wider FX swap corridor is designed to discourage the use of foreign currency as collateral when raising tenge liquidity. As a result, FX swap rates are much more volatile than repo rates. They have good intraday correlation, especially when TONIA rarely detaches from lower boundary. But when less frequent, FX swap market reflects longer-term changes in the structure of interbank demand for dollars with uneven distribution of dollar liquidity. Thus, the outflow of foreign currency funding from some banks may lead to lower rates on swaps, much lower than the repo corridor (Chart 1.32). A wide spread with repo market indicates poor arbitrage opportunities between these markets.

Chart 1.32 *Currency swap rates are more volatile than repo rates*



Source: KASE, National Bank

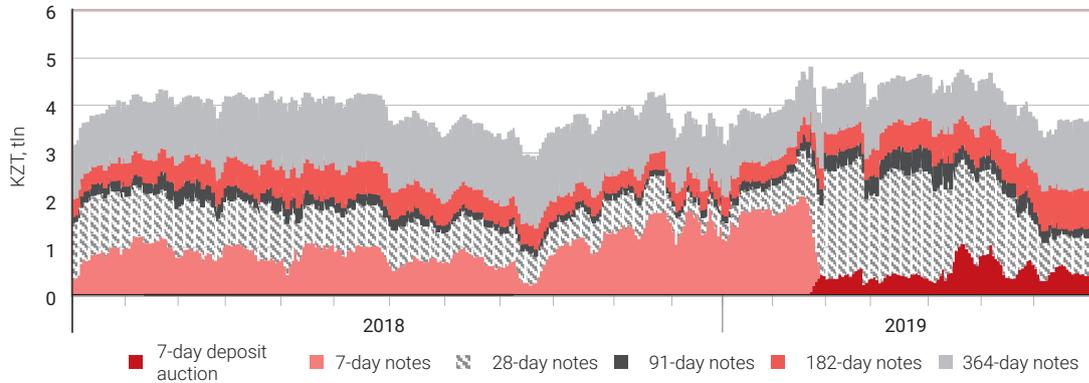
From 2019, NBK began to place longer term notes to enhance stability of liquidity handling tools (Chart 1.33). As a result, the share of short-term notes (7 and 28 days), which from January to June ranged

between 49% and 61% in August, was reduced to 28%, and the share of longer-term notes (182 and 364 days) rebounded from the range of 35% to 46% between January and June to 67% in August. Market players

demanded higher return for liquidity binding for longer

periods, which manifested as increased interest rates on longer-term notes.

Chart 1.33 **Notes in Circulation**

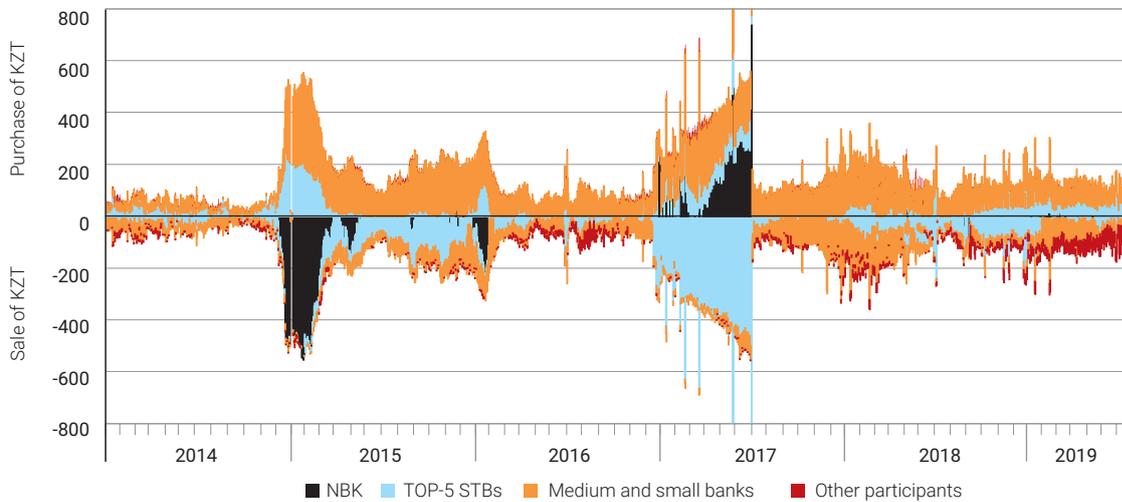


Source: National Bank

In the total volume of NBK operations, standing facilities (repo, FX swap) take a smaller share as compared to notes. Because of excessive tenge liquidity on the market in 2018, NBK practically had no swap market

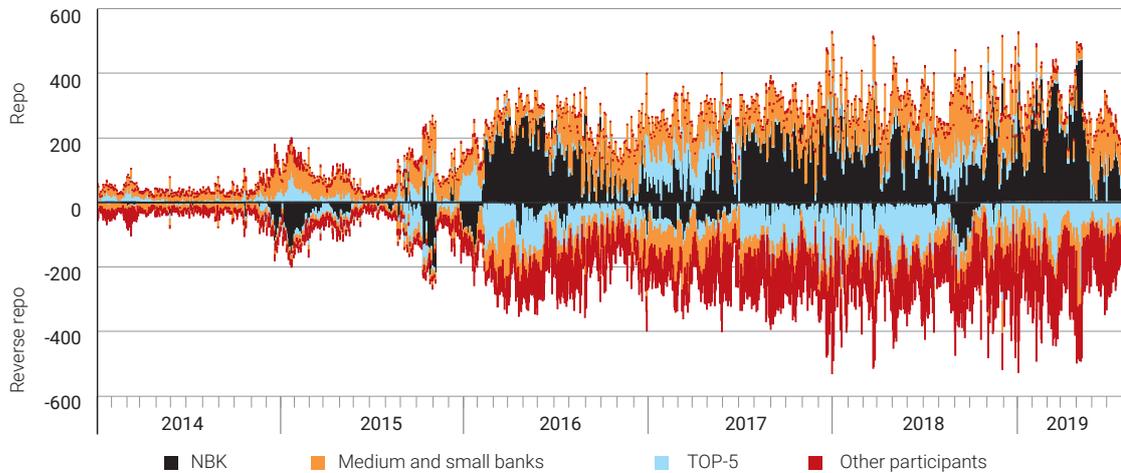
transactions (Chart 1.34). In the repo market in 2018, NBK mainly withdrew liquidity, with the exception of certain periods in 3Q 2018 (Chart 1.35).

Chart 1.34 **Starting from the middle of 2017, the NBK practically did not participate in the market of short-term currency swaps billion tenge, per day**



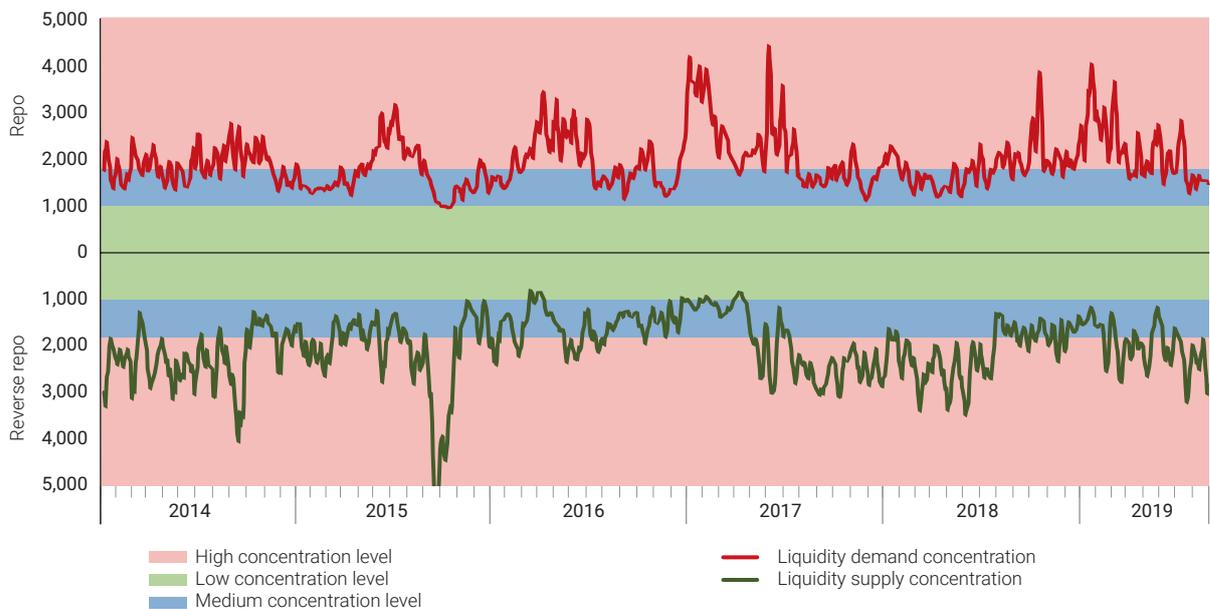
Source: KASE

**Chart 1.35 NBK Was Mainly Withdrawing Liquidity on Repo Market**  
billion tenge, per day



Source: KASE

**Chart 1.36 Concentration of Participants on Repo Market**  
HHI Index for repo



Source: KASE, National Bank assessment

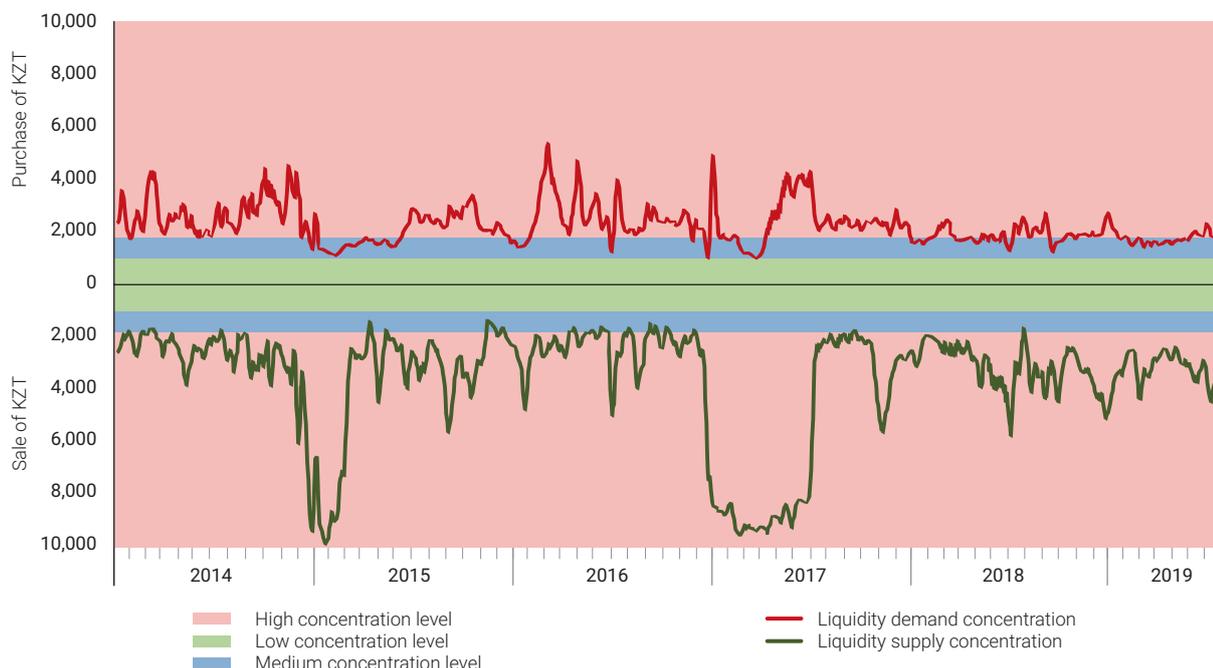
Note: HHI is the Herfindahl-Hirschman index, calculated as the sum of squares of the shares of the volumes of each player to the total market transactions; Concentration is calculated as an HHI moving average for 5 consecutive days

Not all banks had excess liquidity. High concentration of liquidity sellers on short-term forex swap market in 2018-2019 indicates a concentration of liquidity in the hands of individual market participants (Chart 1.37). The repo market was similar in the first half of 2018 (Chart 1.36). The main sellers of liquidity

in the repo market in 2018 were the top 5<sup>2</sup>, group banks, development banks and brokerage companies (Chart 1.35). At the end of 2018 and in early 2019, some banks experienced the need for liquidity, and it manifested as increased concentration of liquidity demand on the repo market (Chart 1.36).

<sup>2</sup> TOP-5 STBs by assets volume on the reporting date

**Chart 1.37 Concentration of Participants in the Short-Term Currency Swaps Market**  
**HHI Index for Swaps**



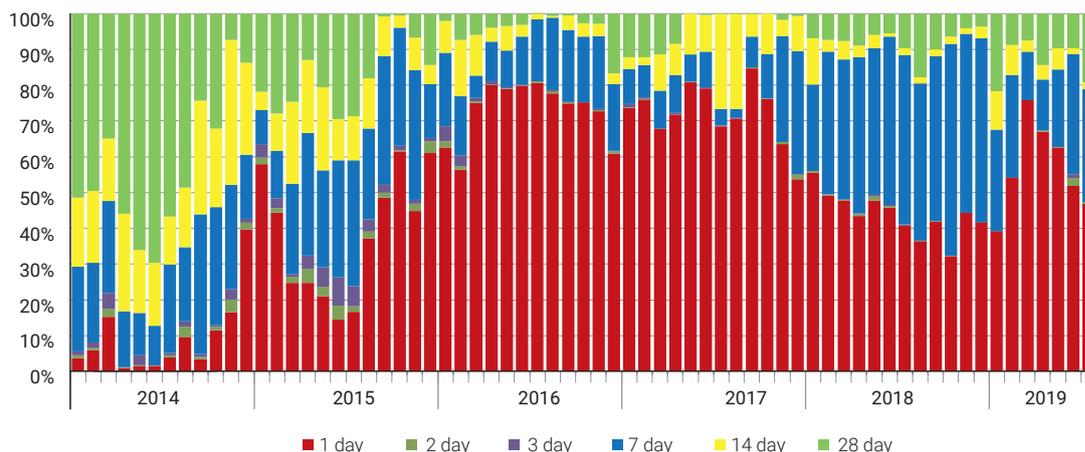
Source: KASE, National Bank assessment

Note: HHI is the Herfindahl-Hirschman index, calculated as the sum of squares of the shares of the volumes of each player to the total market transactions; Concentration is calculated as an HHI moving average for 5 consecutive days.

Tenge liquidity problems in some banks affected the lengthening of repo terms in 2018, and liquidity demand

shifted from overnight repo market to 7-day repo (Chart 1.38).

**Chart 1.38 Lengthening of terms in the repo market, reflects an increase in liquidity needs**  
**Repo market volumes, weighted by maturities**



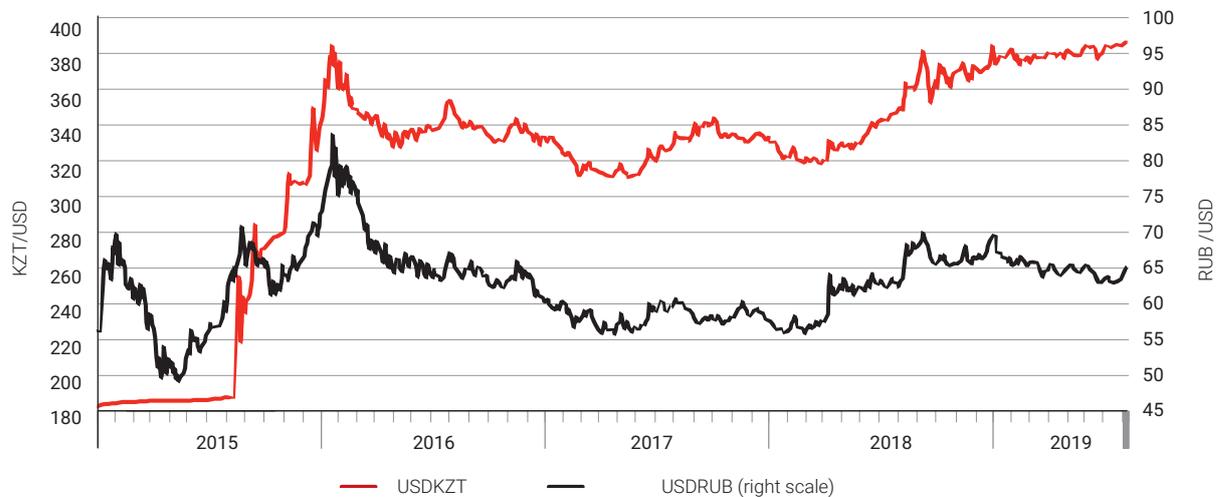
Source: National Bank assessment, KASE

### FX Market

In 2018, tenge depreciated against the dollar by 15.6%. The main pressure on exchange rate was rendered by anti-Russian sanctions in April 2018, stripping of capital from emerging markets as a result of higher US Federal Reserve rates (August-September), and

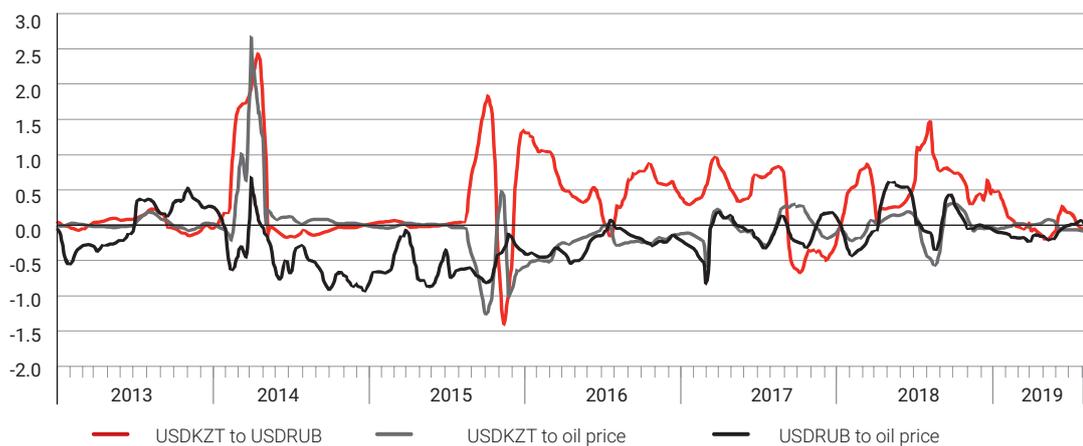
lower oil prices in 2018. In addition to external factors, fiscal flows played a significant role both as increasing socially-oriented government spending and the costs of supporting the banking sector.

Chart 1.39 Discrepancy of USDRUB and USDKZT Rate Movements



Source: National Bank, Central Bank of Russia

Chart 1.40 In 2019, the elasticity of the tenge to the ruble and to oil prices decreased noticeably



Source: National Bank assessment

Note: elasticity between the two variables is calculated by finding the regression ratio between the logarithms of the variables based on data from the last 60 days as of the date

In 2019, the impact of external factors on the exchange rate pricing decreased, as shown by the narrowing of the ruble and tenge exchange rate gap (Chart 1.39), and a decrease in the elasticity of the tenge to the ruble and to oil prices (Chart 1.40). In the first half of 2019, the tenge depreciated against the ruble by 8.6%. Ruble appreciation was previously associated with a significant capital inflow to Russian FLBs<sup>3</sup>.

Prior to the transition to a free-floating rate, the exchange rate had very low short-term volatility that was coupled with the leaps when the exchange rate was aligned as a result of periodic significant deviations of the real exchange rate. Since the transition to a free-floating exchange rate regime in August 2015, there has been a strong boost of short-term volatility, after which

a period of stabilization has begun. The dynamics of the national currency began to reflect to a greater extent the volatility of external factors affecting the exchange rate (Chart 1.41). Enhanced volatility of the ruble exchange rate in 2018 was reflected in the increased tenge exchange rate. By the end of 2018, the volatility of the exchange rate began to decline, while the volatility of oil prices, since the second quarter of 2019, has steadily increased, which is an indirect indicator of the prevailing influence of internal factors over external ones.

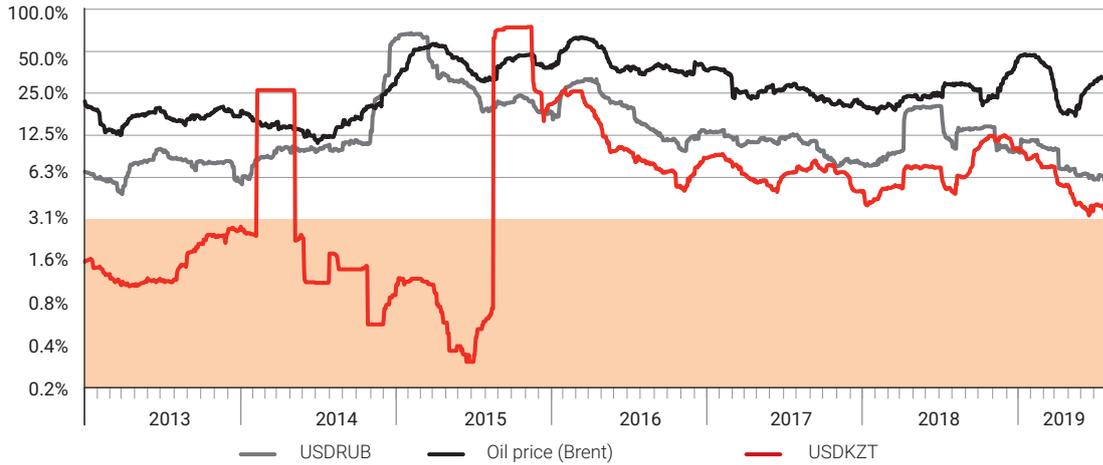
It is worth noting that Russia had a similar situation, and ruble volatility also decreased in 2019, despite enhanced oil price volatility. However, in Russia's case it was caused by the introduction of the budget rule that provides that all oil and gas revenues at an oil price higher than the budget's cut-off price to be used for

<sup>3</sup> Federal Loan Bonds

foreign currency purchase by the Ministry of Finance for subsequent placement in the National Welfare Fund. The cut-off price was fixed at \$40 per barrel in 2017 prices, followed by an annual indexation of 2%, starting in 2018. At the same time, reserves are spent only if the oil price falls below the cut-off price, which was not the case for past two years. Also, according to the rule, the volume of federal budget expenditures should

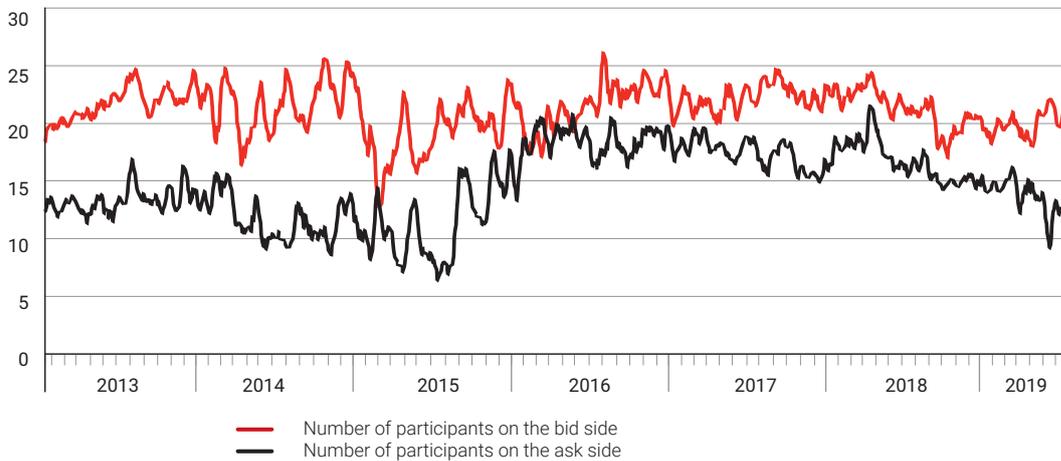
not exceed the sum of non-oil and gas revenues, basic oil and gas revenues and public debt servicing, and the Fund's assets should be at least 7% of GDP. Such a budget rule helped to cut dependence of the federal budget and domestic economic conditions on energy prices for raw material exporting countries by sterilizing oil and gas budget revenues and accumulating sovereign assets.

Chart 1.41 Rates and Oil Price Volatility



Source: National Bank, Bloomberg, National Bank assessment  
 Note: volatility is calculated by finding of a standard deviation of a change logarithm over 60 days

Chart 1.42 Number of Currency market participants

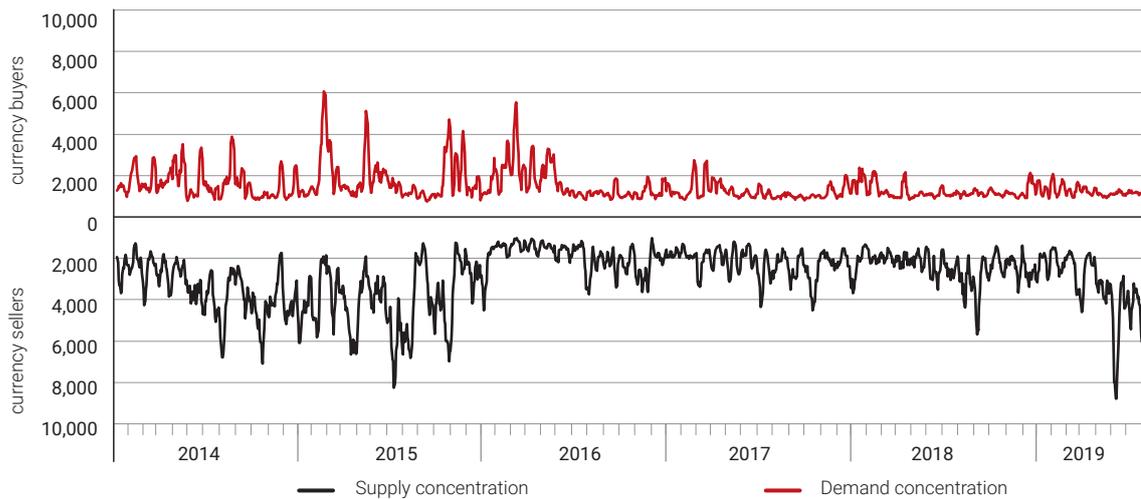


Source: National Bank assessment  
 Note: a moving average over 10 working days

Pricing on the forex market remains of little efficiency because of high concentration as a result of small number of participants, especially on the sale side. High concentration of forex sellers indicates the prevailing number of those willing to buy currency; the main volume of currency is sold by a limited number of market participants ([Chart 1.42](#)).

In mid-2018 and in mid-2019, the concentration of currency sellers enhanced notably, a significant part of currency demand over this period was met by a small number of market participants servicing export companies, as well as foreign currency the sales from NFRK for transfer conversion ([Chart 1.43](#)). NBK directly participated on foreign exchange market in 2018 only in September ([Chart 1.44](#)).

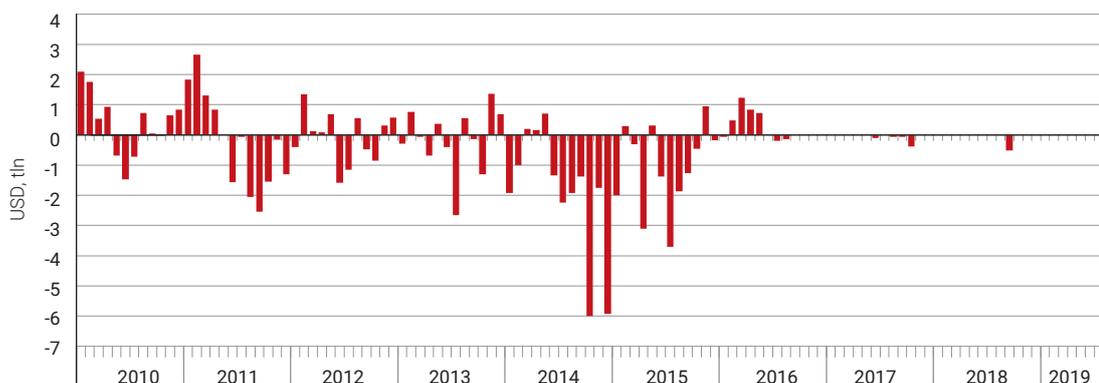
**Chart 1.43 Strengthening of Supply Concentration in the Foreign Exchange Market**  
HHI index for USDKZT



Source: KASE, National Bank

Note. HHI is the Herfindahl-Hirschman index, calculated as the sum of squares of the shares of the volumes of each player to the total market transactions. Concentration is calculated as an HHI moving average for 5 consecutive day

**Chart 1.44 Reduction of NBK interventions in the domestic foreign exchange market**

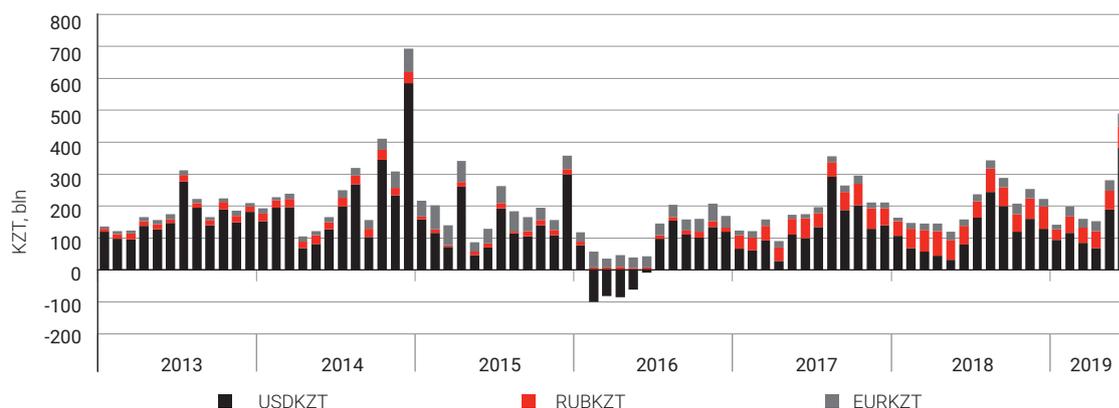


Source: KASE

Expectations of the population significantly influence exchange rate formation. With high devaluation expectations, the demand for foreign currency in cash increases significantly, thereby putting extra pressure on tenge. Thus, the volume of USD purchases at exchange offices during the period of increased pressure on exchange rate in 3Q2018 has doubled as compared to the previous quarter. By the end of 2018, the net volume

of operations decreased to 223 billion tenge per month along with stabilization of the national currency. A significant increase in USD purchase volumes was also observed in June 2019 ([Chart 1.46](#)).

Chart 1.45 Net Buy/Sale of Foreign Currency by Exchange Offices



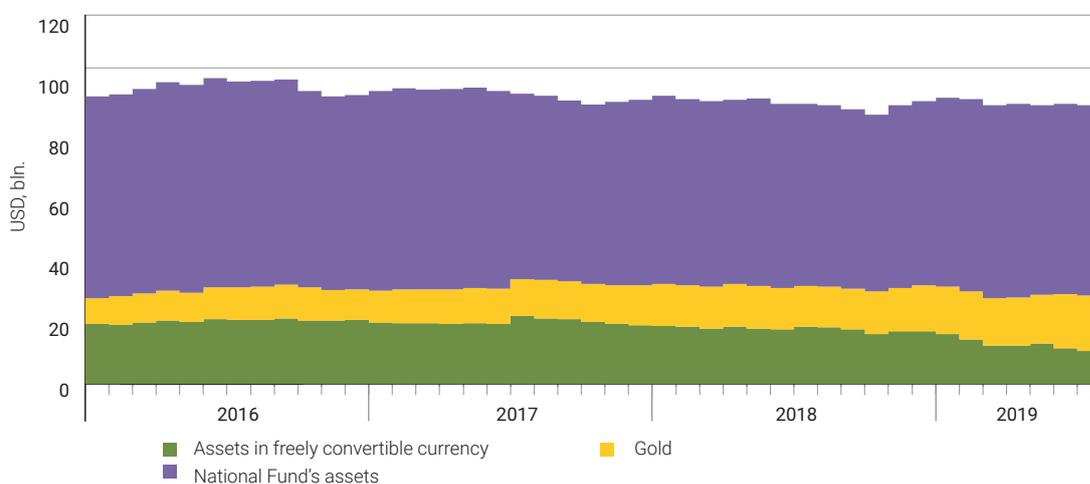
Source: National Bank, National Bank assessment

The main factors affecting the exchange rate of the national currency are the current account and financial account. By the end of 2018 and early 2019, for the first time in four years, the current account was not deficit and was financed mainly by the public sector, in particular, NF's transfers. Improved current account reduced the need for external financing without significant changes in the volume of international reserves.

However, the structure of international reserves in 2018 underwent some changes. NBK continued to

grow gold reserves as part of the exercise of the state's priority right to purchase refined gold to replenish gold and foreign currency assets. As a result, over past three years, the share of gold in the structure of foreign exchange reserves grew by 33% (Chart 1.46). The volume of freely convertible currency has recently shown a decrease as a result of de-dollarization of deposits, repayment of external debt by quasi-state companies and a decrease in the volume of funds in correspondent accounts at the National Bank.

Chart 1.46 International Reserves of NBK and Assets of the National Fund



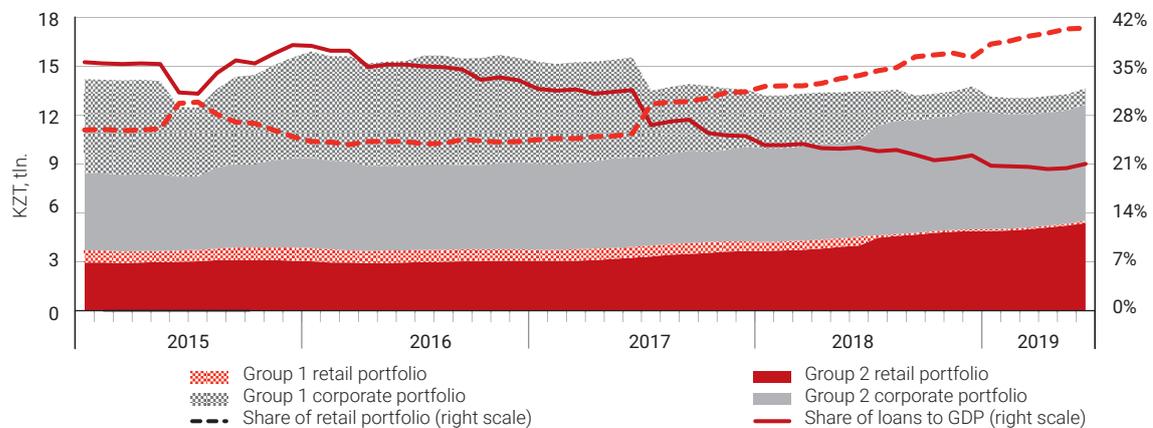
Source: National Bank

## 1.6. CREDIT ACTIVITY

**In 2018 and the first half of 2019, along with revived economic activity, the credit operations were also restored. There was an increase in the volume of loans to the economy provided mainly by well-capitalized banks. The loan portfolio grew slightly against the backdrop of high growth of the retail portfolio due to growing mortgages and unsecured lending and the compressed corporate portfolio as a result of reduced number of problem loans and the withdrawal of insolvent banks from the system. The share of retail in the loan portfolio reached 40% in 1Q2019.**

The growth rate of the loan portfolio was gradually recovering, amounting to one percent y/y in 2018 and the first half of 2019. Positive growth rates were secured by high pace of growth of the retail portfolio, which share reached 40% in the first half of 2019. The decrease of the corporate portfolio volume was associated with the withdrawal of insolvent banks from the system and the sale of bad loans to individual banks (for more details, see Section IV). Despite a slightly grown loan portfolio, the level of loans to GDP decreased since 2015 and reached 21% in the first half of 2019 (*Chart 1.47*).

*Chart 1.47 Retail portfolio grows, Corporate portfolio shrinks*  
*Loan portfolio structure*



Source: STB reporting

Note: Group 1 - insolvent banks, as well as banks whose portfolios were cleared of problem loans; group 2 - other banks

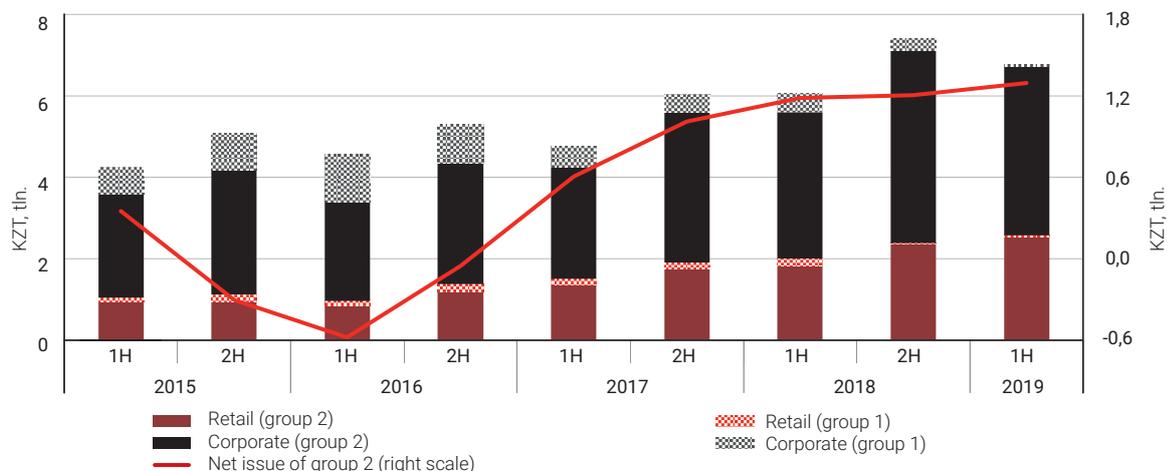
The issuance of loans to the economy continued to grow moderately since 2016. At the same time, the growth of both corporate and retail portfolios was secured by the banks with higher loan quality, i.e., group 2 banks (*Chart 1.48*).

Loans to businesses increased by 21% in the second half 2018 compared to the second half of 2017, and by 3% in the first half of 2019 compared to the same period of the previous year. Credit operations in the economy was largely maintained by the demand for short-term loans and working capital financing. At the same time, competition for high-quality borrowers caused the softening of lending conditions and was more often realized by refinancing borrowers from competing banks. This practice, as a rule, increases the portfolios of individual banks, but has no effect on the growth of the banking sector's loan portfolio. According to the National Bank, in 2017-2018, the share of refinanced

loans in the structure of the corporate loan portfolio reached 23% (for more details, see Section 4.2). In turn, the issuance of loans to households increased by 25% in the second half of 2018 compared to the second half of 2017, and by 28% in the first half of 2019 compared to the same period of the previous year. The main contribution to the growth in the issuance of retail loans was made by unsecured and mortgage lending.

SMEs' loan portfolio was gradually decreasing over past two years, returning to early 2015 level (*Chart 1.49*). Large business loan portfolio compressed even faster. At the same time, despite the large number of preferential financing programs on the market, the contribution of lending from public funds to the growth of the corporate portfolio since the second half of 2017 remained negative, as well as lending from own funds.

**Chart 1.48 Loans to the Economy continue to grow**  
**Issuance of loans to the economy**



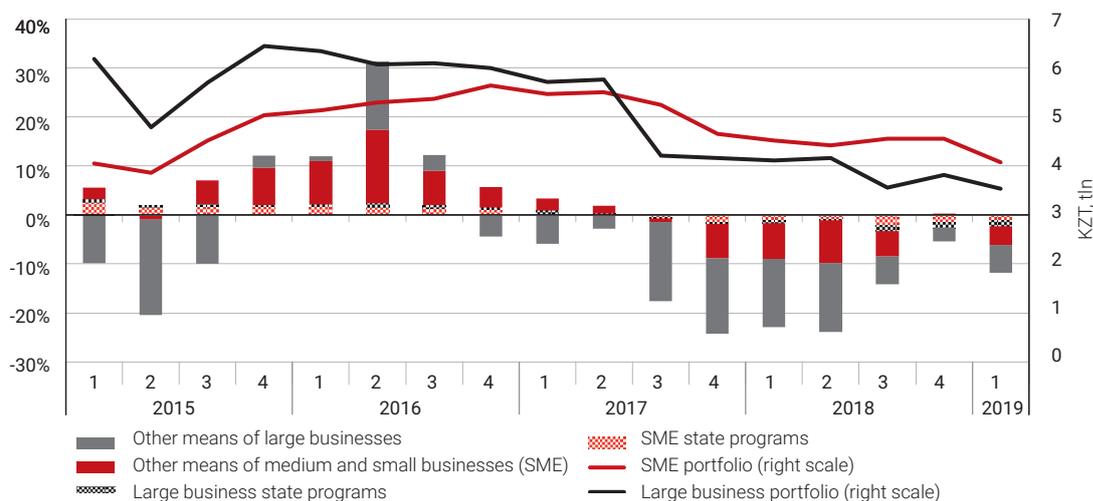
Source: STB reporting

Note: Net issue is the moving data for 12 months. Group 1 includes insolvent banks and the banks with portfolios cleared of problem loans; group 2 are other banks.

According to the National Bank assessments, the role of state financing programs in bank lending has been increasing. In 2014 every fifteenth corporate loan was issued under state programs, then in 2018 it was every eighth. At the end of 2018, every fifth corporate borrower was a recipient of concessional financing. At the same time, the contribution of government programs to the growth of the retail portfolio has increased significantly, mainly for mortgage loans and car loans (Chart 1.50).

Against the background of the growth of public financing of the economy, the effective development of public funds requires quality underwriting and selection of most solvent borrowers, both in corporate and retail segments. High-quality borrowers with projects and sustainable banks remain essential conditions for productive lending to the economy, including in the framework of the state programs.

**Chart 1.49 Large Business Portfolio shrank faster than SME portfolio**  
**Contribution to corporate portfolio growth, y/y.**

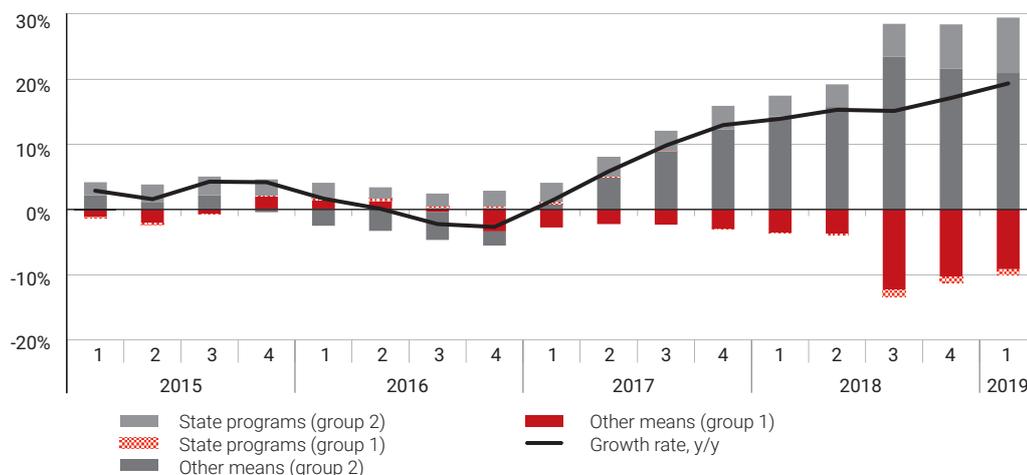


Source: Credit Register

Note: other assets - own and other means of financing

Chart 1.50 *Contribution of government programs to the retail portfolio growth is increasing*

Contribution to retail portfolio growth, y/y.



Source: Credit Register

Note: Group 1 - insolvent banks, as well as banks whose portfolios were cleared of problem loans; group 2 - other banks

## 1.7. CORPORATE SECTOR

Lending to under-capitalized and credited enterprises of the real sector, which is disproportionately represented in the loan portfolio of the banks, creates the main risk for financial stability in the coming years.

The 2018 reporting by the enterprises suggests that across business segments over 40% of the enterprises with bank loan arrears and more than half of small business borrowers were re-credited. The bulk of small business debt is concentrated on the balance of such enterprises, with 62% of the loan debt spread across enterprises with negative capital and another 17% across enterprises with a high debt burden. Additional credit or subsidies to such companies reduces real sector's stability and brings further losses. At the same time, banks' ability to lend to the economy without taking additional risks is limited by a narrow group of solvent enterprises, most of which are not interested in getting bank loans.

In the short run, risks to financial stability are associated with loans stimulation measures alongside current practices of borrowed selection from amongst the banks and non-bank financial institutions. To minimize these risks, the banking sector and the quality of credit decisions shall continue to improve, supervision shall be further strengthened, and the quality of credit decisions in the banking sector enhanced. The real sector has to remove the gaps in the legislation on corporate bankruptcy and protection of the rights of entrepreneurs. Also, eliminating information asymmetries, increasing enterprise transparency, and enhancing the level of legal and

**financial literacy of the owners will contribute to the financial stability of the real sector.**

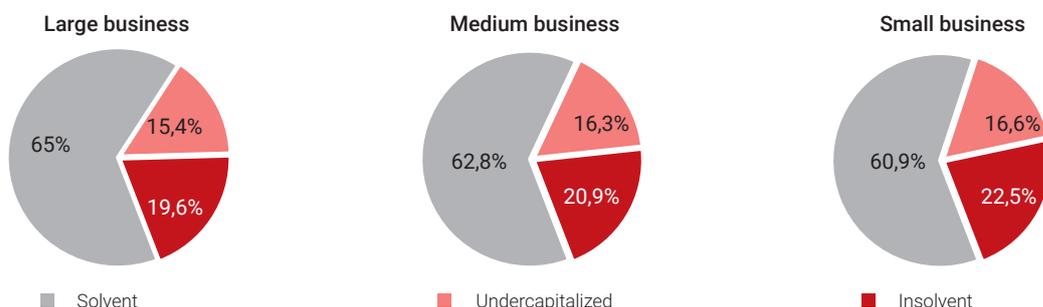
High debt burden and equity shortages reduce financial independence and increase the risk of bankruptcy. The reporting of the enterprises in the economy<sup>4</sup> for over past five years shows a high proportion of enterprises with liabilities over 80% to the assets and negative or low capital. For the real sector analysis, enterprises with negative capital were identified as insolvent<sup>5</sup>; and those with positive capital but a high debt burden (more than 80%) as undercapitalized.

At the end of 2018, small business segment had borrowed the most. Its share of undercapitalized or insolvent enterprises amounted to 39%, and same share among medium and large business, to 37% and 35%, respectively. At the same time, at least 20% of enterprises in each segment had negative capital (Chart 1.51). Since 2015, large and medium-sized businesses saw a gradual decrease in the number of loans enterprises. High company debt is practically independent from enterprise size.

<sup>4</sup> The source of information is the statistical data form from SC MNE RK for real sector enterprises (legal entities): 1-PF (large and medium enterprises, continuous monitoring), 2-MP (small enterprises, sample survey, extrapolated data). The data are disaggregated and unidentifiable, exclude enterprises in government and defense, education, health and social services, households and extraterritorial organizations.

<sup>5</sup> The concept of insolvency used in this section is based on an analysis of enterprise reporting. They are unidentified enterprises, and information on them declared insolvent by court is absent.

**Chart 1.51 High Share of Indebted Enterprises across all Business Segments**  
 Structure by the number of enterprises, at the end of 2018



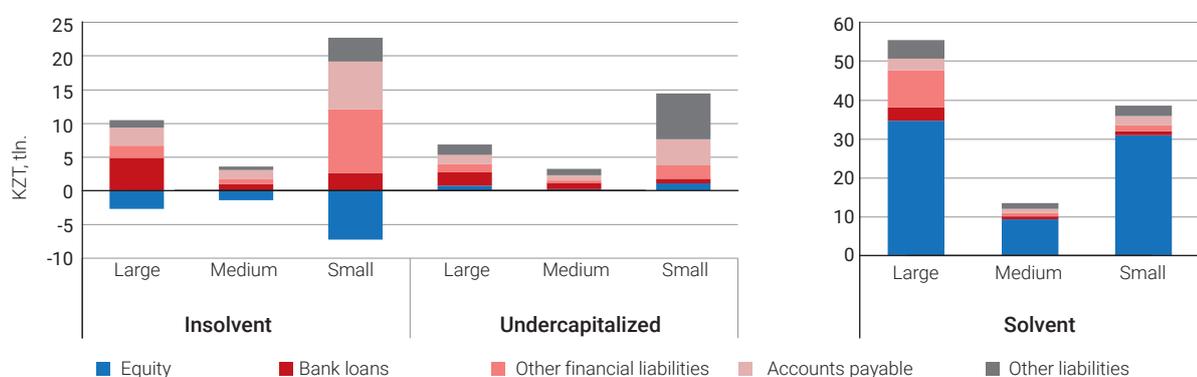
Source: SC MNE RK  
 Note: The share of small business enterprises is calculated by a sample, and that of large and medium-sized businesses by general population

The liabilities structure of the balance sheet of enterprises varies significantly depending on enterprise's an business segment's financial solvency. Borrowers' attitude to commitments also varies. Solvent enterprises are more cautious in assuming new liabilities and financing their operations primarily at their own expense. Their equity has continued to grow. Enterprises that finance their activities, mainly through borrowed funds, make decisions less prudently

and continue to increase financial liabilities even with negative capital.

At the end of 2018, 64% of enterprise's negative capital was concentrated in small business segment. At the same time, financial liabilities of insolvent enterprises in this segment between 2015 and 2018 grew by 58%, while they decreased among large and medium-sized businesses by 24% and 34%, respectively. (Chart 1.52).

**Chart 1.52 Enterprise's Negative Equity is mainly concentrated in Small Business**  
 Liabilities on the balance sheet at the end of 2018



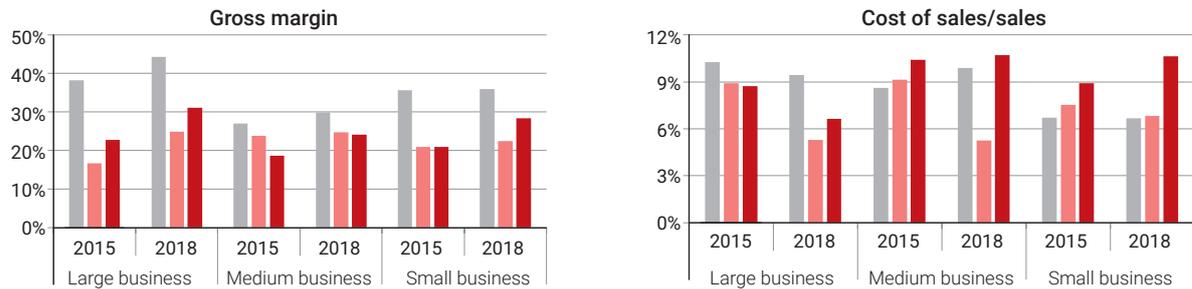
Source: SC MNE RK  
 Note: Sampling data were distributed to general aggregate by small business enterprises on the basis of SC MNE RK

According to the National Bank, enterprises with a high debt burden have lower profitability ratios. This is cause not only by higher costs of funding, but also to low operational efficiency (Chart 1.53). In addition, negative capital enterprise owners are more prone to accepting high-risk projects. Solvent companies are more efficient. Compared to enterprises with low or negative capital, they spend less money per revenue unit, both at

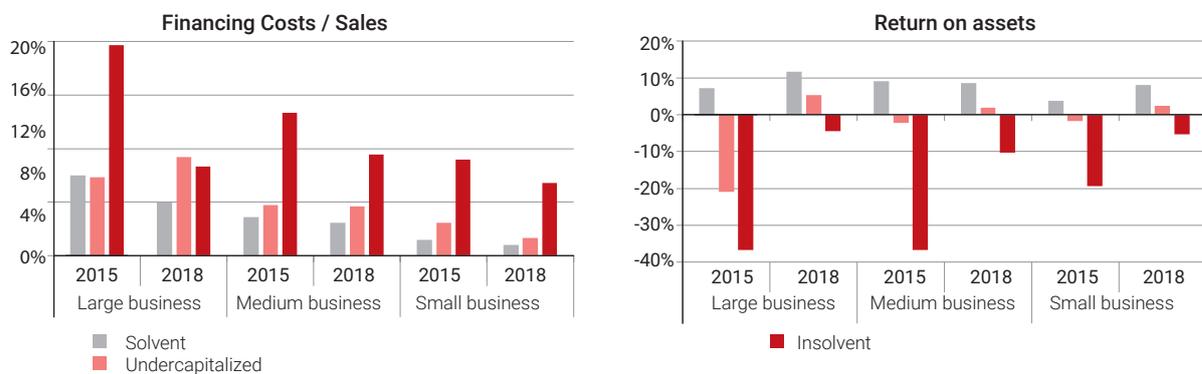
the stage of production / acquisition of goods / services and at the stage of their implementation.

In 2016, the share of costs of funding of the enterprises with negative capital in small business segment grew to 13% of the product and services sales revenues. In the same period, lending to the SMEs in the banking sector increased.

Chart 1.53 Companies with Negative Equity are less efficient, but not only due to high costs of funding



Combination of high debt burden and low operating efficiency objectively leads to Lower Return on Assets



Source: SC MNE RK, National Bank assessment

**Bank loan debt is concentrated on the balance sheet of enterprises with negative or low capital. In 2018, such enterprises accounted for more than half of the borrowers among small enterprises and for over 40% among large and medium ones.**

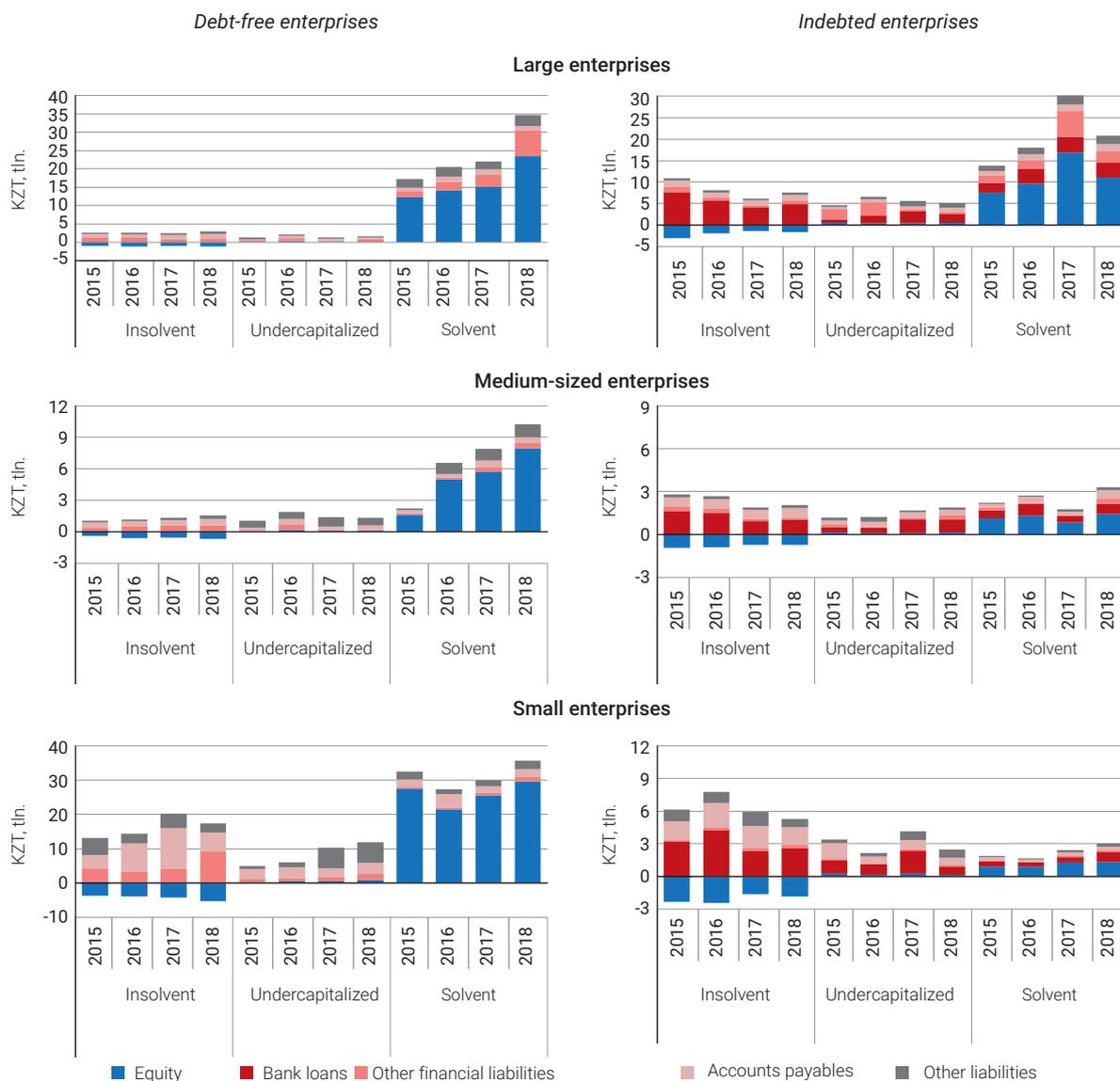
According to estimates for 2018, the debt of the enterprises with negative capital accounted for 62% of all bank loans to small enterprises, and for 39% and 47% of loans to medium and large enterprises, respectively (Chart 1.54, Chart 1.55). A high share of bank debt of under-capitalized and insolvent enterprises is practically not linked to an economic sector, but they represent nontraded sector for the most part.

Large and medium-sized enterprises have access to foreign lending markets. At the same time, only 4% of large enterprises and 1% of medium-sized enterprises had debt to non-resident banks, also concentrated on the balance of the enterprises with high leverage, i.e. 73% of loans of medium-sized enterprises and 78% of large ones.

Small business grow risks due to high liabilities to the financial sector, there was 50% increase in 2018 due to liabilities to non-banking sector. Such liabilities of small insolvent enterprises without bank loans more than doubled and amounted to 73% of the debt of small enterprises to the non-banking sector.

In connection with this, banks and other creditors should pay more attention to analyzing the risk of potential hidden losses in enterprises' liabilities structure, which manifestation may bring a company to insolvency in a very short time.

**Chart 1.54 Liabilities of Indebted Small Businesses outgrow Liabilities of Other Segments and continue to increase**



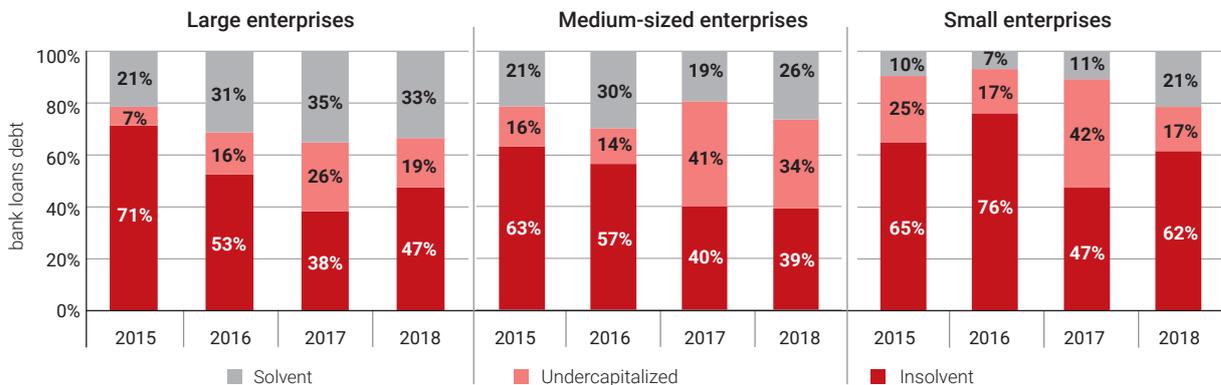
Source: SC MNERK

The concentration of debt to the financial sector on the balance sheet of enterprises with negative capital may result from, among other things, poor quality of credit decisions made by the banks and non-banking organizations. To illustrate, with invariably low level of credit penetration in small businesses, banks continue to lend to insolvent enterprises even more than to solvent ones (average debt of insolvent enterprises in bank loans is 3-6 times higher than of solvent ones). The structure of small business debt shows that the bank loans account for 25% of micro-enterprises with less than five employees. Continued lending to credited companies would not only aggravate their financial

condition, but also increase banks' losses, and in case of lending under government programs, stimulate public sector spending.

At the same time, 58% of small solvent enterprises are not covered by bank credit (46% of medium and 43% of large ones). Financially independent enterprises that are a potential high interest to the banks are less likely to undertake obligations under a loan and this limits banks' ability to lend to the economy without taking additional risks.

**Chart 1.55 Bank Loan Debt is mainly concentrated on Balance Sheet of Enterprises with Negative Equity**  
The structure of debt on bank loans, depending on enterprise credit-worthiness



Source: Data of SC MNE RK

## 1.8. HOUSEHOLDS

In 2018, the contribution of household consumption to economic growth increased as a result of growing real incomes and accelerated retail lending. The ratio of the number of unique borrowers to the economically active population reached a record 53% at the end of 2018 due to the growth of new borrowers among the younger generation.

In 2018, real income growth rates headed for recovery, mainly due to the continued growth of social transfers.

According to a household survey, households began to save less due to rising debt servicing costs. Thus, in 2018 population's propensity to save decreased to 6% compared to 10% in 2015. The household debt burden remains lower than in countries with similar income levels, although it continues to grow and approach its record level of 2014-2015. In 2018, expenses on debt repayment to disposable income reached a historic maximum for households in the top income decile (6-7%), while for the whole sample this indicator was 3.5-4%.

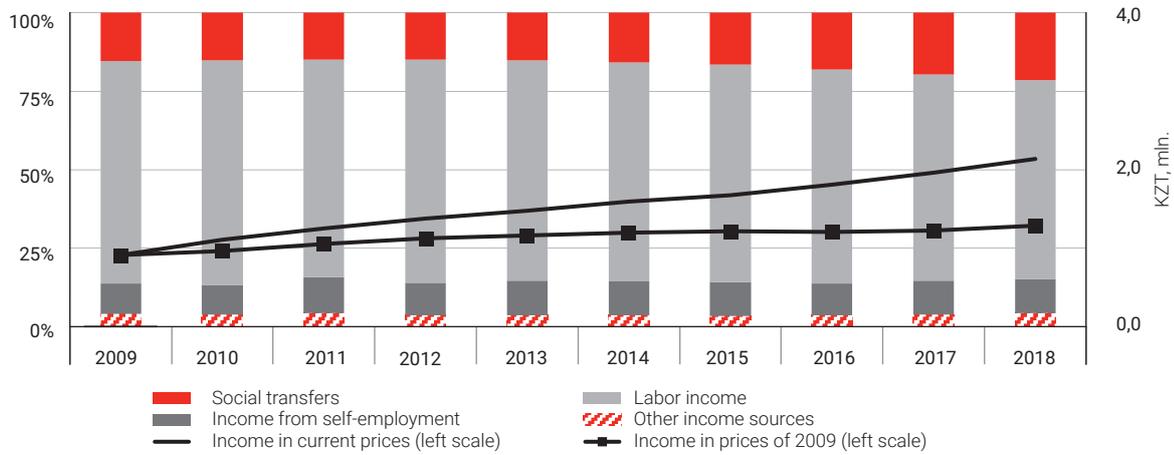
Relatively low leverage may indicate, with other things being equal, lower credit risks and remoteness from the saturation point in the retail lending market. At the same time, households' willingness to service debt may have declined as a result of several government debt relief and restructuration programs, and interest rate subsidies.

Measures are required to prevent systemic risks, as the growth of bank and non-bank household debt, concentrated in certain population groups, may become systemic and socially-important when the market reaches its saturation point. So, a number of programs were introduced, which included the conversion of mortgage loans to tenge at a non-market rate, writing penalties and fines off consumer loans of socially vulnerable population groups, introduction of mortgage subsidies, and judicial practice to meet borrowers' claims on compensation for previously paid penalties and fines.

According to the National Bank's banks' lending survey, state programs further reinforce expectations of state support among the most indebted households, thus decreasing borrowers' willingness to service the debt, which may lead to defaults and moral hazard.

In 2018, real income growth was gradually recovering, mainly due to continuous growth of social transfers. Until 2014, growth of real income was supported by the consumer spending, and after that, increased spending of the population was financed by debt. Increase of government spending on social transfers during the crisis of 2014-2015 helped to prevent decline in real incomes of the population and maintain them at the same level. This caused share of labor incomes in the structure of household incomes to drop (Chart 1.56).

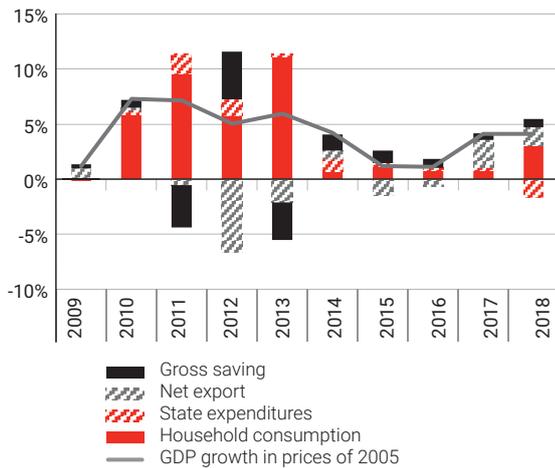
**Chart 1.56 In 2018, after Long Stagnation, Real Incomes of Population have opted for Recovery**



Source: SC MNE RK

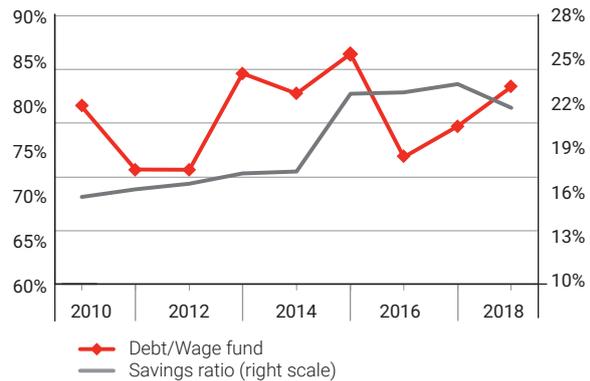
In 2018, after the shocks of 2014-2015, the contribution of household consumption to GDP growth increased (Chart 1.57). This recovery was mainly caused by accelerated growth of lending and gradually increased real incomes. In 2018, the growth of individuals loan portfolio reached 17% compared to -3% in 2016. This increased the ratio of debt to wage fund (wage bill) by 8% to 83% between 2017 and 2018 (Chart 1.58).

**Chart 1.57 Household Consumption Expenditures Significantly Contributed to Country's Economic Growth**  
Annual GDP Growth in 2005 Prices



Source: Credit Register, SC MNE RK

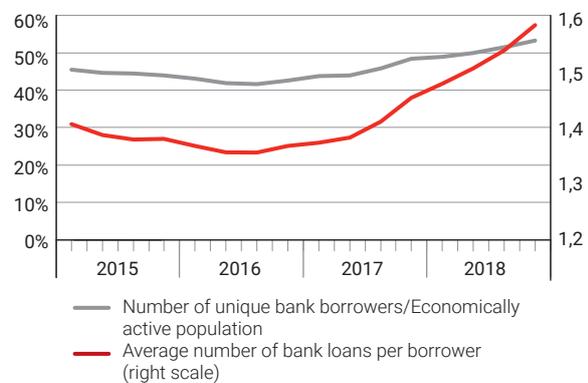
**Chart 1.58 Growing Household Debt to Wage fund ratio was Accompanied by Decrease in saving ratio**



Source: STB reporting, SC MNE RK

Note: The savings ratio is calculated as the ratio of household deposits at the end of the year, with the exception of large deposits, to the gross disposable income of the population.

**Chart 1.59 Bank Loan Penetration Soars**



Source: Credit Register, SC MNE RK

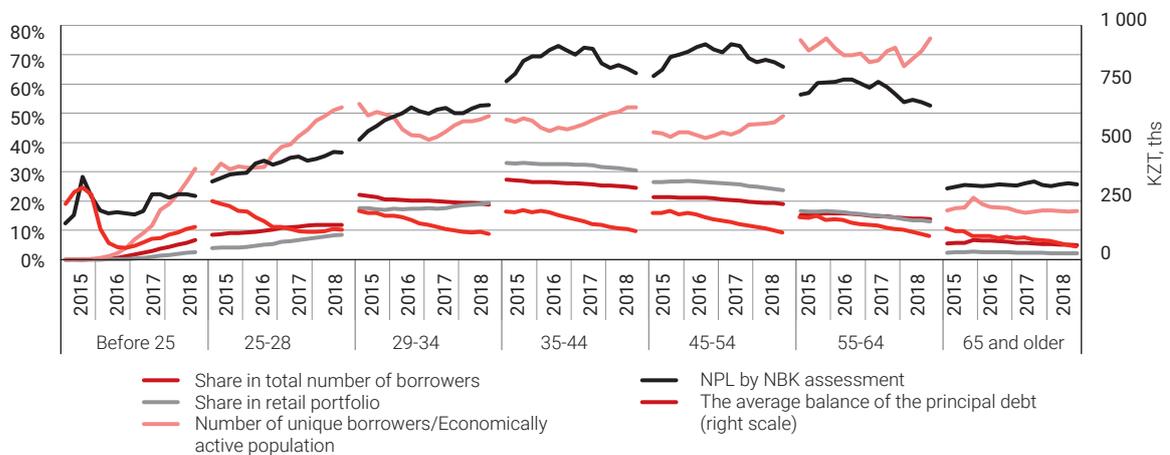
The penetration of bank credit increased among economically active population, as evidenced by growing ratio of the number of unique borrowers to economically active population over 2016-2018 to 53% (Chart 1.59). The average number of loans per borrower increased sharply, amounting to 1.6 loans at the end of 2018. At the same time, loan penetration grew across all age groups (Chart 1.60). The greatest growth was among borrowers under 28 years old. For 2017-2018, the ratio of the number of unique bank borrowers to economically active population among persons under 25 years increased from 4% to 31%, and among 25-28 year olds, from 31% to 51%

The highest average principle balance of the main debt was recorded among borrowers of 35-54 years (about 820 000 tenge), share of loans of these borrowers accounted for the largest part in banks' retail portfolio (25% - 35-44 years, 19% - 45-54 years at the end 2018). In recent years, the share of principle debt of borrowers of 35+ years has gradually declined and substituted by loans to the younger generation. This was caused by both accelerated unsecured lending and housing support programs, that have young generation without housing, as a part of its target audience.

**Chart 1.60 Loans to Young Generation Outweighed Loans to Borrowers in 35 Years and Above Age Group in Total Retail Portfolio of the Banks**

*Debt distribution by age groups*

Source: Credit Register, SC MNE RK.



*Note: 1) When calculating indicators, the largest loans in the retail portfolio of the banks were excluded. The largest loans are the loans above 99 percentile in terms of the balance of the principal debt in the respective portfolio of the banks; 2) For borrowers of 65 years and above, the penetration rate is calculated on the basis of the population above 65 years, and not upon the number of economically active population.*

In 2016-2018, as a result of the growing household debt, the costs of debt repayment as a share of household disposable income increased from 3.5% to 4%. This increase was observed across all decile groups of the samples households in a survey conducted by a statistical body. The highest value was reached by 9<sup>th</sup> and 10<sup>th</sup> deciles (Chart 1.61, Chart 1.63). However, this level of debt is not critical and remains low in international comparison. For example, in Russia (19%), Georgia (15%), Romania (10%), this indicator has not fallen below 9% since 2012.

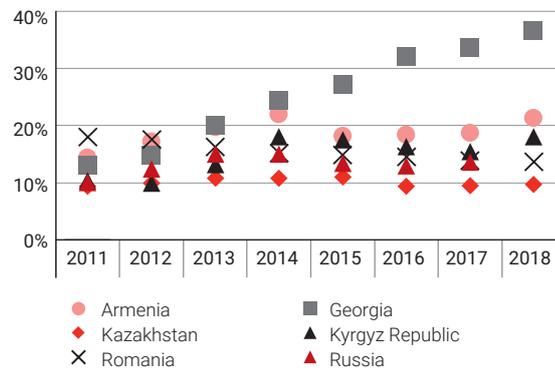
With the growth of debt servicing costs, the population's propensity to save decreased from 10% to 6% (Chart 1.62). Thus, the expenditure on goods and services increased mainly due to decrease in savings.

This may be caused by stabilized inflation level, decrease in interest rates, technological development of business lending processes that boosted households' appetite for new loans. Also, lasting stagnation could entail significant level of deferred demand in years to come as a result of stabilized macroeconomic situation. Altogether, these factors could have influenced the growth of household spending and led to increased debt and lower savings.

At this stage, the population's debt burden has not reached the level of instability at which it could trigger economic recession. This is underpinned by low ratio of household debt to GDP, which was at the level of 9.7% in 2018, below its pre-crisis level of 2014 (11%).



**Chart 1.64 Kazakhstani population debt burden is low**  
Household debt to GDP



Source: IMF

Note: Household debt includes debt to the banks and other financial organizations (IFOs, ICOs etc.)

International comparisons of this indicator are also in favor of Kazakhstan. In 2018, it stood at 13-14% in Russia and Romania, 18% in the Kyrgyz Republic, 37% in Georgia, and 22% in Armenia (Chart 1.64).

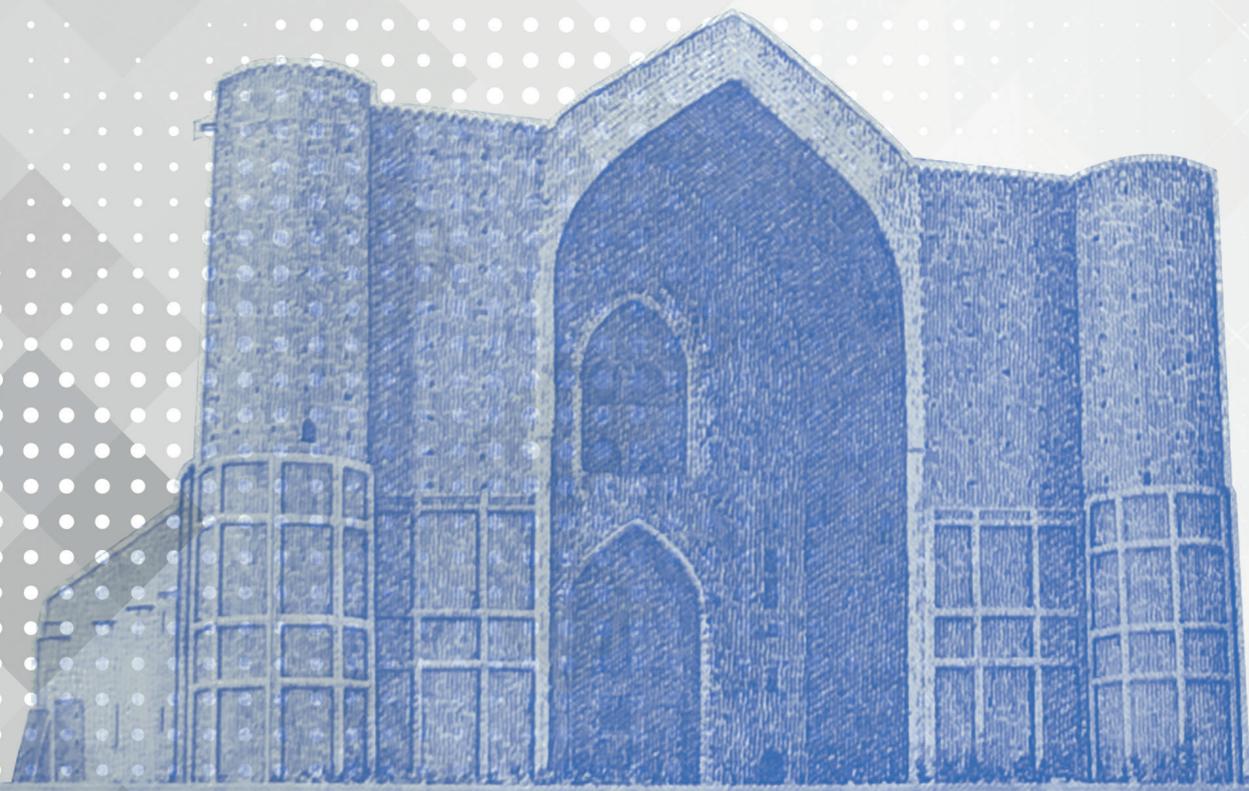
Relatively low leverage may indicate, with other things being equal, lower credit risks and a higher distance to the point of saturation on the retail lending market. At the same time, Kazakhstani household saturation point, as well as their willingness to service debt, may have been decreased after implementation of several state programs on debt relief, debt restructuring, and introduction of interest rate subsidies. The decrease in indebtedness is also associated with

state measures to decrease debt burden of socially vulnerable groups of population. A number of programs were thus introduced on conversion of mortgage loans to tenge at a non-market rate, writing penalties and fines off consumer loans of socially vulnerable groups, introduction of mortgage subsidies and judicial practice to meet borrowers' claims on compensation for previously paid penalties and fines.

According to the National Bank's banks' lending survey, state programs reinforce expectations of state support among the most indebted households, decrease borrowers' willingness to service the debt, which may lead to defaults and moral hazard.

## Section 2.

# GOVERNMENT SECURITIES MARKET



After the base rate was reduced in 2016-2017, the mid-term and long-term yield curve remained flat during 2018 and the first half of 2019. The market for tenge government debt remains extremely illiquid, especially for over-a-year period, and this reduces the informational value of the yield curve and the ability to efficiently perform its function of a primary chain of the interest rate channel.

The high degree of segmentation of the government securities market and maturity-dependent liquidity unevenness require spread factoring in the NBK bonds segment with under-a-year maturity and MF bonds with over-a-year maturity. The NBK bonds market remains relatively liquid, and bond rates are the reflection of voluntary demand of second-tier

banks for risk-free tenge assets and their monetary policy expectations. The MF bond market remains extremely illiquid. Two thirds of the MF tenge debt are concentrated among captive investors. The small issues' sizes limits the number of potential holders. The tendency of investors to hold government bonds to maturity reduces their turnover.

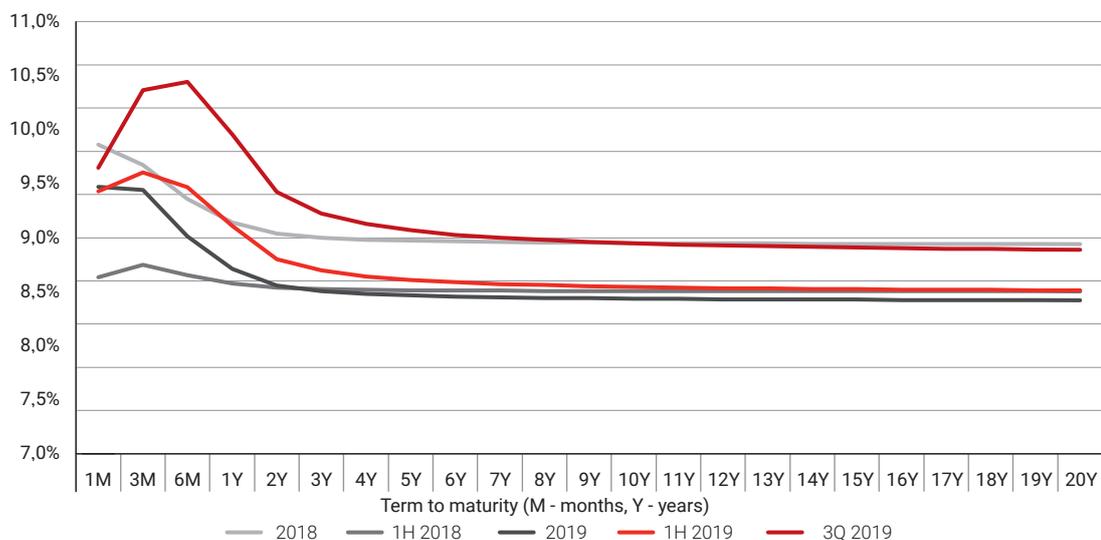
The role of the GS market in the monetary policy interest rate mechanism can be steadily increased through enhanced efficiency, developed market pricing principles, strengthened role of voluntary investors and expanded number of institutional investors, their liberalized and rationalized regulation, and reduced volume of assets in the hands of capital investors.

## 2.1. SEGMENTATION OF INVESTORS IN DIFFERENT SECTIONS OF THE YIELD CURVE

**The information value of the GS yield curve degrades on over-a-year term segment: changes in the base rate affected the rates of short-term GS only, the rates transmission ceases after a year.** The negative slope of the yield curve of government securities (hereinafter referred to as GS) decreased during the first half of 2018, but started to grow again from the second half of 2018 and became positive in one-month-one-year section in the third quarter of 2019 (*Chart 2.1*). Almost all changes in the curve shape occurred in under-a-year period and were associated with eased monetary policy (until the end of the first quarter of 2018), tightened response to deteriorated global sentiment (starting

from the second quarter of 2018), and operations for the extension of liquidity binding instruments term (in the third quarter of 2019). At the same time, the curve shape in its medium and long-term portion remains flat, and the rates of medium and long-term government securities are almost irresponsive to changes in the short-term government securities. As a result, the GS market poorly fulfills its function as the first chain in the interest rate channel of the monetary policy, thus generally reducing the effectiveness of the current monetary policy.

*Chart 2.1 The yield Curve for Over-a-Year Term Formed by Non-Market Investors*  
GS yield curve (spot)

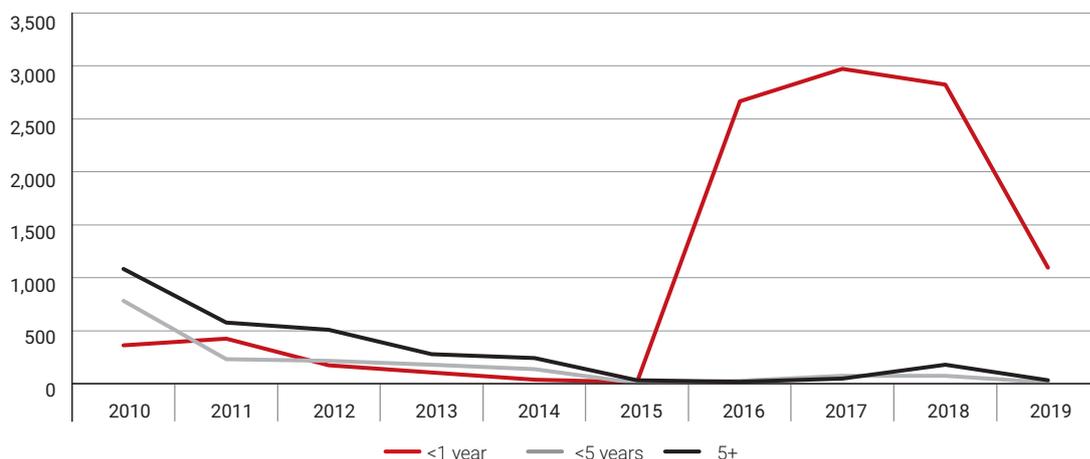


Source: IRIS Finance, National Bank assessment

Poor response of medium- and long-term rates to changes at the short end of the curve is the indication of low liquidity and minor presence of market investors in the market of longer-term government securities. The number of liquidity events in the Kazakhstan government securities market fell sharply after the consolidation of pension assets in 2014; the non-

diversified investor base was limiting the operation of the secondary market. In 2016, the NBK began to actively issue under-a-year bonds as part of its interest rate management process thus causing the liquidity at the short-term end of the yield curve to increase (*Chart 2.2*).

**Chart 2.2 Number of Trades with Government Securities within Six Months for different Maturities**

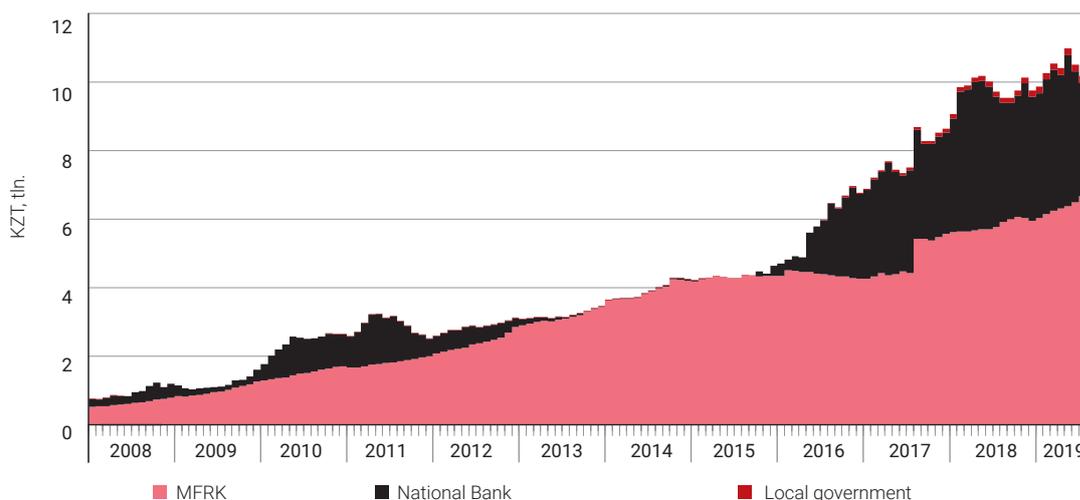


Source: IRIS Finance, National Bank assessment

At the level of over a year the GS yield curve is formed by fixed-coupon bonds issued by the Ministry of Finance of the Republic of Kazakhstan (hereinafter - GS of MFRK). Decreased liquidity in the GS market with over-a-year maturity occurred as a result of the narrowing of the circle of investors in this market and was not factored

in the decreased volumes. Since the end of 2017, for a year and a half, the volume of MFRK government securities in circulation increased by 19%, and its share in the total volume of placed government securities increased from 58% to 63% in circulation (*Chart 2.3*).

**Chart 2.3 Volume of Government Securities in Circulation by Issuers**

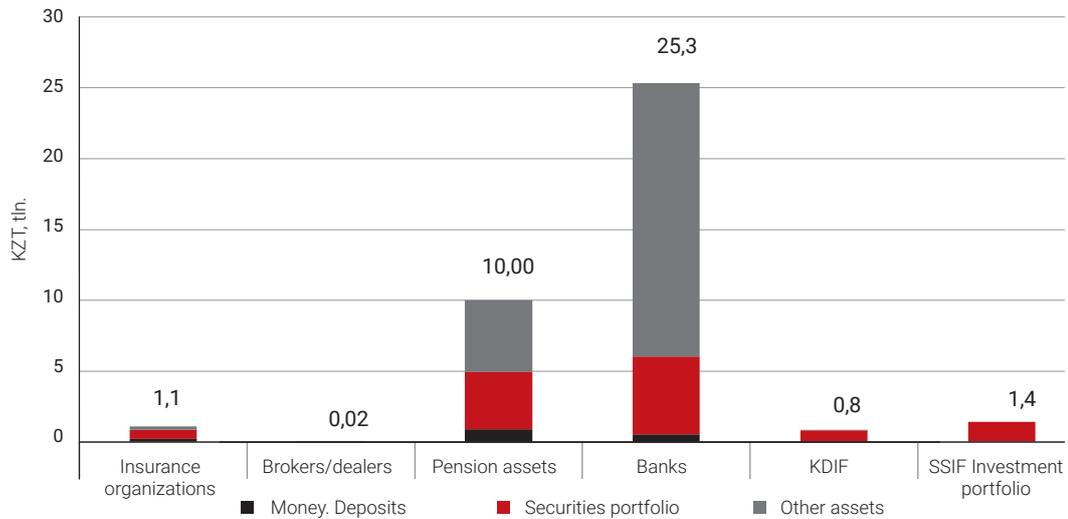


Source: Central Securities Depository

After pension funds merged, the second-tier banks became the largest voluntary institutional investors able to affect the pricing notably (*Chart 2.4*). From 2018, STBs significantly reduced their operations in the market of GS of MFRK, and were involved mainly in the

NBK notes market (*Chart 2.7, Chart 2.10*). Therefore, the rates along over-a-year yield curve were defined mainly as a result of the captive demand, explaining poor information in this section on the yield curve.

Chart 2.4 Assets of Institutional Investors



Source: National Bank, UAPF, KDIF, SSIF  
 Note: data are presented as of January 1, 2019

### Box 1. Risk-Free Yield Curve Assessment Methodology

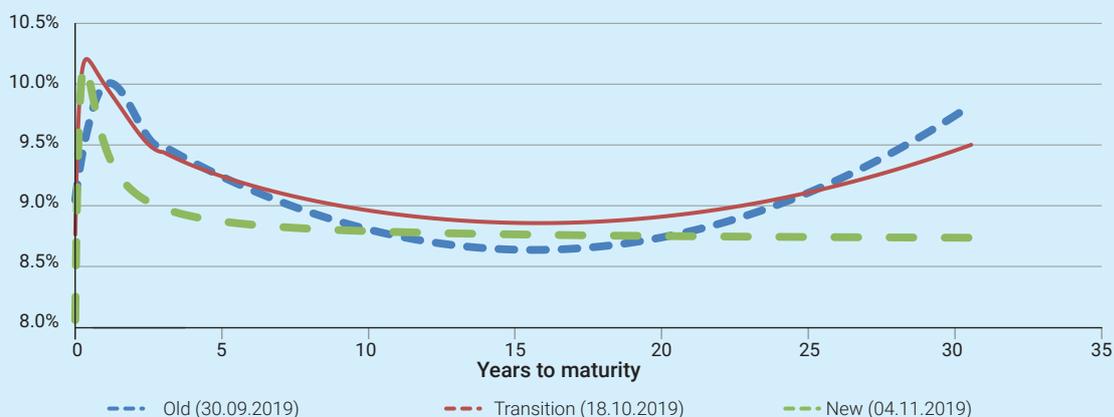
In November 2019, Kazakhstan Stock Exchange (KASE) switched to a new methodology for official valuation of the government securities (official risk-free yield curve). The transition from GS valuation by the old methodology to the new valuation methodology was carried out gradually over the course of a month.

The need to switch to a new methodology for constructing an official risk-free yield curve was caused by inability to replicate the “old” yield curve, its poor adaptation to low and variable liquidity, and almost complete lack of the context for informed interpretation of the time structure of the rates. The new technique is based on the Nelson-Siegel parametric model. This methodology includes many criteria taken into account for the development of a simple, convincing, reproducible method of aggregating useful information, conveying of both the time structure of the rates and a yield curve match to market liquidity, sampling age by every term range, to offer a required economic information context.

The old KASE methodology used since 2011 was based on a piecewise polynomial approximation. In a low liquidity market with segmentation of investors and poor secondary market, a curve built under such methodology provides the best fit and flexibility, however significantly distorts the rate structure. Investors have poor knowledge of the origin of many anomalies, and this maintains the vicious cycle of the low liquidity problem.

In the new parametric model, the parameters are interpreted in relation to the levels of long-term interest rate, short-term interest rate and a curve slope. The new curve model and its results are more transparent, and its explanatory power better meets the needs in communication and interpretation of financial markets and professional players.

**Chart 2.5 Dynamics of KASE Transition from the Old to the New Methodology for Constructing a GS Yield Curve**



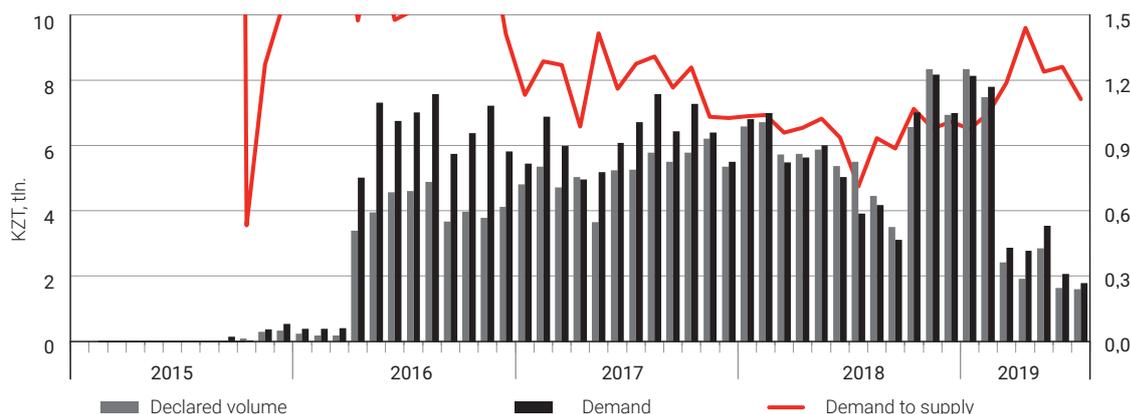
Source: KASE

## 2.2. NBK NOTES MARKET

The market for NBK notes compared to government securities of MF RK is characterized by higher liquidity due to a wider investor base compared to the market of long-term government securities. A significant share of NBK notes market is held by market players, with second-tier banks being the largest of them. NBK notes meet the needs of second-tier banks in profitability and maturity.

In 2018, down to Q3, there was a decrease in demand for notes due to deterioration in risk perception by investors amid expectations of a weakening tenge ([Chart 2.6](#)). The decrease in primary demand in the third quarter of 2018 happened owing to the banks ([Chart 2.7](#)).

**Chart 2.6 Decrease in Demand for Notes in the Primary Market in 2018**  
Bonds Demand and Supply in the Primary Market

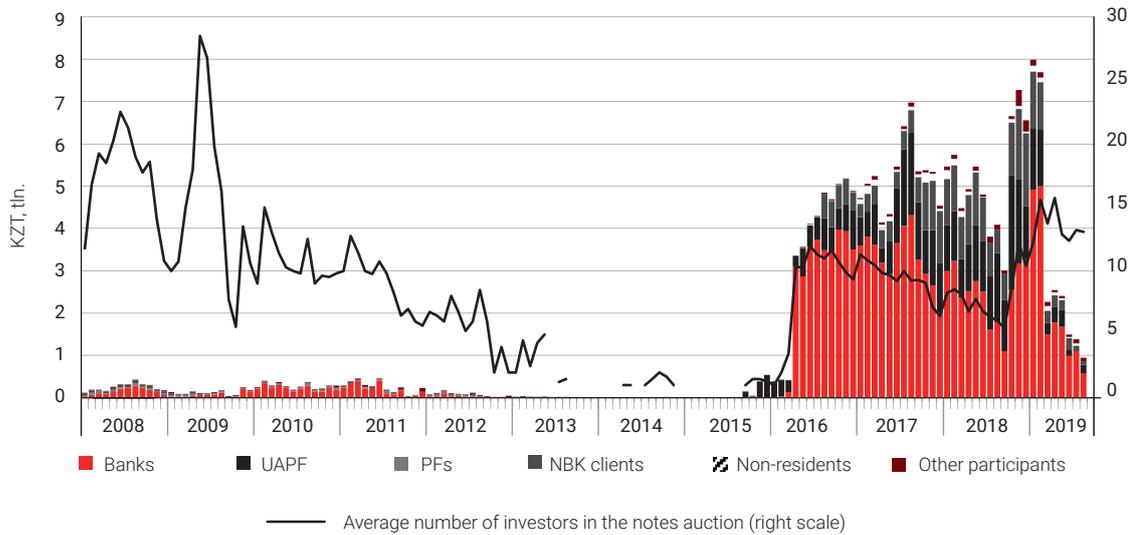


Source: National Bank

Starting in March 2019, a floatation volume has decreased in the primary notes market following a number of events. In February 2019, the NBK ceased the issue of seven-day notes ([Chart 2.8](#)). Demand in seven-day notes market shifted partially to deposit auctions and to longer-term bonds. With an increased

term of placed notes taken into account, a significant change in the NBK position on liquidity withdrawal has not happened.

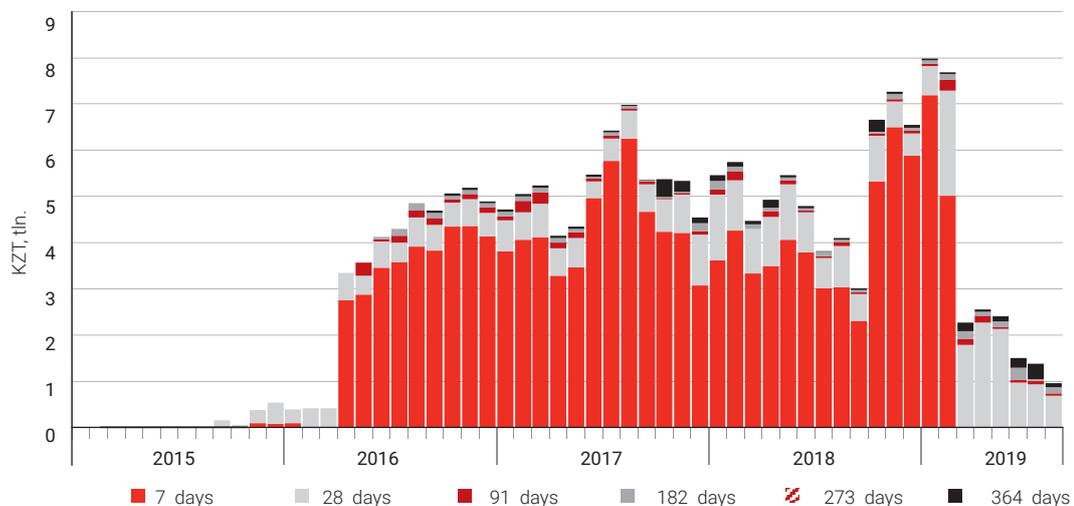
**Chart 2.7 Decreased Operations in the Primary Market in 2018 Due to Reduced Banks Participation**  
Auctions' volumes of NBK notes placement by investors' types



Source: Central Securities Depository

Note: The type of investor "Other" includes brokers-dealers, investment funds, individuals, state organizations, other legal entities and own assets of pension funds

**Chart 2.8 Decrease Volumes of NBK Notes Placement in 2019 Due to Increased Terms of Notes Placed**



Source: Central Securities Depository

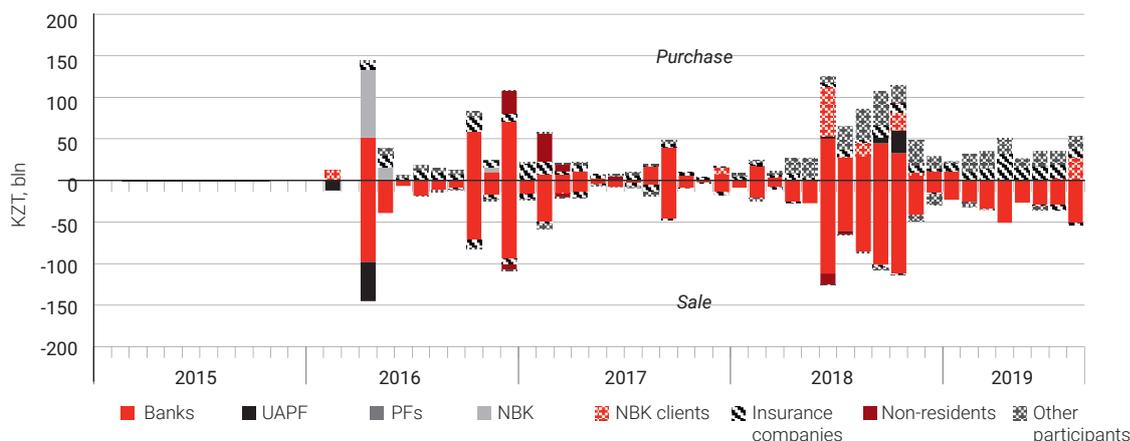
In 2018, second-tier banks noticeably enlarged their operations on the secondary market, though these were to a greater extent the sales of the notes ([Chart 2.9](#)).

The most intense STBs withdrawal was observed as a response to the outflows of foreign investors from Kazakhstan's market. Some banks with large volumes of highly liquid assets in foreign currency were willing to sell notes above market rates to meet their tenge liabilities.

Despite the fact that the influx of foreign investors has improved market liquidity, stability has not been attained. With increased risks, foreign investors quickly exit the market. Without sufficient domestic market depth to absorb the potential outflow of non-residents, the long-term cost of borrowing debt will be high.

**Chart 2.9 Banks Need for Liquidity Caused Outflow from the NBK Notes Market**

Volumes on the Secondary Notes Market by Market Participants



Source: Central Securities Depository

Note: The type of investor "Other" includes broker dealers, investment funds, individuals, state organizations, other legal entities and own assets of pension funds

**The National Bank held measures to globalize tenge and stabilize demand for government securities of the Republic of Kazakhstan.**

In July 2018, the National Bank implemented a project to include NBK notes in the list of securities covered by international settlement system Clearstream; the aim was to sufficiently simplify the access of international investors to the Kazakhstan stock market and to increase the demand for Kazakhstan government bonds. Also in 2018, the primary and secondary markets for government securities operations on the exchange market were transferred to the T+2 settlement system.

The introduced deferred payment systems in the securities market contributes to the improvement of the banking sector liquidity projection systems and creates the prerequisites for an increased foreign capital inflow.

The launch of Clearstream coincided with the general trend of capital outflows from emerging markets amid tightening monetary policy in the United States, and therefore, there was a decrease in foreign investments into the short-term notes. In the first quarter of 2018, the share of non-residents in the total volume of notes in circulation amounted to 10.47%, and it has decreased to 2.94% at the end of the year.

**2.3. MFRK SECURITIES MARKET**

**Despite the growing volume of GS of MFRK in circulation, a narrow investor base limits market liquidity. MFRK funding needs in 2018–2019 was mainly resourced by captive investors. Secondary market is practically non-existent.**

Demand in the primary market for the placement of GS of MFRK in 2018–2019 was formulated by captive investors (UAPF and funds managed by the NBK) (Chart 2.10). The share of voluntary investors in the auctions for the placement of government securities of the Ministry of Finance was not significant.

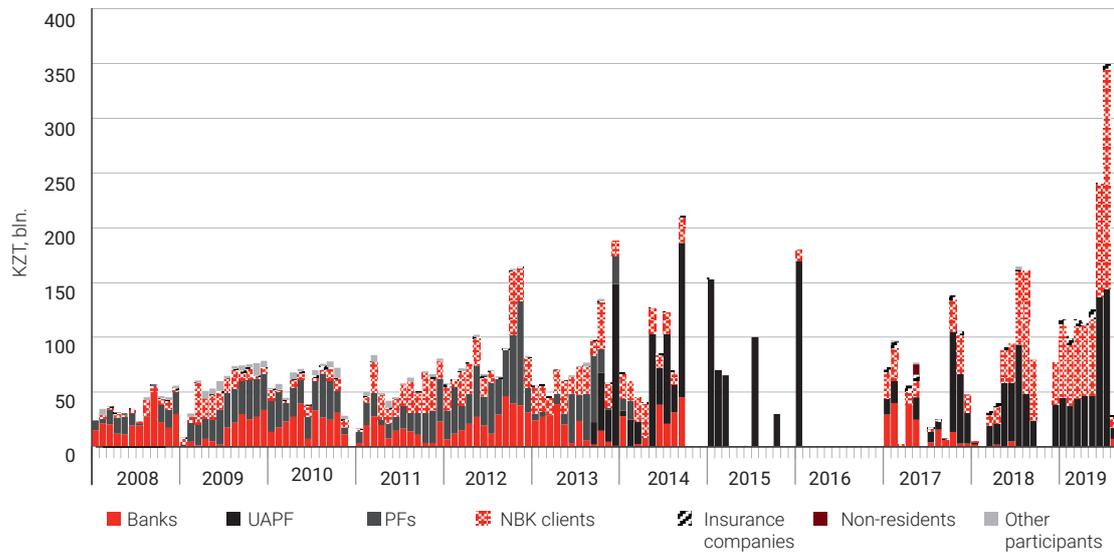
One of the reasons behind the decreased interest of market players in GS of MFRK is that the Ministry of Finance of the Republic of Kazakhstan places government securities under a value basis and not by a placement volume as announced previously. To eliminate debt placement at an undesirable price, the auctions of the Ministry of Finance of the Republic of Kazakhstan on placement of government securities are

held upon a yield level cut-off. Ministry of Finance of the Republic of Kazakhstan has no obligation to place the previously announced volume of government securities. At the same time, the market is not informed about the cut-off price of the Ministry of Finance of the Republic of Kazakhstan, nor about the principles of its setting. As a result, the transparency of the primary market is poor, the rates in the primary government securities market are no reflection of market expectations.

In countries with developed markets, initial placement is done at declared volume, and not at the cut-off price. Purchase orders are executed in ascending order at stated rates until the announced volume is fully exhausted. This allows the market to independently determine the market rate for risk-free securities for a given maturity.

**Chart 2.10 Limited Demand for MFRK Government Securities**

Raised volumes at the auctions for the placement of MF RK government securities by types of investors



Source: Central Securities Depository

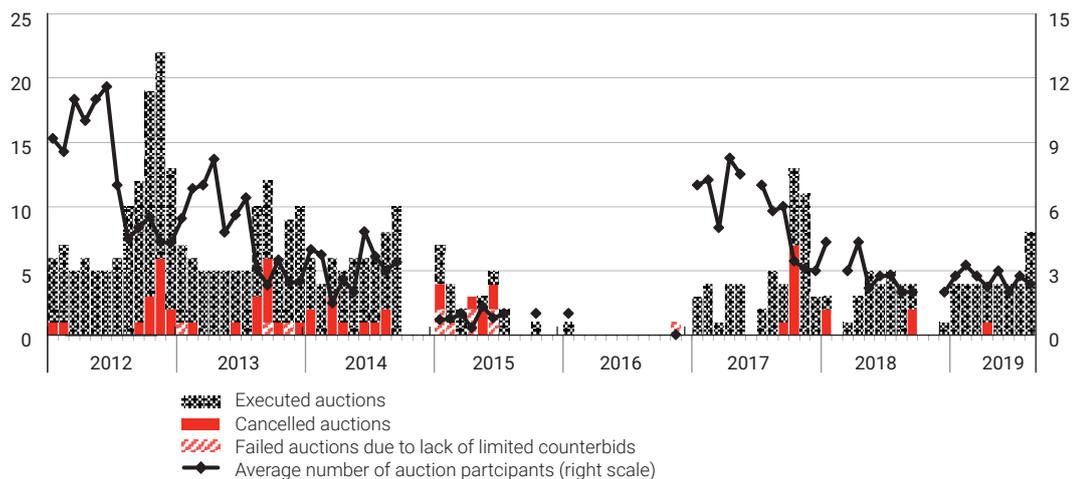
Note: 1) GSs purchased by a system-forming bank in July 2017 as part of its rehabilitation was excluded from the sample; 2) The type of investor "other" includes broker dealers, investment funds, individuals, government organizations, other legal entities and own assets of pension funds

In 2018-2019, auctions were conducted with greater success compared to previous years. Only four of 30 auctions held in 2018, and one of the 24 auctions for the placement of government securities in 1H 2019 have not taken place. They were canceled by the Ministry of Finance of the Republic of Kazakhstan due to unsatisfactory price parameters in the bids submitted by market players (Chart 2.11).

At the auctions held in 2018, the declared demand was fully met; in 2019, demand was largely satisfied (Chart 2.12). However, the success rate of auctions is determined by the fact that the main share in the auctions was held by captive investors. The practice of debt placement at rates below the yield required by the market has discouraged market players' interest in the GS of MFRK.

**Chart 2.11 High Level of Success of Auctions with a Small Number of Bidders**

The number of held and failed auctions on placement of government securities MF RK

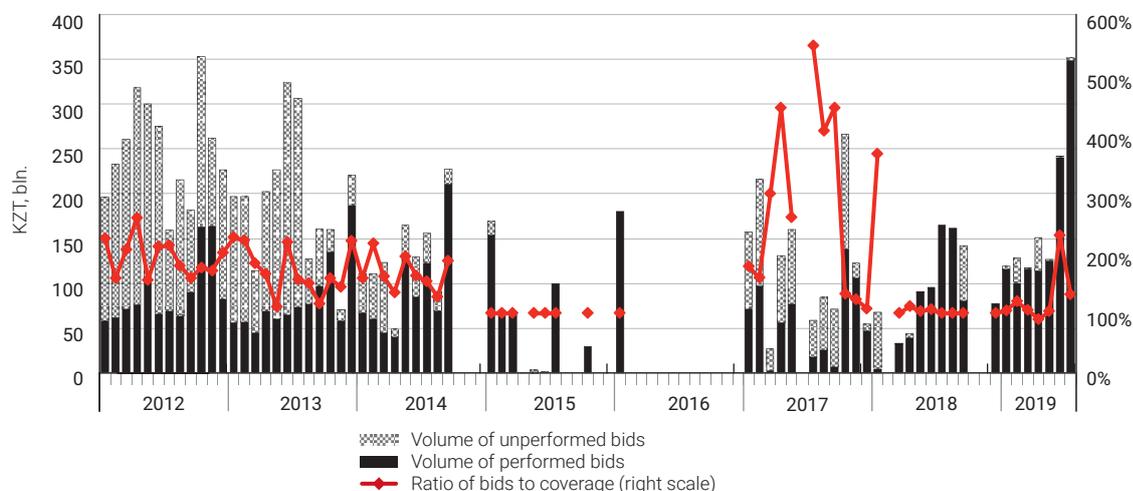


Source: KASE

Note: 1) GSs purchased by a system-forming bank in July 2017 as part of its rehabilitation were excluded from the sample; 2) Data on the number of bidders on auctions failed due to the absence of counter-bids are presented excluding the data on market bids

**Chart 2.12 Volume of Unperformed Bids Fell in 2018-2019**

Volumes of performed and unperformed bids at auctions on floatation of GS of MFRK

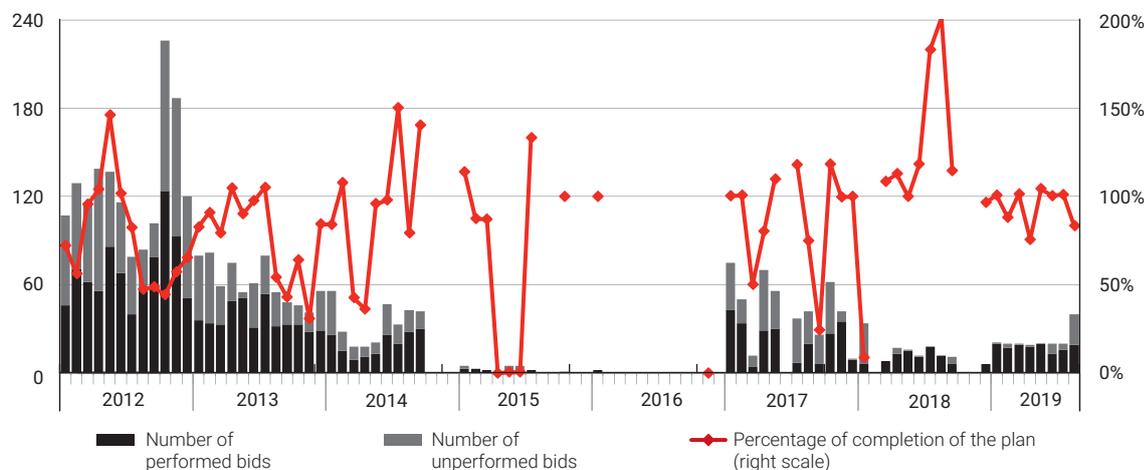


Source: KASE

Note: 1) GSs purchased by a system-forming bank in July 2017 as part of its rehabilitation were excluded from the sample; 2) The ratio of bids to coverage for the month is calculated as a weighted average (according to the announced volume of placement) of the ratio of the number of all active bids to met bids for each auction on government securities of the MF RK; 3) To calculate bids to coverage ratio, only the data on the number of active bids were taken into account

**Chart 2.13 Decreased Number of Bids at the Auctions on Placement of MF RK Government Securities and Their Increased Performance in 2018**

The number of met and unmet bids at auctions at placement of GS of MFRK



Source: KASE

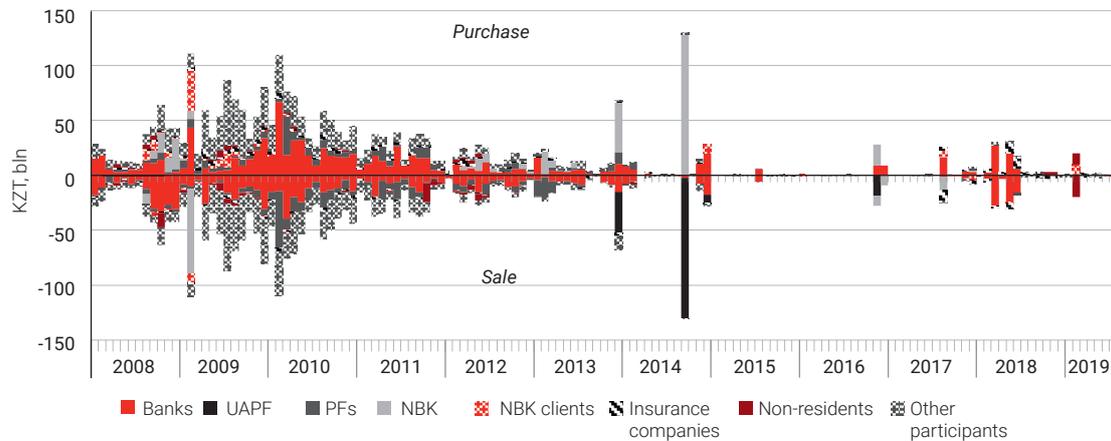
Note: 1) GSs purchased by a system-forming bank in July 2017 as part of its rehabilitation were excluded from the sample; 2) The percentage of the plan is calculated as the ratio of the actually allocated volume to the announced volume of government securities

The secondary market of MFRK government securities remained low in 2018-2019. Captive investors held the acquired GSs to maturity and were not engaged in the

secondary market. Growing operations by second-tier banks in the secondary market was caused by a demand in liquidity of individual banks.

**Chart 2.14 Increased Sales of MFRK Government Securities issued by on the Secondary Market Associated with Liquidity Problems of Individual Banks**

Volumes on the secondary market of government securities MFRK by market participants



Source: Central Securities Depository

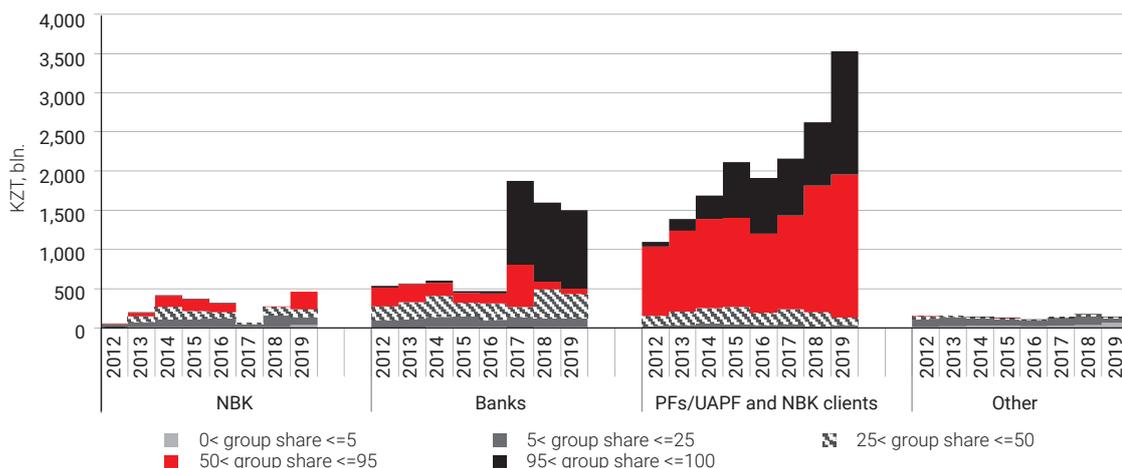
Note: The type of investor "Other" includes broker dealers, investment funds, individuals, state organizations, other legal entities and own assets of pension funds

## 2.4. INCREASED CONCENTRATION AMONG GS HOLDERS

The dominance of captive investors in the primary market increased their concentration among GS holders (Chart 2.15). Chart 2.15 demonstrates volume of GS of MF held by the group of holders and the share of the group in every issue. Thus, the share of UAPF JSC and funds under NBK management in most issues

held by them is more than 50%. The volume of coupon-indexed issues where the share of UAPF JSC and funds under NBK management is more than 95% continues to grow since 2012. In 2019 their volume reached 44% in GS portfolio of the group.

**Chart 2.15 Increasing Concentration of MFRK Government Securities among Captive Investors**  
(a) Distribution of GS of MFRK that are not MEUJKAM, by shares of types of holders in the volume of each issue



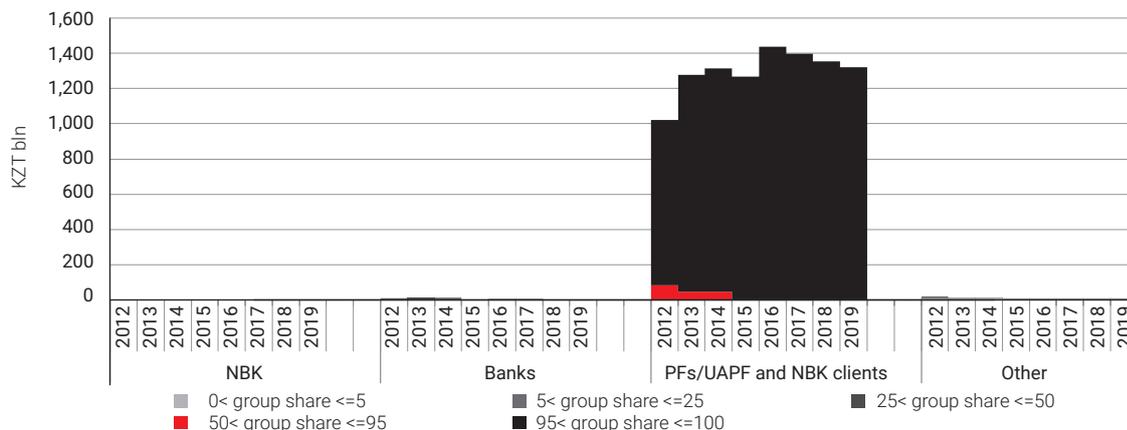
Source: Central Securities Depository, National Bank assessment

Note: Data for 2019 is presented as of November 1, 2019

Bonds of the Ministry of Finance of the Republic of Kazakhstan with an index-based coupon (MEUJKAM) are almost completely concentrated in the portfolio of UAPF and NBK clients. The reason for this was the

restriction of MEUJKAM on floatation and circulation in the first half of the term among UAPF JSC, PF, GFSS and life insurance companies.

(b) Distribution of GS of MFRK, which are MEUJKAM, by shares of types of holders in the volume of each issue



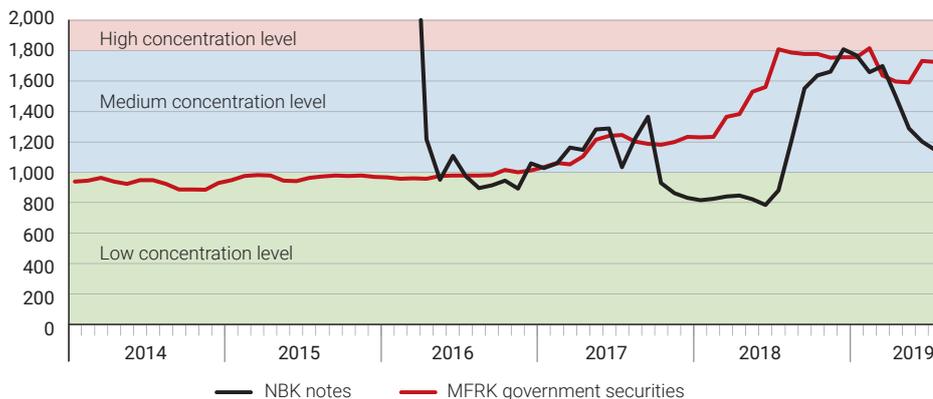
Source: Central Securities Depository, National Bank assessment  
 Note: Data for 2019 is presented as of November 1, 2019

Significant increase in concentration of holding GS among banks observed in 2018 was due to mergers of banks with high share of GS (Chart 2.16). Banks

experiencing liquidity problems sold large volumes of MFRK government securities to large banks in March, May and June.

Chart 2.16 Concentration Index of GS holders among Banks

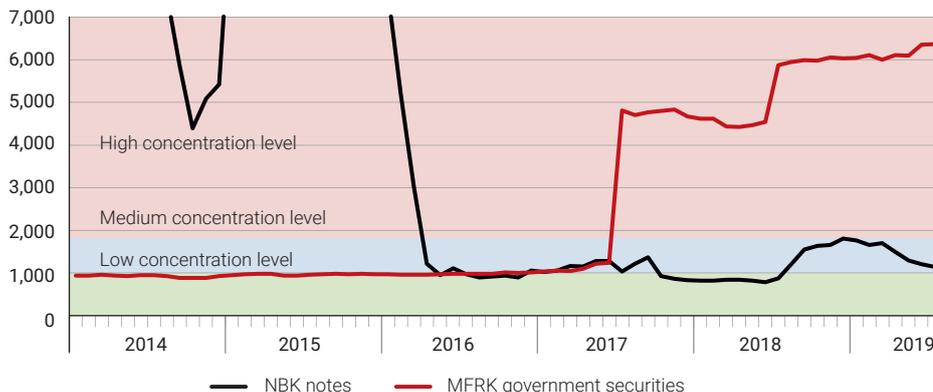
(a) Graph excluding government securities acquired by a systemically important bank in July 2017 as part of its rehabilitation



Source: NBK, National Bank assessment

Note: The concentration index is calculated by the formula of the Herfindahl-Hirschman index- market monopolization indicator.

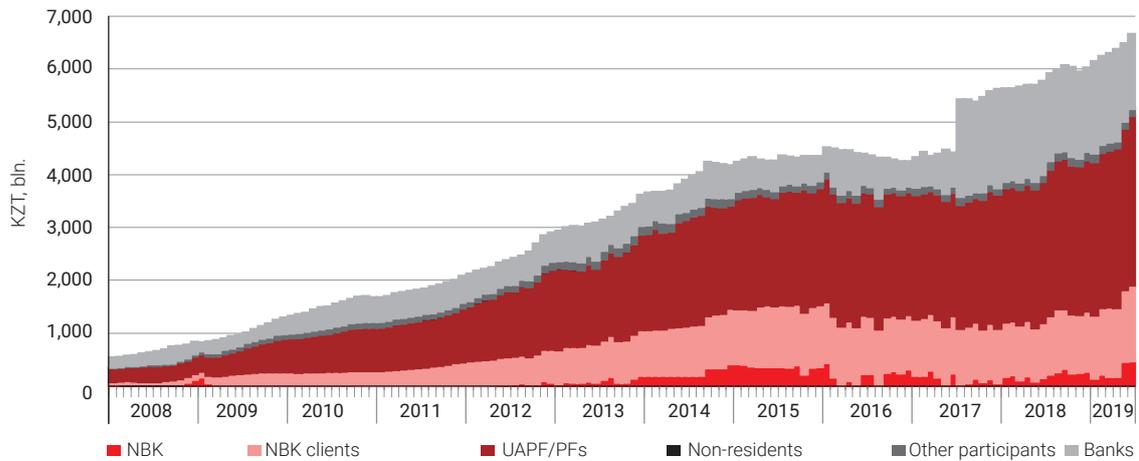
(b) Graph taking into account government securities purchased by a systemically important bank in July 2017 as part of its rehabilitation



Source: NBK, National Bank assessment

Note: The concentration index is calculated by the formula of the Herfindahl-Hirschman index- market monopolization indicator.

Chart 2.17 MFRK Government Securities Holders



Source: Central Securities Depository

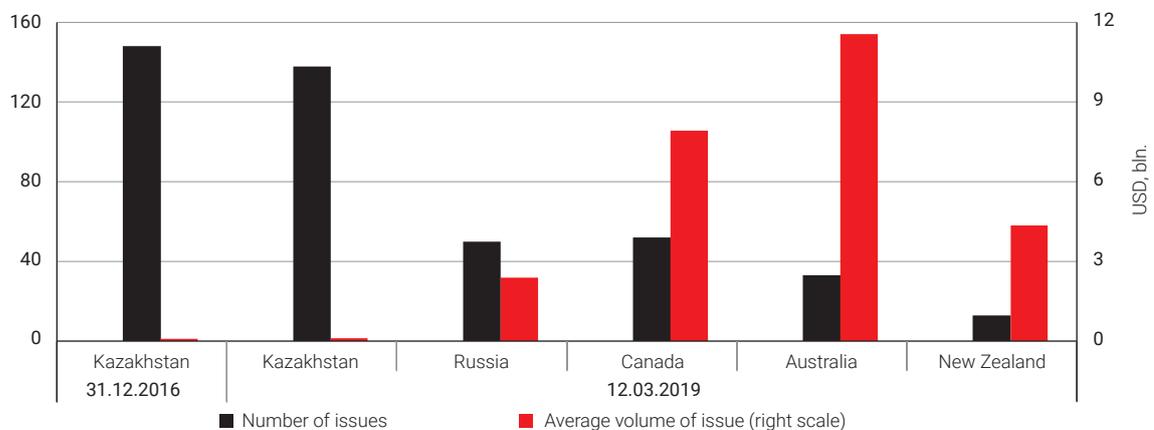
## 2.5. THE POLICY OF RAISING DOMESTIC DEBT OF THE MINISTRY OF FINANCE OF THE REPUBLIC OF KAZAKHSTAN

Some features of the policy on raising domestic debt of the MF RK adversely affect the liquidity of the government securities market of the MF RK. One of them is the high level of fragmentation of domestic debt, namely, a large number of issues of government securities MF RK in small volume (Chart 2.18, Chart 2.19). Small output volume limits the potential number of issue holders and adversely affects market depth. This reduces the number of transactions for this issue and, accordingly, decreases the relevance of the market valuation. At the end of 2018, the number of issues of the Ministry of Finance of the Republic of Kazakhstan reached 149 (Table 1). Still, another issue of government securities is not needed when raising

debt, as a change in market conditions may be seen in yield of the additional placement of available issues.

In international practice, a decrease in the level of fragmentation occurs through liquidity accumulation and maintenance in large reference issues, the key points of the yield curve. As a rule, reference securities emerge with additional placement of the same security at several auctions and by redeeming "old" (off-the-run) securities of low trading level to maximize the volume of the "new" (on-the-run) GS issues. This enables the minimization of debt fragmentation and concentration of market liquidity in small amount of securities, thereby ensuring their active trading.

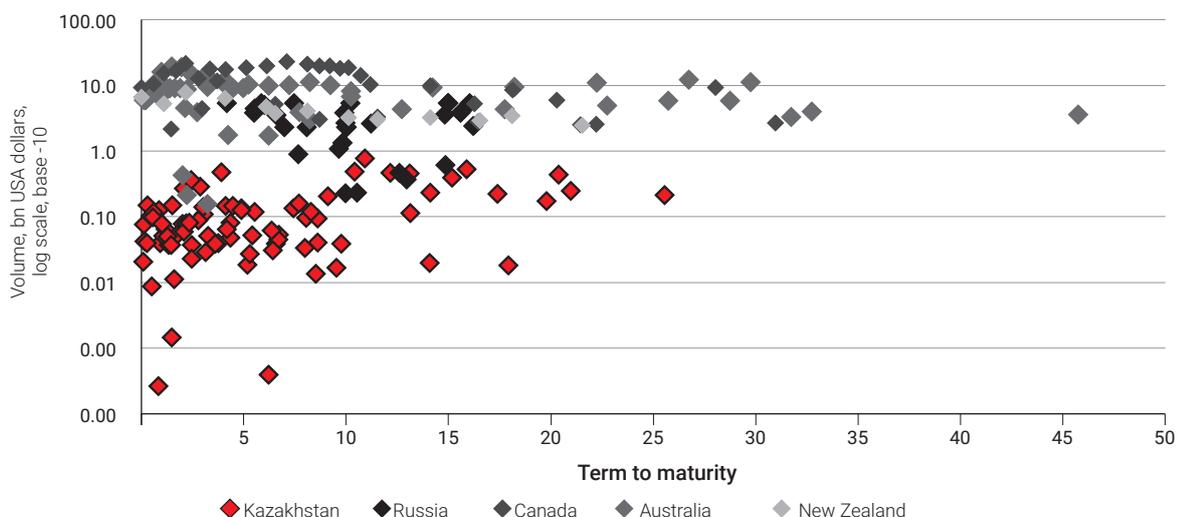
Chart 2.18 Number and Average Volume of GS Issues by Countries



Source: Thomson Reuters, Central Securities Depository

Note: 1) Only government securities of the countries with over-a-year maturity are included in the sample of government securities; 2) Government securities of the Republic of Kazakhstan purchased by a system-forming bank in July 2017 as part of its rehabilitation are excluded from the sample

Chart 2.19 Fixed Coupon GS in Circulation by Issue (March 2019)



Source: Thomson Reuters

Note: 1) (March 2019) Countries' government securities with over-a-year fixed coupon are included in the sample of government securities.

Table 1. Number and Volumes of Outstanding GS Issued in Tenge

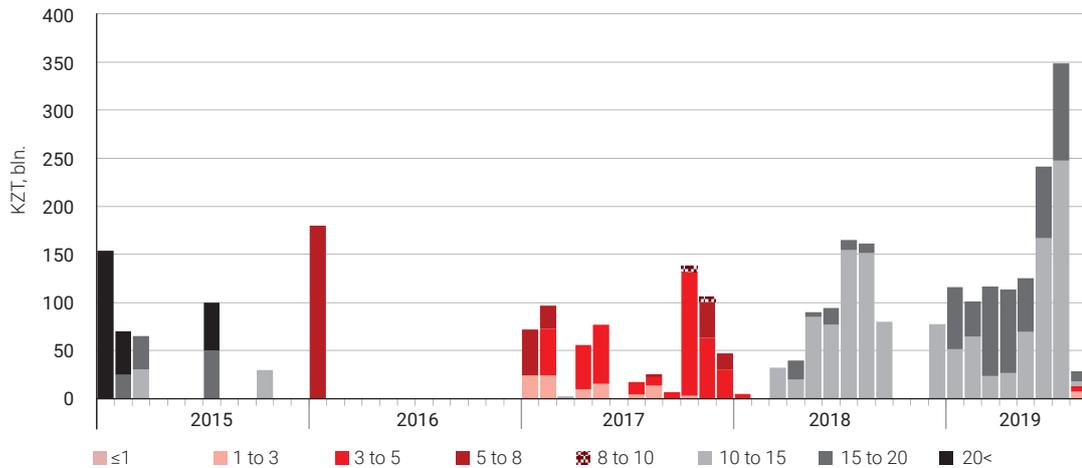
|                                      | 2009    | 2013    | 2016    | 2017    | 2018     | 2019     |
|--------------------------------------|---------|---------|---------|---------|----------|----------|
| Number of GS issues in circulation   |         |         |         |         |          |          |
| MFRK GS                              | 122     | 187     | 154     | 152     | 143      | 131      |
| - with an indexed coupon             | 31      | 66      | 64      | 60      | 57       | 54       |
| - with non-indexed coupon            | 91      | 121     | 90      | 92      | 86       | 77       |
| NBK notes                            | 15      | 2       | 22      | 35      | 35       | 29       |
| LEB GS                               | –       | 1       | 17      | 45      | 50       | 48       |
| Total                                | 137     | 190     | 193     | 232     | 228      | 10,325   |
| Volume in circulation. billion tenge |         |         |         |         |          |          |
| MFRK GS                              | 1,293.4 | 3,616.9 | 4,255.0 | 5,622.6 | 6,030.9  | 6,951.42 |
| - with an indexed coupon             | 431.2   | 1,329.2 | 1,446.2 | 1,403.2 | 1,359.20 | 1,326.23 |
| - with non-indexed coupon            | 862.2   | 2,287.7 | 2,808.8 | 4,219.4 | 4,671.7  | 5,625.19 |
| NBK notes                            | 476.7   | 3.6     | 2,596.0 | 3,310.3 | 3,638.2  | 3,160.7  |
| LEB GS                               | –       | 13      | 38.2    | 125     | 188.9    | 426.3    |
| Total                                | 1,770   | 3,633   | 6,889   | 9,058   | 9,858    | 10,325   |
| Average output. billion tenge        |         |         |         |         |          |          |
| MFRK GS                              | 10.6    | 19.3    | 27.6    | 37      | 42.2     | 53       |
| - with an indexed coupon             | 13.9    | 20.1    | 22.6    | 23.4    | 23.8     | 25       |
| - with non-indexed coupon            | 9.5     | 18.9    | 31.2    | 45.9    | 54.3     | 73       |
| NBK notes                            | 31.8    | 1.8     | 118     | 94.6    | 103.9    | 211      |
| LEB GS                               | –       | 13      | 2.2     | 2.8     | 3.8      | 213      |

Source: Central Securities Depository

In addition to the practice of MF RK on placement GS with yield cutoff rule, **interest of market players in 2018–2019 was low due to the placement of government securities with over 10 year maturity.** This investment horizon includes long-term funds only. In addition, in an illiquid market, the sale of bonds before maturity can be sold at a great discount, which explains poor interest of market players.

The issuance of sole long-term bonds by the Ministry of Finance of the Republic of Kazakhstan was associated with the need to optimize main debt repayment schedule ([Chart 2.20](#)). The absence of transactions with under-10-year government securities has negatively affected the yield curve in these sections.

Chart 2.20 Placement of MFRK Government Securities by maturity

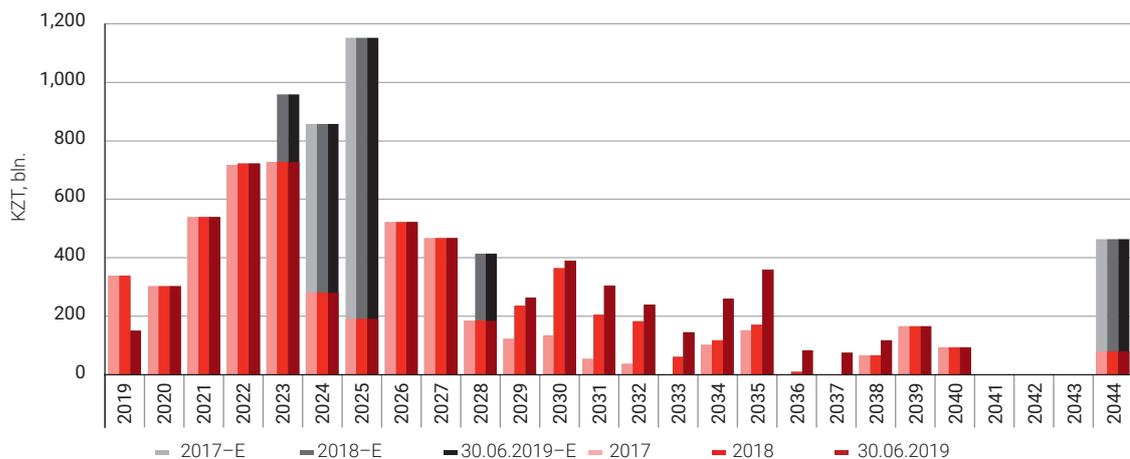


Source: Central Securities Depository

Note: Government securities of the Republic of Kazakhstan purchased by a system-forming bank in July 2017 as part of its rehabilitation are excluded from the sample

Chart 2.21 To Harmonize the Repayment Schedule, the Ministry of Finance of the Republic of Kazakhstan Placed Long Maturity GSs in 2018

Repayment schedule of the main debt of the Ministry of Finance of the Republic of Kazakhstan on government securities of the Ministry of Finance (including Eurobonds) at the end of the periods



Source: Central Securities Depository, National Bank assessment

Note: 1) GSs purchased by a system-forming bank in July 2017 as part of its rehabilitation were excluded from the sample; 2) E – Eurobonds liabilities of the Ministry of Finance of the Republic of Kazakhstan; 3) The amount of principal Eurobonds repayment was converted into tenge at official rates as of December 31, 2018.

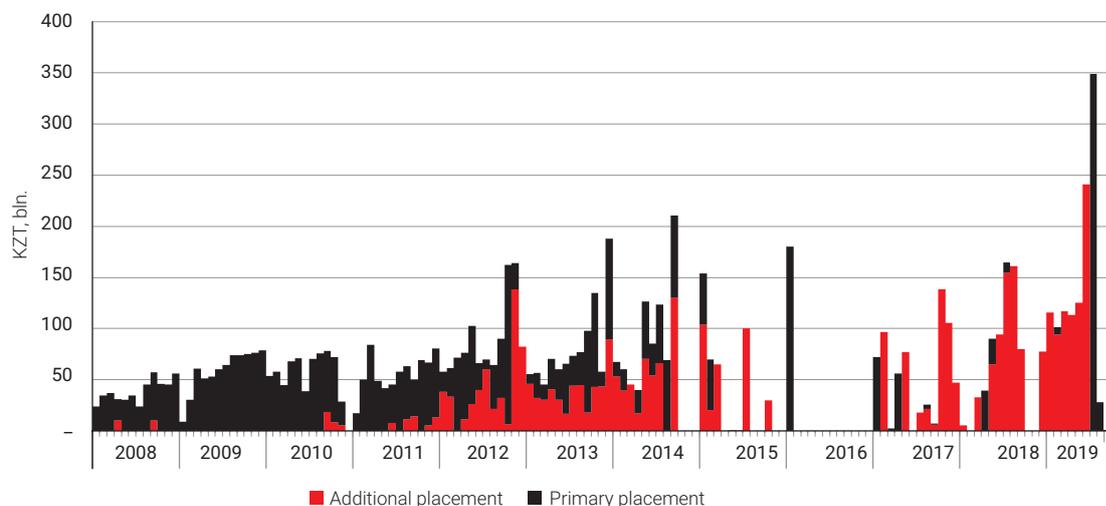
Since 2012, the Ministry of Finance has intensified the practice of additional floatation of available issues of government securities, but only in 2018 the Ministry of Finance began to float individual issues with maturities of 11, 15 and 16 years. This was caused by the need to consolidate these issues and include the Government Securities of the Ministry of Finance in international global bond indices. When choosing individual issues, the Ministry of Finance of the Republic of Kazakhstan has also factored the optimization of the repayment schedule, floatation of additional issues in over-10-year segment of the yield curve.

### Poor GS floatation schedule compliance has caused low confidence of market participants in debt management policy.

One of the reasons for poor demand on the primary market could be the absence of solid supply of government auctions. The historically formed unstable schedule for the issuance of government securities by the Ministry of Finance of the Republic of Kazakhstan by auction dates, placement volumes, terms of circulation and types of government securities, as well as non-compliance with the issuance schedule enhanced market uncertainty, decreased the level of decisions' transparency and potential investors' trust in government debt management policy, were the factors behind poor market demand in Kazakhstan (Chart 2.23).

**Chart 2.22 In 2018, the Ministry of Finance of the Republic of Kazakhstan Began to Place Additional GS to Consolidate Issues**

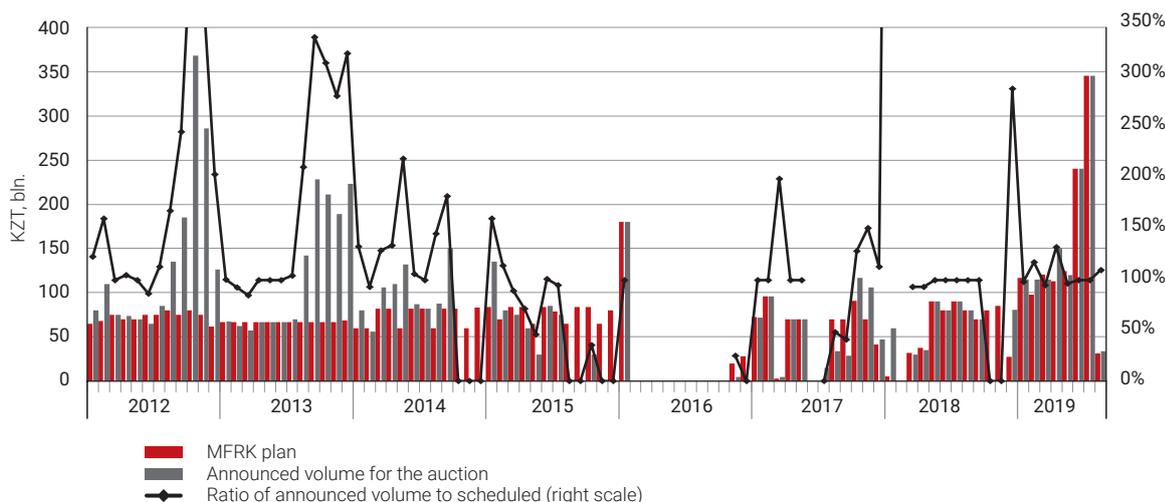
Placements and additional placements of government securities MFRK



Source: Central Securities Depository

Note: GSs purchased by a system-forming bank in July 2017 as part of its rehabilitation were excluded from the sample

**Chart 2.23 Planned and Auction Volumes of Government Securities**



Source: Ministry of Finance of the Republic of Kazakhstan, KASE, National Bank assessment

Note: 1) GSs purchased by a system-forming bank in July 2017 as part of its rehabilitation were excluded from the sample;

2) The planned volumes for 2012-2015 are presented at the beginning of the year of the reporting periods, data for 2017 as of 04/17/2017, for 2018 as of 04/09/2018, data for 2019 as of 07/02/2019.

To enhance the liquidity of government securities market NBK conducted a work to include measures in the Macroeconomic Policy Measures Coordination Agreement for the year 2019 between the Government of the Republic of Kazakhstan and the NBK (hereinafter the Agreement) aimed at raising the confidence of market participants in debt management policies of the Government of RK. Pursuant to the Agreement, the Ministry of Finance will: (1) publish a government bond issue schedule for the coming year; (2) hold repeated auctions for the placement of government securities, consolidate the issues of government securities in circulation, and reduce the number of issues in circulation to 30-40 in the medium and long term. In addition, in July 2019 the issue schedule for government securities was changed, under which, on top of long-

term government securities, the Ministry of Finance of the Republic of Kazakhstan, from August 2019 started placing government securities with different terms of under 10 years.

**Preference of the Ministry of Finance of the Republic of Kazakhstan for external sources of financing due to low cost of funding.**

The opportunity to use funds of the NFRK and access to cheaper external funds have defined the secondary role of raising domestic public debt in covering the budget deficit.

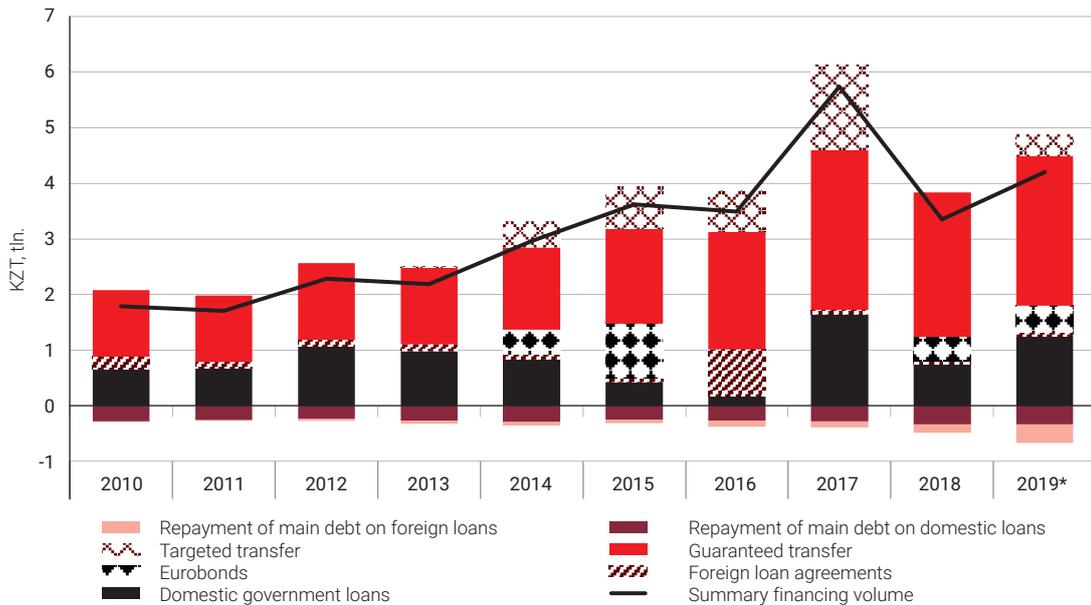
Despite the restrictions on targeted transfers spending within the framework of the Concept for Raising and

Use of the Funds of the NF RK, the main source of financing of the budget deficit remains the NFRK.

Also, in 2018, the Ministry of Finance of the Republic of Kazakhstan again financed budget deficit through

Eurobonds floatation: in November, a 5-year issue with a yield of 1.55% and a 10-year Issue with a yield of 2.375% of Eurobonds in the amount of 525 million euros each were issued (*Chart 2.24*).

**Chart 2.24 Transfers from the NF RK Remain the Main Source of Deficit Financing**  
The structure of budget deficit financing of the Republic of Kazakhstan



Source: Ministry of Finance of the Republic of Kazakhstan

Note: \* Data on servicing internal and external debt is presented as of November 1, 2019.

Internal debt includes state treasury GS of MFRK, Eurobonds external debt and foreign loan agreements of the Ministry of Finance of the Republic of Kazakhstan

The choice of a deficit financing source for the Ministry of Finance of the RK was rather based on funding cost. It should be noted that with the Eurobonds issue, despite the lower cost of funding, foreign debt is exposed to currency risks, and its realization may increase the actual cost of external resources. Therefore, a sole focus on external debt nominal value reduction may cause an increased country's economic dependence and a narrowing of the fiscal space.

The government securities market, as a tool for budget deficit financing, can contribute to accumulation of sovereign assets by reducing the NFRK transfers and country's exposure to market risks by decreasing the share of foreign currency debt.

Thus, the priority of reduction of the cost of the Ministry of Finance's internal debt servicing and optimization of the repayment schedule over improvement of liquidity of government securities market significantly

inhibits the development of the entire securities market and decreases the efficiency of the transmission mechanism. To increase the participation of market investors in the government securities market, the current debt management policy shall be adjusted.

To increase the confidence of market participants, the debt management policy shall be further improved, ensuring transparency, predictability and fairness of the placement terms of government securities in the primary market.

Moreover, a necessary condition behind increased liquidity and marketability of decisions is the development of the market of institutional investors. One solution is to transfer investment management of pension savings to private asset management companies to create more competitive environment in the securities market.



### Section 3.



## HOUSING MARKET



Between 2018 and the first half of 2019, the volume of housing market transactions in Kazakhstan continued to grow. Systemic risks associated with overheating of residential real estate market and further decrease of prices are seemed to be low.

Increasing affordability of housing positively affected consumer demand, especially for the population that acquires its first housing or improves the conditions

of the housing. The housing market has become more liquid as evidenced by the growing number of secondary market transactions.

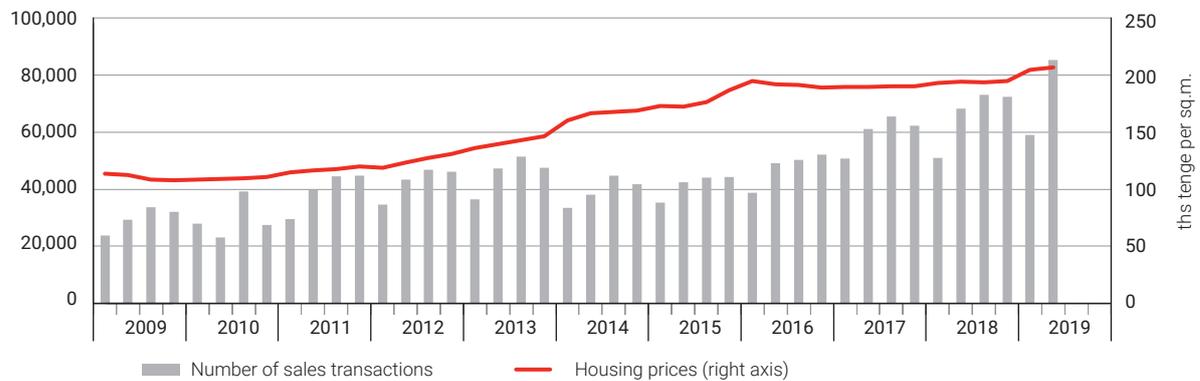
Socially oriented government programs stimulate demand, but undermine market pricing for mortgage lending, crowd out mortgage lending at market rates and increase the dependence of the housing market on subsidies.

### 3.1. HOUSING PRICES

The growth trend in the number of purchase and sale transactions in the housing market has been maintained since early 2015 (Chart 3.1). In 2018, the number of

transactions increased by 12%, and the number of transactions in the first half of 2019 increased by 21% compared to the first half of 2018.

**Chart 3.1 Increasing Activity on the Housing Market**  
Number of sales transactions and housing prices in the Republic of Kazakhstan



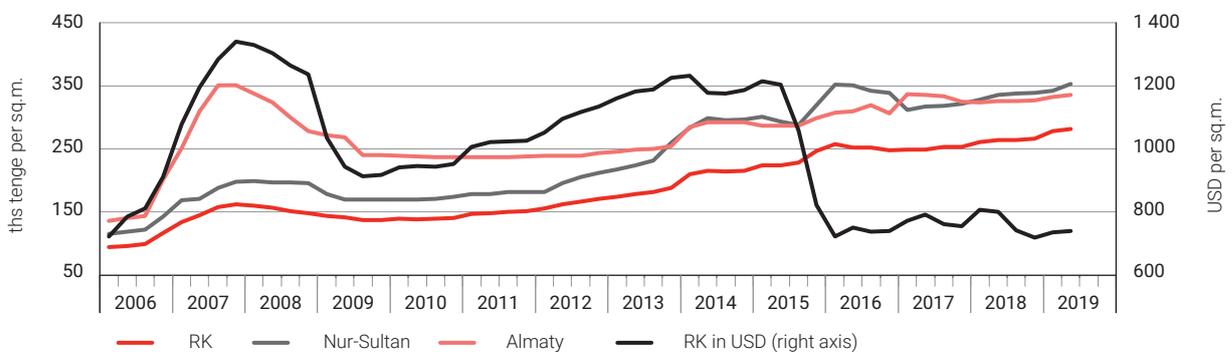
Source: SC MNE RK

Note: The number of sales transactions in 4Q2012, due to the lack of data, was calculated by extrapolating the 4th quarters of 2011 and 2013. Housing prices are calculated as the average of average prices in 4 categories: new housing, comfortable housing, poor housing and elite housing.

Between 2018 and early 2019, prices for new housing continued to (Chart 3.2). In real terms, prices for new

housing stabilized by 2018 after a 12% decline in 2017 compared to 2015 (Chart 3.3).

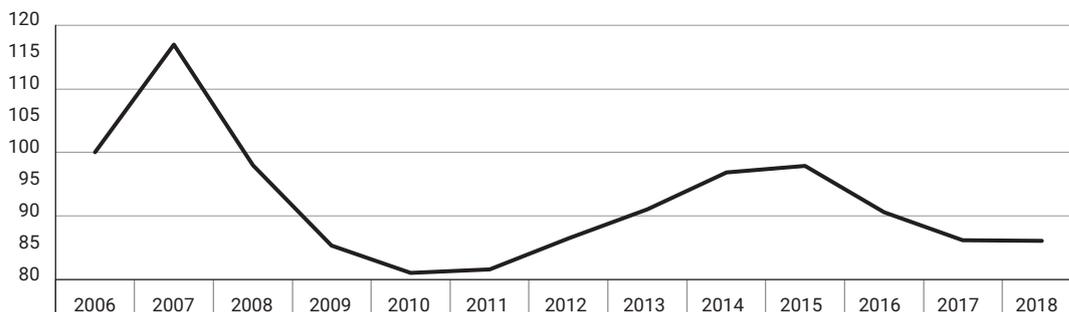
**Chart 3.2 In 2018, Growing Housing Prices Observed in Primary Market Only**  
Prices for new housing



Source: SC MNE RK

**Chart 3.3 Over Past Three Years, Inflation Outstripped Rising Housing Prices**

Index of real prices for new housing (100 = 2006)



Source: SC MNE RK, NBK assessment

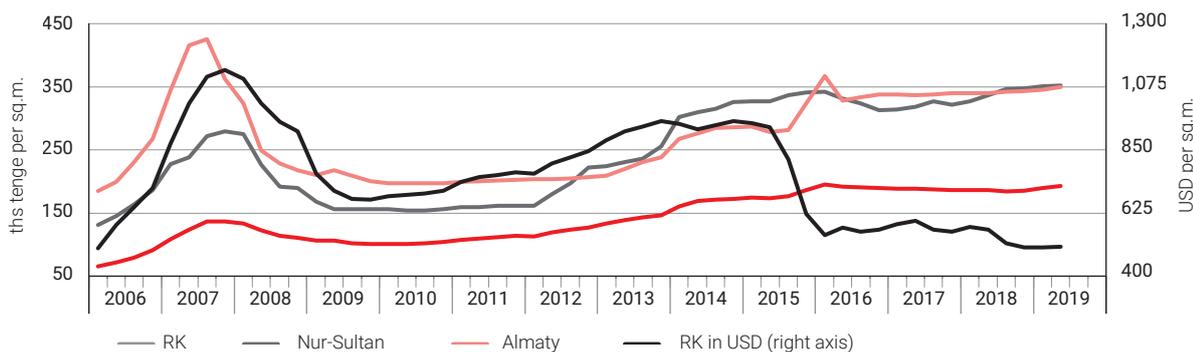
Note: The real price index is calculated as the ratio of the nominal price index for new housing to the cumulative inflation index

In the first half of 2019, prices began to rise in the secondary real estate market (Chart 3.4). According to the Baspana mortgage organization, demand in the

secondary housing market is growing, and this resulted in a new Baspana Hit program that was introduced to subsidize the secondary housing market.

**Chart 3.4 Prices in the Secondary Market Began to Rise in Early 2019**

Comfortable housing prices



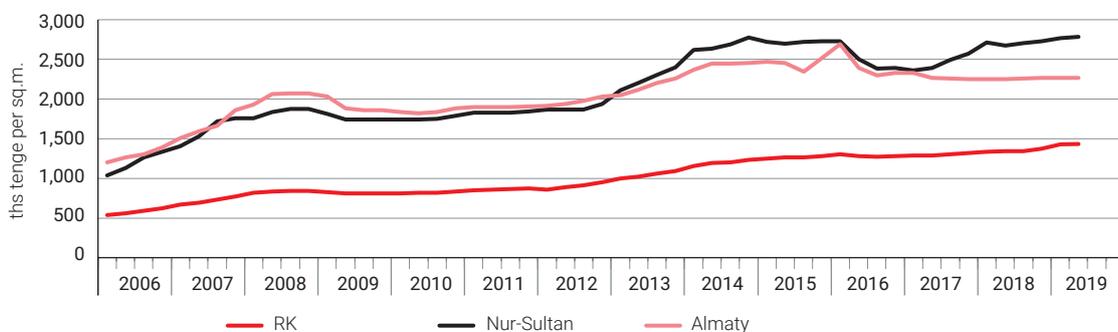
Source: SC MNE RK

In Nur-Sultan, prices rose the fastest in the Republic of Kazakhstan, reflecting the rapidly growing demand

for housing, especially rental (Chart 3.5).

**Chart 3.5 Prices on Rental Housing Market**

Rental of comfortable housing



Source: SC MNE RK

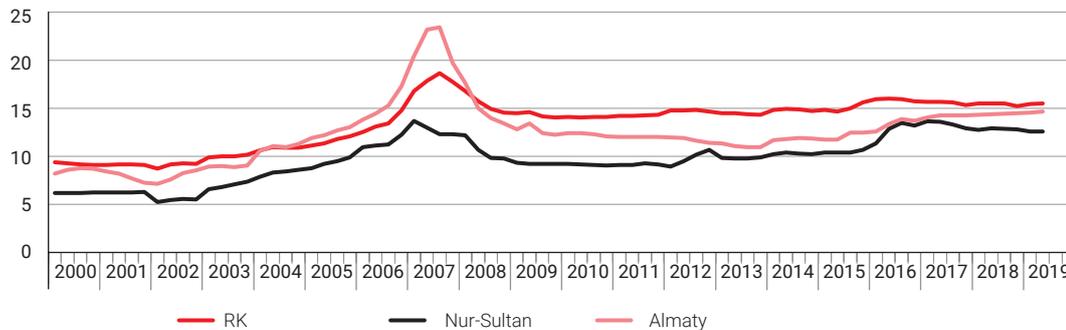
The ratio of housing prices to rental prices has remained stable since 2016, with the exception of the city of Nur-

Sultan, where the indicator has decreased and reached 12.59 (Chart 3.6). Thus, it becomes more profitable to

purchase housing in Nur-Sultan. The ratio of housing prices to rental prices in the Republic of Kazakhstan at the end of the first half of 2019 amounted to 15.49. The indicator does not grow rapidly, as it was in 2007,

when housing prices exceeded prices for annual rents by almost 19 times, after which the “bubble” burst, and housing prices collapsed.

**Chart 3.6 Housing Profitability Remains Stable after Slight Decline in 2016 and Grows Rapidly in Nur-Sultan**  
"Price / rent" ratio



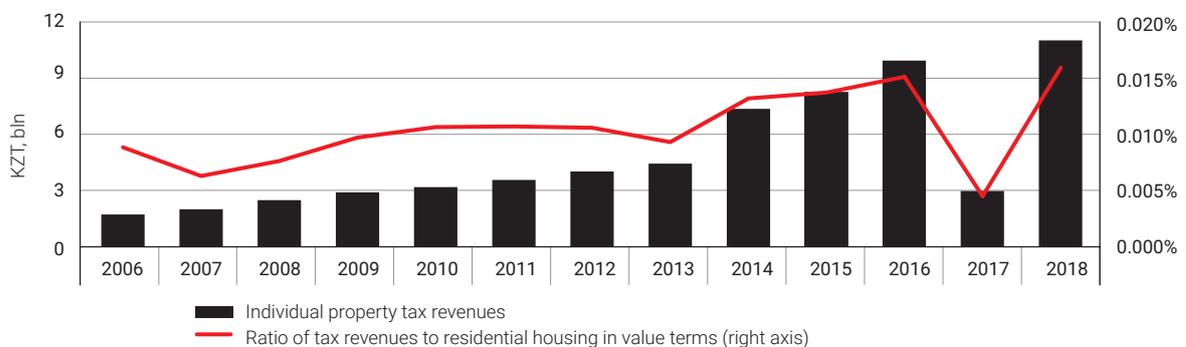
Source: SC MNE RK

Note: Price / rent ratio = Housing prices / (12 \* Monthly rental prices)

Prices for luxury housing have stagnated, also following the introduction of progressive individual property tax in 2014. The collection rate of individual property taxes

has grown 2.5 times over the past 5 years, but remains almost 3 times lower than minimum rate of 0.05% (Chart 3.7).

**Chart 3.7 Personal Property Tax Revenues Grow but Remain Low**  
Personal property tax revenues



Source: SRC MF RK, SC MNE RK, National Bank assessment

Note: 1) Housing stock in value terms is calculated as the product of the area of the housing stock and the average price of housing; 2) In 2017, amendments were made to the Tax Code of the Republic of Kazakhstan in individual property tax calculation for the next reporting tax year.

3) The 2019 housing data will be released in October 2020

### 3.2. HOUSING AFFORDABILITY AND MORTGAGE LENDING

Housing acquisition is the largest household investment, and housing affordability largely determines the level of household consumption. Real estate accounts for a significant share of collateral accepted by the banks. Accordingly, market development and changes in real estate prices affect the stable functioning of the financial sector and the economy, both directly through the market value of the real estate as collateral at banks and indirectly through the welfare of bank borrowers. Decreased real estate prices and an appropriate

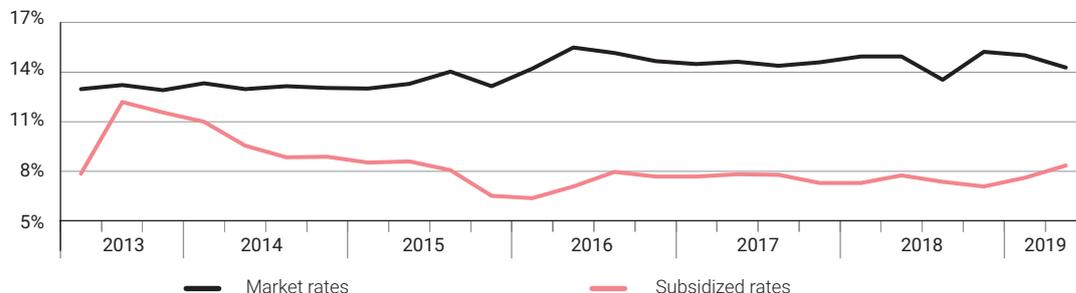
reevaluation of the collateral will cause borrowers' welfare level to decrease and entail loss of access to the borrowed capital market.

Housing affordability is improved through state subsidy programs at low interest rates (Chart 3.8) or through a system of housing construction savings that require at least 50% of the borrower's savings for down payment. Rates are subsidized through repurchase of mortgage loans by mortgage organizations (Mortgage

Organization Baspana) or through HCSBK programs with an annual state premium of up to 200 monthly

calculation index. Thus, in 2018, total amount of the credited state premium amounted to 28.6 billion tenge.

**Chart 3.8 Average Weighted Mortgage Market Rates Exceed Subsidized Rates by Almost 6% Weighted Average Rates**



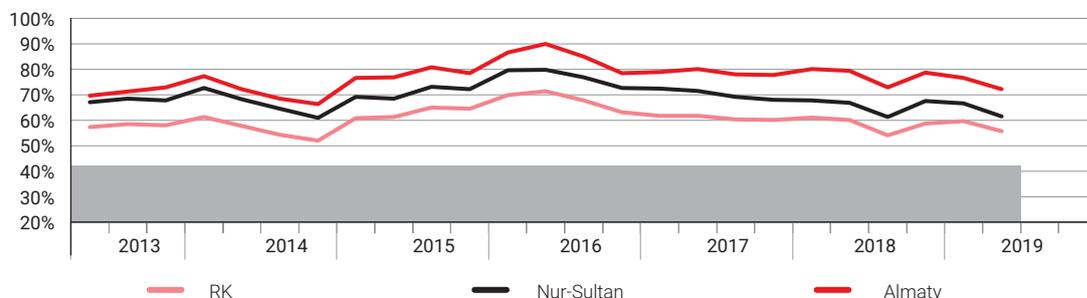
Source: Credit Register, National Bank assessment

Note: The volume of mortgage loans on market conditions is calculated upon sampled loans provided by STBs (excluding data from mortgage organizations and Housing Construction Savings Bank), based on the following criteria: individual is a lender; purpose of lending is the purchase of residential real estate; residential real estate is the collateral; and second-tier banks, own funds, other funds are the source of financing.

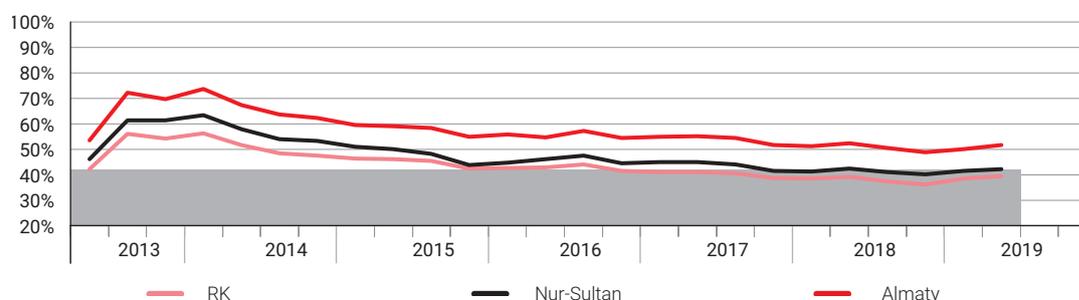
State subsidization of the rates through housing programs can improve the living conditions of the population, but distort market relations between borrowers and banks and have no long-term effect on the mortgage market. The average ratio of estimated mortgage payment at market rates to the average

wage at the end of the first half of 2019 was 57% in Kazakhstan, 63% in Nur-Sultan and 74% in Almaty (Chart 3.9). This indicator at subsidized rates amounted to 42% in Kazakhstan, 43% in Nur-Sultan, and 52% in Almaty.

**Chart 3.9 Comfortable Housing Remains Affordable Only with State Support Ratio of mortgage payments at market rates to wages**



**Ratio of mortgage payments at subsidized rates to wages**



Source: Credit Register, SC MNE RK, National Bank assessment.

Note: 1) According to the Qualified Mortgage Rules of January 10, 2014, of the Consumer Financial Protection Bureau, monthly mortgage payments should not exceed 43% of the monthly income of one individual borrower; 2) Monthly mortgage payment is calculated under following conditions: housing prices - by the average price of new, elite and comfortable housing; area of purchased housing: 54 sq.m. (18 sq.m. \* average family of three persons), with 30% down payment and 20 year loan term

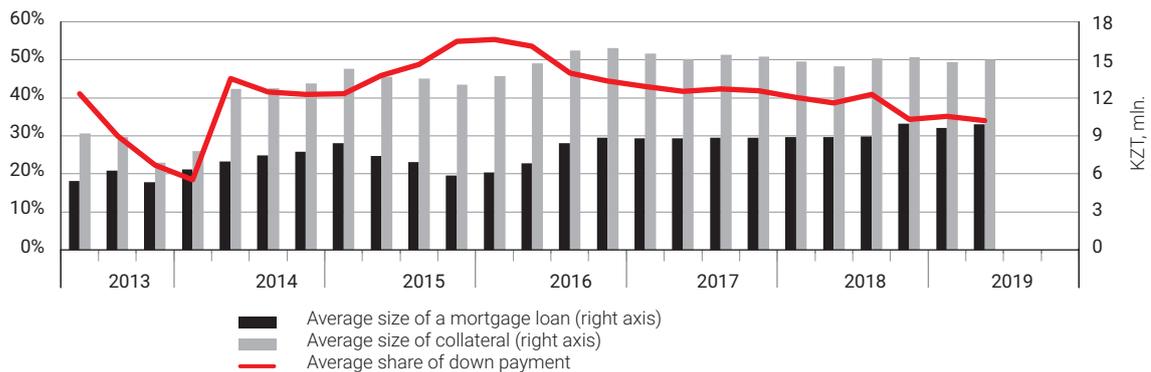
In 2018, real incomes increased by 1.7% after three years of decline and continued to grow in 2019, increasing by 4.7% for 9 months. Growing incomes of the population enhance its solvency and positively affect the availability of housing. However, the ratio of mortgage payments at market rates to the average wage in Kazakhstan was 57% for the first half of 2019, which is way above the international quality indicator of 43%. Estimated mortgage payment at subsidized rates

puts less pressure on the borrower (42%) and allows for the expansion of a circle of borrowers who are able to service mortgage loans.

By mid-2019, the average size of mortgage loans increased, while the average amount of collateral had no changes (Chart 3.10), and this resulted in the reduction of the average share of the down payment.

**Chart 3.10 Declining Share of Down Payment**

*Average size of a mortgage loan, its collateral and a share of down payment*



Source: Credit Register, National Bank assessment

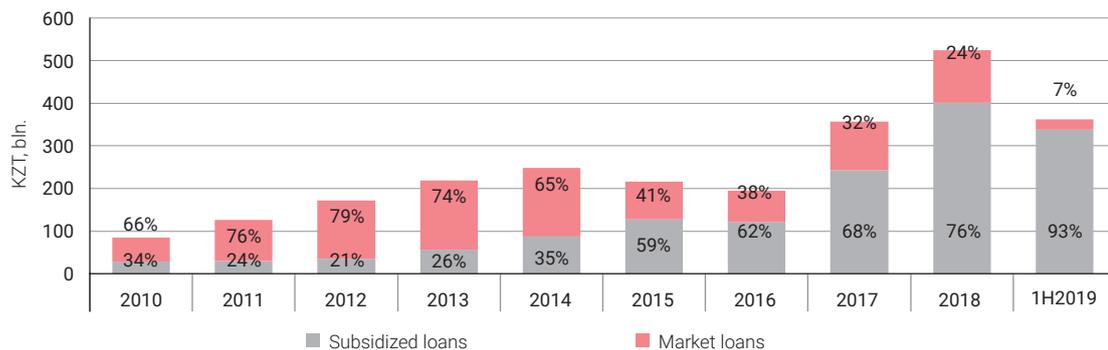
Note: 1) The average size of a mortgage loan is calculated upon sampled loans provided by STBs (excluding data from mortgage organizations), based on the following criteria: individual is a lender; purpose of lending is the purchase of residential real estate; residential real estate is the collateral; all sources of funding, except for PLF 2) In the 2nd quarter of 2014 and in the 3rd quarter of 2018, one bank was excluded from the sample, the values of which differed sharply from the values of other banks in the sample developed upon a specified data set.

In 2018, total volume of issued mortgage loans amounted to 525 billion tenge, a highest historic indicator (Chart 3.11). The revitalization of mortgage lending market occurred mainly due to realized demand of participants of the state programs and loans issued as part of housing construction savings of House

Construction Savings Bank (HCSBK), as well as from 2018 with the introduction of state programs "7-20-25" and Baspana Hit. For the first half of 2019, the share of mortgage loans on market conditions amounted to 7% only of the total volume of issued mortgage loans.

**Chart 3.11 Lending Grows Mainly Due to State Programs**

*Volumes of issued mortgage loans*

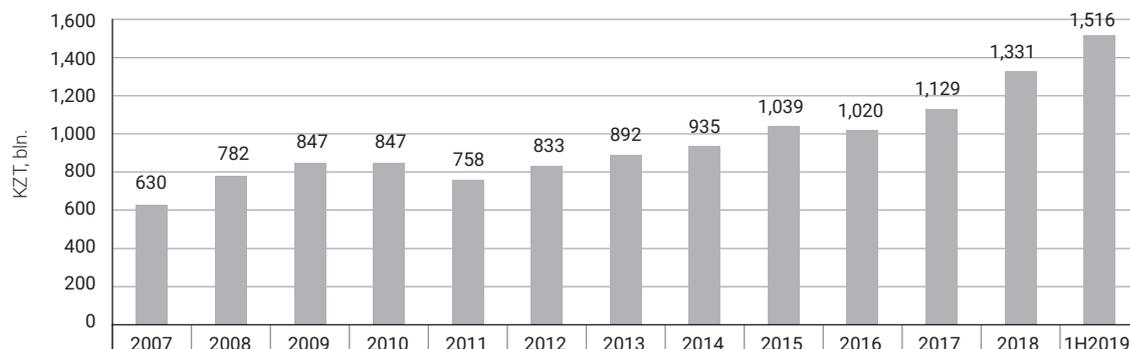


Source: STB reporting

The volume of loans issued by the banks as mortgages to population continued to grow rapidly (Chart 3.12). However, available statistics on issued loans include

refinanced loans. Thus, the actual issuance of new housing loans may be significantly less than that of the statistics.

Chart 3.12 Portfolio of Issued Mortgages Grows Rapidly



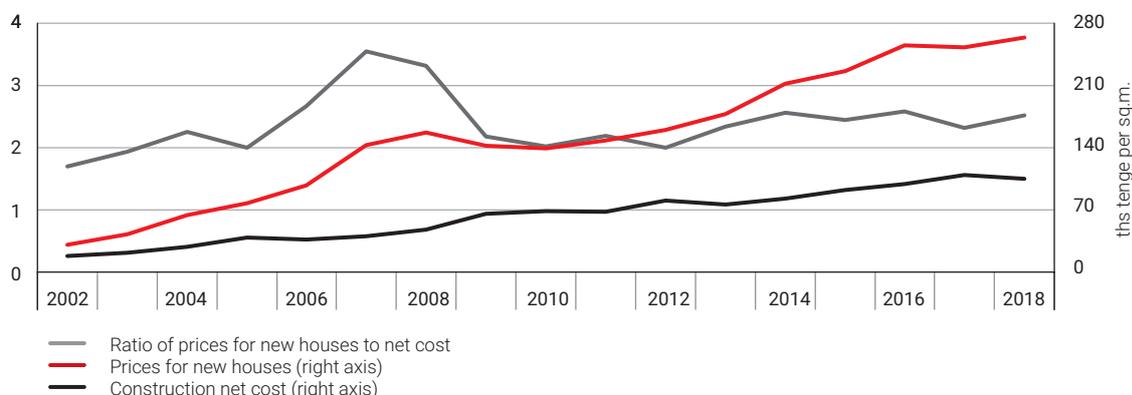
Source: STB reporting

### 3.3. HOUSING CONSTRUCTION

After market overheating in 2007, the ratio of prices for new housing to the cost of construction remained stable. In 2018, prices for new housing exceeded the cost by 2.5 times (Chart 3.13). When this indicator has

high values, the housing prices become very detached from the fundamental values and signal an overheating of the market.

Chart 3.13 Ratio of Prices for New Housing to the Cost of Construction Remained Stable since 2009  
Ratio of prices for new housing to net cost



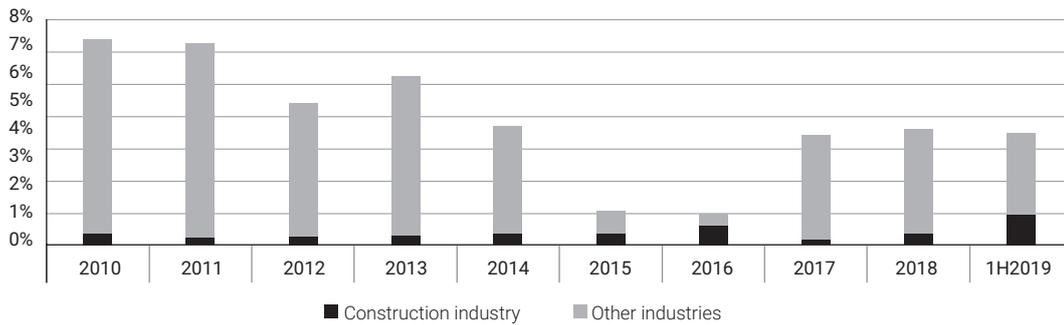
Source: SC MNE RK, National Bank assessment

Note: Sampled objects for calculation of its new housing price and net cost may vary

Growing activity in the real estate market and rising prices for new housing stimulate growth in the construction sector. The contribution of the construction industry to GDP growth and the gap between wages in construction sector and the average economy in 2018 increased as compared to the previous year (Chart 3.14, Chart 3.15). In the first half of 2019, the contribution of the construction industry to GDP growth was 1% and increased by 10% compared to the first half of 2018.

Aggregate pace of housing commissioning grows mainly due to the growing contribution by the population and private companies (Chart 3.16). In 2018, with a total investment of 1.2 trillion tenge, the total area of commissioned residential facilities amounted to 12.52 million sq.m. The pace of housing commissioning in footage exceeds the population growth rate by 2.2%. This gap has widened since 2014, which indicates a growing supply in the market.

**Chart 3.14 Contribution of Construction Industry to GDP Growth is increasing**  
GDP growth and the contribution of construction to GDP growth (in 2005 prices)



Source: SC MNE RK, National Bank assessment

Note: Contribution to growth in 1H2019 compared to 1H2018

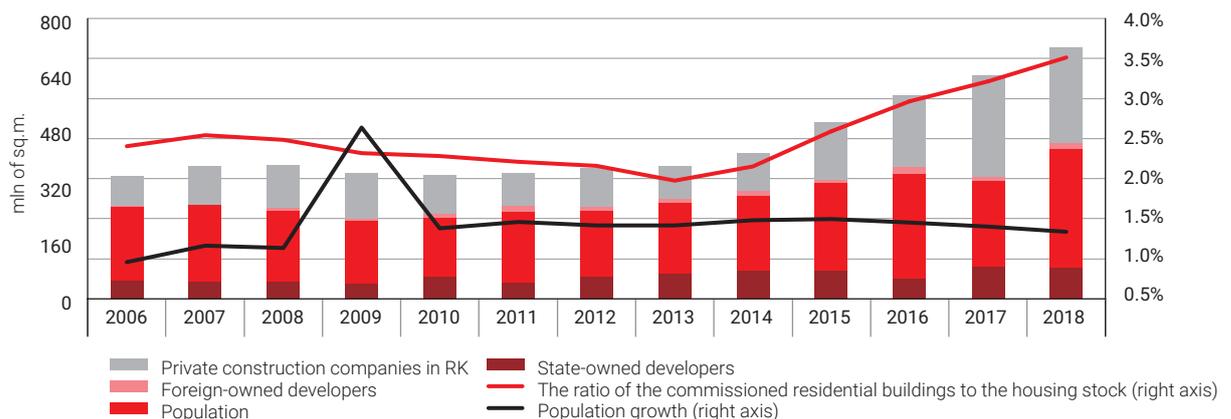
**Chart 3.15 Gap between Wages in Construction and the Average for Kazakhstan Widens**  
Number and salary of workers in construction industry



Source: SC MNE RK

**Chart 3.16 Pace of Housing Commissioning Outgrows Population Rate and Grows Mainly due to the Construction of Private Property**

The area of commissioned residential facilities in the context of developers, the population growth rate and the ratio of the commissioning of space to housing commissioning



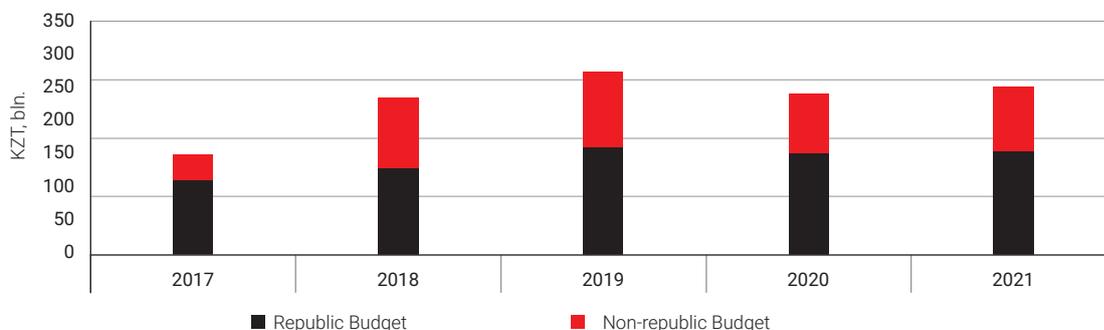
Source: SC MNE RK, National Bank assessment

Notes: 1) The commissioned objects include the completed individual residences and blocks of residential flats, dormitories and residential buildings; 2) Housing stock is the total area of residential units intended and used for permanent residence. The housing fund does not include dormitories, orphanages and nursing homes, summer residences, motels, sanatoriums, rest homes, boarding houses, guest houses, hotels, barracks and other buildings and facilities intended for recreation, seasonal and temporary residence, regardless duration of residence of citizens in them; 3) The 2019 housing data will be released in October 2020

Programs aimed at preferential lending to developers, increased availability of mortgage lending and stimulated construction by private developers are covered by Nurly Zher program (Chart 3.17). In case

target indicators of the Nurly Zher program are attained for the period 2019-2021, 42 million square meters of the housing will be commissioned, and potentially 2 million people could get a housing.

**Chart 3.17 Fiscal Support for Nurly Zher Housing Construction**  
Financing of Nurly Zher program



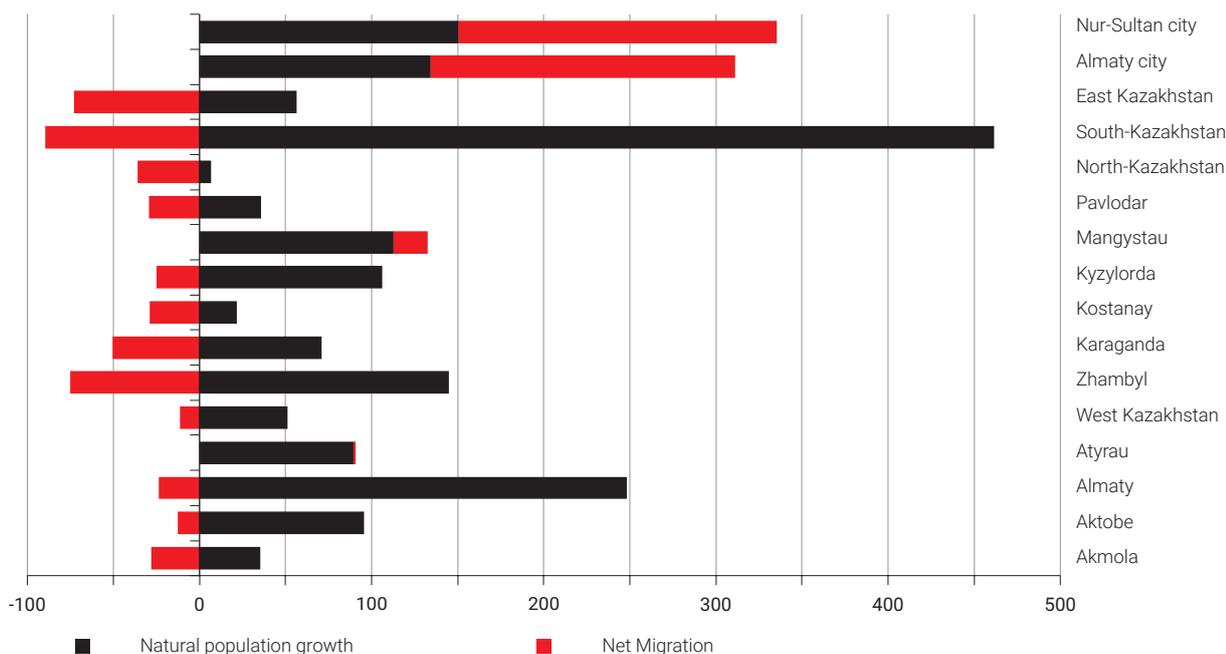
Source: Decree of the Government of the Republic of Kazakhstan dated June 22, 2018 No. 372 "On Approval of the State Housing Construction Program "Nurly Zher"

### 3.4. DEMOGRAPHY

Migration from villages and small towns to large cities with a more developed public infrastructure and a larger and more liquid labor market has continued. Most sought-after urban real estate is located in nationally significant cities. Thanks to migration, they are growing

faster than other regions, and their real estate prices are almost double that in regional centers. Over past seven years, all regions, with the exception of Mangystau and Atyrau, observed a net outflow of the population (Chart 3.18).

**Chart 3.18 Population Aspires to Nationally Significant Cities**  
Absolute population growth in 2012-1H2019



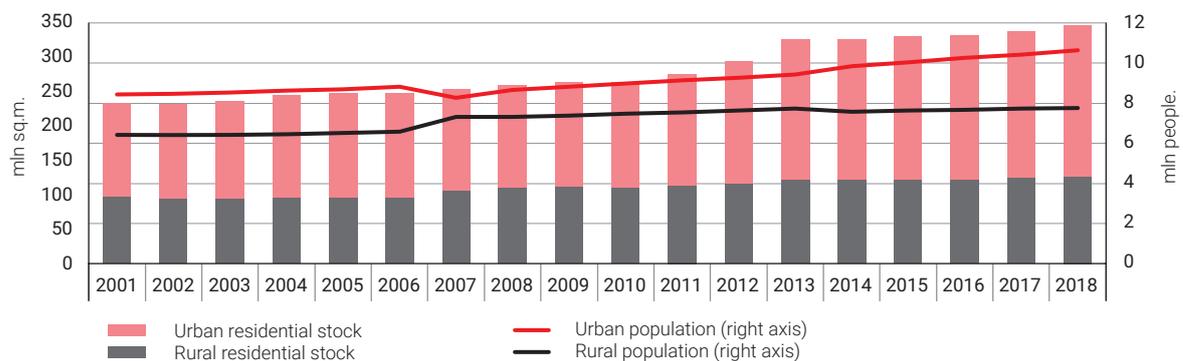
Source: SC MNE RK  
Note: 1) Natural increase is the difference between the number of births and the number of deaths over a certain period of time; 2) Migration balance is the difference between the number of arrivals in the region for the reporting period and the number of departures from it

Despite the transfer of rural households into the cities, the level of urbanization in Kazakhstan remains relatively low ([Chart 3.19](#), [Chart 3.20](#)). According to the World Bank Report, the percentage of the urban population in 2017 was 74% in Russia, 78% in the Republic of Belarus; the share of urbanization in the developed countries is over 80%, which significantly exceeds the degree of urbanization in Kazakhstan that stands at 58%. Also, despite the high level of commissioning of new housing and the high growth rate of transactions, the housing stock does not grow at the same rate due to the natural

retirement of old and unsuitable housing from the housing stock.

The growth rate of urbanization is constrained by relatively high real estate prices in large cities and limited opportunities for the rural population in the urban market, which is reflected in the structural unemployment of migrants from rural regions. Increased housing affordability only partially solves the problem of low urbanization.

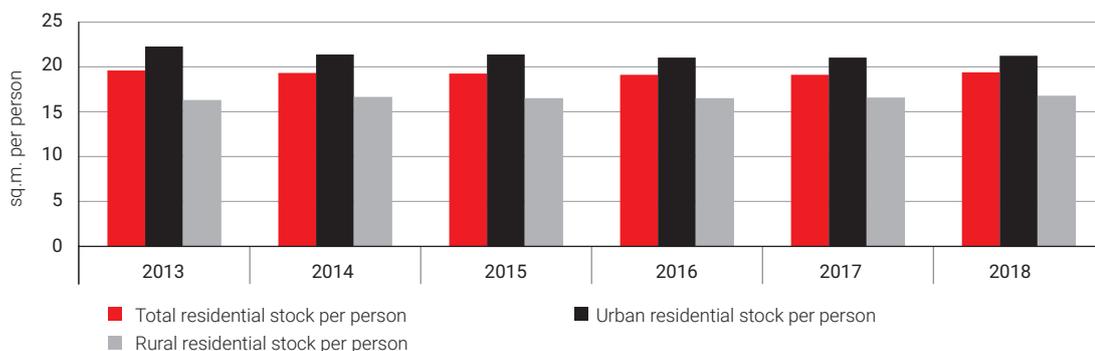
**Chart 3.19 Urbanization as a Factor of Growth of Demand for Urban Housing**  
Population and residential stock



Source: SC MNE RK

Note: The 2019 housing data will be released in October 2020.

**Chart 3.20 Ratio of Housing Stock and Population since 2013 Has Not Changed**  
Housing to population ratio



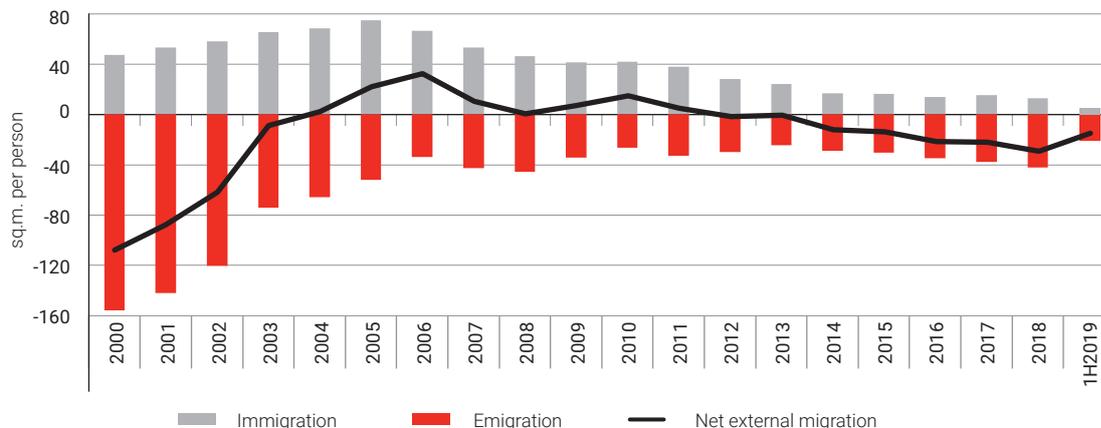
Source: SC MNE RK

Note: The 2019 housing data will be released in October 2020

The level of outflow of the population was the highest in the early 2000s, but since 2005, the balance of external migration has been positive. Net outflow of the population resumed in 2014 and continues to date ([Chart 3.21](#)). The effect of emigration on the real estate

market in the regions is insignificant, a greater risk for economic growth is associated with the effect of emigration on the labor market.

**Chart 3.21 Growing Emigration**  
Housing to population ratio



Source: SC MNERK

### 3.5. SYSTEMIC RISKS

The risks of falling real estate prices are estimated as low. Prices have been stable over past three years, and the number of transactions in the real estate market continues to grow. The ratios of the price of new housing to the cost of construction and the ratio of housing prices to rental prices remain stable, which means that current prices are not far from the fundamental levels, and there is no market overheating. The main risks are associated with a drop in demand and may be caused by a drop in real incomes of the population, an increased structural unemployment and increased level of emigration.

The increased housing availability among population has had a positive effect on the welfare of the population, especially first-time housing buyers. The acquisition of the housing is one of the largest and most important investments for the population, which indirectly affects the level of consumption and household savings.

Government programs have increased housing affordability for the population and the attractiveness of the construction industry for private companies.

Housing programs, despite increasing housing affordability, still carry certain systemic risks. The state support, among primary aspects, including through subsidized rates, has no long-term effect on the mortgage market and impedes the development of the market relations. This creates risks of falling prices on real estate market if state support will be cut.



## Section 4.



# CREDIT RISK



During 2018 and 1H2019, credit risk of the banks' loan portfolio continued to decline, but remained high and, as before, poses the main threat to the stability of the banking system. The level of credit risk was reduced as a result of decreased volume of loans with high risk of default and improved quality of credit decisions.

Just as before 2018, the quality of banks' loan portfolio has improved, mainly due the redemption of problem loans by the state and, to a lesser extent, due to the write-offs of loans recognized by banks as non-performing; recognition and provisioning of previously unrecognized losses, including within the Bank Stability Improvement Program, and retreat of insolvent banks from the system.

More timely recognition of credit losses contributed to improved reliability of financial statements but was still constrained by capital adequacy. At the same time, individual banks continued to aggressively manage the quality of the loan portfolio by modifying the repayment schedule, capitalizing interest and revaluing collateral.

The quality of the corporate portfolio remained significantly lower than that of the retail portfolio, also as a result of high concentration of loans, lack of equity for borrowers and implicit signs of affiliation. Credit risks in retail portfolio were concentrated in large secured loans with implicit signs of affiliation. The volume of such loans in 2018 fell sharply after liquidation of the banks.

The creditworthy demand of the corporate sector remains limited amid structural changes caused by worsening trading conditions for the non-tradable sector and a low base in the tradable sector. Moreover, the real sector includes a high number of indebted enterprises with low or negative capital. Such enterprises are rather incapable of servicing their liabilities, and potential credits to them mean risks for financial sector.

The role of the government programs grew both in corporate and retail lending. Subsidized products supplanted credit on market conditions. The quality of corporate loans issued under government programs remains low, but it is still higher than the quality of loans extended on market terms.

The quality of retail mortgages and car loans, which are increasingly dependent on government programs, remained high. However, rapidly growing debt burden of households with a high degree of credit penetration and rejuvenating credit risk escalates into a systemic threat without a rather conservative analysis of borrowers' solvency. In 2019, government support was provided to individual groups of population to reduce their debt burden. In order to limit risks, the regulator increased the requirements for unsecured lending and encompassed all companies that provide household loans by its regulation.

The transition to a risk-based supervision from 2019 and a supervisory judgement will eliminate most serious violations in the banking practice and improve the requirements for internal risk management systems. Further strengthening of the quality of assets will require the banks to continue improving the quality of credit decisions and enhancing responsibility of bank management, shareholders, auditors and appraisers.

Assets quality review of 2019 will help diagnose the quality of bank loan portfolios and make a supervisory opinion on identification and settlement of unviable banks more credible. In turn, independent methodology for assessment of the quality of assets and best practices will be introduced into the supervisory process in order to strengthen and improve the monitoring quality of the banking sector stability.

## 4.1. LOAN PORTFOLIO QUALITY

**The quality of banks' loan portfolio continued to improve and enabled the banking sector to regain its profitability. The problem loans decreased in numbers, mainly because insolvent banks have retreated from the system, and the loans were repaid by the state. The level of provisioning has increased gradually but still failed to cover expected losses. In 2019, asset quality review was launched, upon which more reliable assessment of problem loans and expected losses should be obtained.**

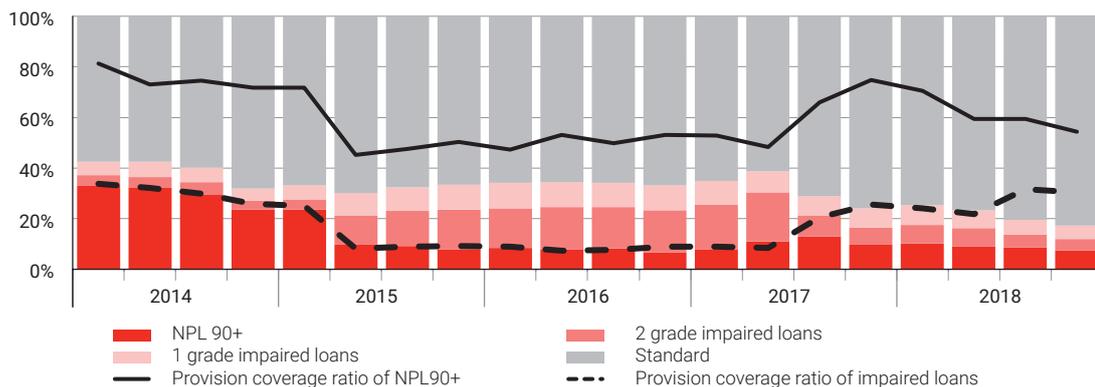
In 2018, the volume of problem loans, including non-performing loans as per bank statements (NPL90+), and impaired loans according to the National Bank<sup>6</sup>, decreased (*Chart 4.1*). The share of problem loans in the loan portfolio decreased from 24% to 17% at the end of 2018, in particular, the share of NPL90+ decreased

from 9.7% to 7.5%, and that of impaired loans, from 14% to 9.5%. At the same time, problem loans still remain on banks' balance sheets, and their share can account for more than half of the portfolio in individual banks. As banks' consolidated audited financial statements 2018 suggest, the share of problem loans classified under IFRS as third stage amounted to 22.9%.

The provisioning rate for problem loans of the banks operating at the end of 2018 increased from 31% to 41% (it went below 45% in the whole system, including insolvent banks). Many banks, including banks participating in the Banking Sector Stability Program for 2017-2021, set up provisions both for NPL90+ and for impaired loans, and the provision coverage rose to 54% and 30%, respectively.

**Chart 4.1 Overall Loan Portfolio Quality improved. Share of NPL90+ and Impaired Loans fell from 24% to 17%**

*Loan portfolio structure*



Source: Credit Register, National Bank assessment

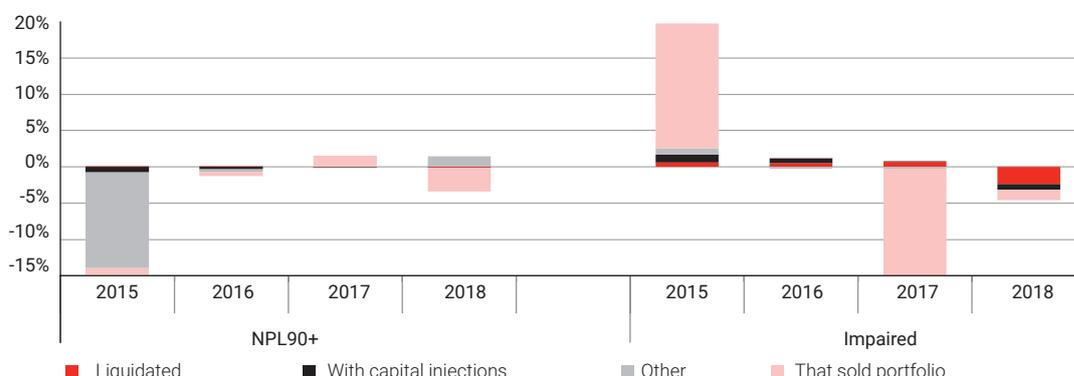
Note: NPL90+ means non-performing loans according to banks reporting; impaired loans are the loans with low repayment according to the National Bank, excluding NPL90+

The quality of the loan portfolio has enhanced mainly following the measures on the improvement of the banking system carried out by the National Bank and the Government (*Chart 4.2*). In particular, the largest contribution was made by loans withdrawn from the system of the insolvent banks and problem loans purchased by the state, about half of which were foreign currency. In 2018, three insolvent banks retreated from the system (loan portfolio totaled 540 billion tenge at the end of 2017). PLF bought back more than a trillion tenge of problem loans in the agricultural sector at a price higher than the market (450 billion tenge in 2018 and 604 billion tenge in early 2019).

Banks that sold problem portfolios in 2017-2018 were subsequently capitalized by new shareholders. Additional capital injections enabled the recognition of most of the credit losses, provisioning and writing-off non-performing loans. At the same time, the transfer of problem loans to the balance sheet of IAMs affected the improvement of the quality of the portfolio according to the statements of individual banks. However, problem loans and risks on them remained on a consolidated basis.

<sup>6</sup> For credit risk analysis, similar to the previous Kazakhstan Financial Stability Report of 2015-2017, loan quality indicators were used, calculated by the National Bank upon the data of the Credit Register for each loan, and updated in the context of 2018 info. The following notations apply: NPL90+ means loans under bank reporting with arrears over 90 days; impaired loans (1, 2 grades) are poorly repaid loans by the National Bank estimates, with no cash flows on principal debt for a long period and a high accumulated accrued interest. Second grade impaired loans have lower quality, no cash flows on principal debt for 12 or more consecutive months; problem loans are the total volume of NPL90+ and impaired; standard loans are the loans by National Bank estimate, not validated as impaired loans.

**Chart 4.2 Quality of Loan Portfolio improved mainly due to Government Support**  
Contribution to loan portfolio changes



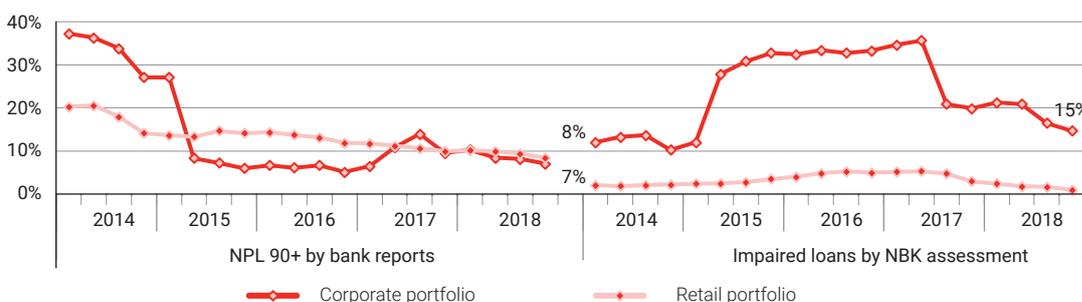
Source: Credit Register, National Bank assessment

Note: 1) Liquidated banks: 5 banks had their license revoked in 2016-2018; three banks sold their portfolio, and their loans were bought by PLF and sold to a special financial company; three banks received capital injection, they participate in the Banking Sector Stability Program for 2017-2021. 2) NPL90+ in 2015 decreased because BTA Bank retreated from the system, and increased number of impaired loans is associated with the opening of a credit line by Kazkommertsbank to BTA Bank. The reduction in the number of impaired loans in 2017 was due to the closure of the BTA credit line and the sale of the RBK portfolio to the special financial company LLP SFC DSFK (for more details see the Financial Stability Report 2015-2017)

The quality of the corporate portfolio remained significantly lower than the retail one, but the reporting difference was insignificant. The volume of impaired loans in the corporate portfolio is much higher (Chart 4.3). The quality of the corporate portfolio largely depends on large borrowers and borrowers that have implicit affiliation with the bank. Such borrowers often extend loans on milder collateral terms and repayment

schedules, and such loans were restructured or refinanced even though the asset value was not expected to recover (for more details, see Section 4.2). Also, despite the reduced number of problem foreign currency portfolio as part of the measures to improve the banking sector, the corporate portfolio still retained risks on poorly repaid foreign currency loans (Chart 4.16).

**Chart 4.3 Quality of Corporate Loans Is much worse than Retail Loans, but It is unseen in Banks' Reports**  
Share in the loan portfolio



Source: Credit Register, National Bank assessment

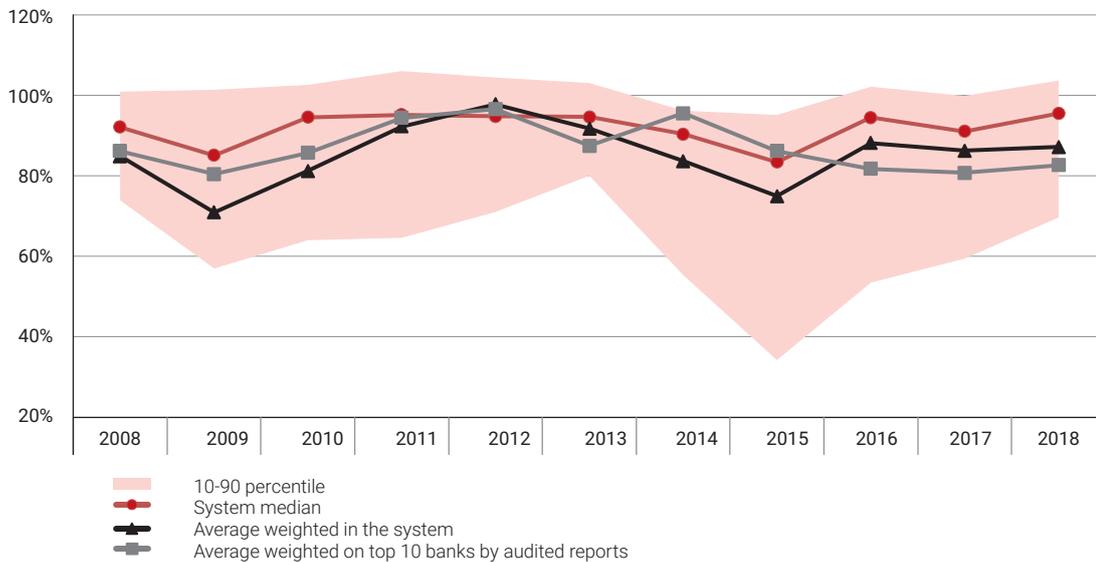
Note: NPL90+ means non-performing loans by banks reports; impaired loans are poorly repaid loans according to the National Bank assessment, excluding NPL90+

### Interest Income Quality

Interest income quality has gradually improved on average in the system, mainly due to the retreat of the banks with the lowest collection rate of interest income from the system. Strengthened supervision and identified aggressive revenue recognition practices also positively affected interest income collection rate. In 2018, the collection of interest income at the system

level was 87% (Chart 4.4). Repurchase of problem loans, including the accrued interest thereon, by the government, reimbursed interest income previously recognized in the statements. As a result, low collection of interest income of individual banks in 2017-2018 exceeded 100%.

**Chart 4.4 Interest Income Quality in the System slightly increased, It remains low in some Banks**  
Assessment of interest income collection



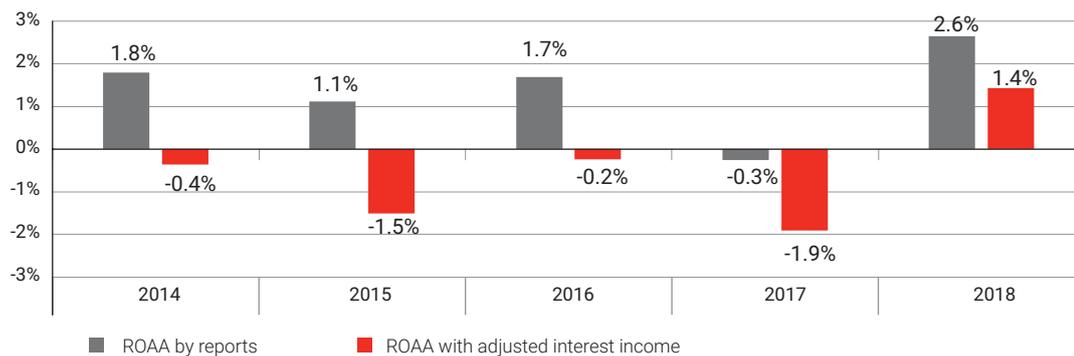
Source: STB reporting, Credit register, audited financial statements of banks, National Bank assessment.

Note: Collection of interest income for top 10 banks was assessed through audited financial statements as the ratio of interest received from cash flow statements to the interest income recognized in the income statement. The National Bank's assessment of interest income collection is based on changes in accrued interest balances and interest income according to the following formula:  $AIBt = AIBt-1 - ClIt + Allt + ADJt$ , where  $AIBt$  is accrued interest balance,  $ClIt$  – cash-based interest (estimate),  $Allt$  – accrual based interest income,  $ADJt$  - adjustment of the balance of accrued interest on loans that were written off, sold / transferred or restructured with capitalization of accrued interest. When calculating interest income collection, individual banks with sold or transferred loans, were excluded

In 2018, the return rate of the banking sector was slowly recovering, and the estimated return on assets was positive. The most significant discrepancies in return

on assets ratios were observed during the periods of economic shocks and decrease rate of loan repayments (Chart 4.5).

**Chart 4.5 Banking Sector Return adjusted for Uncollected Income is back to positive after four years of Losses**



Source: STB reporting, Credit Register, National Bank assessment.

Note: Net interest income is adjusted for interest income on loans that were written off, sold/transferred or restructured with capitalization of accrued interest. The balance of accrued interest on loans that were sold / transferred was adjusted for individual banks

## 4.2. QUALITY OF CREDIT DECISIONS AND QUALITY OF REPORTING

**The quality of credit decisions over past three years continued to improve gradually, laying the foundation for improved quality of loans to the economy, financial stability, and sustainable and balanced growth. Maintaining this trend in the near future will require greater efforts by supervisory bodies, enhanced responsibility of banks, their shareholders, management, auditors and appraisers, as well as deeper monitoring of banks' operations by a wide range of stakeholders, including taxpayers, depositors and minority investors.**

To create added value, that defines bank's value for the shareholders and its economic contribution, a commercial bank should make sound credit decisions, underwriting and loan support, communication with problem borrowers, adequate factoring for loans in reports, litigation. Bank losses, most of which have crystallized and socialized over past three years, were, therefore, the implication of poor quality credit decisions made years earlier, but were revealed only after their maturity and recognition throughout inspections.

As banks were liquidated and supervisors identified the most unproductive lending practices, their attitude to the role of credit risk assessment has changed. Banks started to pay more attention to the development of credit risk management systems. However, the role of risk managers in key corporate decisions, their accountability and responsibility remained limited.

### Underwriting Quality

High quality credit decision-making process primarily rests upon a properly built underwriting system of the borrowers. Capital adequacy, in turn, covers potential losses from deteriorated quality of the loan portfolio, including as a result of high-risk credit decisions.

The problems of banks' loan portfolio piled up over previous years have restricted the adoption of balanced credit decisions, and the quality of extended loans deteriorated year after year ever since (Chart 4.6). Banks made most risky credit decisions in 2015 - 2016 when loan portfolio was actively growing, including through lending to persons affiliated with the bank. In some banks, extension of loans with knowingly high risk of non-servicing exceeded a critically acceptable level and

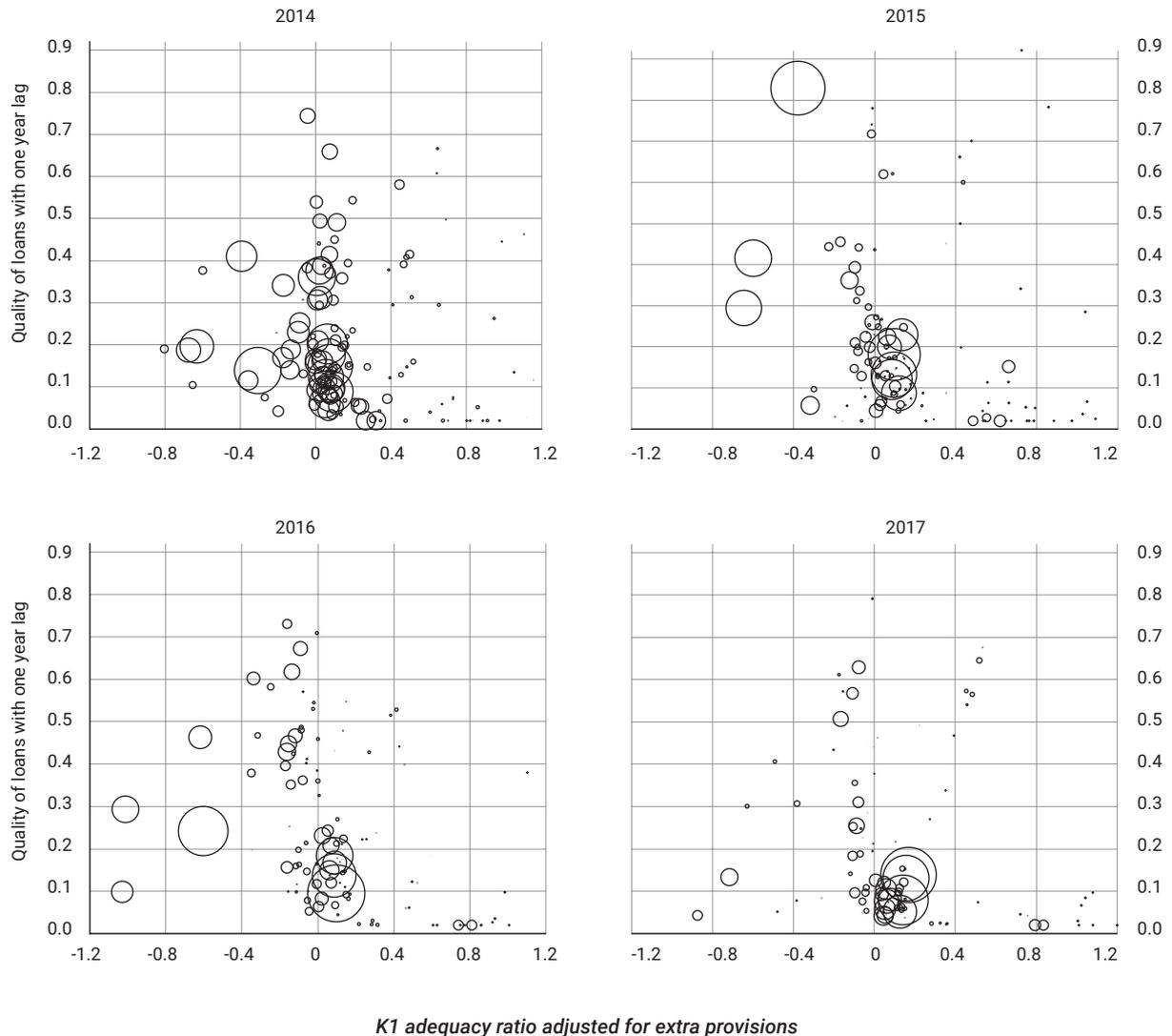
Despite elimination of most serious bad faith practices, still vigilance must be present to timely identify many variations of affiliated lending and hidden debt leverage.

This will require highly qualified supervision and adequate systems for collecting regulatory and management information that will provide a required level of soundness of decisions in addition to the right to a motivated supervisory opinion obtained within recent amendments to banking legislation. In the supervisory process, as part of risk-based supervision, a comprehensive assessment of risk management systems in supervised organizations and their role in corporate governance will be strengthened.

In 1H2019, the quality of reporting continued to improve, and credit losses were recognized in a complete and timely manner, also while asset quality review results were still pending. However, in contrast to the quality of extended loans, improvement of accounting quality, full recognition and adequacy of provisioning for credit losses, conceals a problem of insufficient capital for their absorption. One of the problems of regulatory reporting quality is poor disclosure of portfolio transferred by banks to associated problem asset management companies. Problem solution will require the extension of the principles of consolidated financial statements to cover regulatory reporting, including the extension of Credit Register's requirements to IAMS.

added pressure on capital. As a result, banks began to work more actively with stress asset management companies, including PLF, and individual banks started to fail. Introduction of banks improvement measures and strengthened supervision forced banks to review internal risk management systems that positively affected loans decision-making quality.

**Chart 4.6 Quality of Credit Decisions determined by Capital Adequacy: with Low Capitalization, Banks issued Lower-Quality Loans**



**K1 adequacy ratio adjusted for extra provisions**

Source: Credit Register, National Bank assessment

Note: Capital adequacy ratios reflect National Bank's assessment by expected losses on one-year horizon. Each point reflects one bank - one quarter combination. A year in the chart title reflects the year the loan was issued. The diameter of the bubble corresponds to the output volume

## Loan Restructuring Practice

Restructuring of problem loans with ungrounded expectations for preservation or restoration of loan value can only serve as a tool for deferring recognition of losses on the loan portfolio in the future.

Restructuring is an effective tool for managing credit risk in order to maintain asset's economic value and reduce borrower's debt burden. With weak risk management systems, chances are that this tool can be used even when there are no well-reasoned expectations to maintain the value or resume loan servicing for the improvement of reporting indicators,

as well as to defer recognition of losses on the loan portfolio. In Kazakhstan, this practice emerged at times of significant deterioration of loan portfolio quality, when banks began to actively extend the term and refinance<sup>7</sup> poorly serviced loans.

Still, amid competition for high-quality borrowers and a small number of new solvent customers, the practice of refinancing borrowers from other banks has spread. Making an informed decision on loan restructuring or borrower refinancing remains a key factor for good faith

<sup>7</sup> Refinancing means the issuance of a new loan to the same borrower, by same or other bank.

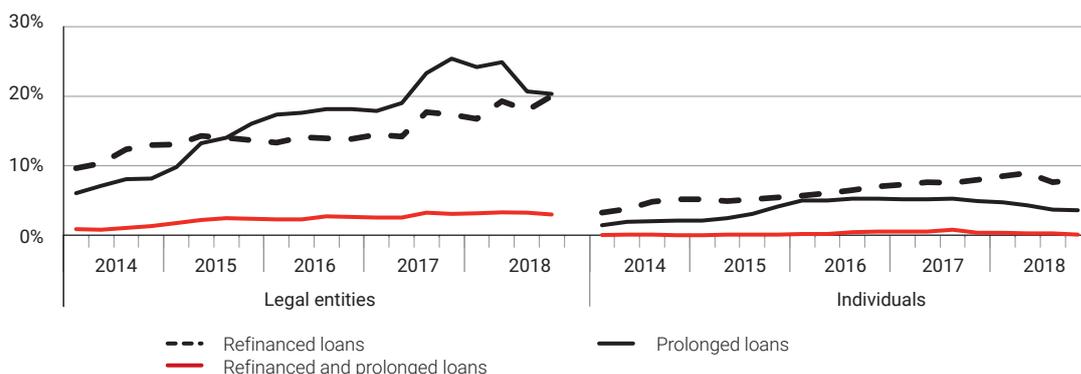
use of these tools, and thorough analysis increases the risk of loan defaults.

According to the National Bank<sup>8</sup>, restructured loans take a larger share in the corporate portfolio, 43% at the

end of 2018, including 3% of previously prolonged and refinanced loans. In some banks, restructured loans take half of the loan portfolio of legal entities. The share of restructured loans in retail portfolio is relatively low and amounts to 12% (Chart 4.7).

**Chart 4.7 Loan Restructuring is more common in Corporate Portfolio than in Retail. Share of Refinancing is growing in Corporate Portfolio**

Share in subportfolio



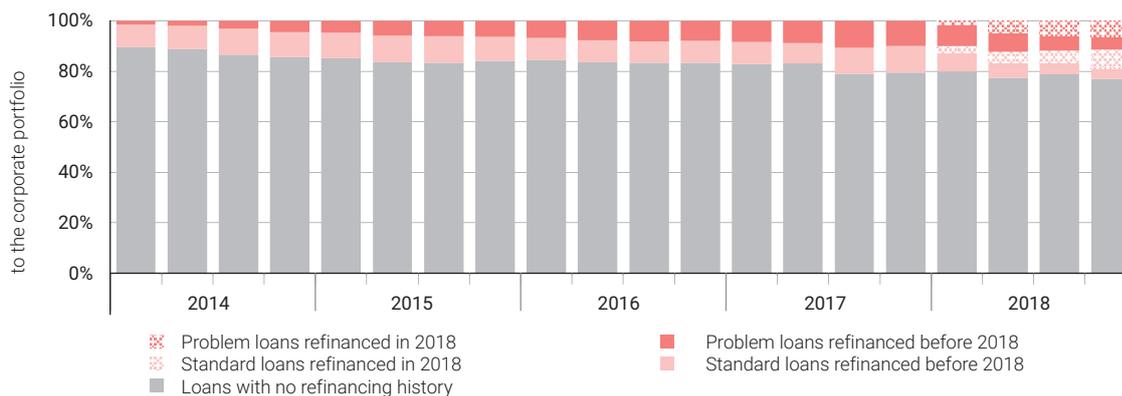
Source: Credit Register, National Bank assessment

Note: Refinancing is the issuance of a new loan to the same borrower, by same or other bank, allowing for a full repayment of a previously issued loan or loans, with a sum under a new agreement slightly different from the repayment amount (analytical indicator). Extension means an extension of the loan term under the contract

According to the National Bank, in 2017-2018, the share of refinanced loans in the structure of corporate loan portfolio reached 23%, with 14% of loans refinanced in 2018, including repeatedly refinanced loans. Banks refinanced both standard loans and impaired loans, that is, poorly repaid loans. Refinancing of standard

loans that take over 12% of the corporate portfolio, is mainly associated with a limited number of solvent borrowers and the desire to attract customers from other banks on more favorable terms. The share of refinanced impaired loans amounted to 11% at the end of the year (Chart 4.8).

**Chart 4.8 Loan Refinancing Operations have increased significantly in recent years**



Source: Credit Register, National Bank assessment

Note: If a loan was refinanced several times, it is entered as the date of last refinancing

<sup>8</sup> The assessment was carried out on the data of the Credit Register; refinancing and loan extension were considered as restructuring.

Analysis of bank loan agreements from the Credit Register for the period 2013-2018 showed that 17% of the total number of unique borrowers, i.e. legal entities, were refinanced. After refinancing, 66% of borrowers began to service their loans, and 34% remained a problem. Loan quality after refinancing in retail sector improved in 78% of borrowers, i.e., individuals ([Table 4.1](#)).

Refinancing of the borrowers with non-repayment records in most cases failed to improve their quality. Only 17% of borrowers among legal entities with impaired loans began to service their debt after refinancing, and 21% of borrowers with loans of NPL90+.

**Table 4.1. Quality of Borrowers with Refinanced Loans, Before and After Refinancing**

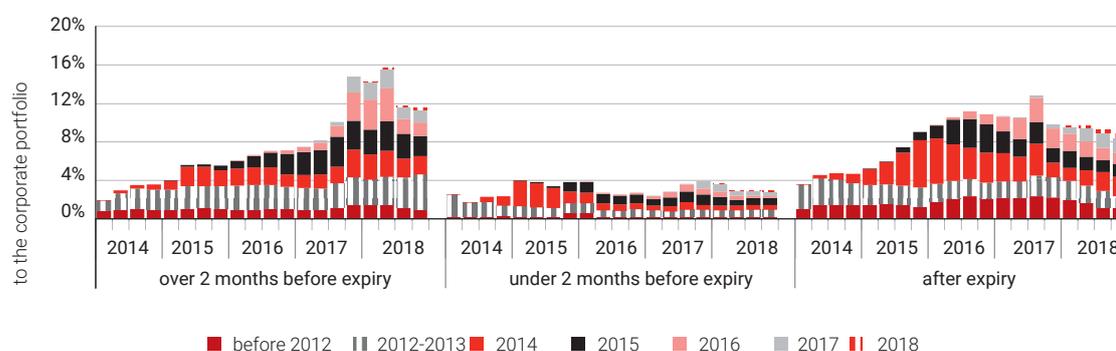
| Borrower's Quality before Refinancing | Borrower's Quality after Loan Refinancing |                                   |             |                                   |
|---------------------------------------|---|-----------------------------------|-------------|-----------------------------------|
|                                       | Legal entities                            |                                   | Individuals |                                   |
|                                       | Standard                                  | Decommissioned, NPL90 +, Impaired | Standard    | Decommissioned, NPL90 +, Impaired |
| Standard                              | 75%                                       | 25%                               | 84%         | 16%                               |
| Impaired                              | 17%                                       | 83%                               | 49%         | 51%                               |
| NPL90+                                | 21%                                       | 79%                               | 40%         | 60%                               |
| <b>Total</b>                          | <b>66%</b>                                | <b>34%</b>                        | <b>78%</b>  | <b>22%</b>                        |

*Note: Borrower's quality is determined by the worst position of all of its loans before refinancing and all loans after refinancing for the entire history of the data transferred by the banks to the Credit Register from April 2013 to May 2019.*

Along with refinancing, prolonged loans in 2018 also take a high share, 20% of the loan portfolio. At the same time, the share of prolonged loans in 2018 decreased due to structural changes in banks' loan portfolio, mainly with the withdrawal of problem loans from the banking system. Among prolonged loans, the practice of loan term extension after contract expiry prevails.

Until 2017, banks' corporate portfolio was dominated by extended loans issued in 2014. At the end of 2018, the largest volume of extended loans in the loan portfolio of legal entities accounted for loans issued in 2012-2013, and amounted to about 5%. ([Chart 4.9](#)).

**Chart 4.9 Banks practice Loan Extension after Maturity, ...**

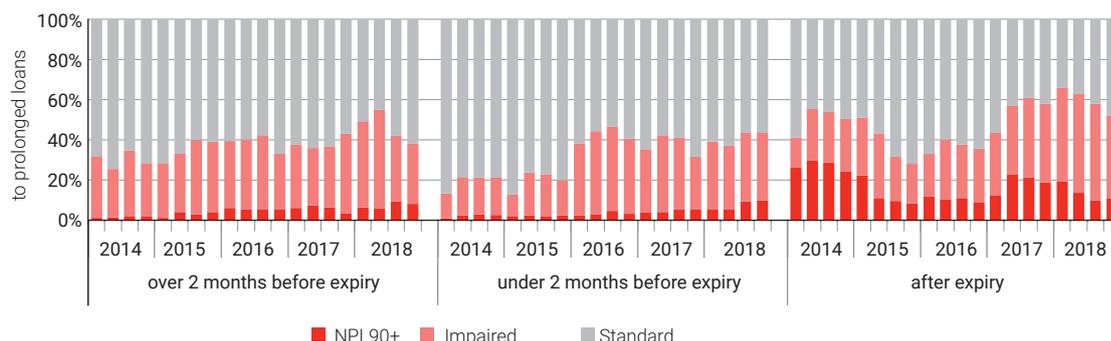


Source: Credit Register, National Bank assessment

The revision of repayment schedule for problem loans enabled banks to defer recognition of losses. The decision to extend loans is governed by banks internal risk management processes, and the quality of decisions define whether the expectation of a return on such loans after extension is reasonable. The lowest quality is noted in the portfolio of loans extended after contract

expiry. At the end of 2018, problem loans accounted for more than half of the portfolio of extended loans after contract expiry, the share of NPL90+ was 11%, and that of impaired loans totaled 41% ([Chart 4.10](#)).

Chart 4.10 ...Most of which are impaired or NPL90+



Source: Credit Register, National Bank assessment

### Repayment Schedules Features

The practice of using non-standard repayment schedules in the corporate portfolio increases the chances of loan default. Non-standard repayment schedules are more reasonable for a seasonal business or projects with insufficient profit at the onset to service the loans.

The definition of a loan repayment schedule is also included in the scope of credit decisions. For retail loans, repayment frequency is usually standard and set by loan product terms, with the exception of large individual borrowers. At the same time, banks often approach each borrower individually when lending to large and medium-sized enterprises. In such being a case, the most risky are the individual schedules with repayment of principle loan principal at the end of the term with/without interest payment, with credit holidays, deferred payments to a later period, and other repayment conditions.

Non-standard repayment schedules may be reasoned by a loan obtained to invest and acquire fixed assets, borrower’s seasonal business, a desire to retain a solvent client by giving a borrower greater flexibility in managing liquidity. A narrow circle of high-quality borrowers and interbank competition offer corporate clients other favorable loan conditions, such as lower interest rates, softer collateral requirements etc. Lending to affiliated parties on concessional terms is legally limited, but in some cases, an individual repayment schedule may be provided to borrowers that have economic affiliation with the bank, often in unstable financial situation. In such case, individual repayment schedule, as well as the extension or refinancing of a problem loan, becomes an instrument of overstating the quality of the bank’s loan portfolio.

Analysis of legal entities’ loan servicing dynamics in bank portfolios between 2013 and 2018 shows a high share of loans with non-standard repayment schedule (Table 4.2).

Table 4.2. Prevalence of Non-Standard Repayment Schedules Reflects Low Quality of Credit Decisions

| Repayment schedule         | Standard | Non-standard | Share of non-standard, % |
|----------------------------|----------|--------------|--------------------------|
| Number of contracts, thou. | 329      | 297          | 47.50%                   |
| Number of borrowers, thou. | 37       | 26           | 41.70%                   |

Source: Credit Register, National Bank assessment

Note: Standard repayment schedule envisages monthly repayment of principal debt

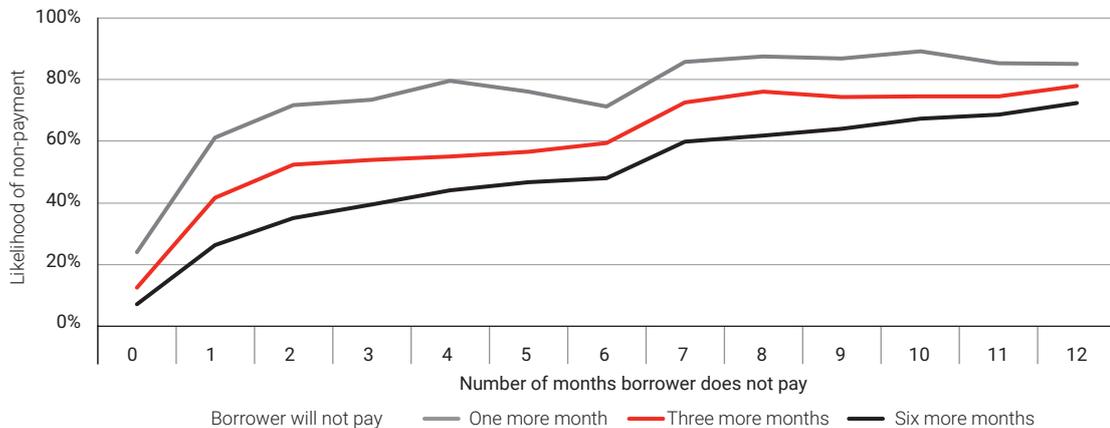
Credit risk monitoring system requires a deeper analysis of financial solvency of the borrowers who enjoy non-standard repayment schedule. Such loans, unlike loans with a standard schedule, carry a greater risk, as the lack of uninterrupted cash flows may cause the bank no to receive regular basic confirmation of borrower’s solvency. Hence, the longer the period of principal debt’s non-repayment by a borrower, the greater the chances of his loan non-repayment (Chart 4.11).

With several months of loan non-repayment, a historic probability of a borrower’s non-repayment for next six months is 60%. At the same time, part of the loans of the remaining 40% was repaid irregularly or was refinanced. A sharp increase of likely non-payments in the future after 6 months indicate rather frequent application of a six-month repayment schedule. The borrower may not pay for half a year, after which a payment is made in almost 30% of cases. However, after a six-month threshold is crossed, a payment is much less likely.

The chances that loans without any payment for 12 months or more will not be serviced are quite high and amount to more than 70%. Such credit holidays can be offered, including for investment loans. However, the

risk is not only on borrower's own capital, but on the borrowed capital, and such non-standard repayment schedules enhances the bank's risks.

**Chart 4.11 More flexible a Payment Schedule is, the greater the chances of Borrower's Non-repayment**



Source: Credit Register

Note: There are no payments on the principal debt for a few months, but the bank fails to mark these defaults as arrears. The sample includes loans that permit non-monthly repayment

## Collateral

Collateral policy quality and its effective implementation ensure the adoption of rational credit decisions and limit excessively risky lending.

Collateral policy that complies with international standards for collateral operations covers processes that ensure complete understanding and documentation of the risks associated with collateral value and its liquidity. The most significant implications of bank's credit risk come from imperfect collateral policies set up by the banks and incomplete factoring for the issues and problems that a bank encounters in collateral operations. The analysis of collateral policies of Kazakhstan's banks<sup>9</sup> showed that banks fail to set up comprehensive collateral policies or to regulate asset quality management procedures.

According to collateral policies developed up to regulator's requirements<sup>10</sup> banks have to re-value a collateral at least once every six months, depending on the type of collateral, and in case of large real estate, once a year with an independent appraiser. Some banks carry out ad hoc monitoring in case the situation of a borrower or with a collateral deteriorate and identify contributing factors to the decrease in the value of collateral, loan restructuring etc. However, as Financial

Stability Report of 2015-2017 demonstrates, the value of collateral remains virtually unchanged when market conditions change, and this may be indicative of insufficient collateral revaluation.

Qualification, experience and independence of the appraiser selected by the bank plays a key role in defining and revising a credible value of collateral. The interaction of the regulator and organizations that control appraisal operations will contribute to improved quality of valuation, valuation culture and boosted confidence in valuation as a whole. As a result, a reliable collateral valuation will improve the effectiveness of credit risk management. To strengthen information support to supervisory functions and improve the accuracy of credit risk assessment, the National Bank has enlarged Credit Register's coverage by including collateral and appraisers' data. Independent appraisers' rating based on this data can also contribute to reducing risks in the banking sector.

Bank's requirements to mortgagors and procedures for periodic collateral monitoring are not specified in collateral policies of individual Kazakhstani banks, and collateral value definition methodology is independent from loan currency. The most critical procedures in

<sup>9</sup> In 2018, the National Bank conducted a survey of banks on collateral policies, with the exception of two banks that provided only unsecured loans (these banks use the assessment of the Independent Evaluation Company for previously entered collaterals, the assessment is not carried out by the banks).

<sup>10</sup> Rules for maintaining credit documentation approved by AFS Board Resolution on February 23, 2007, No. 49. They expired as per the resolution of the Board of the National Bank of the Republic of Kazakhstan dated October 29, 2018, No. 257.

credit decision making process, such as registration and cessation of the right to pledge, are not covered by bank collateral policies; LTV performance<sup>11</sup>; development; documentation and use of early response indicators for different types of collateral.

At the same time, banks claim there are problematic issues beyond collateral policy that undermine the effectiveness of collateral monitoring and collection, including poor mortgagor's access to collateral or failure to provide documents required for revaluation, as well as legal restrictions on exercise of their rights (more in Section VIII).

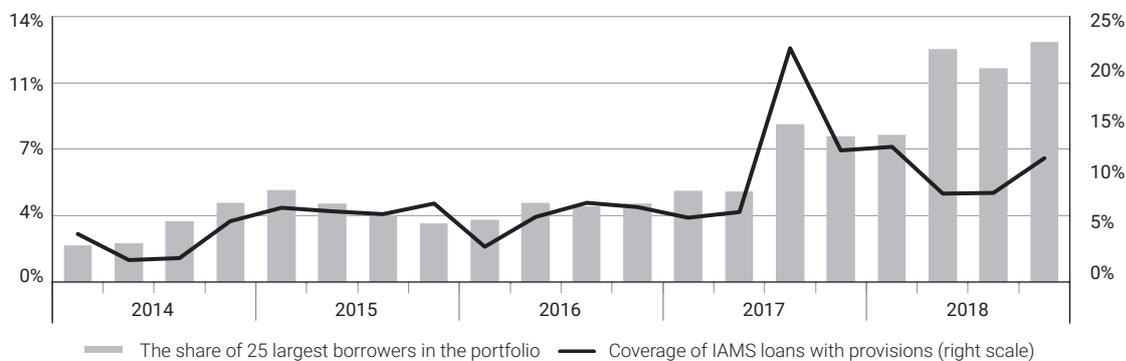
### Bank Practice with IAMS Subsidiary

IAMS is a bank subsidiary charged with the management of impaired and stressed that banks were entitled to set up from 2011. IAMS was set up following the need to enable banks to carry out activities beyond banking: real estate construction and sale, leasing, management of equity interests in legal entities, and other activities provided by law.

Expansion of the scope of activities was assumed to enable the banks to significantly improve asset quality, as a large portion of collateral assets were accumulated on banks' balance sheets, and they could be effectively disposed of only upon completion of construction, reorganization, or any other type of management. However, IAMS's initial goals were often undermined, and banks began to use it to conceal the level of non-performing assets on their balance sheets.

The main problem that exists with reliability of reporting and asset quality is that the portfolio of loans transferred to IAMS is not consolidated in regulatory reporting and, accordingly, not entered in the Credit Register. Typically, banks finance loan acquisition by a subsidiary at non-market value. Thus, loans transferred to IAMS on bank's balance sheet are replaced by IAMS debt to the bank (usually as loan, but sometimes as accounts receivable) and assessed by loan servicing status by repayment schedule. Coverage of provisions of such IAMS loans with the bank often fails to suffice, given high credit risk of loans in the IAMS portfolio and IAMS specifics. So, in 2018, IAMS loan provision coverage ratio was 12% (Chart 4.12). It is a common practice for the banks to operate with IAMS subsidiary. Almost all IAMS are banks' large borrowers. The most aggressive use of IAMS was noted in a liquidated bank in 2018, which IAMS debt exceeded 50% of bank's loan portfolio.

Chart 4.12 Provisioning Level is insufficient to cover Credit Risk of IAMS Loans in the context of its specific operations



Source: Credit Register

<sup>11</sup> Loan-to-value ratio is the ratio of the loan amount to the market (or estimated) value of the collateral.

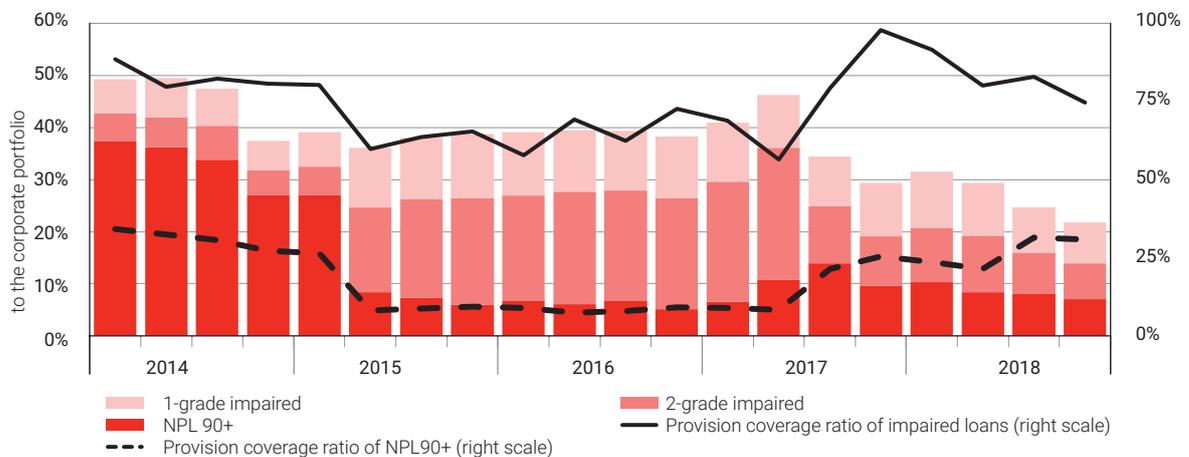
### 4.3. CORPORATE PORTFOLIO

Corporate sector's credit risk continued to decline but was restrained by a large number of financially unstable enterprises. Problem loans in the agricultural sector were purchased by the government to support the sector. In 2018, extension of loans was one of the tools to reduce the level of losses on impaired loans across all sectors of the economy. Competition for quality borrowers boosted the volume of refinanced loans. Corporate sector lending is supported by government programs. Credit risk on such loans is below market but cannot be treated as acceptable.

In 2018, 80% of bad bank loans were concentrated in corporate portfolio. The level of credit risk of real sector borrowers remained high, and non-performing loans accounted for 22% of corporate portfolio (-7pp per year) (Chart 4.13).

Provisions for problem loans excluding insolvent and merged banks in 2018 rose from 29% to 40%. In general, the system saw a decrease of this indicator from 49% to 45%.

Chart 4.13 Corporate Portfolio Quality improved mainly due to Write-offs and Sale of Bad Loans to the Government

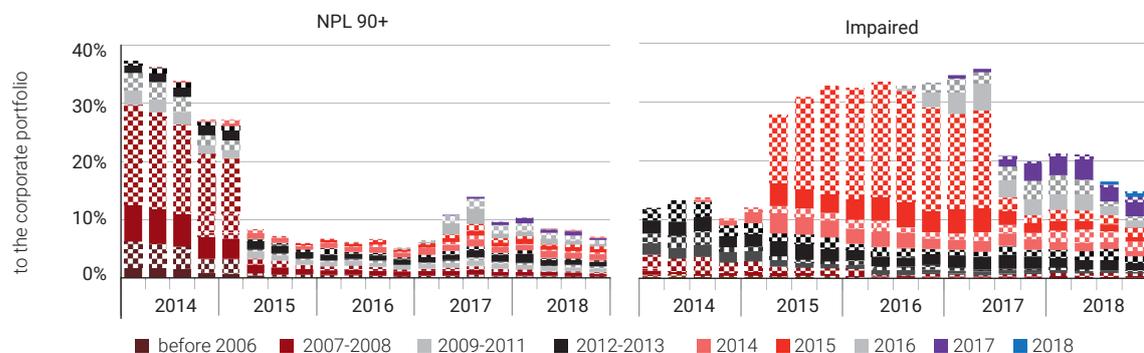


Source: Credit Register, National Bank assessment

After implementation of rehabilitation measures at the end of 2018, the largest volume in the structure of problem corporate loans portfolio was taken by NPL90+ loans issued in 2014 and 2016 (1.4% and

1.1%, respectively), impaired loans issued in 2014 in foreign currency and in 2017 in tenge (1% and 2.5%) (Chart 4.14).

Chart 4.14 Problem Loans of Previous Years remain in Corporate Portfolio



Source: Credit Register, National Bank assessment

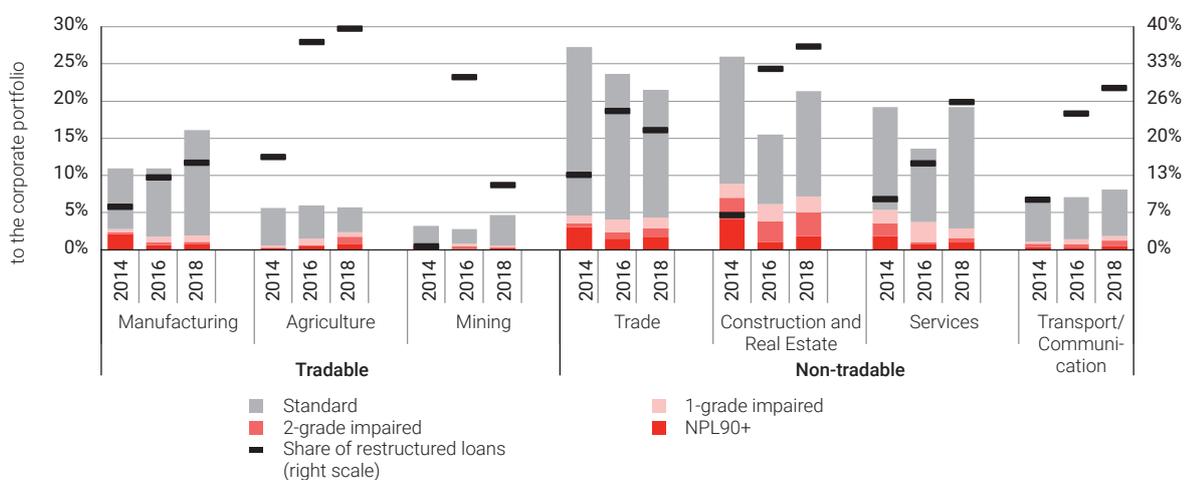
Note: Pattern fill corresponds to loans in foreign currency

The largest accumulated problems persisted in non-tradable<sup>12</sup> sector of economy and were targeted with a bulk of business lending (Chart 4.15). In 2018, the share of the traded<sup>13</sup> sector grew in the corporate loan portfolio, and its quality of loan servicing, with the exception of agriculture, was significantly higher than that of the non-tradable sectors. The share of problem loans in tradable sector as a whole fell from 28% to 18% in 2018, and in non-tradable sectors, from 31% to 23%. At the same time, in 2018, restructured loans grew across all sectors of the economy: such loans were refinanced against the background of growing

competition for quality borrowers or had repayment terms extended.

Quality of loans in agriculture, construction and real estate<sup>14</sup>, transport and communications, as before, remained low. Portfolio recovery by the government in 2018 mainly affected poorly repaid loans of enterprises from agricultural sector. Problem loans for agriculture in 2018-early 2019 were purchased at face value by the government (PLF) in order to support the agro-industrial complex. Potential losses on acquired claims, in addition to previously acquired banking sector assets, may increase PLF's credit risk for its payables.

Chart 4.15 Loans historically concentrated in Cyclical Sectors



Source: Credit Register, National Bank assessment

Note: Restructured loans are the loans refinanced or extended, excluding BTA line issued by KKB

In 2018, the volume of foreign currency loans decreased by 23% as compared to 2017. The quality of such loans has improved slightly, but, as before, high risk of their default still remains. Thus, at the end of 2018, impaired loans accounted for 8% in foreign exchange portfolio of large businesses, and NPL90+ loans, for 4%. At the same time, foreign currency portfolio of SMEs is much worse than that of large companies. The share of their impaired loans at the end of 2018 was 28% by official reports, and banks marked only 10% of these loans as NPL90+ (Chart 4.16).

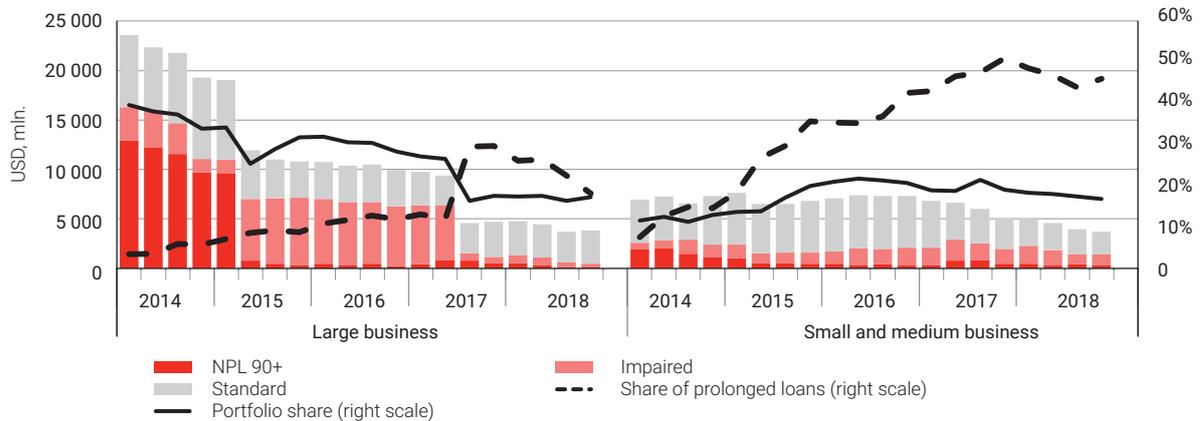
The volume of prolonged foreign currency loans to SMEs in 2018 gradually decreased from 51% to 46%, and tenge portfolio amounted to about 20%. It was likely caused by banks' extension of such loans to improve reporting before the loans were transferred to PLF, including loans to SMEs (Chart 4.17).

<sup>12</sup> Non-tradable sectors include construction and real estate, trade, transport and communications, services

<sup>13</sup> Tradable sectors include mining and manufacturing as well as agriculture

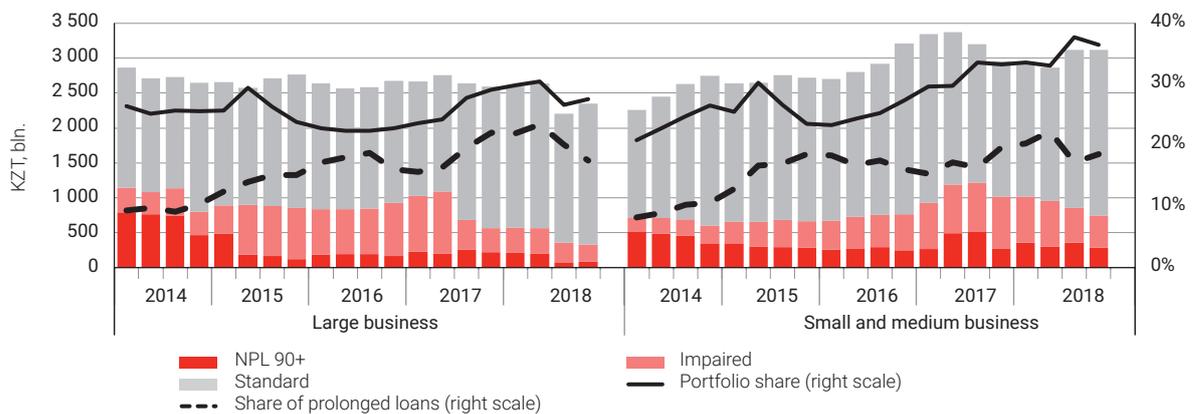
<sup>14</sup> Construction and real estate include construction and real estate operations

**Chart 4.16 Indirect Currency Risk of SME Sector is reduced but Extension grows**  
FX portfolio



Source: Credit Register, National Bank assessment

**Chart 4.17 In Tenge Portfolio, Extension Level is lower than in FX**  
Tenge portfolio



Source: Credit Register, National Bank assessment

## Large Borrowers and Concentration of Credit Risk

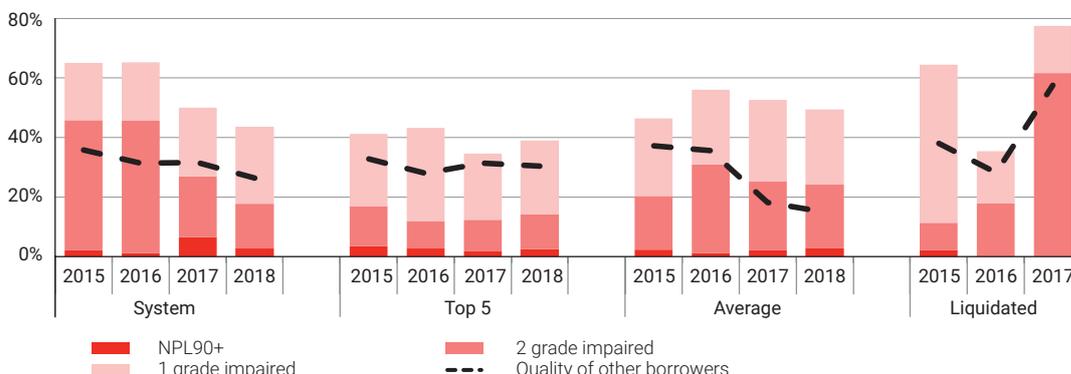
The dependence of bank portfolios' quality on concentration of top borrowers in the system is heterogeneous. In some banks, the share of loans of 25 top borrowers may be significant in corporate portfolio, in other banks it will not exceed one third. In each individual bank, lending to top borrowers and level of their concentration is defined by credit policy and depends on the quality of corporate culture and capital adequacy.

The quality of top corporate borrowers remains opaque. Banks continued to resort to prolongation, amendment of contract terms and refinancing as instruments to cut the level of problem loans. The volume of prolonged loans of top borrowers at the end of 2017 amounted to 17%, and in 2018, to 15%. In addition, top borrowers of the banks include IAMS, which loan quality is difficult

to assess with available information. IAMS loan obligations to banks grew. In particular, in 2015, IAMS loans accounted for 2% and in 2018, for 9%, of the portfolio of banking systems's top borrowers (for more details, see Section 4.2).

On the whole, in 2018, the concentration of top borrowers in the corporate portfolio of the banks remained at 50% in the system ([Chart 4.18](#)). Moreover, high dependence on top borrowers was observed in insolvent banks. As of the last reporting date, the concentration of top 25 borrowers in the portfolio of these banks averaged 65%, and in some banks it exceeded 90%. The quality of loans of top borrowers there plummeted in 2017 from 35% to 77%, implying affiliation.

**Chart 4.18 Quality of Largest Borrowers improved but remains worse than Other Borrowers. Risks of Largest Borrowers are not disclosed by Banks in the Statements**  
**Portfolio Structure of Largest Borrowers**



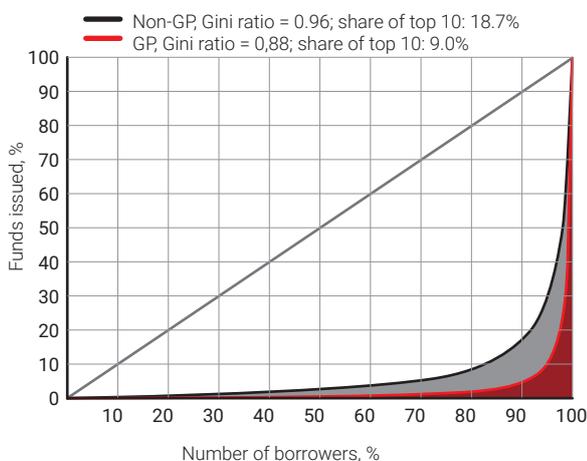
Source: Credit Register, National Bank assessment.  
 Note: Bank groups are calculated by loan portfolio size as of 01.01.2019 (medium banks include 15 banks); liquidated are the banks deprived of a license in 2016-2018. The quality of other borrowers is the share of problem loans in the portfolio of borrowers, not including 25 largest ones

### Loans Issued under Government Programs

Government lending programs were set up to support businesses and enhance available financing, mainly to SMEs and priority sectors of economy.

At the end of 2018, loans under government programs were less concentrated than market ones: average loan size was 3 times smaller, average risk per borrower was 4 times smaller. At the same time, loan concentration under government programs continued to decline: the share of 10 top borrowers from 2013, and the Gini ratio from 2014 (Chart 4.19). This trend positively affected the quality of loans under government programs, which was relatively higher than market corporate loans.

**Chart 4.19 Concentration of Loans issued under Government Programs is significantly lower than Market Ones and continues to decline**



Source: Credit Register, National Bank assessment  
 Note: Calculations were made for the period 2013-2018

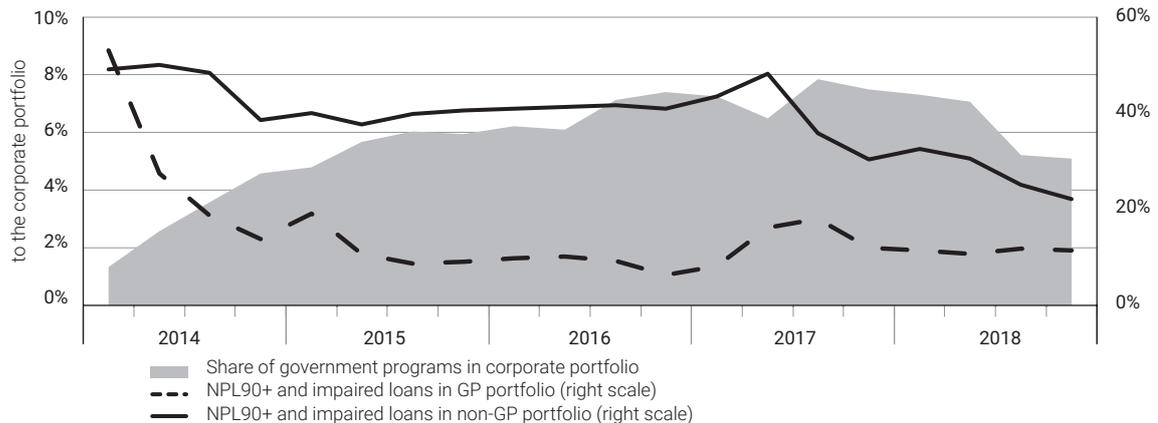
According to the National Bank estimated, the share of problem loans under government programs has historically remained below the market (Chart 4.20). At the same time, deteriorated quality in 2017-2018 was mainly associated with deteriorated quality of the portfolio of the banks that were deprived of their licenses or sanitized. This indicates the need for enhanced control by government program operators and interaction with the regulator (share of loans under government programs reached 57% in insolvent banks).

As analysis shows, for the period of 2014-2018, the average share of impaired and non-performing loans in total volume of loans issued under government programs was 10%, the lowest quality was in 2014 and 2015 (the share of problem loans is 17% and 20%, respectively).

As for the sectors of the economy, the bulk of lending under government programs was in the manufacturing industry, where loan servicing was relatively high. The lowest quality of loans was noted in transport, agricultural and mining sectors. Loans issued for refinancing had the lowest quality, but the largest in size and issued in foreign currency.

To ensure proper quality of loans issued under state programs, a careful selection of solvent borrowers who are able to effectively absorb public funds.

Chart 4.20 Quality of Loans issued under Government Programs surpasses the quality of market loans



Source: Credit Register, National Bank assessment

#### 4.4. RETAIL PORTFOLIO

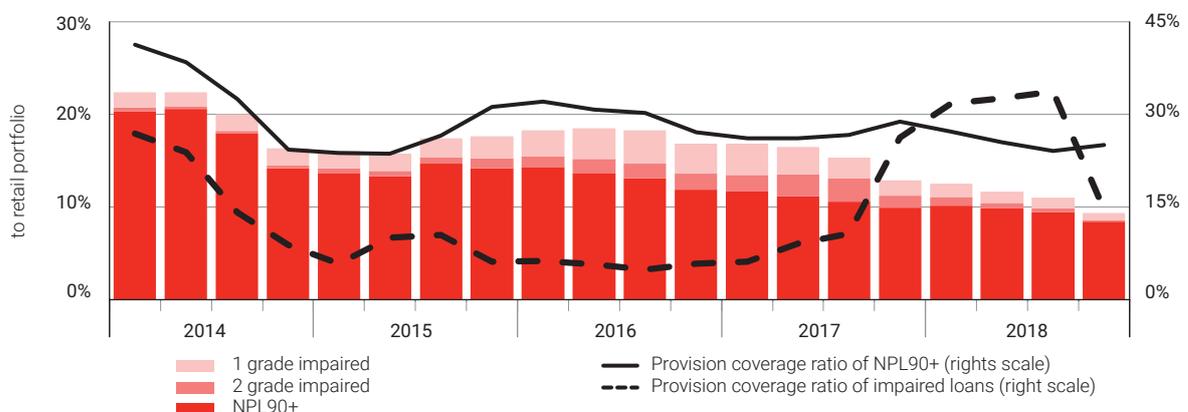
**In 2018, high growth of the retail portfolio continued, mainly due to unsecured lending. The growth of mortgages and car loans was also accelerated, though supported by government programs. Secured consumer loan portfolio shrunk, mainly due to decreased debt of top borrowers with low payment discipline. The level of credit risk of retail borrowers is moderate and sensitive to fluctuations in their income and quality of banks' solvency assessment. The household debt burden is gradually growing but is yet to reach critical levels. Measures taken to regulate the retail segment will limit the risk growth, enabling for a steady growth of this segment.**

In 2018, banks continued to actively grow their retail portfolio. At the year end, the share of retail loans in the

portfolio of the banking system reached 37% (+5pp per year) as a result of annual increase in the consumer portfolio by 17% (13% in 2017). Unsecured lending remains the main market factor for portfolio growth; growth in car lending and mortgage housing lending segments was mainly supported by government programs.

The quality of retail portfolio loans is much higher than corporate. The share of problem loans in 2018 in retail portfolio decreased from 13% to 9% (Chart 4.21). Credit losses on retail loans, in contrast to the corporate loan portfolio, were timely recognized: the level of impaired loans was only 1%. The exception was secured consumer lending, where impaired loans were not fully entered in the statements of individual banks.

Chart 4.21 Credit Losses in Retail Portfolio are lower and recognized better  
Distressed loans in the retail portfolio



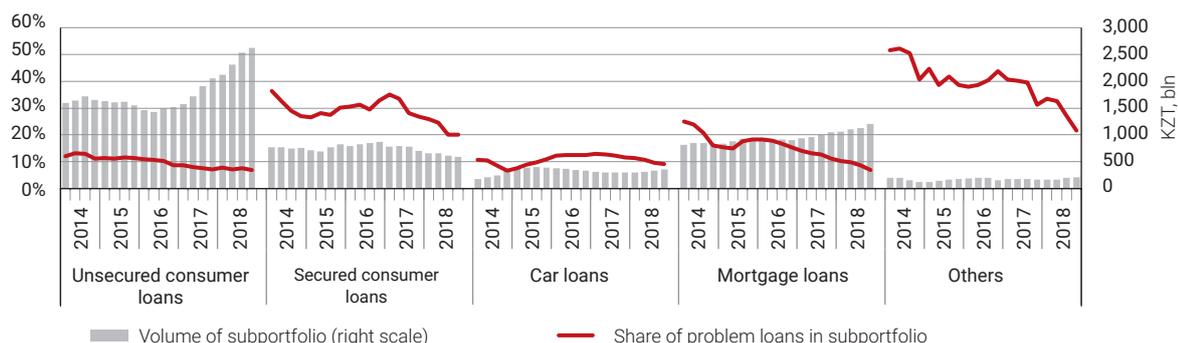
Source: Credit Register, National Bank assessment

The largest secured consumer loans, poorly repaid and implying affiliation, which were concentrated in the banks with revoked licenses in 2016-2018, contributed the most to the reduced number of problem loans in 2018. These loans, in addition to poor servicing quality, were repeatedly refinanced and/or extended (Chart 4.22).

non-performing loans (8%), despite a gradual increase in the absolute value of NPL90+ volumes during 2018. The share of problem car loans and loans secured by residential property remained virtually unchanged, 9% and 7%, respectively. At the same time, problem loans were reduced in residential mortgage loan segment, and facilitated, among other things, by refinancing of foreign currency mortgage loans under government program.

Significant volumes of unsecured consumer lending portfolio maintained a low share of NPL90+

Chart 4.22 Retail Portfolio grown rapidly due to Unsecured and Residential Mortgage Loans



Source: Credit Register, National Bank assessment

### Credit Risk of Consumer Loans

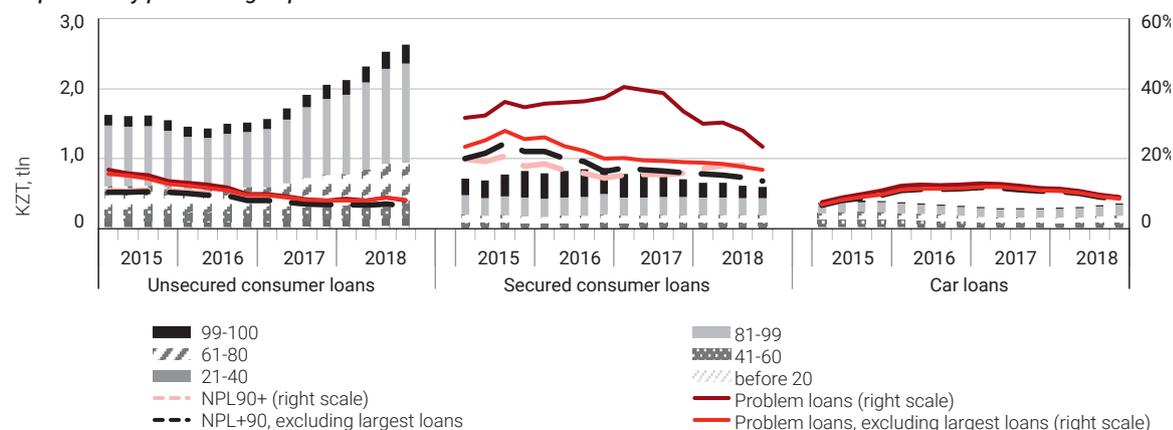
**Consumer lending, in particular, unsecured lending, remained for the banks, in comparison with corporate, a more profitable type of lending with fast turnover. Quality of loans improved across all segments of consumer lending. The highest risk was observed in secured loans, especially in top loans likely to be affiliated.**

performing loans as estimated by the National Bank gradually decreased (Chart 4.23). Moreover, compared with unsecured loans and car loans, the quality of secured loans remained significantly worse. This was caused by poor quality of top loans servicing (main debt balance is higher than 99th percentile), which in 2016 took almost half of the portfolio of secured loans (Chart 4.24). The share of top loans in the portfolio of unsecured and car loans remained under 10% and 6%, respectively.

In 2018, quality of consumer loans continued to improve. The share of NPL90+ in bank reports and non-

Chart 4.23 Quality of Consumer Loans continued to improve. High Risks remain in Portfolio

Principal debt by percentile groups



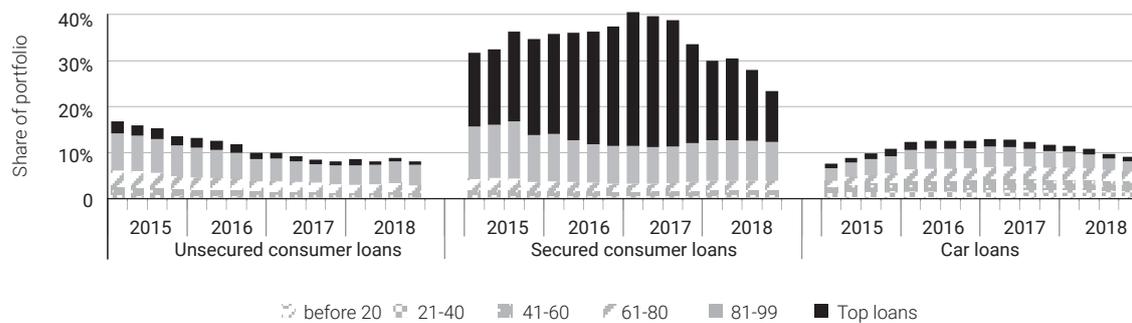
Source: Credit Register

Note: Largest loans are the loans, which principal debt balance exceeds 99th percentile

The share of problem loans in unsecured loan portfolio fell from 10% to 8% in 2018, that of car loans, from 12% to 9%, and that of secured loans, from 40% to 24% (excluding top loans, from 19% to 17%). The share of problem loans in the portfolio of unsecured and car

loans fell against the backdrop of high lending growth rates; its decrease in the portfolio of secured loans was caused by a retreat of insolvent banks from the system and write-offs of top problem loans.

**Chart 4.24 The largest Loans took the biggest part in the Portfolio of Distressed Loans**  
*Distressed loans by percentile groups*



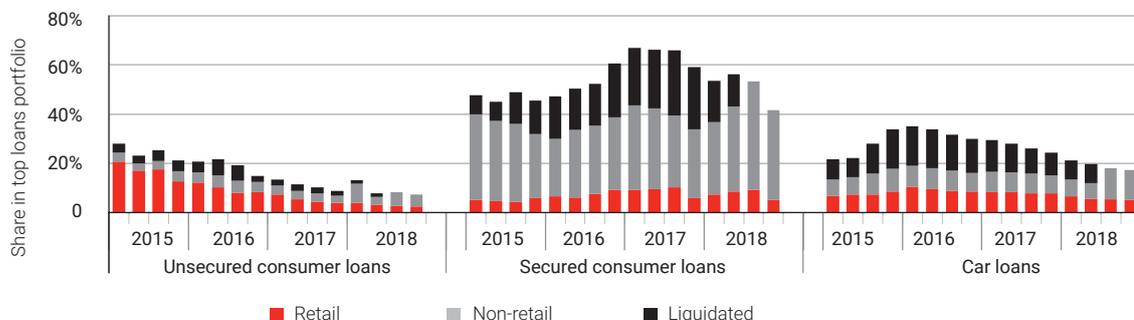
Source: Credit Register, National Bank assessment

Note: Largest loans are loans for which the balance of the main debt is higher than the 99th percentile

A significant part of top problem secured consumer loans and car loans was placed with the banks that had their licenses revoked in 2016-2018. For the period of 2017-2018, the share of problem loans in the portfolio

of top secured loans decreased from 67% to 42%, and in car loans segment, from 30% to 17%. At the same time, the risks associated with top loans still remain in the portfolio of non-retail banks.

**Chart 4.25 Top Problem Loans were concentrated in Liquidated and Non-retail Banks**  
*Top problem loans by bank group*



Source: Credit Register

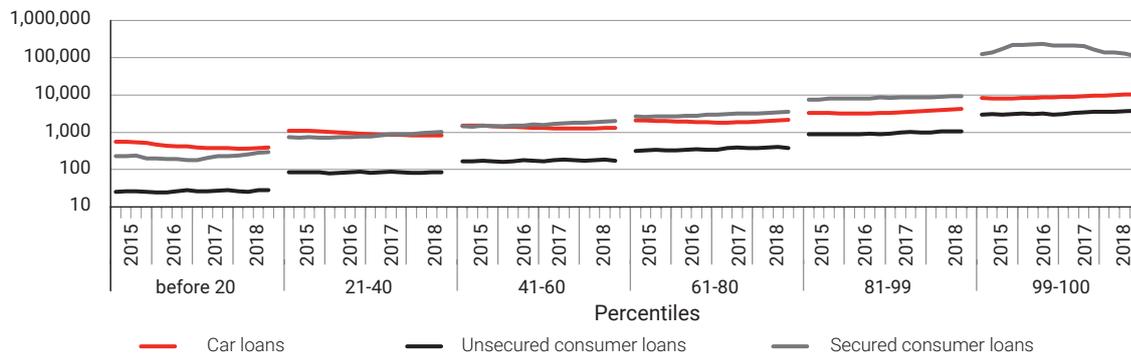
Note: Retail banks are the banks with a share of retail loans in the loan portfolio of 50% and above.

Secured portfolio was characterized by a significant spread in the sum of a principal debt (Chart 4.26). At the same time, top secured loans were too big to be categorized as consumer loans, which principal debt's average balance could exceed the value of 99th

percentile by 8 times. At the same time, it was only a 1.3-1.4 times excess in the portfolio of unsecured loans and car loan portfolio.

**Chart 4.26 Secured Consumer Loans, in contrast to Unsecured and Car Loans, are distributed less evenly in size**

Average principal debt per borrower, thou. tenge



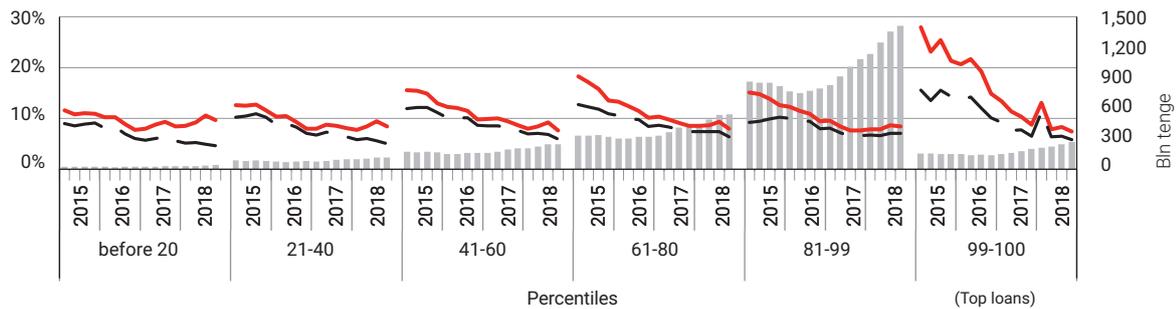
Source: Credit Register

In 2018, the share of problem loans in general decreased in unsecured consumer loan portfolio. However, the quality of smaller unsecured loans up to 40th percentile deteriorated (Chart 4.27). The lowest servicing rate in

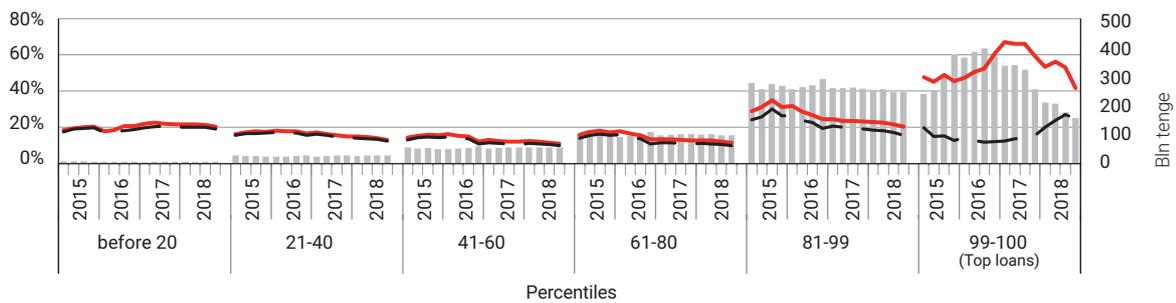
the portfolio of secured consumer loans and car loans was observed for top loans above the value of 99th percentile.

**Chart 4.27 Portfolio Quality improved in all segments of Consumer Lending**

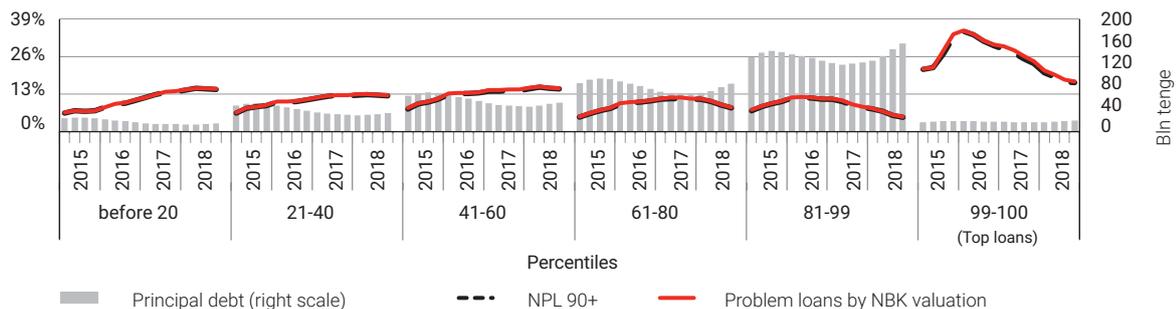
Unsecured Consumer loans



Secured Consumer loans



Car loans



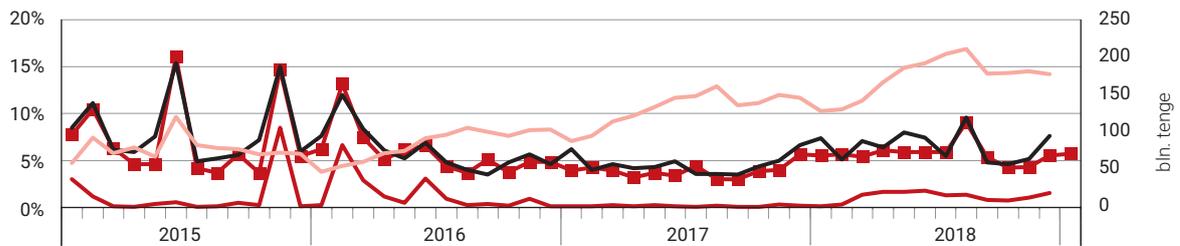
Source: Credit Register

Note: This section includes an analysis of loans issued for consumer purposes, except for the loans issued through credit cards

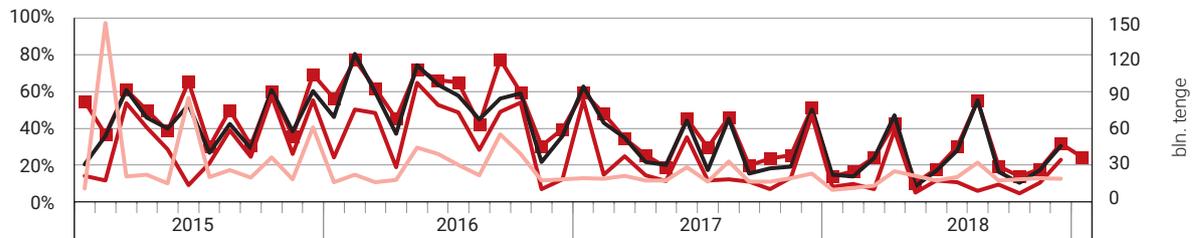
The quality of car loans and unsecured loans remained high enough, which was confirmed by lower default level on first and second payments. In 2018, default levels on the first and second payments on car loans remained at 4% against the backdrop of growing car loans volume. In turn, unsecured loans had an increase in defaults on first and second payments, which may affect the

level of problem loans later as portfolio matures. The issuing quality of unsecured loans was also affected by the banks that previously not targeted retail lending and which entry was undermined by significant technological barriers associated with borrower's application review and its solvency assessment.

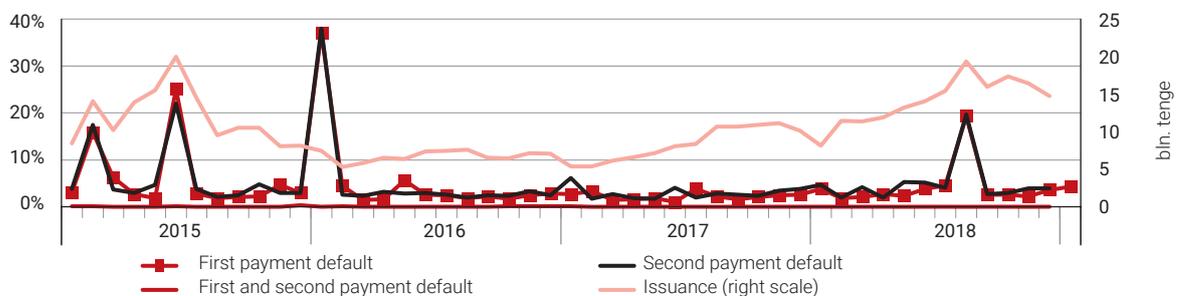
**Chart 4.28 In 2018, Defaults on First and Second Payments on Unsecured Loans are more frequent**  
*Unsecured Consumer loans*



*Secured Consumer loans*



*Car loans*



Source: Credit Register, National Bank assessment

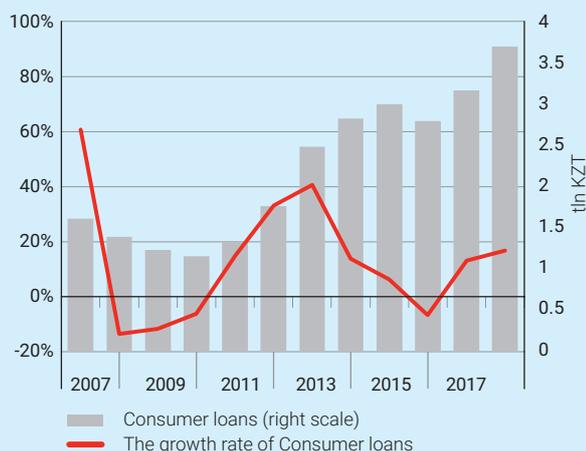
Note: First payment default is the share of loans defaulted within first loan repayment period, taking into account the 30-day grace period; second payment default is the share of loans with delayed second loan repayment with payment in the first period, taking into account the 30-day grace period; default on first and second payments includes loans with consecutive defaults on first and second payments. The volume of issuance excludes credit card loans issued and repaid within one month

### Box 4.1 Features of Consumer Lending Development

Positive contribution of household consumption to economic growth in 2018 was supported by both growth in real incomes and in consumer lending, mainly unsecured. Unsecured loans grew by 23% in

2018 (21% in 2017), and the volume of their issuance significantly exceeded the import of durable goods (*Chart 1, Chart 2*).

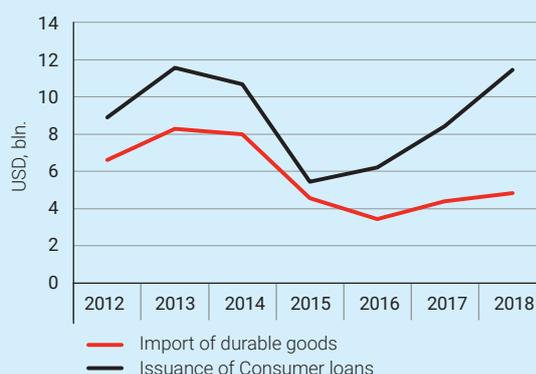
**Chart 1 Rapid Growth in Consumer Loans continued in 2018**



Source: STB reporting

Attractiveness of unsecured loans for the population compared to secured loans has boosted as a result of technological upgrading of the lending processes (reduced speed of loan applications processing, ease of transactions etc.) and increased maximum amount and term of the loan<sup>1</sup>. Growing demand for unsecured loans contributed to expansion of supply also from

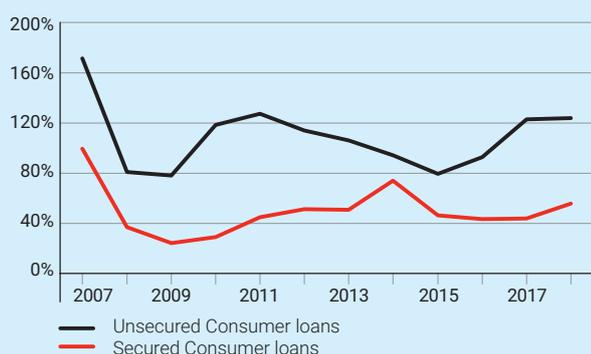
**Chart 2 Consumer Lending finances Import of Durable**



Source: STB reporting, Constitutional Court of MNE RK

traditionally corporate banks as well as to the refusal of individual banks to issue secured loans. At the same time, unsecured loans were issued at higher rates, with faster turnover and smaller size than secured loans (*Chart 3*). This ensured high bank returns and low portfolio concentration.

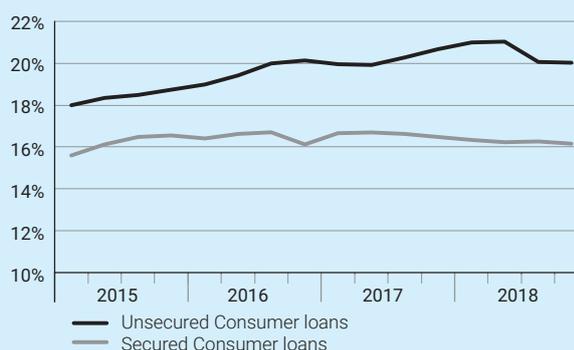
**Chart 3 Unsecured Loans' Turnover was twice as fast and with higher rates than Secured Loans Issuance of a loan portfolio at year end**



Source: Credit Register, National Bank assessment

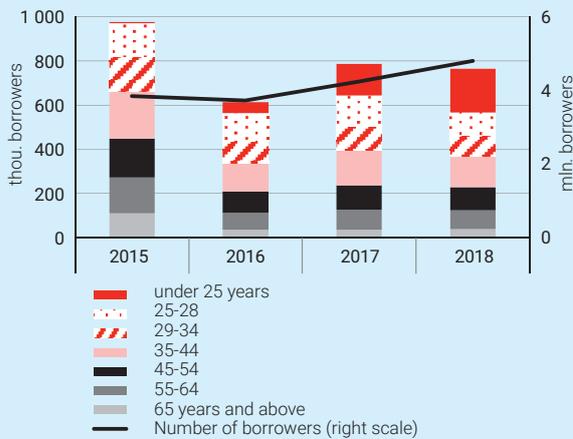
Note: Rates are weighted on principal debt balance, excluding top loans (over 99th percentile)

**Weighted average interest rates**

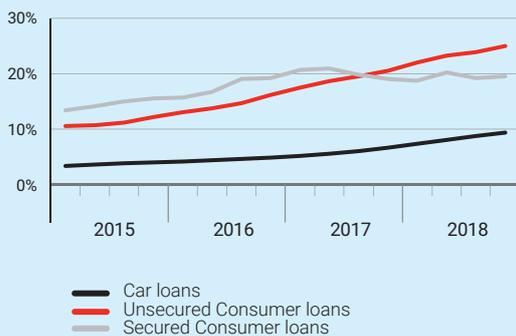


In 2017-2018, penetration of consumer loans in the banks has grown, including as a result of the growing number of new borrowers among younger generation under 25 (*Chart 4*). As loan penetration grew, interbank

competition for quality borrowers intensified. The market became more saturated, banks were actively refinancing unsecured loans and softening lending conditions (*Chart 5*).

**Chart 4 Consumer Lending rejuvenates****New borrowers by age group**

Source: Credit Register, National Bank assessment

**Chart 5 Consumer Loan Refinancing intensifies****Refinancing share**

Source: Credit Register, National Bank assessment

The growth of unsecured loan portfolio created the prerequisites for increasing households debt burden amid slower growth of households real incomes (see Section 1.8. for more details). Average debt balance rose to 570 thousand tenge (430 thousand tenge in 2016), the average number of unsecured loans per borrower went up to 1.6 (1.4 in 2016).

In 2019, fines and penalties for unsecured consumer loans from the banks and microfinance organizations were written off, and debts to individual household groups (up to 300 thousand tenge)<sup>2</sup>. were repaid. Hence, to strengthen responsibility of financial organizations, a ban was introduced on extension of loans to households with income below the subsistence level and charging of forfeits and commissions after 90 days of delay.

Also, to prevent risk growth in consumer lending, the National Bank scaled up banks' own capital adequacy requirements; since 2020, all legal entities that extend households loans (online lending companies, pawnshops and credit partnerships) are covered by the regulation. Accordingly, all lending entities will operate in one regulated field and comply with regulatory requirements, such as marginal interest rates, supply of information to credit bureaus, and calculation of debt burden ratio.

<sup>1</sup> By the results of Banks Lending Survey.

<sup>2</sup> Decree of the President of the Republic of Kazakhstan dated June 26, 2019 No. 34 «On Measures to Reduce Debt Burden of Citizens of the Republic of Kazakhstan».

## Credit Card Segment

**Credit card market in Kazakhstan is peculiar as, along with classic revolving cards, it is used for issuing consumer loans. Over past two years, card loan portfolio has grown<sup>15</sup>. The quality of this portfolio in the system slightly deteriorated in the second half of 2018. In general, this segment manifests moderate risks, but monitoring of rapidly growing market and level of borrowers' debt burden is required.**

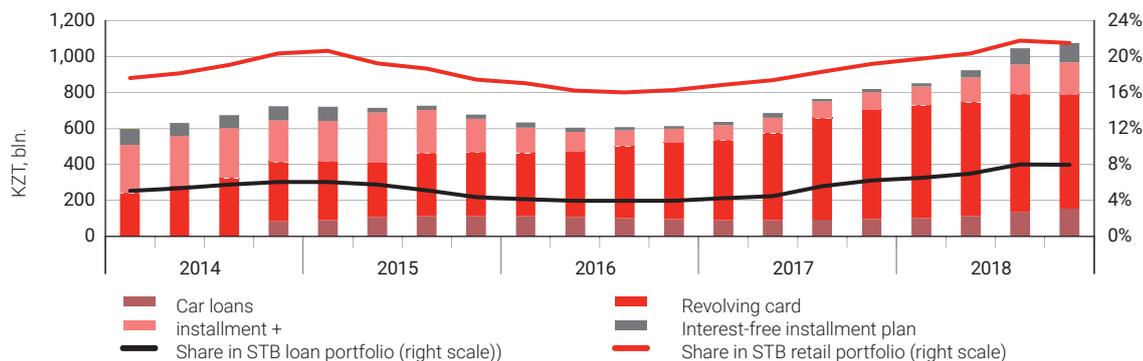
Kazakhstan's banks enjoy the practice of using credit cards in its classical operations and for issuance of consumer loans, including car loans. In general, volume of accounts payable on cards has increased, and so

the debt on revolving cards. According to the National Bank's estimates, at the end of 2017 the share of revolving credit cards in credit card portfolio reached 84%, and it fell to 69% at the end of 2018 (Chart 4.29).

Between 2012 and 2018, the volume of banks' card loan portfolio tripled 3 times, from less than 0.4 trillion tenge to about 1.1 trillion tenge and amounted to 8% of the banking system's loan portfolio. At the end of 2015 and in 2016, the market contracted as a result of falling consumer demand and household real incomes after transition to a free-floating national currency regime.

<sup>15</sup> The portfolio includes both revolving credit cards and consumer loans issued through credit cards

Chart 4.29 Growth of Portfolio of Loans issued through credit cards



Source: Credit Register

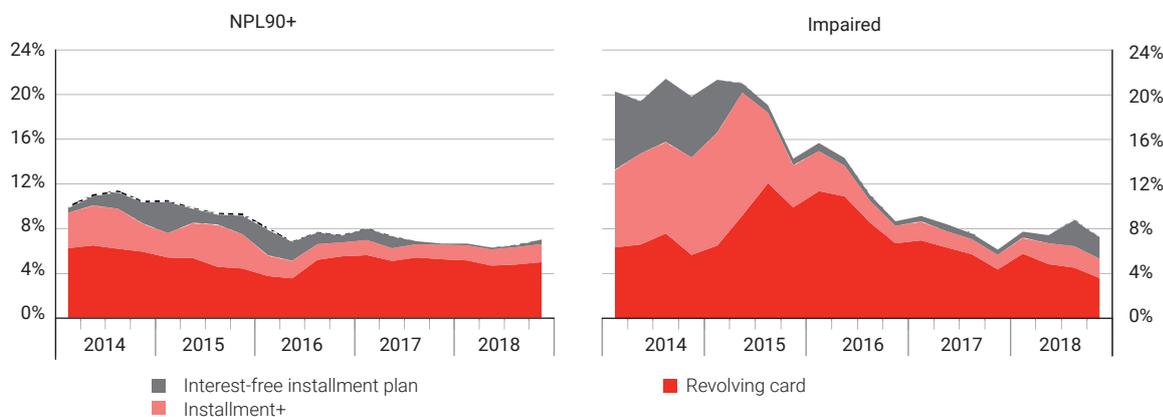
Note: Solid fill means tenge loans, pattern fill means loans in foreign currency (almost none). Installment + - installment plan with a percentage or several loans on one card, one of which is an installment plan; revolving card means a classic credit card.

The card product market, and accordingly, the card portfolio, was emerging gradually, and the quality of its service conceals several problems that banks encountered as this segment was developing. When selling cards, banks observed a high level of loans among potential product users, and when using cards, there were numerous delays caused by difficulties with calculation of monthly payments and poorer responsibility to a product compared to a regular loan. The difficulties with perception and use of a credit card

caused overdue payments and deteriorated borrowers' credit records.

Between 2014 and 2017, a general trend was to improve the quality of loans issued through credit cards. The share of NPL90+ loans in the card loan portfolio fell from 11% to 8%. In 2H2018, a slight deterioration of the portfolio as a result of loans issued for goods purchased in installments was registered (Chart 4.30).

Chart 4.30 Deteriorated Quality of Loans issued through credit cards



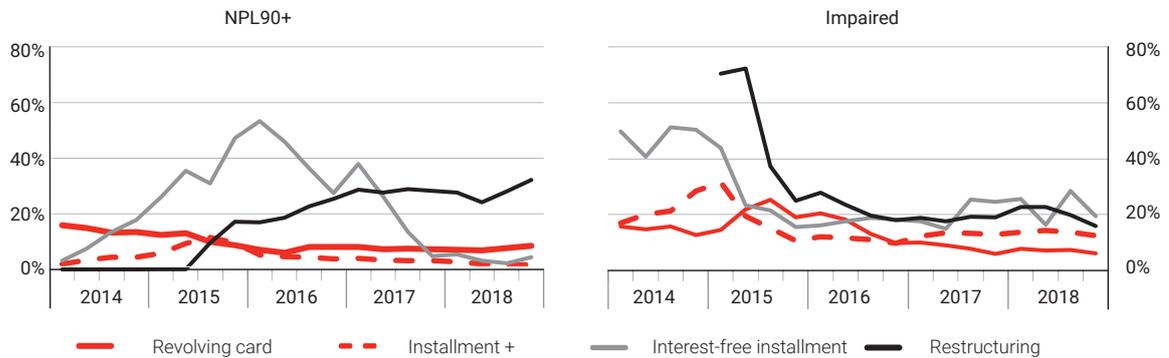
Source: Credit Register

Note: Solid fill means tenge loans, pattern fill means loans in foreign currency (almost none). NPL90 + means non-performing loans according to bank statements; impaired loans mean poorly repaid loans as estimated by the National Bank, excluding NPL90 +. Installment + means interest rate installment plan or several loans on one card, one of which is the installment plan

Some banks resorted to restructuring to improve credit card quality, such as amended credit card conditions or reduced interest rate, which enabled to carry recognition of losses to problem loans. In fact,

for such loans, with subsequent non-repayment of 90 days or over, the loan would not fall under category of NPL90+, rather of NPL180+, implying low restructuring efficiency. (Chart 4.31).

**Chart 4.31 High Proportion of Impaired Loans on Restructured Credit Card Balance Sheets and in Installment Segment**



Source: Credit Register

Note: NPL90+ means non-performing loans according to banks reporting; impaired loans mean poorly repaid loans as estimated by the National Bank, excluding NPL90+. Installment + means an interest rate installment plan or several loans on one card, one of which is the installment plan

### Box 4.2 Credit Card Market Development

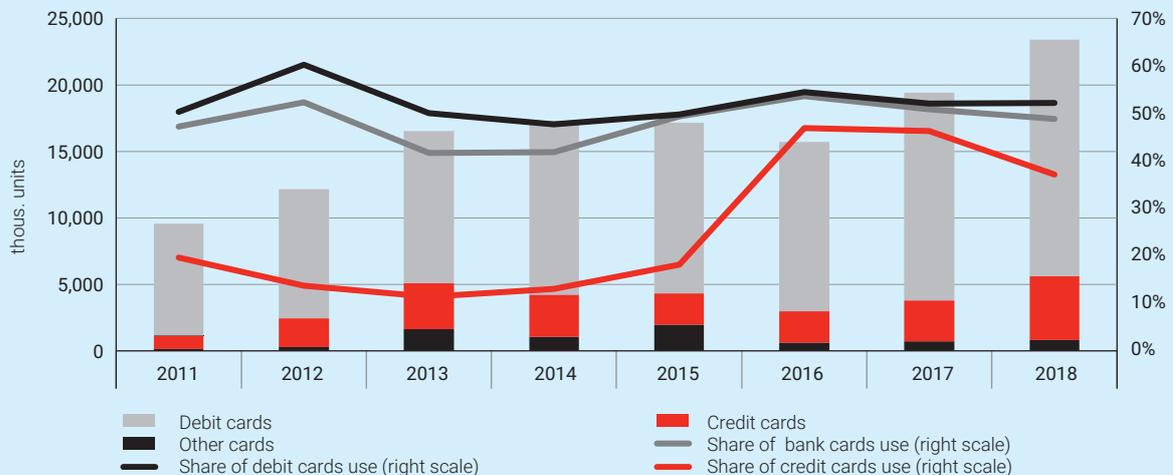
The bank card market emerged and reached its maturity in quantitative terms. Active development of credit card products continues, credit card market development indicators match the level of other developing countries. Kazakhstan's credit card market is characterized by widespread use of cards for consumer loan issuing and servicing loans, including car loans.

The share of credit cards is growing, but the most common are debit cards that make three quarters out of the number of cards in circulation. From 2011 to 2018, the number of credit cards in circulation quintupled from 900 thousand to 4.6 million, and their share doubled from 10% to 20%. Over the same period, the number of monthly used credit cards increased almost 10-fold from 200 thousand to 1.7 million units,

and their share in the total number of used cards grew from 4% to 15%. The growing number of cards in 2018 caused their less active use (Chart 1).

The share of credit cards used at least once a year increased from about 45% of cards in circulation in 2014 to 85% in 2017 and reached the global average. The low percentage of credit card use until 2016 was associated with the rapid growth of clients who received a card to get a loan for a specific product purchase. The issuance of credit cards was not underpinned by corresponding demand; credit cards were imposed on clients as a supplement to other banking products, a part of cross sales.

**Chart 1 Growth of Bank Card Number and Intensity of their Use**



Source: National Bank

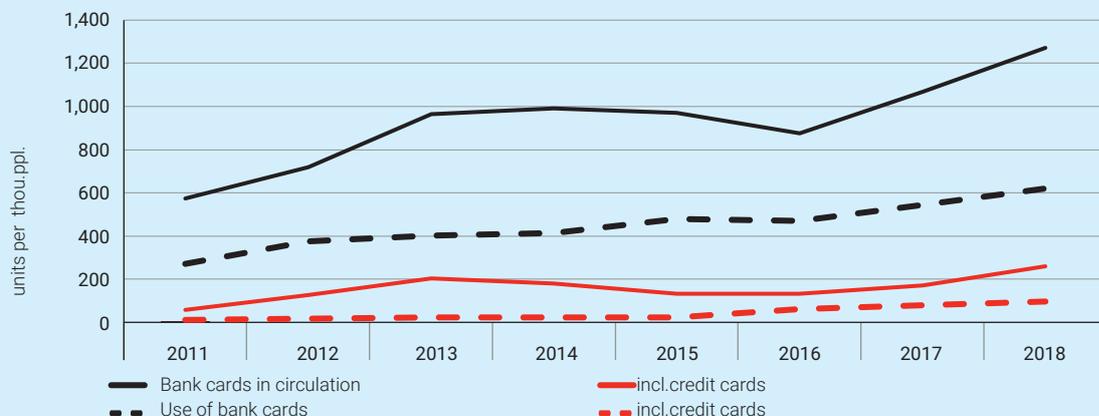
Note: Credit cards mean revolving cards and cards on which consumer loans are issued; other cards mean credit limit debit cards and prepaid payment cards

<sup>1</sup> World Bank – Financial Inclusion Index (Findex)

In Kazakhstan, penetration rate of credit cards in circulation increased from 60 cards per thousand

people in 2011 to 250 in 2018, which is about the same level as Russia<sup>2</sup> (Chart 2).

**Chart 2 Improving Penetration of Bank Cards, including Credit Cards**



Source: National Bank assessment  
 Note: Credit cards mean revolving cards and cards on which consumer loans are issued

The convenience of using credit cards compared to other credit products is paid as higher interest rates. The most common nominal interest rates on

credit cards are 0% (installment cards), 18%, 20-21%, 23-25%, 27%, 39% and 45% (Chart 3).

**Chart 3 Distribution of Balance of Principal Debt on Credit Cards based on Interest Rates as of 01.01.2019**



Source: Credit Register  
 Note: Credit cards mean revolving cards and cards on which consumer loans are issued

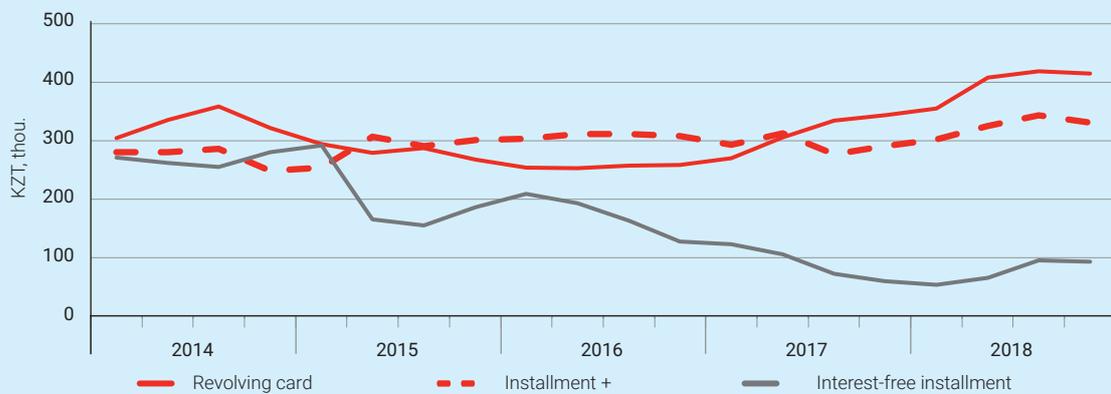
The most common credit card limits range from 50 000 to 500 000 tenge, divisible by 50 thousand tenge; among large sum limits the most common are 1, 1.5 and 3 million tenge. In addition, a credit card often functions as a balance mechanism, for example, for a specific purchase, and it is not automatically revolving.

Credit card distribution is expected to continue in Kazakhstan as remote service channels, cashless payments and Internet banking will be further developed amid growing real incomes. However, as households are increasingly covered with mobile phones, the instant payment system and mobile payments, including with an QR code, will compete with credit cards as a means of payment. The introduction of biometric technologies in Kazakhstan, including the distribution of biometric ATMs that can be serviced card free, may restrain the demand for credit cards.

Over past two years, the average weighted amount of principal debt on revolving cards and on restructured loans has increased. Since 2015, a slight decrease in the weighted average debt on car loans serviced through credit cards is associated with a shift of lending in this segment to second-hand cars (Chart 4).

<sup>2</sup> For comparison, Poland's penetration rate is about 300 cards, and that in Vietnam, about 100. In developed countries, many residents have several credit cards, so the same indicator in the USA and Canada is at the level of 4,200 cards per thousand people, and it is 2 300 in Japan.

Chart 4 Increased Average Weighted Amount of Principal Debt on Revolving Cards



Source: Credit Register

Note: Installment + means an interest rate installment plan or several loans on one card, one of which is the installment plan

## Credit Risks of Residential Mortgage Loans

**Credit risks of residential mortgage loans (RML) remained low. The mortgage market was largely shaped by government programs; banks' own mortgage programs were practically not in demand because of high interest rates. Refinancing of foreign currency mortgages in tenge continued within the framework of the government programs.**

In 2018, the government's role in households mortgage loans increased with the introduction of new social lending programs. A variety of state mortgage programs (programs of JSC Housing Construction Savings Bank of Kazakhstan, Nurlı Zhol, Nurlı Zher, 7-20-25, Baspana Hit, Askeri Baspana) enabled households to purchase both primary and secondary market housing, while some programs were available even to real estate owners. Following high interest rates, banks' own mortgage programs were less attractive to the general public (see Section III for more details).

Over past 5 years, the quality of RML portfolio improved, and their share of problem loans fell to 10.9% in 2018. The quality of RML also continued to improve, loans issued in 2016-2018 were serviced better and had lower number of 90+ delays (Chart 4.32).

The volume of problem loans continued to decline from mid-2016, more than half of the NPL90+ portfolio still remained in foreign currency loans (Chart 4.33, Chart 4.34). Losses on mortgage loans issued during

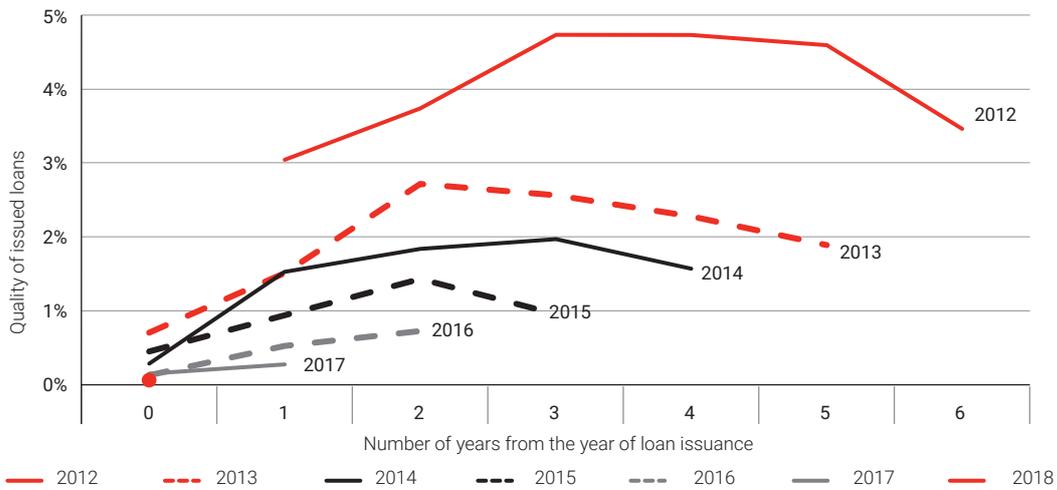
pre-crisis and crisis years, mainly in foreign currency, were recognized by banks or refinanced. The National Bank's foreign currency mortgage refinancing program allowed for a transfer of foreign currency mortgage loans to individuals, including non-performing loans, in tenge<sup>16</sup>. At the same time, in 2018, loans issued before 2011 still accounted for 75% of non-working mortgage loans.

The ban on issuance of mortgage loans<sup>17</sup> in foreign currency to individuals that have no income in same currency, and the implementation of the Refinancing Program contributed to the reduction of problem forex portfolio and, consequently, future mortgage forex risk. The level of NPL90+ remained low (3% in 2018) in tenge mortgage portfolio, and its quality preservation will be determined by credit decisions made amid growing households demand.

<sup>16</sup> Transfer at the rate of the National Bank of Kazakhstan on August 18, 2015 (188.35 tenge per US dollar).

<sup>17</sup> According to paragraph 3-1 of Article 34 of the Law of the Republic of Kazakhstan "On Banks and Banking Activities" from January 1, 2016, it is forbidden to provide mortgage loans in foreign currency to individuals who have no same currency income for 6 consecutive months preceding the date the individual's contact with the bank.

Chart 4.32 Improving the Quality of Residential Mortgage Loans

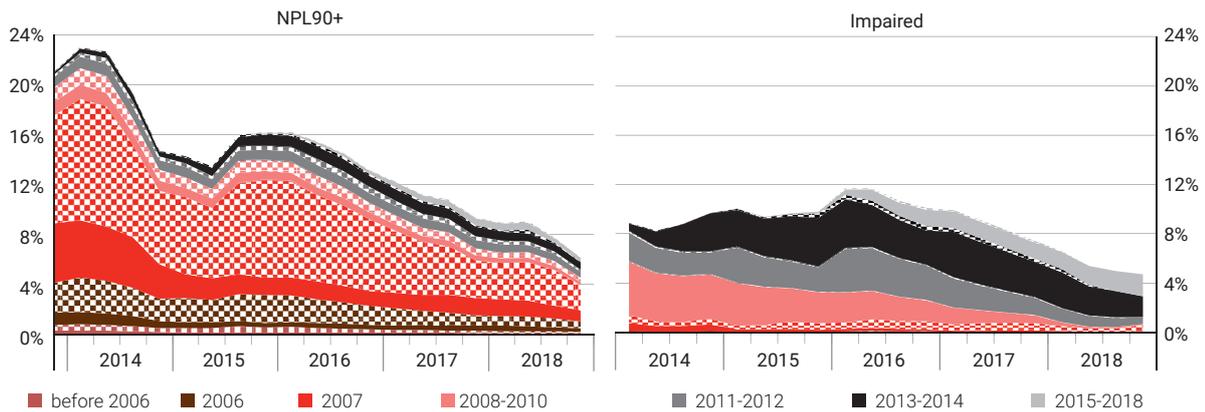


Source: Credit Register

Note: The share of NPL90+ in total volume of loans originally issued. Loans issued in 2016, excluding JSC Kazkommertsbank in connection with the transfer of assets of JSC BTA.

Chart 4.33 Residential Mortgage Portfolio Quality improved

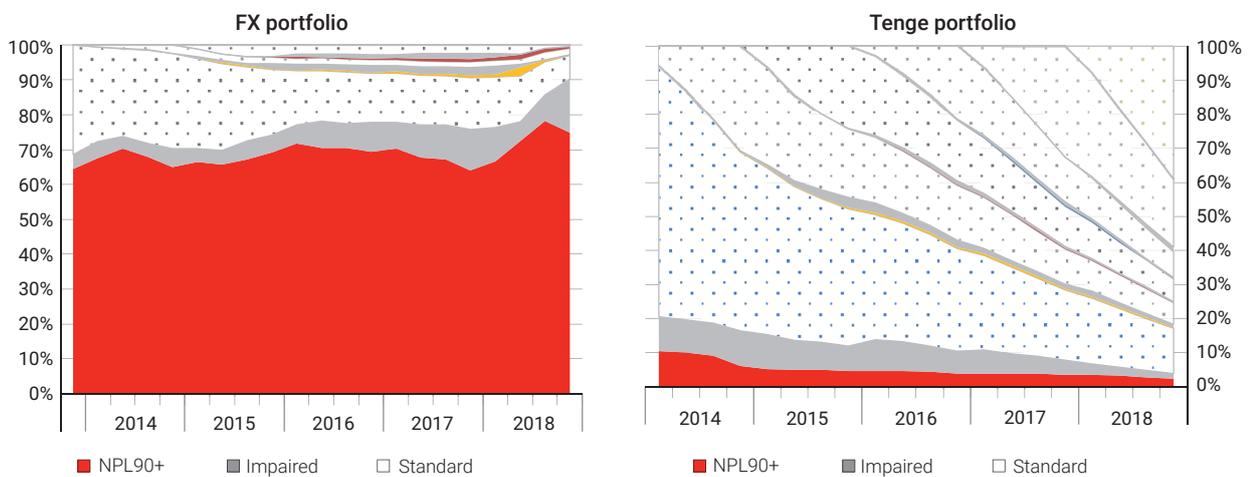
The share of problem loans in mortgage portfolio



Source: Credit Register

Note: Solid fill means tenge loans, pattern fill means loans in foreign currency; NPL90+ means non-performing loans according to bank statements; impaired loans mean poorly repaid loans as estimated by the National Bank, excluding NPL90+

Chart 4.34 Mortgage Loan Portfolio by Vintage

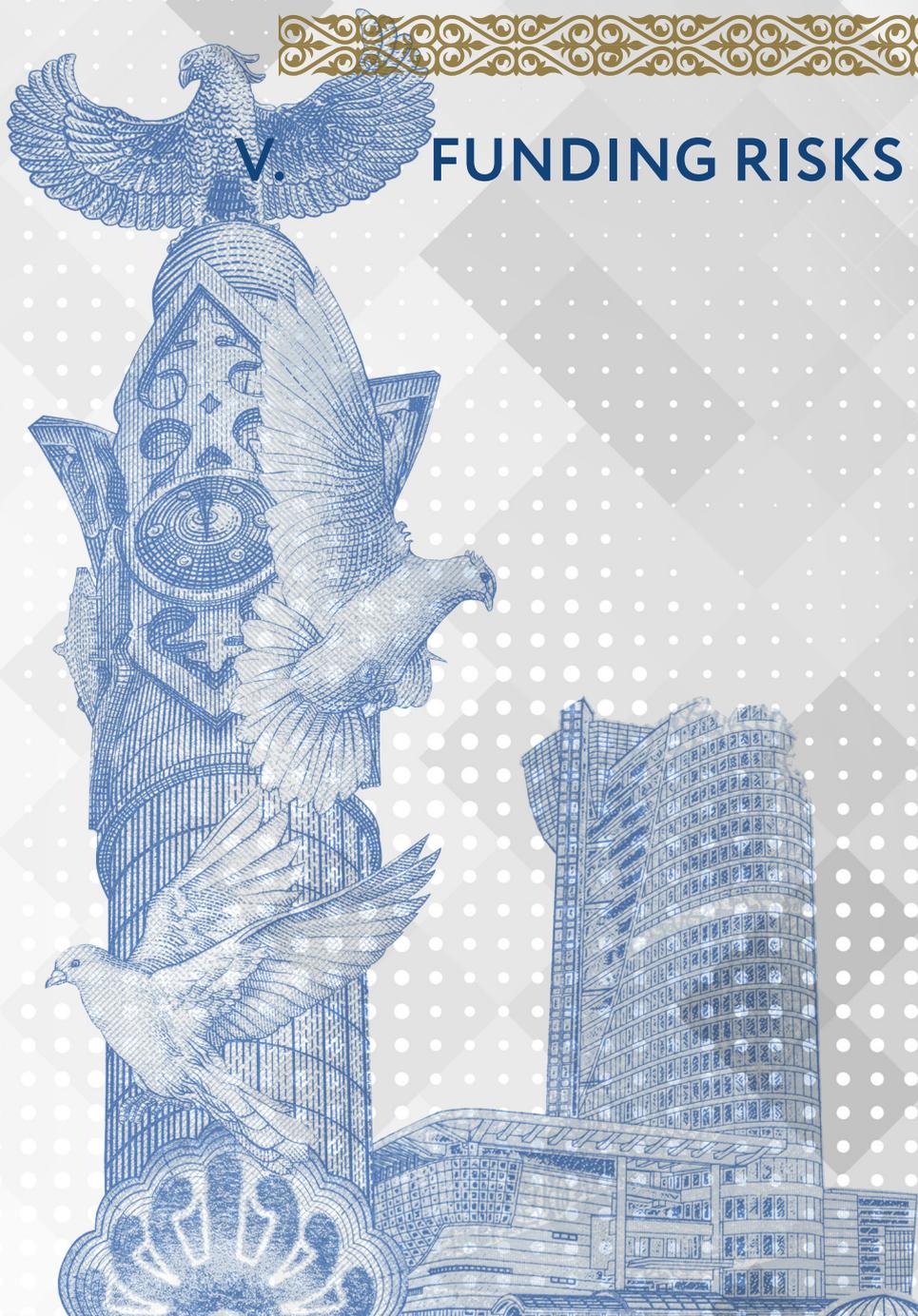


Source: Credit Register

Note: Every three consecutive areas starting with a colored area represent a portfolio for the corresponding year of issue (until 2014, 2015, 2016, 2017, 2018). NPL90+ means non-performing loans according to bank statements. Impaired loans mean poorly repaid loans as estimated by the National Bank, excluding NPL90+

## Section 5.

# V. FUNDING RISKS



Liquidity risks of the banking sector remained at a moderate level against the background of a significant stock of highly liquid assets that account for more than a third of cumulative assets. The National Bank continues to absorb excess liquidity with short-term notes and standing facilities to keep money market rates within the interest rate range of the base rate. Transparency and predictability of monetary policy mechanisms enable the banks to manage liquidity risks and keep them low.

High dollarization of liabilities still remains the main funding risk, as it widens the currency gap on the banks' balance sheets and forces banks to choose between currency risk and liquidity risk. The pace of de-dollarization has slowed down and its further decrease will require solid macroeconomic policy, including commitment to floating rate and interest rate policy and countercyclicality of the fiscal policy.

Direct currency risks remain insignificant. Open current position (OCP) of the bank is in the range

of  $\pm 0.5\%$  of equity and far from breaking limit values, thanks to significant volume of excess liquidity. Despite the decrease of the share of foreign currency loans from 27% to 19%, indirect foreign exchange risks associated with the recognition of losses on foreign currency loans remain high.

Low funding sustainability remains a vulnerable issue and manifests itself in high concentration of lenders, especially in the public sector, and a low share of fixed term funding. In 2018, for the establishment of fixed term deposit market, the new mechanism of population deposit marginal rate by risks was set up with reference to market benchmark.

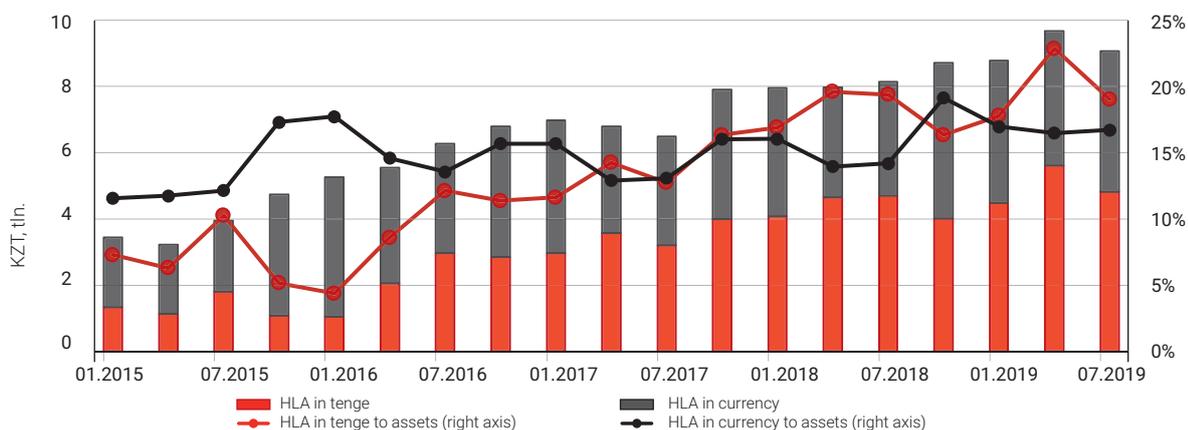
Further enhancing of funding sustainability will require a more adequate accounting of risks in prudential liquidity ratios (LCR, NSFR), improved quality of interest rate risk reporting, and wider application of supervisory assessment measures under requirements of the Basel Committee on Banking Supervision (Pillar 2).

## 5.1. LIQUIDITY RISKS

In 2018, a significant reserve of liquidity remained in the banking sector. Highly liquid assets (HLA)<sup>18</sup> at the end of the first half of 2019 reached 9.1 trillion tenge or 36% of the banking sector assets, increasing by 14% over

1.5 years (Chart 5.1). At the same time, growing tenge liquidity (9% of 14%) contributed greatly to the increase of the total volume of HLA.

Chart 5.1 HLA in the banking sector has been gradually increasing from the beginning of 2016



Source: STB reporting

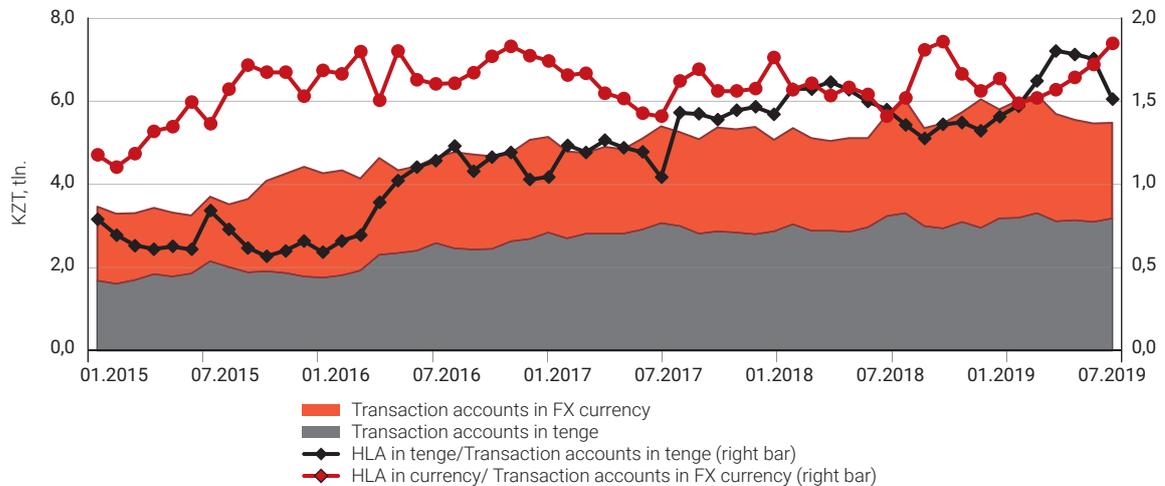
Note: HLA include cash, precious metals, correspondent accounts, interbank deposits and government securities (GS) (excluding encumbered). Data at the end of the quarter

As of July 1, 2019, the volume of HLA of the banking sector exceeded liabilities on transaction accounts of individuals and legal entities in tenge by 1.5 times and in currency by 1.9 times (Chart 5.2). It is a historical rarity

and rather an anomaly for the banking system. Such a liquidity reserve is neither a prerequisite for financial stability, nor is it desirable for the banks efficiency.

<sup>18</sup> Excluding encumbered HLA

Chart 5.2 Current excess of HLA fully covers potential outflows in transaction accounts

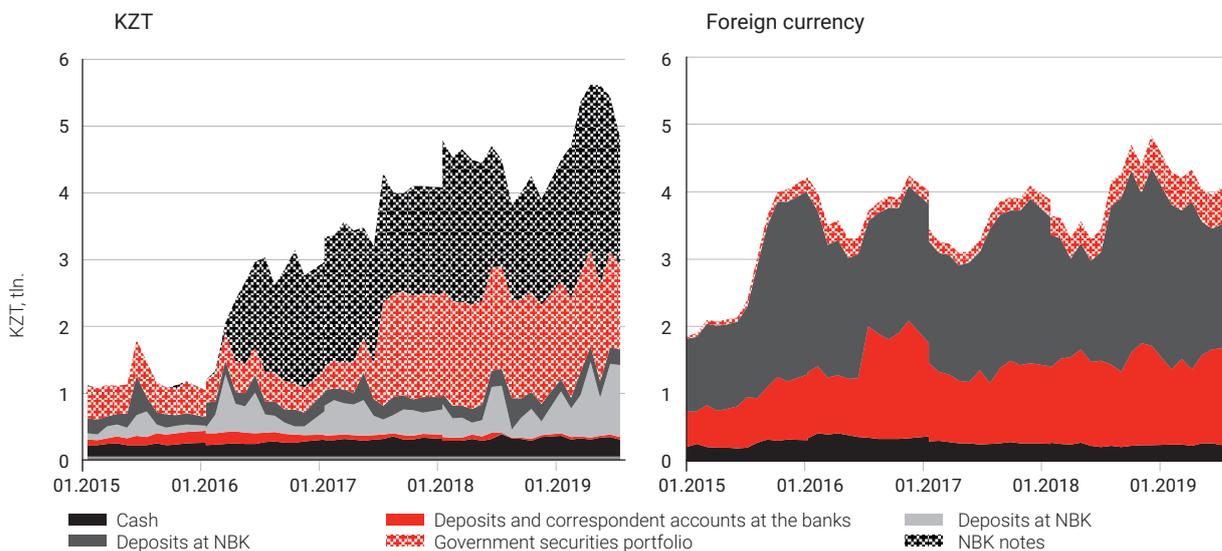


Note: Transaction accounts include current accounts and demand deposits of financial institutions and legal entities, including interbank correspondent accounts

The volume of highly liquid assets in tenge and foreign currency remained comparable, i.e., 4.8 and 4.3 trillion tenge, respectively. Banks put tenge liquidity mainly in government securities, National Bank notes, deposit

foreign currency in correspondent accounts of the National Bank (45%) and foreign banks' accounts (34%) (Chart 5.3).

Chart 5.3 Government securities (GS) and NBK notes prevail in HLA's tenge portion, while HLA's foreign currency portion remains in correspondent accounts of NBK and foreign banks



Source: STB Regulatory Reporting.

Note: HLA includes cash, precious metals, correspondent accounts, interbank deposits and government securities, except for encumbered ones. Data at the end of the month

The volume of HLA in national currency continues to grow, increasing the surplus of tenge liquidity formed out of budget deficit financing, banking sector consolidation programs financing, and liabilities de-dollarization. At the same time, HLA increased in

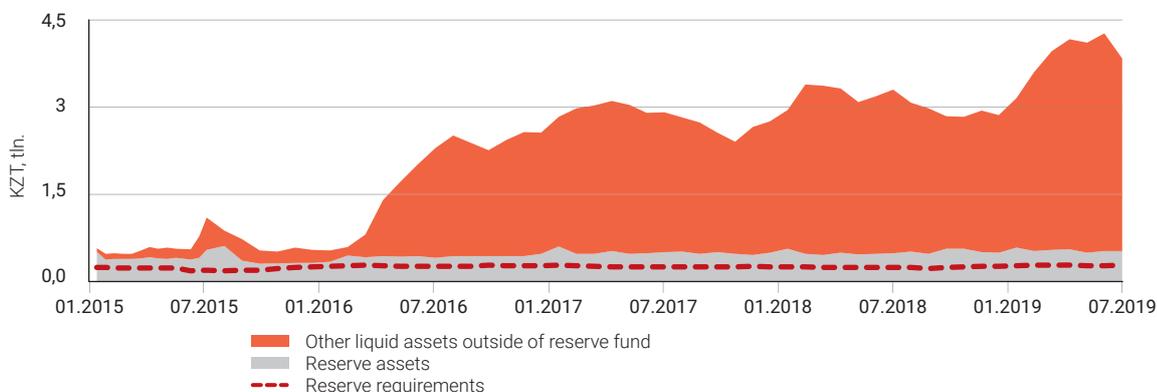
the first half of 2019 due to the influx of funds from the government support to the banking sector.

At the end of the first half of 2019, reserve assets as hard cash and national currency in correspondent

accounts at the National Bank outperformed the reserve requirements twofold. From 2017, banks maintained primary tenge liquidity at the level of 450-550 billion tenge with the required minimum of about 250 billion

tenge (*Chart 5.4*). Tenge liquidity in deposits and notes of the National Bank, i.e., assets easily convertible into reserve assets, exceeded reserve requirements twelvefold.

**Chart 5.4 From 2016, banks meet minimum reserve requirements with a significant margin**

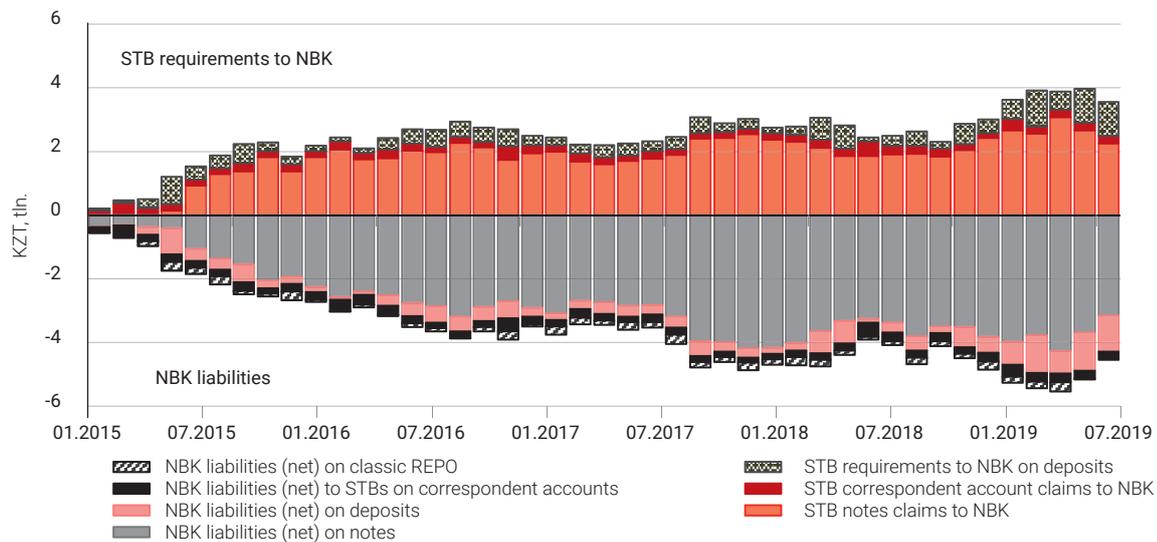


Source: STB reporting.

Note: Tenge requirements for the NBK include bank requirements for the funds in correspondent accounts, deposits and notes in national currency. Reserve assets include balances in national currency on banks' correspondent accounts at NBK and cash (cash on hand, cash in transit, ATMs, payment terminals). Reserve requirements are the minimum amount of funds required to be maintained by banks on a correspondent account in national currency at NBK.

Data on MRR, reserve assets and requirements for the NBK are indicated on average for the period.

**Chart 5.5 NBK absorbs excess liquidity mainly by selling notes**



Source: STB reporting, National Bank.

Note: Requirements for the NBK in tenge include banks' claims on the National Bank for funds placed on correspondent accounts, in deposits and notes in national currency. NBK liabilities include open position on deposits, repo, notes and correspondent accounts of banks.

Bank requirements for the National Bank at the end of the first half of 2019 amounted to 3.6 trillion tenge (*Chart 5.5*). The excess of tenge HLA in the banking sector, represented mainly by short-term liabilities of the National Bank, prompts the need of constant refinancing to maintain money market rates in the target corridor.

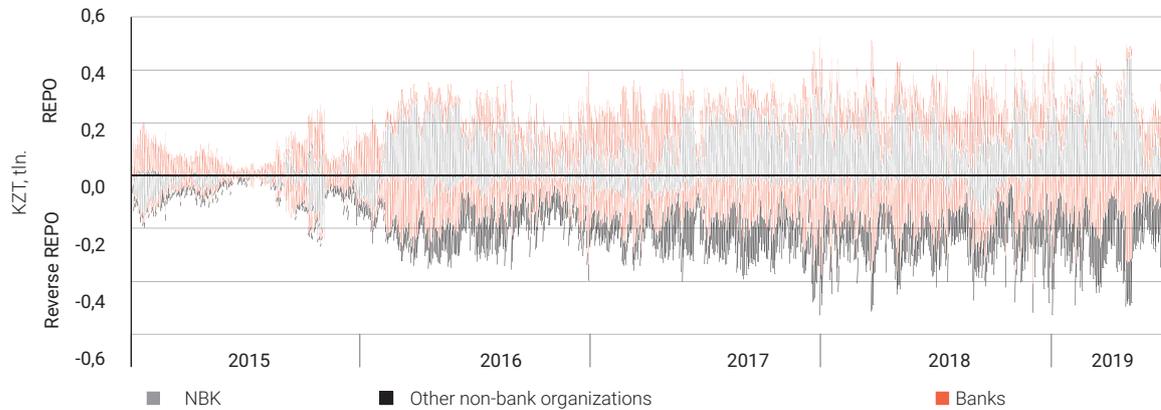
In addition to the notes, the National Bank also acted as a net buyer on the organized repo market (*Chart 5.6*), absorbing the remaining volume of offered liquidity using standing facilities to maintain TONIA<sup>19</sup> rate within the target interest rate range of the base rate. Occasionally, at times of higher demand, in particular in 3Q2018, the National Bank offered liquidity through a reverse repo at upper corridor threshold.

<sup>19</sup> Tenge OverNight Index Average

The stock of forex liquidity is grounded in the need for compensation of short forex position towards real sector, i.e. deposits and loan portfolio. The banks have

limits in issuing foreign currency credits due to high credit risks on such loans for borrowers without forex revenues.

**Chart 5.6 NBK withdraws tenge liquidity in overnight REPO market at the lower bound of the interest rate corridor**



Source: KASE

The structural liquidity surplus limits the effectiveness of the monetary policy interest mechanism, and quickly convertible short-term notes do not add to free liquidity. To strengthen the effectiveness of monetary policy mechanisms, improve the quality of liquidity management by banks, and reduce dollarization, the National Bank implemented the following measures in the first half of 2019:

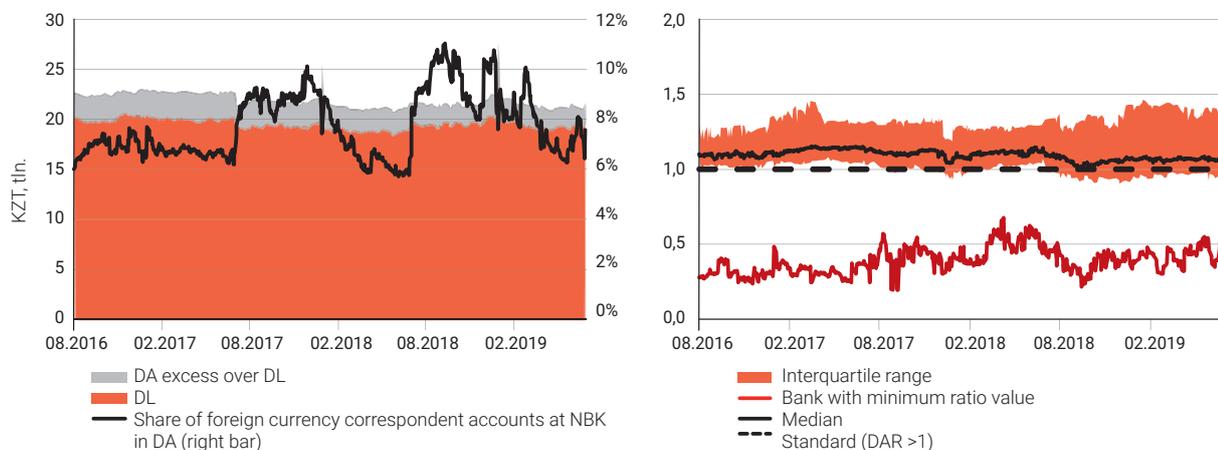
- 7-day deposit auctions as the main instrument of open market operations in exchange for 7-day short-term notes of the National Bank;
- mechanism of minimum reserve requirements (MRR) has been optimized. Bank liabilities used for MRR calculation are divided by currency and maturity, the residency principle has been excluded. The amount of hard cash used for calculation of reserve assets is limited (50% of average MRR size). Four, instead of eight MRR standards, were established (for short- and long-term liabilities in tenge and in foreign currency).

For a year and a half ending in the first half of 2019, the funds of the banks in foreign accounts grew by 22%, reaching 1.5 trillion tenge. Foreign currency correspondent accounts at the National Bank decreased by 14% to 1.9 trillion tenge. This amounted to 9% of so-called “internal assets” of the banks placed in Kazakhstan for compliance with the prudential standard for depositing some funds in domestic assets (DAR) ([Chart 5.7A](#)). The historical goal of DAR was to stimulate lending. Currently, most banks maintain DAR even without using funds in foreign currency accounts at NBK ([Chart 5.7B](#)). Only some small foreign banks need to resort to foreign currency correspondent accounts at NBK to maintain DAR.

Chart 5.7

A. Foreign currency correspondent accounts at NBK are a relatively small part of domestic assets

B. At the same time, funds in foreign currency accounts have almost no effect over banks' maintenance of DAR

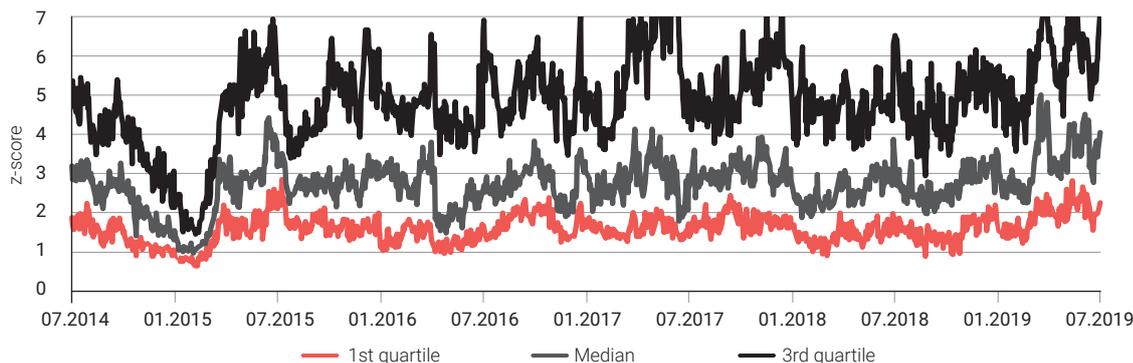


Note: DA - domestic assets, DL - domestic liabilities, which are calculated as the sum of average monthly values of the subdebt, issued bonds, with the exception of Eurobonds, domestic liabilities to residents of Kazakhstan and part of equity. DAR is the ratio of investments in domestic assets ( $> = 1$ ). Interquartile range includes banks in 2nd and 3rd quartiles.

An analysis of intraday liquidity shows that between 2018 and the first half of 2019, the amount of tenge funds on accounts in most banks was maintained at the level sufficient to cover for one-day standard deviation of the deposit base (Chart 5.8). At the same time, in the third quarter of 2018, banks in all quartiles had an outflow of tenge liquidity associated with both tax

week withdrawals and tenge exchange rate pressure. Moreover, even during periods of unexpected higher demand in tenge liquidity, money market rates stayed within the upper corridor threshold. Should primary liquidity be insufficient, banks have liquid assets to match the demand in borrowed tenge liquidity.

Chart 5.8 Most of second-tier banks (STB) have sufficient tenge funds to cover one standard deposit deviation



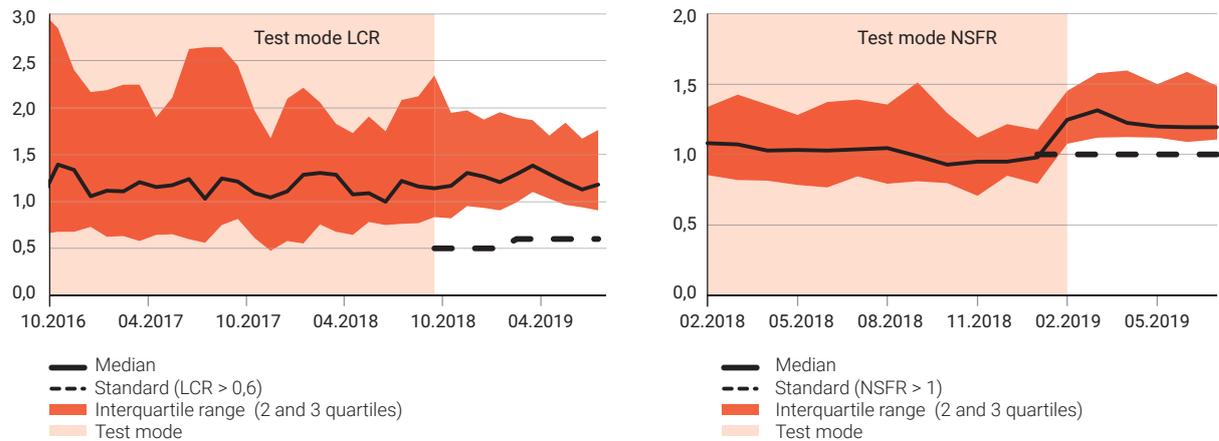
Source: STB reporting

Note: The adequacy ratio of basic liquid assets is calculated as the ratio of basic liquid assets of the banks (cash on hand, precious metals, funds in correspondent accounts and deposits with the NBK / STB) and standard deviation of deposits in national currency for 3 months on a per day basis (Z-score). In 2018-2019, first quartile corresponds to the 7th bank on liquid assets adequacy ratio. Daily reports.

Despite excess liquidity, LCR liquidity ratio (liquidity coverage ratio) is still being introduced in stages, and the regulatory value recommended by Basel at the level of 1.0 will come into force in 2022. The net stable funding ratio (NSFR) in 2018 was calculated by banks as a test to assess liquidity risk. From January 1, 2019,

the required minimum is set at 1.0. The results of the first half of 2019 have shown that all banks, except one, which risks have no significant effect on the system, maintain LCR and NSFR standards (Chart 5.9).

Chart 5.9 Most banks comply with current LCR and NSFR requirements



When calculating LCR and NSFR ratios, penalties for early repayment on deposits or their absence are not accounted for in classifying sustainable and fixed term funding and have no effect on the calculation of ratios. Whether the interpretation of these standards is

compliant with the principles and spirit of the Basel is an issue related to the definition of sustainable funding discussed in more detail in the Funding Sustainability Subsection.

## 5.2. FUNDING RISKS

The main risks in the funding structure are associated with a low share of actual term funding, as well as high

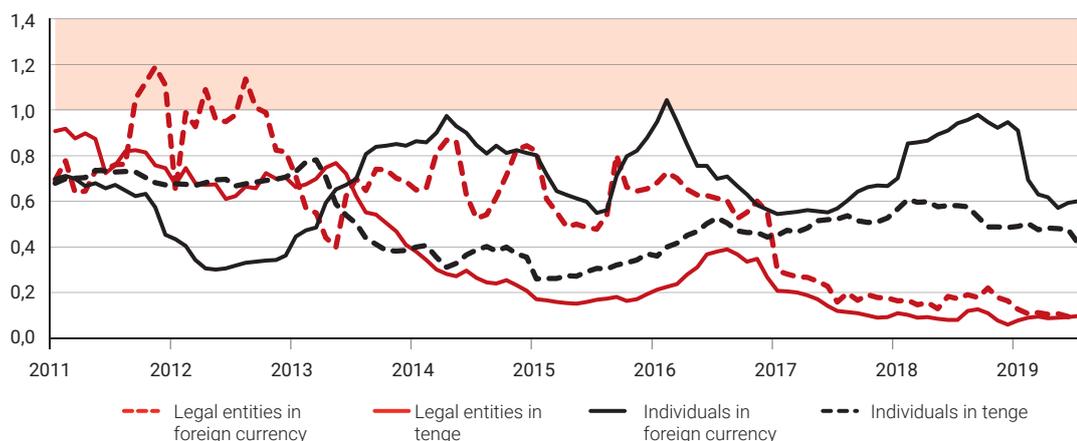
dollarization and concentration of lenders, mainly state-owned companies.

### Low Funding Sustainability

The problem with stability of bank funding is manifested in the low proportion of actual fixed term deposits with penalties for early withdrawals. Deposits account for

75% of bank liabilities. Their actual maturity remains extremely low (Chart 5.10).

Chart 5.10 The average actual maturity of deposits with a fixed term of 1-5 years is less than a year



Source: STB reporting

Note: The average turnover is determined by the modified formula for the receivables turnover period taking into account the turnover on attracting and withdrawing deposits. Data for the reporting month

Until 2018, the risk of early withdrawal was not duly priced in fixed deposit rates. Historically, competition for depositors led by unstable banks spilled over to non-pricing conditions amid limited rates on retail deposits.

As a result, most, supposedly fixed term deposits, had an early withdrawal (replenishment) option without any penalty. In fact, there was no much difference between fixed term deposits and demand deposits. At the same

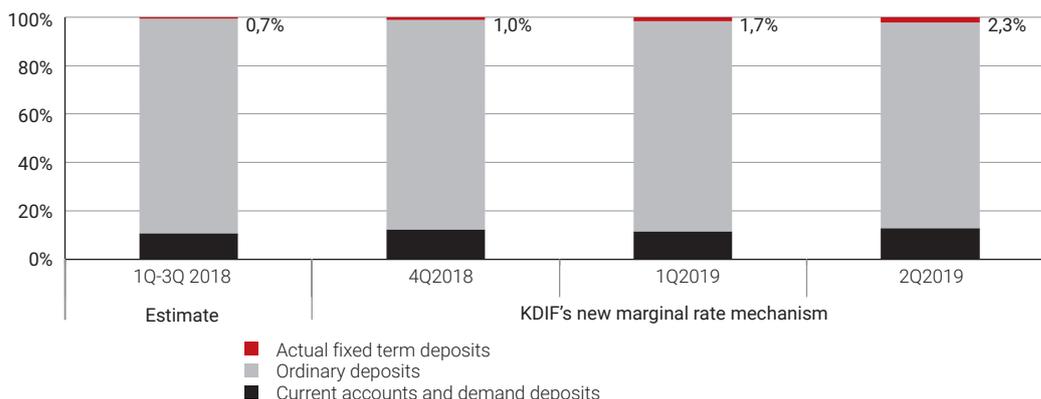
time, business divisions played a decisive role in the development of conditions for deposit products without coordinating it with the risk division and the treasury.

The Basel Committee on Banking Supervision recommends taking into account the risk of early withdrawals on fixed term deposits both within the framework of the bank's risk management system and within the framework of prudential regulation (LCR / NSFR). The world practice shows that banks reduce the risk of early withdrawals when fixed term deposit agreements have discouraging conditions, such as the loss of a significant portion of remuneration, mandatory advance notice of early withdrawals, etc.

To develop the deposit market by market mechanisms without direct regulatory bans, to extend the funding base of the banks, and to reduce interest risks, the National Bank, together with KDIF, implemented the following measures:

- KDIF's new mechanism of marginal rate on population tenge deposits was introduced from 4Q2018, and on population foreign currency deposits, 2019 - for foreign currency deposits. The new mechanism provides for (1) the binding of marginal rates to market rates and their differentiation by the deposit term; (2) the introduction of a regulatory definition of fixed term deposits to manage the risks of early withdrawals in the pricing of deposits; (3) valuation of the right to replenish (see a Box 5.1)
- at a regulatory level: 1) savings deposits have been introduced with increased returns and a higher sum of state guarantee and discouraged early withdrawals (loss of remuneration and mandatory 30-day notice of early withdrawal); 2) deposits with floating rates are set out by the law; 3) banned remuneration on current accounts and limited rate on demand deposits at a level of not more than 0.1% per annum.

**Chart 5.11 Role of actual fixed term deposits in banks' retail funding remains insignificant but grows rapidly**



After the transition to the new system of marginal rates, the banks became very active in offering actual fixed term deposits. Nevertheless, the share of such funds in the structure of household deposits remains extremely low, just over 2% by the end of the first half of 2019, however it continues to grow rapidly (Chart 5.11). There are no statistics on the corporate sector, but unhealthy competition in the deposit market suggests that the volume of actual fixed term deposits of legal entities is also insignificant.

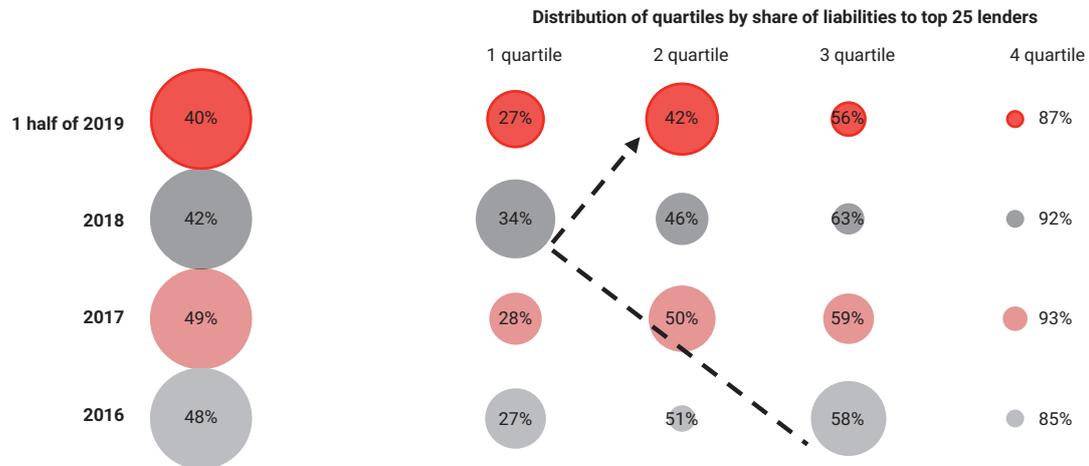
**To further increase the sustainability of funding and properly respond to risks, the regulator and the banks themselves have to take measures. In particular, the regulator should introduce a regulatory definition of maturity of deposits in prudential instruments (LCR / NSFR) and enhanced supervision within the framework of Basel recommendations (Pillar 2). In turn, banks need to continue strengthening the risk management system and give more space for risk**

**takers and treasurers when setting interest rates on deposit products.**

**Funding Concentration.** The share of top 25 creditors, of which more than two-thirds are state-owned companies, amounted to 40% of banks' liabilities (49% at the end of 2017). The reduction in liabilities during the reporting year and a half occurred for all groups of top creditors, including large retail depositors and non-state legal entities.

Analysis of the risks of creditors concentration in the banks shows that the group of small banks remains to be the most exposed, and the share of top creditors in their liabilities averages 87% (Chart 5.12). The share of liabilities of large banks to top 25 creditors gradually decreased from 58% at the end of 2016 to 42% at the end of the first half of 2019.

**Chart 5.12 Major lenders and depositors are concentrated in large banks, but the concentration problem is most acute in several small banks**



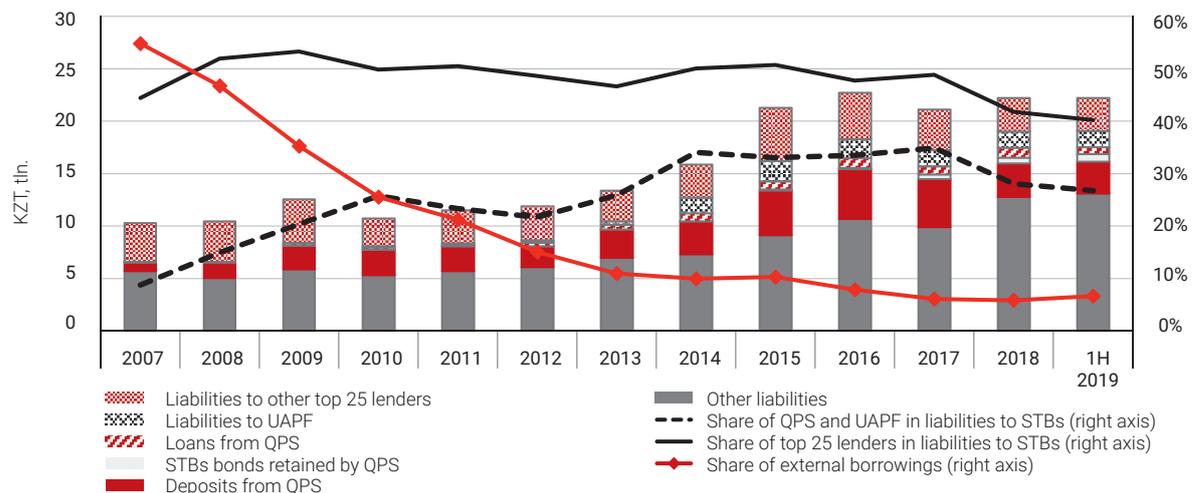
Source: STB reporting

Note: The ranking and distribution of quartiles is done according to the share of top 25 creditors for a given bank in the bank's liabilities: 1 quartile - banks with the smallest share of top creditors, 4 quartiles - banks with the largest share. The bubble area is proportional to the share of quartile banks' liabilities in sector liabilities. Inside the bubble, the quartile average share of top creditors is indicated.

**Dependence on State-Owned Companies.** The problems of high concentration of funding, dependence on the public sector and low sustainability of funding are closely intertwined. The share of state-owned companies sharply increased after the 2008 crisis against the background of reduced access to external borrowing. In 2007-2017, the share of public and quasi-

public sector and UAPF in the structure of liabilities increased from 10% to 35% alongside the decrease of external funding (from 55% to 6%). By the end of the first half of 2019, the share of funding from state-owned companies and government agencies decreased and amounted to 27% of banking sector liabilities (35% at the beginning of 2018) (Chart 5.13).

**Chart 5.13 Since mid-2018, the share of the largest funding, including from the public sector, has been gradually decreasing, but remains significant**



Source: STB reporting

Note: PQPS - public and quasi-public sector. Liabilities to UAPF include liabilities on deposits and securities. Other liabilities include liabilities to other non-PQPS or major lenders.

Over 55% of funding from the public sector was raised in most unstable and expensive form, as deposits. Nevertheless, despite the decreased share of deposits in raised funding from the public sector (from 67% at

the end of 2017), its value remains significant. Over the reported 1.5 years, the volume of deposits of state-owned companies in banks decreased by 1.6 trillion tenge. The level of state-owned deposit funds was

reduced to repay external debt and convert deposits into bonds. In addition, in anticipation of the merger of two backbone banks, deposit funds were withdrawn from them by a large state holding, also on the advice of one of the banks.

In some banks, mostly small ones, the share of the public sector in funding in some periods was 100% (Chart 5.14A). At the same time, some banks raised all funding as public sector deposits (Chart 5.14B).

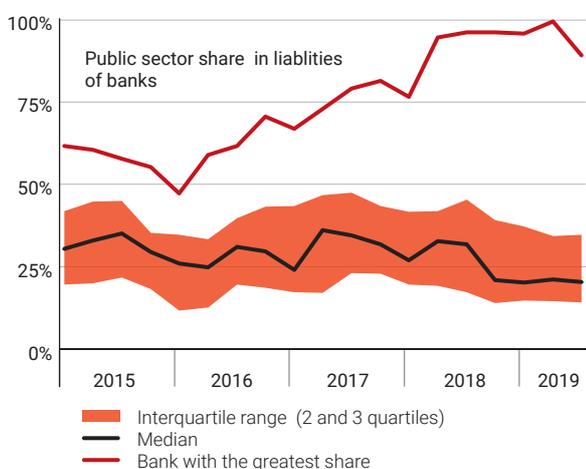
The risks of funding from the public sector are associated, firstly, with the funding of under-capitalized

and insolvent banks, and, secondly, with fiscalization of losses of insolvent banks to reduce losses of state creditors.

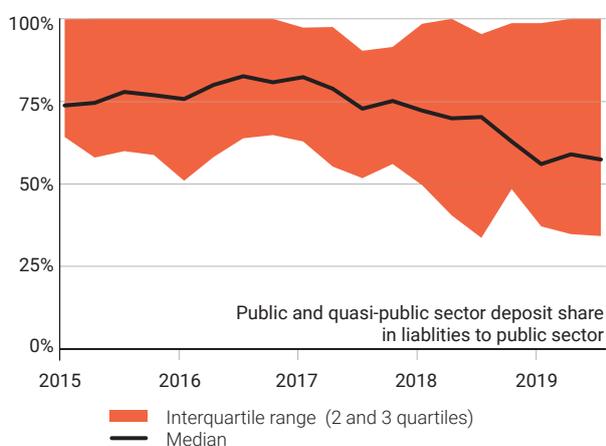
In the first case, market actors have distorted motivation and behavior; in the second case, the chances of an orderly bank solvency resolution without loss transfer to the public sector are limited. These risks are less obvious than the risks inherent in market funding, but their behavioral implications pose greater threats to the sustainable development of the financial sector and financial stability.

Chart 5.14

A. The public sector funds more than a half of some banks' liabilities



B. Funds are raised mainly by non-term deposits



Source: STB reporting

**High dependence of bank provisioning on state sector cannot be solved immediately and requires comprehensive and consistent work of the banks, the regulator, and the public sector. Banks need to improve funding risk management systems, including the estimate of sustainability of corporate deposit funding. The regulator is required to take into**

**account risks specific to funding from QPS as part of risk-based supervision model. Quasi- and public sector should work to strengthen its autonomy when selecting banks for the placement of temporarily free liquidity.**

### 5.3. DOLLARIZATION AND FX RISKS

Risks associated with dollarization of deposits remain high despite a decrease of dollarization level from 47% in 2018 to 43% in the first half of 2019. Dollarization decreased against the background of growing retail tenge deposits and declining large size foreign currency deposits. Potential de-dollarization may occur in public medium-sized deposits, which is no longer valid for small-sized deposits. Large-sized depositors still prefer foreign currency deposits.

Dollarization puts pressure on tenge liquidity against enhanced external shocks and increased currency risks. Banks have limited capability to manage dollarization risks amid limited availability of long-term market hedging instruments. Direct currency risk is negligible. Indirect foreign exchange risks have decreased, but remain high despite a decrease in the share of foreign currency loans. Significant unrealized indirect currency risk is associated with unrecognized losses on foreign currency loans.

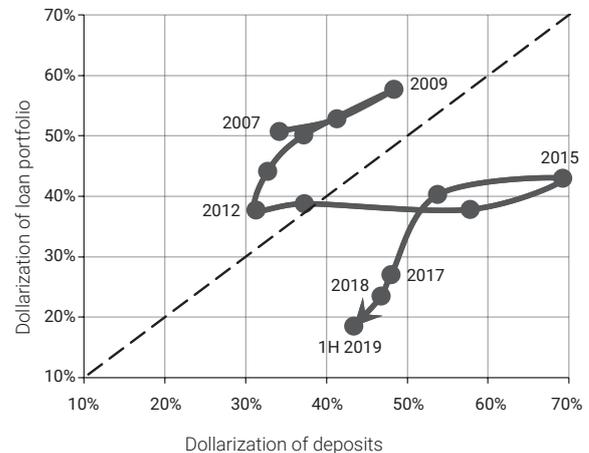
**To reduce dollarization risks, a flexible exchange rate should be maintained, foreign currency lending discouraged, and institutional reforms carried out for economic diversification and decreased vulnerability to external shocks.**

High level of deposit dollarization remains the main vulnerability factor on the funding side of the banks, despite its decline from 47% in 2018 to 43% in the first half of 2019. In recent years, deposits' de-dollarization process has slowed down as such, loan portfolio has de-dollarized in a more active way (Chart 5.15). This is due to the redemption and write-off of the foreign currency loan portfolio, including as part of bank recovery measures, as well as owing to enhanced risk weighting in prudential standards.

Further de-dollarization will require macroeconomic stability, maintenance of credibility of the floating rate and inflation targeting, adequate factoring of indirect forex risks within prudential regulation, as well as the adoption of countercyclical fiscal rules.

Banks have limited capability to manage the risk of deposit dollarization. The key factors affecting dollarization levels are the weakening tenge and declining oil prices. The effect of exchange rate revaluation significantly affected the level of dollarization during the fixed exchange rate period in 2014-2015. After the transition to flexible exchange rate, the effect of revaluation on dollarization levels has decreased significantly (Chart 5.16).

Chart 5.15 *De-dollarization of deposits in 2018-2019 was slower than de-dollarization of loan portfolio*



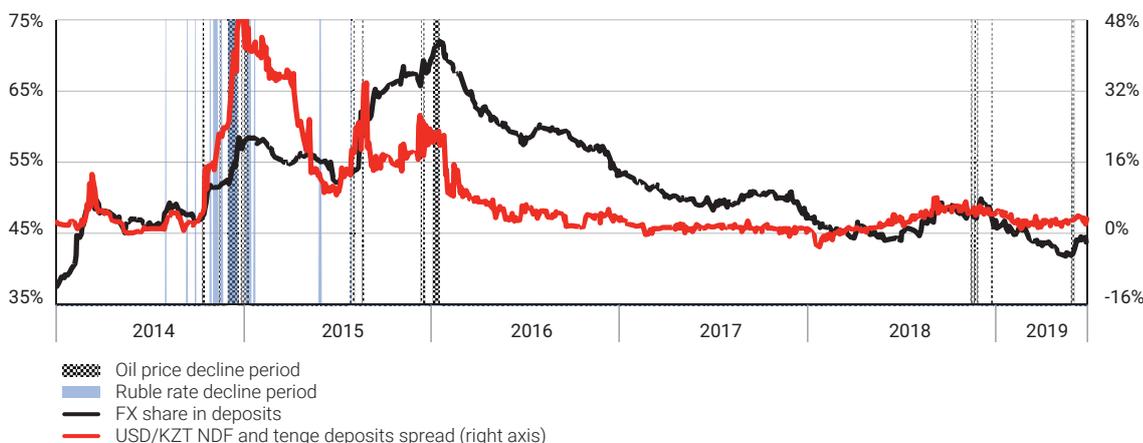
Source: STB reporting

Note: Data at the end of the period

Dollarization process in Kazakhstan has the following characteristics depending on subject, type and size of a deposit:

1. Dollarization in retail deposits is concentrated in fixed term deposits (49%) and in the corporate segment on transaction accounts (49%, Chart 5.17).
2. Dollarization of household deposits depends on a deposit size: the larger a deposit is, the higher its dollarization level (Chart 5.18). In the first half of 2019, dollarization of retail deposits under 1 million tenge amounted to 10%, and over 500 million tenge, to 84%. Therefore, chances are that medium-sized deposits of households may be de-dollarized, which is no longer valid for small-sized deposits; large-sized depositors still prefer foreign currency deposits.

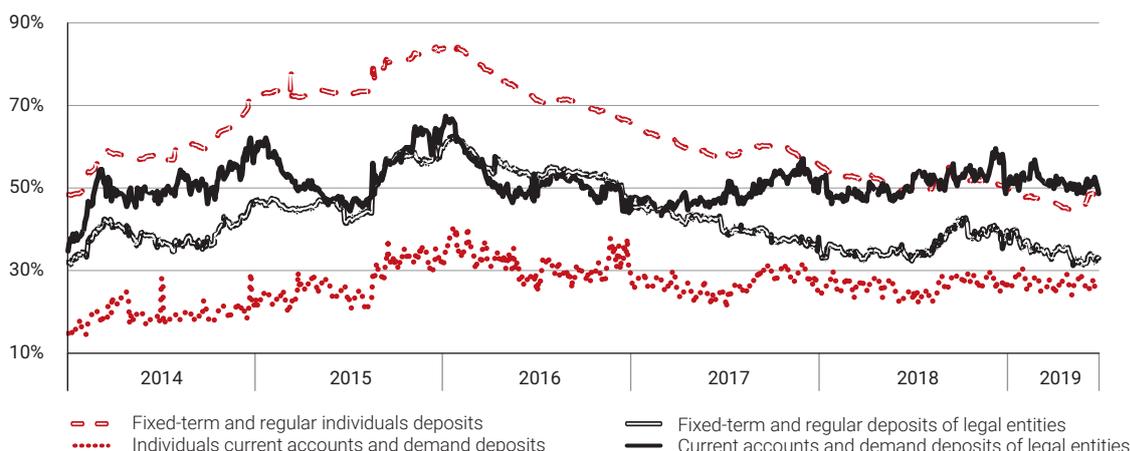
**Chart 5.16 Exchange rate expectations drive liability dollarization which intensifies during a period of external volatility**



Source: STB reporting.

Note: Ruble rate decline period – significant devaluation of Russian ruble with respect to Kazakhstan tenge.

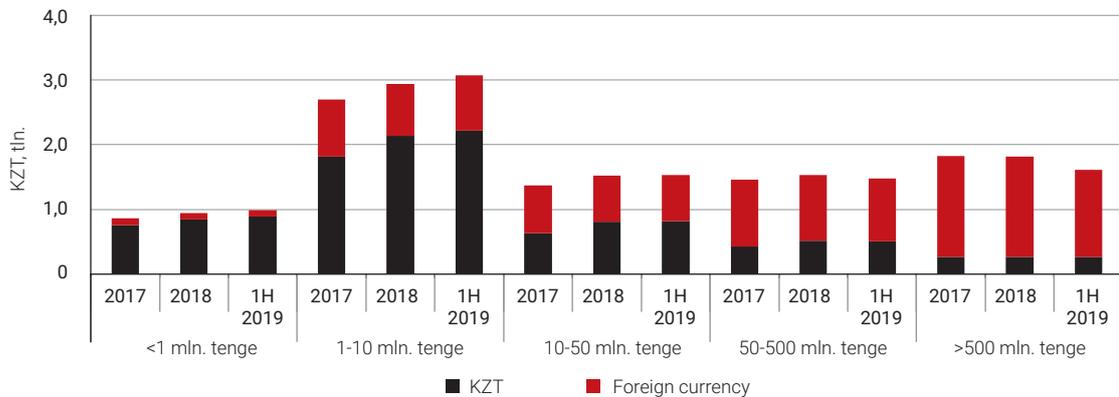
**Chart 5.17 In compare with current accounts, dollarization of household fixed term deposits is higher, when in the corporate sector it is vice versa**



3. Between 2018 and the first half of 2019, small-sized tenge deposits of the population have increased (790 billion tenge) and large-sized foreign currency deposits exceeding 50 million tenge have outflown (275 billion tenge, [Chart 5.19](#)). It is likely due to more attractive profitability rate of foreign investment instruments. The largest decline in the corporate sector, according to the National Bank, was observed in quasi-public sector ([Chart 5.20](#)).

In second quarter of 2019, to prevent the outflow of foreign currency deposits from the system, the National Bank together with KDIF, introduced changes to marginal rates mechanism by increasing the yield on actual fixed long term foreign currency deposits to 2%. Further liberalization of the rates on foreign currency deposits may currently lead to increased risks in the banking sector. In particular, this can lead to an increase in the rates way above the level of banks' placement capability.

**Chart 5.18 The larger household deposit, the higher dollarization level; de-dollarization potential remains for medium-sized deposits**



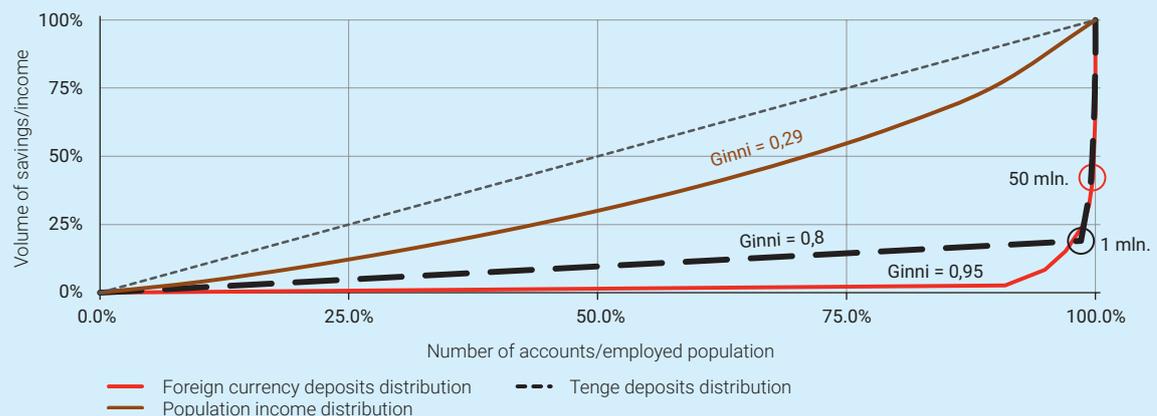
Source: KDIF

### Box 5.1. Evaluation of Household Deposit Even Distribution

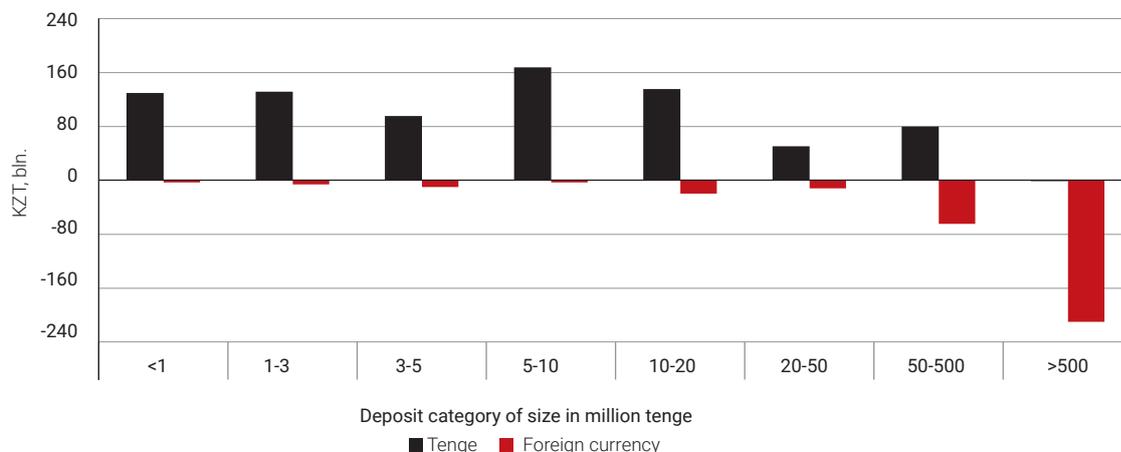
Gini index-based assessment of even distribution of household deposits shows that foreign currency deposits are distributed less evenly than tenge deposits. Major foreign currency deposits are concentrated on the bulk of savings, while small-sized tenge deposits are spread across a large number of accounts. In particular, national currency

deposits under 1 million tenge make 99% of tenge accounts and 19% of their funds volume; foreign currency deposits over 50 million tenge account for 0.3% of foreign currency accounts and 58% of their funds volume (Chart 1). It should be noted that population incomes, as compared to deposits, are distributed almost evenly.

**Chart 1 Evaluation of even distribution of household deposits**

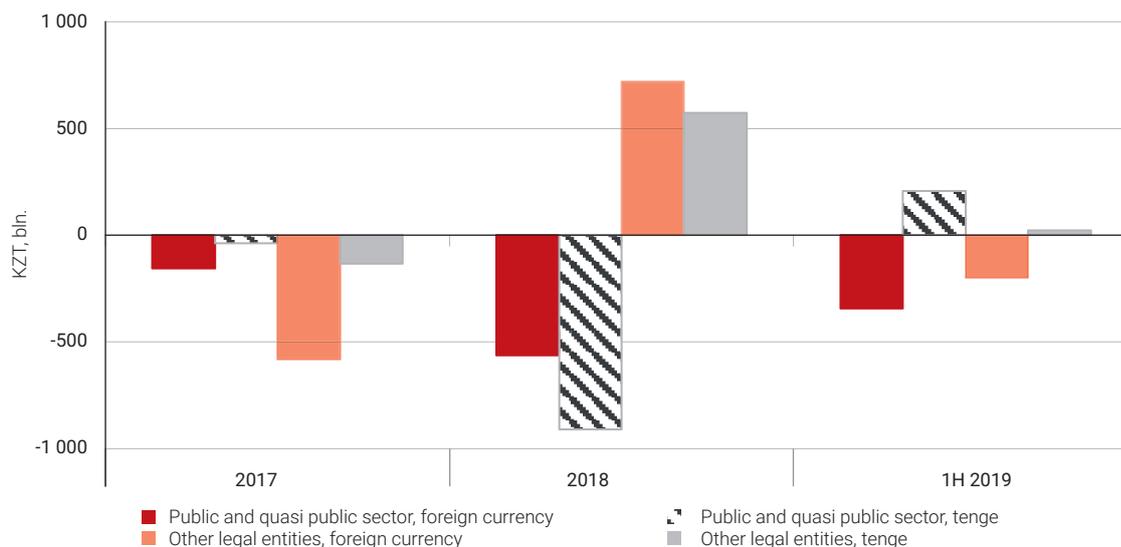


**Chart 5.19** *Main inflow of retail deposits between 2018 and the first half of 2019 was driven by small-sized tenge deposits; level of large-sized foreign currency deposits has been declining*



Source: KDIF

**Chart 5.20** *In the corporate sector, quasi-public organizations experienced the biggest decline of foreign currency and tenge deposits*



Note: NBK Assessment based on top 25 creditors. 1H2019 – half year change

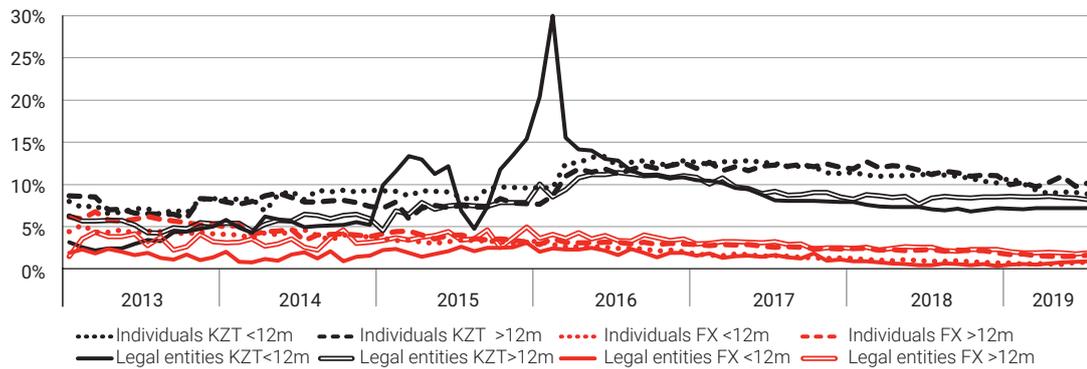
At the same time, banks still actively mobilize foreign currency funding (Chart 5.21), and the ability of the banking system to introduce a pricing policy for deposits with a factor of funding risks, including foreign exchange risks, remains limited.

At the individual bank level, coordination between business units and risk management units remains low. At the system level, the ability of the banks to set risk-taking rates is also constrained by increased competition for foreign currency deposits of the banks with weak capital and liquidity positions. The shift towards growth following undermined stability, higher risks and the quality of financial intermediation have become the causes of bank losses over the past decade.

**Forex Risk.** Direct foreign exchange risk is negligible, net open foreign exchange position (ORP) in relation to capital in the system stands at 0.5% (with a standard of 25%). Indirect foreign exchange risks remain high, despite a reduced share of foreign currency loans from 27% to 19%. Unrealized indirect currency risk is associated with unrecognized losses on foreign currency loans.

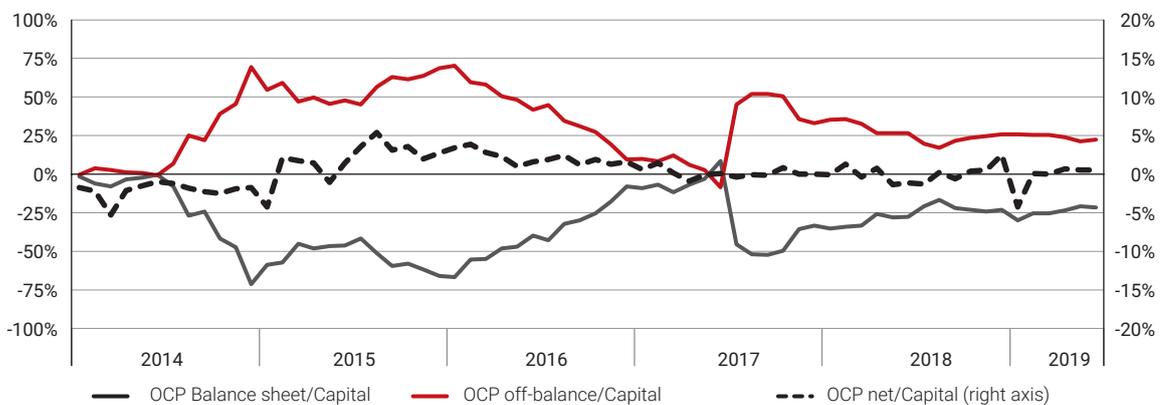
Between 2018 and the first half of 2019, the gap between balance sheet and off-balance sheet positions decreased (Chart 5.22).

Chart 5.21 Attraction cost of tenge and foreign currency deposits gradually decreases



Source: STB reporting

Chart 5.22 Significant short balance sheet position offset by long off-balance sheet position to maintain direct forex risk at an acceptable level



Nevertheless, banks are forced to maintain a significant long off-balance sheet position to neutralize a short position on the balance sheet that emerged as a result of high dollarization of liabilities. To reduce forex risk, banks use mainly short-term financial derivatives. For

effective management of forex risk, long-term market hedging instruments should be developed and indirect forex risks shall be further factored within prudential regulation.

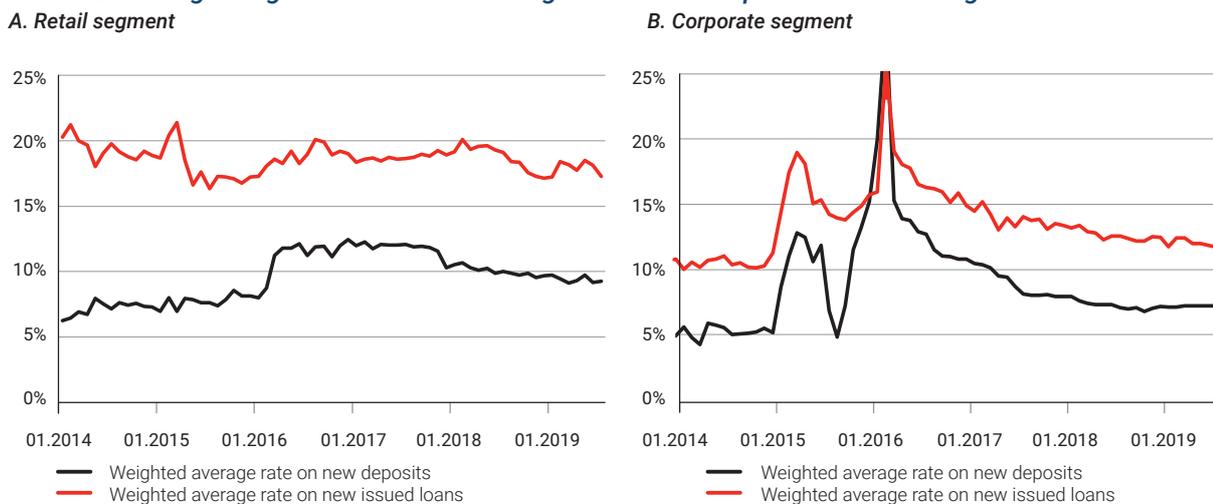
## 5.4. INTEREST RATE RISK

**The transition to inflation targeting and predictability of monetary policy allowed banks to manage interest rate risks, which are currently low, in a more effective way. Since 2018, interest rates on deposits and loans have decreased. However, the spread of placement and mobilization rates has decreased, as deposit rates have declined to a lesser extent than loan rates. To properly price deposit funding and reduce interest rate risks, the National Bank in 2018 introduced a mechanism to factor the value of replenishment rights on deposits.**

Between 2018 and the first half of 2019, interest rates on issued loans and deposits of individuals and legal entities have decreased. Weighted average interest

rates on new tenge deposits of individuals decreased by 1.3 points, and on issued tenge loans - by 1.9 points. As a result, the spread of placement rates and mobilization rates in the retail sector amounted to 8.0 percentage points by the end of the first half of 2019 against 8.6 percentage points by early 2018 (Chart 5.23A). Weighted average rates on deposits of legal entities decreased by 0.7 percentage points, on loans by 1.5 percentage points, and led to a narrowing of interest rates and placement rates spread by 0.8 percentage points to 4.5 percentage points (Chart 5.23B).

**Chart 5.23 Average weighted rates are declining both on new deposits and new tenge loans**



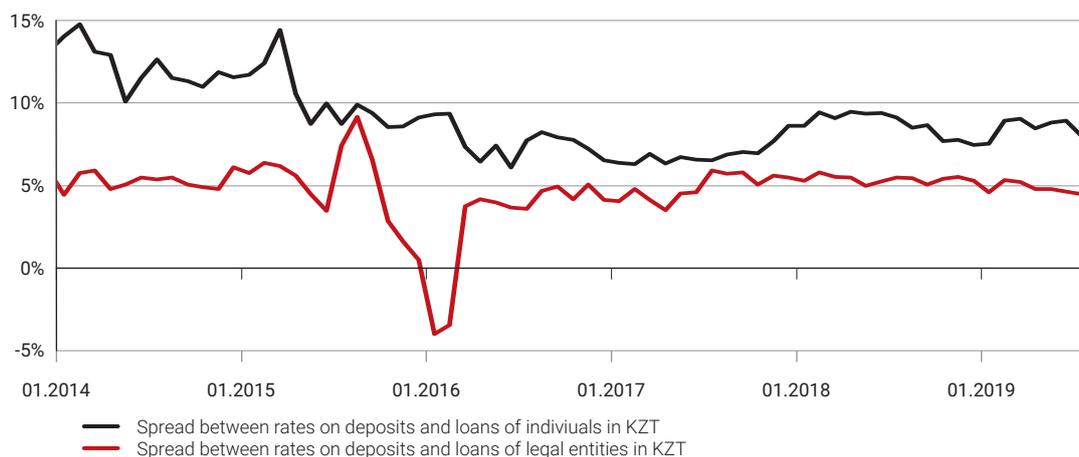
Source: STB reporting

Note: Mobilization rates are the average weighted rates on deposits mobilized over the reporting period (new deposits and replenishment of previously opened deposits). Placement rates byb are the weighted average rates for new bank loan agreements signed during the reporting period. Retail segment are deposits and loans of individuals, corporate segment includes deposits and loans of the legal entity. The reporting period is a month.

The review of deposits' marginal rates by Kazakhstan Deposit Insurance Fund (the KDIF) was a contributing factor to the reduction of deposit rates in the reporting period. This also included a newly introduced mechanism of marginal rates that cover the risks of early withdrawals and replenishment rights.

Between 2018 and the first half 2019 the decrease in interest rates on new loans was observed at most banks. Interest rates on loans decreased to a greater extent than interest rates on deposits, which has led to decreased interest spread. At the same time, the interest spread in the retail sector is higher than in the corporate sector following higher interest rates on consumer loans (Chart 5.24).

**Chart 5.24 Spread between interest rates on loans and deposits is reducing both in corporate and retail segments**



In 2018, in order to reduce interest rate risks associated with replenishing previously opened deposits at higher rates than set out in newly signed agreements, the National Bank introduced a model the factor the value

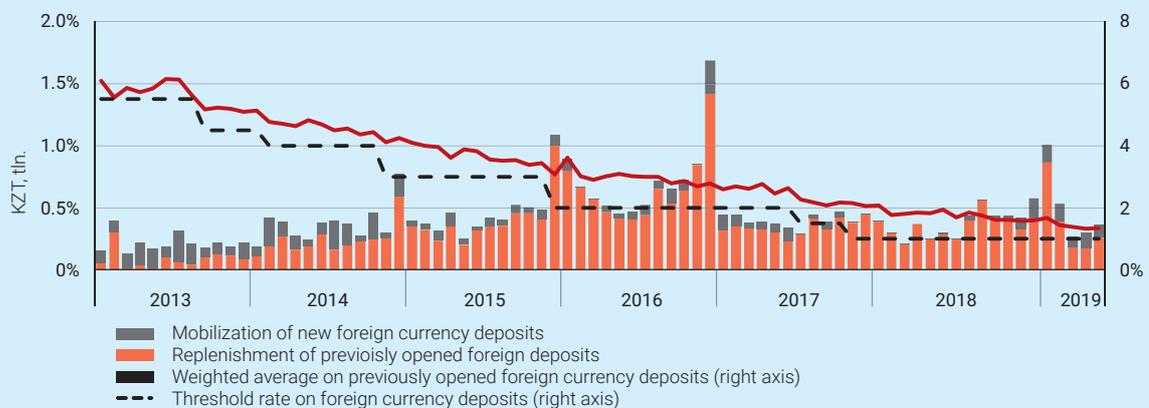
of replenishment rights when setting deposit rates. A detailed model for assessing the value of replenishment rights is given in Box 1.

### Box 5.2 Right to Replenish a Deposit at a Fixed Rate – Unaccounted Interest Risk of Banks

Almost all banks on the deposit market of Kazakhstan provide depositors with the right to replenish the deposit. In 2016, 83% of analyzed contracts set out the right to replenish. Such deposits, combined with a fixed rate and a long-term period, are a source of optional interest rate risk for the banks. Should market interest rates be lower than the deposit rate,

a depositor will be able to save at a rate higher than the market, and the cost of funding for the banks will remain at a high level until the expiry date of previously opened deposits. This increases interest risks and average cost of funding for the banks and reduces the efficiency of KDIF's threshold rates.

**Chart 1. During a decrease of market interest rates, funds were raised mainly on account of the replenishment of previously opened deposits**



Source: KFDI, STB reporting, National bank assessment

The Basel Committee on Banking Supervision (the BCBS) (2016) divides optional interest rate risk into automatic and behavioral. The automatic option risk comes from instruments with explicit built-in options. The behavioral option interest rate risk is posed by flexible terms of the instruments that change customer behavior when interest rates change. In case of deposit products, this is a replenishment of a deposit with a fixed rate against the background of market rates lowering. Basel recommends taking into account the behavioral optional interest rate risk when developing stress test scenarios and evaluating losses in case of changes in interest rates and customer behavior.

With effective pricing, the optional interest rate risk should be taken into account when setting the deposit rate, namely, the rates on deposits with replenishment option, with all other equal conditions, should be lower than on deposits without replenishment option. Kazakhstan banks failed to factor optional interest rate risks when setting deposit rates. So, in 2016, most banks that

had deposits with restricted replenishment right had set the rates on deposit with replenishment option at the same or higher level than on deposits without replenishment option.

To keep the records of optional interest rate risks, in 2018 the National Bank together with the KDIF introduced a differentiated regulation of deposit market rates. Under the new mechanism<sup>1</sup> marginal rates on replenished deposits have to factor the value of deposit replenishment option. The model for estimating the value of fixed-rate replenishment option is a modified Black Swaption pricing model (1976) with numerous assumptions<sup>2</sup>.

<sup>1</sup> The methodology for determining and establishing the maximum interest rate for new deposits of individuals is approved by the Board of Directors of Kazakhstan Deposit Insurance Fund (KDIF).

<sup>2</sup> For more details see article by I. Alimbetova and Ye. Mustafin (2019) "Methodology for Assessing the Right to Replenish a Bank Deposit at Primary Interest Rate".

Under KDIF's marginal rate methodology, the value of deposit replenishment option is calculated by the formula (1):

$$RRV_t = e^{-R_t \cdot t} [MRR_t \cdot F(-d_2) - F^d \cdot F(d_1)] \cdot t/2 \cdot k \quad (1)$$

with:

**RRV<sub>t</sub>** – KDIF's maximum remuneration rate on new deposits with t being a term;

**F<sup>d</sup>** – forward rate on deposits on the date t / 2 and for the term t / 2. The forward rate of deposits is calculated on the forward rate of government securities (GS) and the spread between the deposit market and the government market;

**F** – cumulative standard normal distribution;

**k** – deposit replenishment coefficient, represents the ratio of the volume of expected replenishment in relation to the primary deposit;

**R<sub>t</sub>** – GS rate of return with maturity t;

**t** – deposit period expressed in years.

The ratios d1 and d2 are calculated by the following formulas:

$$d_1 = (\ln F^d - \ln MRR_t) / \delta + \delta / 2$$

$$d_2 = d_1 - \delta$$

with:

**δ** – interest rate volatility reduced to half of a deposit term  $\delta = \sqrt{250 \cdot t/2}$

**δ<sup>d</sup>** – long-term expected daily volatility of interest rates.

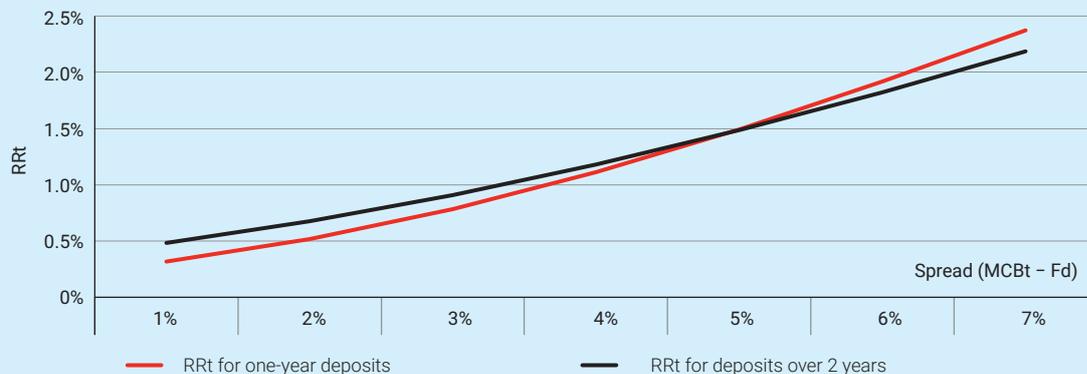
The value of replenishment option is converted into the annual effective rate by formula (2) and is used as a spread between the maximum rate on deposits without replenishment right and deposits with the right to replenish according to the formula (3):

$$RR_t = (1 + RRV_t)^{1/t} - 1 \quad (2)$$

$$MRR_{rr} = MRR_t - RR_t \quad (3)$$

Thus, according to this model, the value of the deposit replenishment right mainly depends on the maximum deposit remuneration rate (**MRR<sub>t</sub>**) and the forward deposit rate (**F<sup>d</sup>**). *Chart 2* shows how the value of the right to replenish deposits with a term of 1 and 2 years increases with the spread (**MRR<sub>t</sub> - F<sup>d</sup>**). In other words, the value of the right rises when the proposed deposit rate significantly exceeds the projected interest rate.

**Chart 2. Sensitivity of a value of the right to replenish option**



The presented model does not claim to be accurate in assessing the losses incurred by the bank in case of replenishment of each individual deposit. The amount of losses on an individual deposit depends on such hard-to-predict factors as the level of market interest rates and replenishment volume. However, this formula gives an average risk assessment for the system, and the application of a separate maximum deposit rate with the right to replenish is aimed at reducing systemic risks.

The introduced mechanism for factoring of the value of the right to replenish a deposit allows to eliminate pricing distortions on the deposit market and reduce interest risks of the banking sector. At the same time, the goal of introducing the methodology was to build the culture of risk management in the banks and enhance their motivation to factor interest rate risks in funding costs.

## Section 6.



# FINANCIAL SECTOR CONCENTRATION



**In 2018, the concentration of the banking sector continued to rise following reorganization and liquidation of insolvent banks. Amid enhanced concentration, the revision of criteria for classification of backbone banks, prevention of the union of the banks with high credit risk and low asset quality and unresolved capital issues, and enhancement of efficiency of identification and bank settlement mechanisms have become relevant.**

**Consolidation of insurance companies continued to grow steadily and reached the level of the banks. The concentration of management companies remains extremely high.**

Mergers and acquisitions as well as the retreat of insolvent financial institutions affected all financial sectors, especially over past five years (Chart 6.1). Consolidation and liquidation predominantly covered organizations in transit or difficult financial situation as well as organizations that were not solvent to continue further activities.

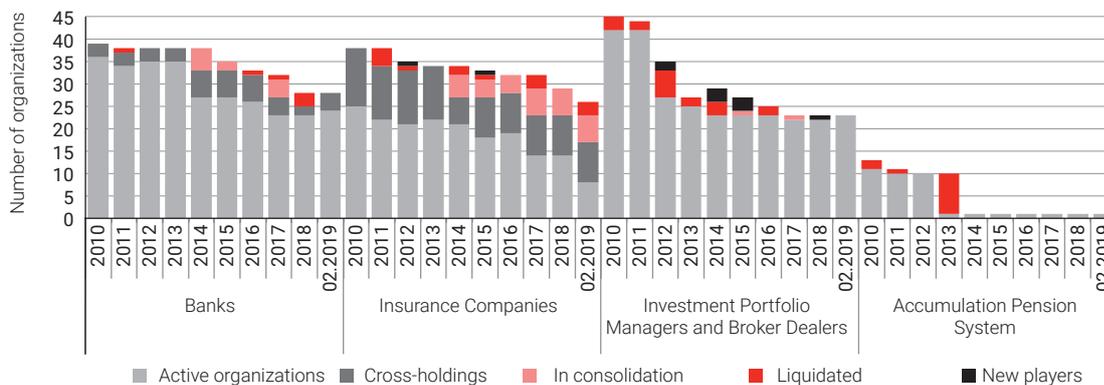
In general, market consolidation processes were the anticipated trend after shocks of the financial sector in 2014-2015. In 2014, the state withdrew its share from the equity of three previously sanitized banks, which resulted in two major consolidation transactions between JSC Alliance Bank, JSC Temir Bank and their sale to JSC Forte Bank, and a transaction for concurrent exchange of assets and liabilities between JSC

Kazkommertsbank and JSC BTA Bank. Also in 2014, a foreign JSC HSBC Bank Kazakhstan abandoned the market, and its shares were repurchased by JSC Halyk Bank. In 2015, JSC Eurasian Bank absorbed small JSC EU Bank (former JSC BankPositive Kazakhstan). Since 2017, two backbone banks - JSC Kazkommertsbank and JSC Halyk Bank launched their merger. The reasons behind consolidations of 2014-2017 were the requirements of enhanced efficiency and regulatory compliance, which was difficult for the banks to fulfill. Resources of the banks with excess capital were redistributed on the market to support low capital banks.

However, over past five years, five insolvent banks had their licenses revoked, including JSC Kazinvestbank in 2016, JSC Delta Bank in 2017, JSC Qazaq Banki, JSC Astana Bank, and JSC Eximbank in 2018, which led to consolidation. In 2017, the P&A transaction was first carried out with assignment of claims and liabilities of an insolvent bank to a healthy bank, where a part of assets and liabilities of the liquidated JSC Kazinvestbank was transferred to JSC Subsidiary Alfa Bank.

At the same time, the financial sector retained the potential to merge cross-holding companies<sup>20</sup> that operate in one sector under the control of a parent organization, whether a single shareholder<sup>21</sup> or affiliated through the management. In early 2019, there were cross-holding companies in the banking sector that could be united.

Chart 6.1 Consolidation affected all Financial Sectors, Number of Companies decreases



Source: National Bank

Note: Cross-holdings are the companies managed by a parent organization, a single shareholder (s) owning more than 5% of voting shares, or affiliated through management.

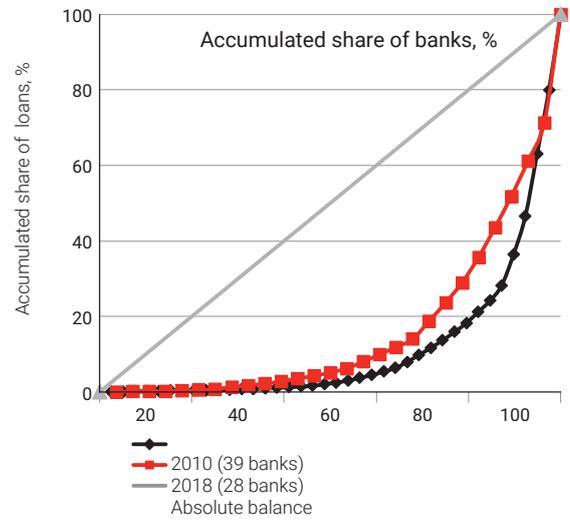
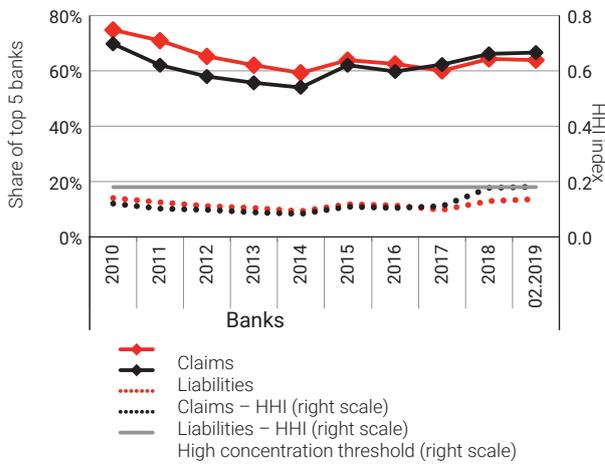
In 2018, a merger of two backbone banks and a retreat of insolvent banks from the system boosted sector concentration (Chart 6.2). The Herfindahl-Hirschman loan portfolio index was 0.13 and reached a high level

of concentration - 0.18 on client deposits following the merger and the ongoing overflow of deposits to larger banks.

<sup>20</sup> Historically, previously existing cross-holding companies were either consolidated or liquidated.

<sup>21</sup> A shareholder owning over 5% of company's voting shares.

**Chart 6.2 Concentration of the Banking Sector Enhanced, While Uneven Distribution of the Loan Portfolio Continues to Decline**



Source: National Bank

Note: Bank claims represent a loan portfolio, and liabilities are customer deposits. HHI - Herfindahl-Hirschman index, is the sum of squares of market shares of all banks. The following interpretation of the index values is generally accepted: below 0.10 - low concentration, from 0.10 to 0.18 - medium level, above 0.18 - high.

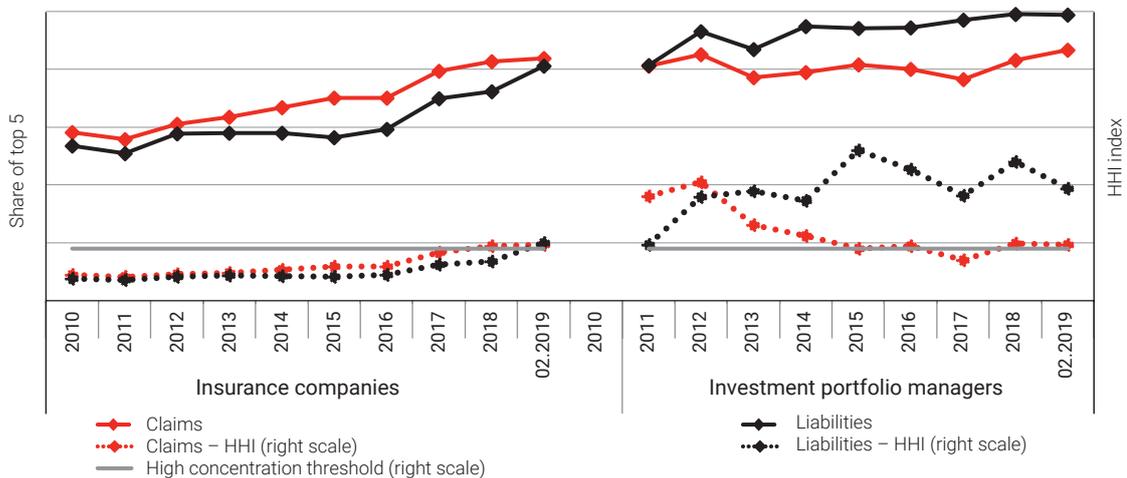
Source: National Bank

Note: Chart shows a degree of imbalance in the distribution of loan portfolios in the banking sector in 2010 and 2018.

In the insurance sector, the concentration level follows that of the banks, as two-third of the market is controlled by bank shareholders. Low financial literacy of the

people, less competitive markets of small insurance and investment sectors are the main reasons behind high concentration for these groups (Chart 6.3).

**Chart 6.3 Concentration in the Insurance Sector grows for seventh consecutive year**



Source: National Bank

Note: Requirements for insurance companies are the insurance reserves, and total assets for investment portfolio managers. The liabilities of insurance companies are the insurance premiums, and that of the portfolio managers are the liabilities.

The issue of reforming the pension asset management system remains open. Since 2014, when pension assets in the hands of private companies were merged and transferred to the National Bank, the level of concentration in the sector remained extremely

high, competition and the level of assets managed by voluntary institutional investors were extremely low.

Under the pressure of poor asset quality on capital, individual banks treat consolidation as a chance to

enhance efficiency, find more stable partners and raise additional capital. In 2018, a number of banks announced their intentions to merge, however, the merger of these banks was suspended because the union of such banks disabled the clearing of loan portfolios problem loans and injection of required capital.

For the market to function effectively, unification of the banks with high credit risks and low asset quality with unresolved capital issues shall not be accepted. Settlement of the issues of the banks with low asset quality and increased credit risks lies beyond the process of consolidation. As such it can facilitate the dilution of already low capital, the transfer of problems to the market, and pose a threat to stability of the sector and the funds of depositors.

## Prospects for the Development of Competition on the Financial Market

The transfer of assets under the management of private companies planned in the pension sector will help to solve the problem of high concentration and promises to create the basis for a more sustainable mechanism capable of perceiving and transmitting market discipline signals, for the improvement of management efficiency and the efficiency of issuers and the economy. As for the market development, the appearance of institutional

investors who manage pension assets will create a more competitive environment and thereby decrease the level of concentration in the securities market. In 2021, Kazakhstan's financial market will welcome branches of foreign companies, and this will require Kazakhstani companies to enhance efficiency, and be financially and technically ready.

## Systemic Relevance

Following consolidation of the banking sector, the issue of defining and intensifying the regulation of backbone banks becomes relevant. Systemic relevance is associated not only with the size of the banks but also with banks' domination in key segments of the financial market and concentration of a notable volume of operations in their business. Backbone banks bear extra responsibility for business performance, thus, they need to enhance their stability and take into account implications of their possible insolvency, reducing their impact on the financial sector.

Today, international practice sets toughened regulatory requirements to national backbone banks, including requirements to stress tests, capital adequacy, liquidity, risk management systems, development of solvency settlements plans – living wills. Since 2015, the National Bank introduced higher capital adequacy requirements for backbone banks.

In part, the risk of backbone banks are associated with the risks of the settlement of the troubled banks (for more details, see Section 7.2), which are manifested in the use of ineffective settlement methods, and, in particular, the practice of using public funds to sanitize the banking sector. Measures designed to reduce risks of excessively large banks can be divided by stages of their implementation:

- transfer of costs of third parties and other implications caused by concentration to backbone banks that create them;

investors who manage pension assets will create a more competitive environment and thereby decrease the level of concentration in the securities market. In 2021, Kazakhstan's financial market will welcome branches of foreign companies, and this will require Kazakhstani companies to enhance efficiency, and be financially and technically ready.

- reduction of the likelihood of events of backbone banks creating systemic risks, including loss of capital;
- reduction of the dependence of the entire sector on a large bank in case the event occurs;
- enhancement of the efficiency of settlement mechanisms that will reduce social losses in the settlement of banks without fiscal support and speed up the settlement process (P&A transactions, setting up of a stabilization bank – a bridge bank, forced restructuring of bail-in obligations);
- strengthened independence and credibility of the regulator for making decisions as regards the backbone banks.

For the banking system as a whole, the decisive factors for the risk reduction will include enhanced market stability, development of infrastructure and appropriate institutions, including valuation and independent audit operations, rationality of prudential requirements, quality and intensity of supervision, requirements for corporate governance and risk management systems, and quality of regulatory reporting.

## Section 7.



# VII. REGULATORY REFORMS ON RISK-BASED SUPERVISION AND BANKS REGULATION



In 2018, a legislative reform was implemented to strengthen the supervisory mandate of the National Bank with the introduction of risk-based supervision and the principles of supervisory judgment. The principle of proportionality of supervision has been introduced, which involves the application of measures taking into account the size, significance, complexity and risks of financial institutions. A step-by-step approach to the application of supervisory measures starting from advisory measures with their subsequent tightening in case of failure to eliminate the identified risks is secured in legislation.

A new mechanism was launched to identify and regulate the operations of insolvent banks with a view to minimize implications for the system and losses to the government. The process of identification and settlement of problem banks and their classification by financial conditions is now regulated. The law defines the triggers and the term for such banks' capital increase, thus enabling the separation of supervisory measures and settlement measures

and contributing to more efficient decision-making process on insolvent banks.

The regulator is now provided with a full set of settlement tools, including mandatory liabilities restructuring (bail-in). The settlement process is now carried out without approval of shareholders and creditors and in accordance with the priority order of creditors and mandatory independent valuation of bank's property. In addition, restrictions have been introduced in terms of state participation only if the liquidation of a bank entails systemic risks. The regulator has been granted the grounds to void the transactions through the court, featuring asset stripping and priority pull-out of individual creditors shortly before the bank is declared insolvent.

The key phase of full-fledged transition to the new supervision regime is conduction of an independent bank asset quality review in 2019. The review helps to diagnose the real situation at the banks, rationalize regulatory requirements for capitalization and take necessary measures to improve the banking sector.

## 7.1. RISK-BASED SUPERVISION AND SUPERVISORY JUDGEMENT

Regulatory amendments of 2018 related to risk-based supervision and resolution of insolvent banks (hereinafter - the Law on Risk-Based Supervision) are an important contributor to financial stability and reduced level of accumulated systemic risks.

Risk-based supervision enables the regulator to interpret the operations of the banks and assess their conditions based on a combination of factors, and not by formal characteristics only. The principles of risk-based supervision are widely used in international practice as a key element of effective banking supervision<sup>22</sup>. A central element of risk-based supervision is the new supervisory model based on the European Union's SREP (Supervisory Review and Evaluation Process) model. SREP's general principles rest upon four fundamental elements: (1) business model analysis, (2) assessment of corporate governance, including the assessment of internal risk management system, (3) assessment of capital adequacy for risk coverage, (4) assessment of liquidity adequacy for risk coverage. The assessment of these elements enables the detection of negative changes in the financial conditions of the banks at early stages and taking of necessary supervisory and corrective measures in a timely and adequate manner.

The legislative expansion of the forms of supervisory response makes it possible to gradually apply supervisory measures through regulatory recommendations to the bank with subsequent tightening of measures in case the identified risks are not eliminated. Supervisory

measures will be applied on the basis of the principles of proportionality, legality, reasonableness, objectivity and a uniform approach. This will lead to flexible regulation of the financial institutions activities of, considering the systemic importance, complexity of activities and related risks.

A comprehensive analysis of the bank's activities includes an assessment of their development plans, risk compliance with bank's strategy and business model, resources and bank's ability to maintain a transparent and controlled business. The supervisor's close interaction with the banks assumes to improve the weaknesses in the risk management system, corporate governance, procedures that set the necessary level of capital and liquidity for risk coverage, and, thus, quality management at the banks. The risk-based supervision becomes efficient when the supervisor is independent and enabled to act upon supervisory judgement that ensures flexible and fast decision-making process. Supervisory judgement is a sound professional opinion of regulator's collective entity, which lies behind supervisory response measures. The mechanism of supervisory judgement is required to settle the accumulated systemic problems of the banking sector such as poor quality of the loan portfolio, lending to banks' related parties and asset stripping, poor quality of risk management systems, reporting, independent evaluation, as well as inadequate responsibility of banks' managers and owners.

<sup>22</sup> Fundamental principles of effective banking supervision set by the Basel Committee on Banking Supervision (September 2012).

Prior to the introduction of regulatory amendments, the National Bank could use supervisory measures only when legal requirements and prudential standards were violated. This entailed poor efficiency of the regulator's supervisory functions, as the banks applied a number of schemes to show their formal compliance with legislation and regulations.

As part of its supervisory functions, the National Bank has identified most common schemes used to lower the provisions and conceal the actual capital level in the reports:

- 1) restructuring of loans of insolvent borrowers, usually de facto affiliated with the bank, by way of constant prolongation of loan payment term or offering a grace period for loan repayment with principal payments scheduled at the end of the period. The banks could thus categorize non-performing loans as standard loan package and defer the date of recognition of losses and provisioning for them;
- 2) overpricing of pledge value and recording of cash flows on pledges with legal risks and unlikely repayment sources, including cash flows on facilities yet to be operationalized; attached property; guarantees and corporate and individual sureties uncorroborated by a documented proof of solvency; insurance contracts outlining numerous grounds for claim denials etc. Overstated value of collaterals and cash flows enabled the banks to underestimate provisions, not recognize losses and hide actual capital level;
- 3) transfer of problem loans to Distressed Asset Management Company (DAMC), which are banks subsidiaries and its large borrowers at the same time. As a result, the banks financed the acquisition of problem loan by DAMC and its asset price recovery. In addition, problem loans were transferred to debt collection companies with subsequent repayment option. As a result, significant risks remained on the bank side at a consolidated level, and they were not shown in the reports and prudential capital ratios (see Section IV. Credit Risk). To settle this, in parallel to introduction of risk-based supervision, the shift to consolidation based prudential regulation is required.

As part of its supervisory activities, the National Bank has also identified loan issuance schemes where credit risks of individuals, de facto affiliated parties to bank management or owners, were not properly assessed, and where such individuals could not be formally categorized as affiliated parties by law. The loans were issued at low interest rates to inadequately solvent borrowers who had no high-quality collateral. As a result, affiliated lending has become the main channel for asset stripping, as well as the main reason behind low quality of assets and risk management system, and unreliable bank reports.

A key element of regulatory amendments in the definition of related parties is the notion of presumption of affiliation, by which the burden of proof on the lack of affiliation is transferred to the bank. The "presumption" of affiliation enables the regulator identify related parties of banks by indirect characteristics, such as non-market conditions for transactions, extension of loan to financially unstable borrowers without a high-quality collateral etc.

As part of the risk-based supervision, the "audit of other information" has also been introduced. This includes the assessment of risk management and internal control systems, corporate governance, strategy and business models, information technology systems, information security, as well as countering the legalization of proceeds from crime and the financing of terrorism. The supervisor is entitled to request an audit of other information if risks and deficiencies in the operations of financial institutions are identified, to establish issues for the audit, to set requirements for audit organizations and agree on the audit plan. The audit of other information provides for an assessment of most risky activity areas of financial organizations for early interventions and timely and effective measures to prevent widespread risks.

It should be noted that the introduction of risk-based supervision does not eliminate all the risks associated with the activities of financial institutions, however, it enables the regulator to apply preventive and effective measures to reduce the risks according to the problem scale. At the same time, banks should ensure that adequate risk management system is available that matches the current market situation, development strategy, size and level of complexity of the bank's operations. In order for the banks to independently and efficiently manage risks inherent in their activities and to properly build the processes required for risks management, the National Bank adopted new requirements for risk management systems at the banks shifting a focus from formal requirements to principles.

The adopted regulatory amendments related to the expansion of supervisory mandate created the legal basis for the National Bank to conduct an independent asset quality review (AQR) of the banks in 2019 and take corrective measures based on its results. AQR is a universally recognized international practice for restoring the confidence of international investors in the banking system and attracting private funding for lending to the economy through profound and extensive verification of assets and capital adequacy. An independent quality review will make it possible to diagnose actual situation of the banks, assess their losses and capital adequacy, as well as provide reasoning behind regulatory requirements for recapitalization and develop further

measures for banks' improvement, also at the expense of bank shareholders and creditors.

In the first half of 2019, the National Bank laid the basis for AQR. With assistance from an international consultant, the AQR methodology (based on the methodology of the European Central Bank) was adapted and approved, and a loan portfolio of the banks to be evaluated was selected. The audit covered 14 banks that account for about 87% of all the assets in the banking system. AQR is planned to be complete by the end of 2019.

Based on the results of a comprehensive audit, individual corrective action plans for each bank from the audit will be developed and approved, among which recapitalization of banks financed by current shareholders. In addition, AQR results will be widely applied by supervisors. The methodology and knowledge gained will be used in the ongoing supervisory process. Quantitative and qualitative results will be accommodated in the risk-based supervision, as well as the supervision capital markup, a new supervisory tool.

## 7.2. IMPROVING THE BANK IDENTIFICATION AND SOLVENCY RESOLUTION MECHANISM

Regulatory reforms taken to introduce a new mechanism for insolvent bank identification and solvency resolution include a full range of measures based on international principles of effective bank solvency resolution:

### 1. The process of bank identification and solvency resolution is regulated.

Prior to the adoption of the Risk-Based Supervision Law, bank identification and solvency resolution was not a regulated process. There were no triggers (grounds) in the legislation for the mandatory recognition of a bank as insolvent and the application of resolution measures. This made the procedures for problem banks' identification and shareholder responsibility less transparent, entailed the delays in adoption of retaliatory measures, and enhanced the regulator's reputation and legal risks.

The new resolution, which entered into force in 2019, classifies problem banks according to their financial situation. At the regulatory level, triggers have been defined to identify problem banks, as well as the time limit for raising the capital of such banks. In particular, problem banks can be classified as follows:

- 1) banks with unstable financial position. The regulator classifies banks as such, even though they have not formally violated prudential standards. The reason lies in significant risks detected in the activities of such banks, including unrecognized losses, that if shown in the financial statements, would constitute violation of capital requirements. The period for enhancing stability (capitalization) of the bank should not exceed one year, but can be extended as a one-off option if financial condition has improved;
- 2) insolvent banks. If a bank with an unstable financial situation fails to improve its financial condition within the time period established by the law, the regulator recognizes it as insolvent. The regulator

is entitled to declare a bank insolvent earlier than established by the law. The reason behind this is the fact that the bank has entered into transactions that worsened its financial condition, including transactions on non-market conditions, bank's failure to take measures to improve the financial condition, as well as a decrease in capital adequacy ratios (to 1/3 of the normative values).

The regulation of problem bank's identification process and established triggers and time limits by law will enhance the transparency of such measures and efficiency of the required measures.

### 2. The regulator has been given a full mandate to promptly resolve bank solvency issue while minimizing systemic implications and government losses, including:

- 1) **The introduction of mandatory restructuring of liabilities of an insolvent bank (bail-in)**, with a partial sharing of losses with large creditors after the absorption of losses by bank's shareholders. Prior to the introduction of the new mechanism, regulatory provisions set out only voluntary restructuring of bank liabilities if approved at least by 75% of creditors, which limited the possibility of distributing losses to creditors and minimizing state losses in case of bank settlement.

The bail-in mechanism entitles the regulator to make a decision on the conversion of the liabilities of an insolvent bank to large creditors into equity, their partial write-off, or amendment of the terms and liabilities rates.

To reduce the risks of contesting a forced restructuring of international liabilities of the banks (in particular, on Eurobonds) regulated by foreign law, requirements have been introduced for the mandatory incorporation

of rules on forced restructuring in securities prospectus of the banks as per foreign legislation.

It should be noted that the bail-in mechanism, as well as other settlement measures, applies only to insolvent banks that are subject to liquidation, without the need for this mechanism. In the event of liquidation, the bank's assets will not cover liabilities to all creditors. Therefore, the introduction of bail-in is seen as a mechanism that allows unguaranteed and unsecured creditors to have clearly defined rules and regulations by the law for the return of their capital (part of the capital) once solvency and reputation of the bank are restored.

## 2) Bank solvency resolution tool in force before the adoption of regulatory reforms were improved

(transfer of assets and liabilities of an insolvent bank to another bank or stabilization bank). In particular, international principles have been implemented to increase the efficiency and effectiveness of the resolution regime, including protective mechanisms for creditors / depositors. In particular:

- coordination of settlement measures with depositors and creditors is no longer required; other barriers (including tax) that rendered the measures inefficient and entailed further collapse of the value of the insolvent bank have been removed. According to the new resolution regime, the property, including collateral, is registered upon a single agreement on the simultaneous transfer of assets and liabilities without payment of registration fees / charges. This will reduce the time and financial costs during the transfer of assets and liabilities of an insolvent bank;
- observance of the rights and interests of creditors / depositors in accordance with the priority hierarchy established in the framework of the bank's liquidation and with preliminary dilution (deletion) of the share of shareholders;
- the introduction of a compensation mechanism for depositors and creditors if, as a result of resolution measures, they incur more costs than liquidation itself, taking into account the opinion of an independent appraiser;
- restrictions have been introduced that provide for state participation in the bank solvency resolution process only if forced liquidation of such banks carries systemic risks to the financial system, and only after equity and liabilities to related creditors (bail-in) are covered;
- the introduction of a mandatory assessment of the financial and property status of the bank, including by appraisers, audit and other organizations, before taking bank solvency resolution measures.

Moreover, regulatory amendments were developed and adopted in 2019, by which the reversal of bank solvency resolution decisions should not entail changes or terminate legal implications arising from the adoption of these decisions (introduced from January 1, 2020).

## 3) The grounds have been introduced upon which the regulator may cancel, by court, transactions featuring asset stripping and priority pulling of creditors shortly before bank's insolvency.

As practice shows, with worsening financial situation, the management and owners of the troubled bank would withdraw assets by selling them at non-market prices, replacing collateral, and issuing bad loans, thus bringing losses to the bank and worsening asset quality. Also, shortly before banks' insolvency, deals are made to settle the claims of some large creditors / depositors. These transactions collapse the value of the bank's assets, violate the interests of other depositors and creditors, and also increase government spending if public funds should be used for bank solvency resolution.

To return the assets stripped in such fraudulent transactions and as a result of prioritized upholding of claims of the creditors shortly before bank's insolvency, the regulator is now enabled to cancel such transactions, by court, including at the request of the creditors, prosecuting their decision-makers.

## 4) The mechanism of financing bank resolution process is separated from liquidity support to solvent banks that experience temporary difficulties, by improving the mechanism of the loans of last resort (LLR) subject to international best practice.

Previous legislation did not have regulation of the terms of extension of loans of last resort (hereinafter - LLR) only for solvent banks secured by assets and market rates. This enhanced the credit risks of the National Bank and created a conflict of interests with the monetary and credit policy.

To limit liquidity support to insolvent banks through the LLR mechanism and to eliminate the risks of an ineffective settlement under the Law on Risk-Based Supervision, the National Bank improved the LLR mechanism based on best international practice. The revised mechanism, which entered into force in 2019, provides for LLR only to solvent banks that experience temporary liquidity problems. LLR is extended only if fully collateralized and in national currency for a period of up to 3 months with one-year prolongation option.

In addition, to improve access of solvent banks to LLR, the list of collateral has been expanded. Non-market assets, aside from market assets, such as a high-quality loan portfolio and bank real estate, can be accepted as collateral.

## Section 8.



# CORPORATE BANKRUPTCY



**Creating conditions for the improvement of enterprises through enhanced efficiency of bankruptcy procedures is a priority task for ensuring financial stability. Without effective bankruptcy institute, the economy cannot be market-based and efficient. Ineffective bankruptcy institute increases credit risks of the banks and makes no contribution to the reduction of historically high level of non-performing loans. As a result, property of insolvent debtors is not a part of economic turnover and loses its liquid value; this limits the scope of economic cleansing of insolvent enterprises and the level of lending to the real sector of the economy.**

**In the first half of 2019, a significant regulatory reform was introduced to provide absolute priority to a security lender within the bankruptcy framework. However, many other fundamental problems of Kazakhstan's bankruptcy institute remain unresolved. In particular, rehabilitation and bankruptcy procedures are yet to be launched, controlled, and made in the collective interests of creditors. They are launched late, with delays, costly, not transparent, and entail assets stripping. Legislation and law enforcement practice are incompliant with the principles of protection of rights of secured creditors, especially during the rehabilitation process.**

**Gaps in corporate bankruptcy legislation coupled with low qualifications of the parties to a bankruptcy process in financial analysis and corporate law, offer loopholes for insolvent debtors to evade liability. In practice, there are no restructuring options that would call for control transfer to creditors. Liquidation accounts for more than 90% of resolution cases. As a result, insolvent debtors have no assets when corporate bankruptcy procedures are launched, with the exception of collateral, which is often low quality.**

**In addition, the debtor's restructuring procedure should be controlled by creditors and give no chance to insolvent debtors to evade liability. It is required that parties to the bankruptcy procedures develop their qualifications; also law enforcement practice, including statutory interpretation by the Supreme Court and its mandatory compliance, methodological recommendations and requirements for financial analysis performed by administrators, and mandatory reasoning of court decisions must be developed. Further enhancement of efficiency of the bankruptcy institute requires streamlining of bankruptcy procedures and terms, taking into account the interests of creditors, including the priority right of mortgage lenders and application of well-established mechanisms for collateral transfer to a mortgage lender.**

An effective bankruptcy institute is predictable and enhances investor confidence by enabling the restructuring of problematic but viable companies, and orderly market-based disengagement of insolvent and non-viable companies with the lowest loss of value to investors. A well-established bankruptcy institute helps to raise investments, ensure efficient allocation of resources in the economy, reduce the risks to the financial sector and the cost of credit for creditworthy borrowers, and quick return of collateral into the country's economic turnover.

In the first half of 2019, regulatory amendments were adopted to offer absolute priority of collateral lenders. However, many of the fundamental problems of the bankruptcy institute, including problems of regulatory control, the lack of adequate mechanisms to protect the interests of creditors, problems with judicial and law enforcement practice, administrators' functions, and compliance with the principles of business ethics remain unresolved and call for revision.

At the regulatory level, international principles of effective rehabilitation and restructuring of insolvent debtor offered by international practice to ensure even distribution of potential losses associated with the restructuring between the debtor and the creditors are not fully implemented. The guideline for fair distribution is the assessment of losses of creditors and the debtor during liquidation of the company. This requires an independent assessment of the financial situation and valuation of debtor's property to develop a debt restructuring scheme taking into account the interests of creditors.

In addition, inadequate qualifications of the parties to a bankruptcy process (administrators, judges, creditors) in financial analysis and corporate law become loopholes for insolvent debtors to evade liability and strip assets. At the same time, the risks of expiration of the limitation period for invalidation of debtor's unfair transactions increase, which reduces the chances to return the stripped assets and hold a decision-maker of such transactions liable.

The mismatch between the development of the bankruptcy institute and the needs of the market economy has confirmed several facts:

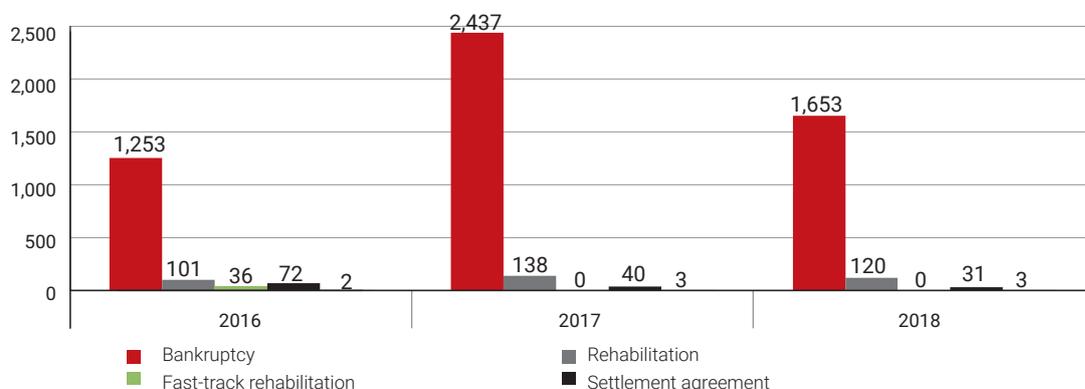
#### **1. The main solvency resolution mechanism in Kazakhstan is the bankruptcy (enforced liquidation).**

Law enforcement practice shows that despite a number of procedures in the Bankruptcy Law for retrieval of solvency and preservation of the debtor, the vast majority of cases result in debtor's liquidation. In 2018, as in previous years, over 90% of corporate resolution cases ended with enforced liquidation

(Chart 8.1). Enforced liquidation is seen as the least desirable option that entails high losses for creditors, the debtor, and the economy; the company's property is

usually sold in parts, undermining its value, offering low repayment level to the creditors and social stress due to rising unemployment.

Chart 8.1 The Often Practiced but Least Effective Solvency Resolution Option is Bankruptcy (Liquidation)

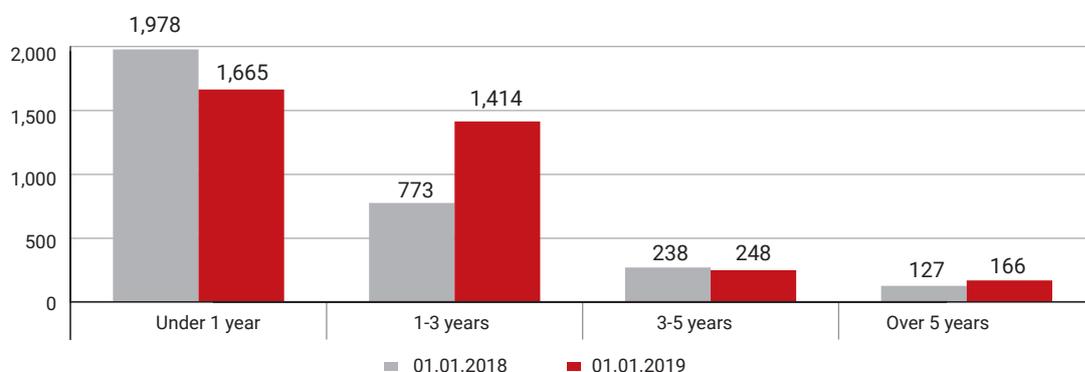


Source: CSR IFRC

**2. Long term corporate bankruptcy.** As of 01.01.2019, more than half of the bankruptcy proceedings have lasted for over a year, and every tenth procedure, for more than three years. Over this period, debtor's property ages, loses market value; as a result, the

creditors' losses, especially collateral, increase. At the same time, bankruptcy periods tend to get longer. As of 01.01.2019, a number of companies in bankruptcy under 1 year decreased by 19%, and over 1 year increased by 56% (Chart 8.2).

Chart 8.2 Duration of Bankruptcy Proceedings for Insolvent Companies as of 01.01.2018 and 01.01.2019

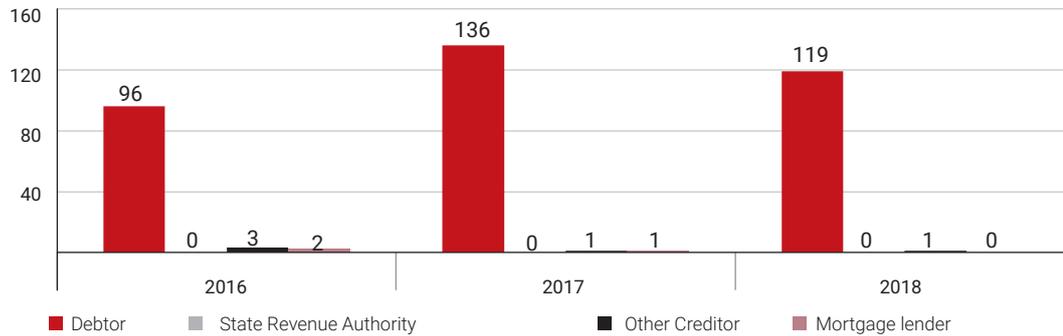


Source: CSR IFRC

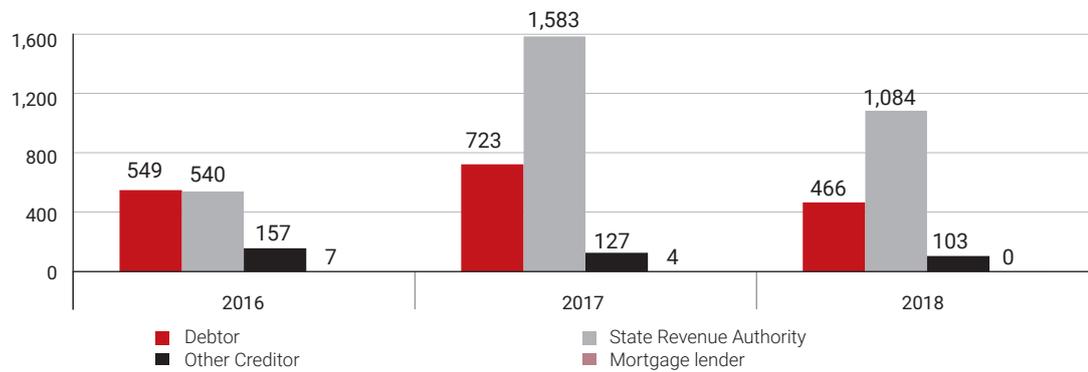
**3. Low interest of creditors in rehabilitation and bankruptcy procedures.** corporate lenders, including mortgagees, are not interested in rehabilitation and bankruptcy procedures. In 2018, there was not a single process launched by mortgage lenders. In most cases, bankruptcy proceedings in Kazakhstan are launched by tax authorities or debtors, and the rehabilitation procedures, by debtors (Chart 8.3A and Chart 8.3B).

Chart 8.3 *Initiators of Rehabilitation and Bankruptcy Proceedings*

8.3A. *Debtors are the Main Initiators of Rehabilitation Proceedings*

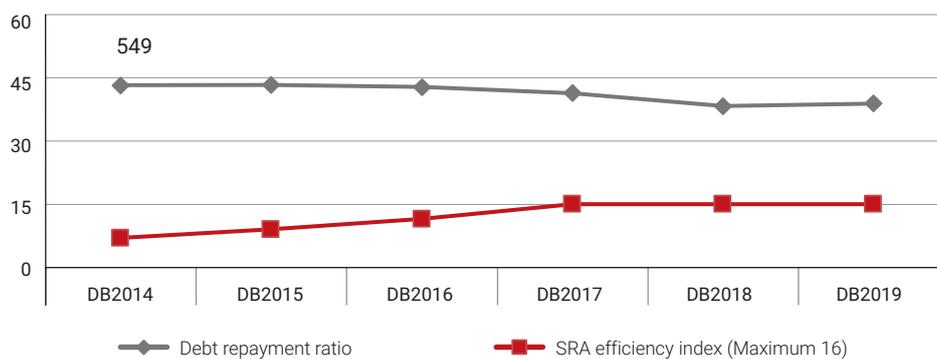
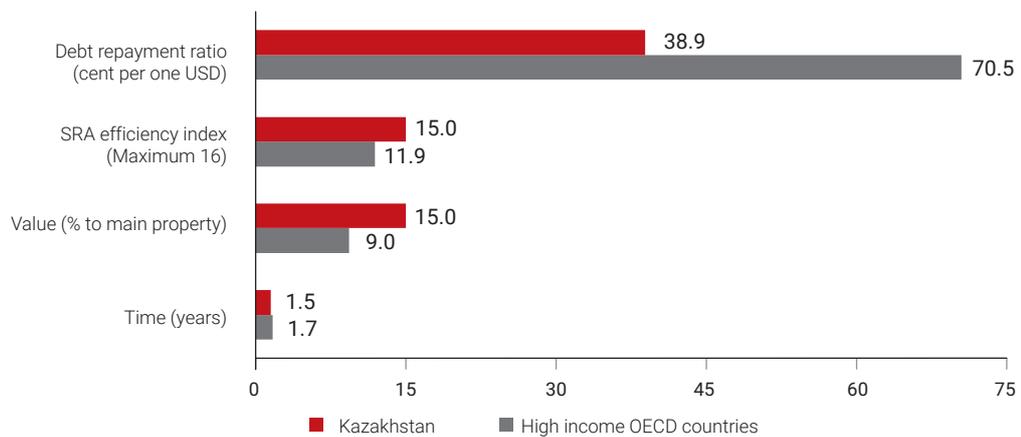


8.3B. *State Revenue Authorities and Debtors are the Main Initiators of Bankruptcy Process*



Source: CSR IFRC

Chart 8.4 *Insolvency Resolution Index Indicators*



Source: World Bank 2019 Doing Business Report

**4. Low indicators that characterize the efficiency of bankruptcy proceedings.** According to the World Bank (Doing Business Report 2019), the bankruptcy efficiency indicators in Kazakhstan remain low: the debt repayment ratio in Kazakhstan is almost 2 times lower than in OECD countries, and costs are 1.6 times higher. At the same time, the debt repayment rate has been decreasing since 2014, despite continuous improvement of the legislation, making Kazakhstan reach the highest SRA efficiency index rating (1st place in the world, [Chart 8.4](#)).

It should be noted that high SRA Performance Index level was attained following 2014-2018 regulatory reforms, which include: (1) expansion of the rights of creditors, including granting creditors the right to launch rehabilitation procedures, appeal court decisions and administrator's actions during rehabilitation or bankruptcy procedures, to request information from the debtor and administrator; (2) optimized voting process of lenders' voting on rehabilitation plans; (3) an established mechanism to get a loan to finance debtor's current expenses after the launch of solvency resolution proceedings.

However, the fragmented nature of regulatory changes on the improvement of Kazakhstan's position in the World Bank rating and ineffective law enforcement practice disable comprehensive resolution of the problems of the bankruptcy institute.

The analysis of existing corporate bankruptcy mechanism by the National Bank revealed the following main shortcomings in the legislation and judicial and law enforcement practice, including the institute of administrators:

#### **1. Limited powers of creditors and the lack of mechanisms to protect their interests within rehabilitation and bankruptcy framework.**

Kazakhstan's bankruptcy law provides for a series of procedures aimed at restoring debtor's solvency, including: (1) fast-track rehabilitation; (2) solvency resolution, and (3) rehabilitation.

At the same time, none of the indicated procedures has implemented a mechanism to protect creditors' rights and interests, especially the collateral, as provided for by international best practice. Rehabilitation procedures are yet to be launched, controlled, and made in the collective interests of creditors. In particular, in rehabilitation procedures, the role of creditors is limited to approval of a rehabilitation plan that is developed and submitted to the administrator by the debtor itself. As a result, in the absence of the debtor's consent, the creditors cannot incorporate necessary measures into the plan to secure themselves from debtor's dishonest acts. Basically, the rehabilitation procedures boil down to deferring debt repayment without debtor's systematic

reorganization that could enable an insolvent company to overcome a crisis. As a rule, this enables only temporary deferrals of the company liquidation, but makes no contribution to its recovery.

The biggest restriction of creditors' rights and interests of creditors and biggest chance for a debtor to evade liability lie within the fast-track rehabilitation procedure that has no option of termination of debtor's right to manage property. In addition, the laws on fast-track rehabilitation contain a number of unreasonable benefits for the companies-recipients of state support; this completely deprives creditors of the control over procedure implementation. In particular, in relation to such companies: (1) approval of the plan by a majority of creditors is not required, and this is the violation of the rights and interests of the creditors; (2) the terms may be set by the debtor independently with no account for regulatory restrictions (may be longer than 2 years). Such regulatory norms undermine the essence of fast-track rehabilitation and enable debtors to abuse the rights granted to them.

#### **2. Restrictions on invalidation of a debtor's fraudulent transactions shortly before bankruptcy.**

One way to maximize the value of the assets of an insolvent debtor in the interests of creditors is to invalidate by court debtor's fraudulent transactions done in anticipation of the bankruptcy with stripping of assets; this includes non-market based transactions and the prioritized satisfaction of individual creditors. It is thus possible to return the assets stripped by the debtor through identification of abuses and holding decision-makers in such transactions liable.

The Bankruptcy Law sets out a challenging mechanism for such transactions. However, bankruptcy law on invalidation of fraudulent transactions has some restrictions that reduce the effectiveness of such a mechanism:

- 1) rules on invalidation of transactions set out in the Bankruptcy Law are not applicable to fast-track rehabilitation and solvency resolution procedures. This allows unscrupulous debtors to abuse these procedures to evade liability;
- 2) delayed launch of rehabilitation and bankruptcy procedures increases the risk of expiration of the limitation period for invalidation of debtor's bad faith transactions, which reduces the possibility of returning the stripped assets and holding officials accountable.
- 3) deliberate loss of accounting documentation leads to failed analysis of transactions done shortly before the bankruptcy procedure. This complicates claim-making against the debtor, invalidating transactions, returning property, and holding debtor officials accountable.

### **3. Restrictions on bankruptcy procedures by request of a single creditor.**

As part of a survey conducted by the National Bank in 2018, banks noted that courts refused to declare a debtor bankrupt at the request of a sole creditor. This is due to the fact that the Bankruptcy Law contains provisions that enable the courts' refusal to declare a debtor bankrupt at the request of a sole creditor, unless the creditor is a tax authority. This limits the ability of the creditor to launch bankruptcy proceeding and delays the recognition of an insolvent debtor as a bankrupt, which entails the undermining of the value of the debtor's assets and increases the losses of the creditors.

### **4. Disadvantages of the judicial practice of bringing debtor officials to subsidiary liability for failure to take measures to recognize a debtor bankrupt in a timely manner.**

One of the ways to protect the interests of creditors and stimulate company management to take timely measures to declare a debtor bankrupt is to bring officials to subsidiary liability for failure to take appropriate measures. Therefore, the Bankruptcy Law establishes the obligation of a debtor to file a claim with the court in a timely manner (within six months) to declare itself bankrupt in case of insolvency, and also in cases when satisfaction of the claims of individual creditors will render a debtor incapable of fulfilling monetary obligations to other creditors. If this obligation is not fulfilled, the debtor's officials must jointly and severally bear subsidiary liability to creditors. It should be noted that according to statutory interpretation by the Supreme Court, this obligation means an independent type of subsidiary liability and does not require a causal relationship. However, in a survey conducted by the National Bank in 2018, banks mentioned the judicial practice of refusing to bring debtor managers to subsidiary liability. In most cases, the reasons behind a judicial refusal were the absence of a causal link between the managers' failure to act (failure to file a bankruptcy petition) and enterprise's bankruptcy.

### **5. On a lender side, the reasons for late launch of the bankruptcy proceeding and low output of the bankruptcy proceedings are the low risk assessment system and associated lending.**

However, this goes beyond the institute of corporate bankruptcy. The practice of loans to related parties and their subsequent restructuring in case of the actual insolvency of the debtor leads to its delayed recognition as default and late launch of collateral recovery or corporate bankruptcy procedures. This reduces the effectiveness of debtor's solvency resolution procedures, undermines the value of the debtor's assets, including due to debtor's stripping, and

priority satisfaction of the claims of the debtor's related creditors. Delayed recognition of a debtor as default increases the risk of expiration of the limitation period for invalidation of debtor's fraudulent transactions. As a result, insolvent debtors enter into corporate bankruptcy proceedings assets-free, with the exception for collateral. In addition, low repayment rate for corporate bankruptcy and collection of mortgages is associated with the low quality of accepted mortgages collateralized for loans issued to related parties. This is a primary flaw in the banks themselves, poor corporate governance, poorly structured management and risk assessment systems.

These problems should be seen in the context of increasing liability of credit decision makers, improving the quality of internal processes and risk management systems of the banks, which should provide a thorough assessment of borrower's solvency position and the quality of collateral, including legal risks. In turn, the regulator has to strengthen supervision over related lending and banks' activities as part of a risk-based supervision (*see section VII. Regulatory reforms on risk-based supervision and regulation of the banks*).

**To enhance efficiency, it is necessary to reduce the terms of bankruptcy proceedings, create a bankruptcy institute with the restructuring option for the debtor under the control of creditors. Granting extended rights and control to creditors within rehabilitation procedures will reflect the priority goal of maintaining a viable business when implementing the plan on most favorable terms for the creditors.**

**To enhance transparency of court decisions, to enable uniform interpretation of the norms of the law and eliminate typical shortcomings and judicial errors from the judicial practice, it is necessary to develop law enforcement practice, including statutory interpretations by the Supreme Court, and ensure their mandatory compliance.**

**Further digitalization in the field of bankruptcy (setting-up of a single electronic database, including information from administrators, electronic trading platforms, self-regulatory organizations, database of judicial acts, etc.) will optimize and enhance the transparency of bankruptcy procedures.**

## Section 9.

# ACTIVITIES OF THE COUNCIL ON FINANCIAL STABILITY AND DEVELOPMENT OF THE FINANCIAL MARKET OF THE REPUBLIC OF KAZAKHSTAN



Between 2018 and the first half of 2019, the Council on Financial Stability and Development of the Financial Market of the Republic of Kazakhstan (hereinafter – the Council) reviewed on a quarterly basis most pressing issues of financial stability, systemic risks reduction and financial sector development. In the

first half of 2019, regulatory amendments were drafted to reform the institutional regulatory model, providing for the separation of the National Bank and the supervisor starting from 2020. In this regard, the role of the Council as an interagency collegial body on financial stability will be strengthened.

## 9.1. COUNCIL ACTIVITIES BETWEEN 2018 AND THE FIRST HALF OF 2019

Between 2018 and the first half of 2019, six meetings of the Council were held to discuss current issues of the financial sector, their solutions and promising areas of the development. In particular, Council members in the reporting period reviewed and decided on the following issues:

- **problems of the deposit market associated with the lack of fixed term deposits, and regulatory solutions.** The Council supported a set of regulatory measures proposed by the National Bank to develop a fixed term deposits market. As a result, from the 4th quarter of 2018, a new mechanism of KDIF's differentiated marginal rates was introduced by duration, early withdrawal conditions and replenishment option<sup>23</sup> (see Section 6). This approach aims at providing banks with sustainable long-term funding, establishing a fixed-term deposit market, creating conditions for competing deposit products, and approximation of deposit market pricing to market pricing;
- **cybersecurity strategy for the financial sector.** The Council approved the National Bank's strategy for cybersecurity of the financial sector for 2018-2022<sup>24</sup>. The strategy aims at creating conditions for safe financial services in cyberspace in the context of sustainable operation of the financial sector;
- **judicial practice of repayment to individual borrowers of loan servicing and bank account at lending fees.** As a result of the banks' work, the collection of monthly fees for loan service for future periods under existing bank loan agreements was annulled;
- **improving regulation of the banking sector, including limitation of non-performing loans and an equity deduction for the funding concentration.** The Board approved the approach to implement a continuous systematic assessment of credit risk and asset quality as part of risk-based supervision, approve new requirements to risk management system in

banks, and also manage high concentration risk through individual capital allowance;

- **securitization of car loans on market conditions on the platform of JSC "Mortgage Company "Baspana" to stimulate car manufacturing and meet public demand.** The Council approved the approach proposed by the National Bank to stimulate domestic vehicles lending. A subsequent program of lending to buyers of locally manufactured passenger cars<sup>25</sup>, was approved aiming at the development of domestic auto manufacturing, strengthening import substitution, improving the investment climate in Kazakhstan;
- **empowerment of the National Bank to block illegal Internet resources.** The Council supported the proposal of the National Bank to set out in the law the regulator's power to suspend access to illegal Internet resources, including information. Necessary regulatory amendments will be made in 2020;
- **introduction of risk-based supervision under SREP methodology of the European Central Bank and asset quality review of Kazakhstani banks in 2019.** The Council supported the proposals of the National Bank regarding the development of a methodology for risk-based supervision and asset quality review<sup>26</sup>. As a result, the National Bank prepared and approved a methodology for assessing the quality of assets. Asset quality assessment will allow to develop and approve individual corrective action plan for each bank.

In addition, taking into account Council's instructions, new requirements have been developed for bank risk management systems<sup>27</sup>. During 2019, National Bank's SREP methodology will be tested without application of supervisory sanctions.

<sup>23</sup> Changes were made by decision of KDIF Board of Directors dated July 12, 2018 No. 12.

<sup>24</sup> Approved by the Resolution of the National Bank's Board as dated October 29, 2018 No. 281.

<sup>25</sup> Approved by the Resolution of the National Bank's Board dated May 31, 2019 No. 79.

<sup>26</sup> Approved by the Resolution of the Board of the National Bank of July 19, 2019 No. 122.

<sup>27</sup> Approved by the Resolution of the Board of the National Bank of November 12, 2019 No. 188.

## 9.2. STRENGTHENING THE ROLE OF THE COUNCIL AMID CHANGING INSTITUTIONAL MODEL OF FINANCIAL SECTOR REGULATION

In the first half of 2019, the National Bank drafted regulatory amendments to reform the financial sector regulation model, where the central bank and the supervisor will be separated. As a result, from January 1, 2020, the mandate of the National Bank to regulate the financial market will be transferred to a newly created Agency for Regulation and Development of the Financial Market<sup>28</sup> (hereinafter – the Agency).

In connection with the separation of the National Bank and the supervisor from 2020, the role of the Council as an interagency collegial body on financial stability and reduction of systemic risks has been strengthened by the law. The functionalities and activities of similar interagency collegial bodies on financial stability in advanced countries (EU countries, the USA, Australia, etc.) were taken into account. In particular, as global practice shows, the Financial Stability Boards coordinate and approve measures for financial stability and reduction of systemic risks, including anti-crisis measures and macroprudential policies, ensuring the proper level of interaction and information exchange between government bodies. Moreover, the composition of Council members is represented by state agencies mandated to ensure financial stability. These are the Central Banks, supervisory agencies, bank solvency resolution bodies, and fiscal authorities. In pursuit of the global practice to strengthen the role of the Council in Kazakhstan, the legislation sets out a list of issues for preliminary review by the Council on a mandatory basis. In particular, they include implementation-related measures:

1) **macroprudential policy**. Here the role of the Council is to review the results of assessment and monitor systemic risks and measures to reduce them, as well as to provide recommendations on implementation of macroprudential policies, including on prudential regulation instruments. At the same time, the Council has the right to request from the National Bank the results of the systemic risk assessment and proposals for its minimization, and from the Agency the information on supervised organizations and regulatory measures;

2) **anti-crisis measures**, where the Council reviews the proposals by state bodies and makes recommendations for their implementation;

3) **bank solvency resolution process and bank recovery financing**. Here the Council will review proposals and provide recommendations for their implementation. At the same time, the Council is entitled to request from the Agency information on the financial condition of banks, proposals on measures to regulate or improve banks and on progress in implementation of previously extended financing to the banks as part of rehabilitation programs, its rationale, appropriateness and effectiveness of state participation and other relevant information.

In addition, due to changed functionality, the composition of the Council will be altered from 2020 to include CEOs of the National Bank, the Agency for Regulation and Development of the Financial Market, Ministry of Finance, Ministry of National Economy and Presidential Administration. Moreover, representatives of the financial sector and other experts may be invited to the Council meetings subject to the matters under review.

These changes will therefore ensure coordination between the Government, the National Bank and the Agency and enhance the effectiveness and efficiency of decisions in case of increased systemic risks.

<sup>28</sup> The Law of the Republic of Kazakhstan dated July 03, 2019 "On Amendments and Supplements to Some Legal Acts of the Republic of Kazakhstan on the Regulation and Development of the Financial Market, Microfinance Activities and Taxation"





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