

III. Financial Intermediary Institutions

4. Role of Financial Sector in the Economy

4.1 Level of Financial Depth

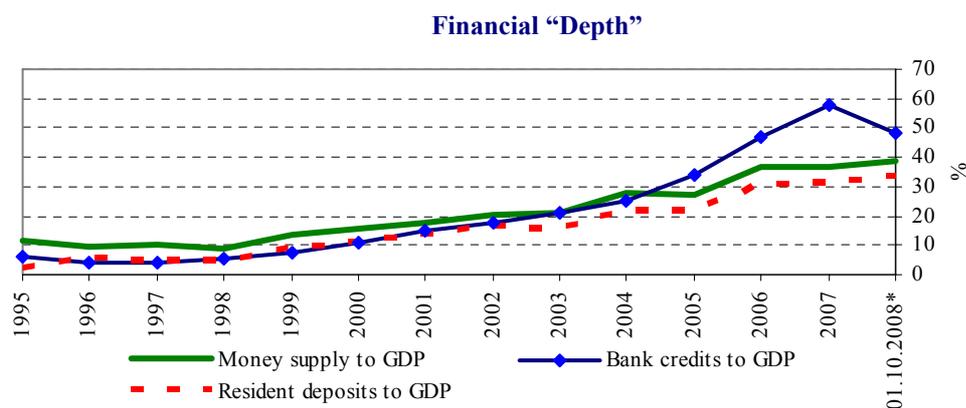
High level of credits growth in previous periods has changed to moderate growth rates which affect the level of financial relations development in the country.

Tightening conditions of funding on external markets resulted in tightening credit conditions and increasing interest rates by banks with regard to domestic consumers of financial services. Tightening credit conditions caused decrease in credit activity in the financial sector.

As a result, a ratio of credits to the economy to GDP indicating the level of financial intermediation considerably decreased from 57.8% as of the end of 2007 to 38.8% as of the end of the third quarter 2008. In turn, decrease in resources attracted from abroad and decrease in domestic economy funding by banks has essentially decreased the gap between the level of crediting, savings of the population and the level of economy monetization. This trend should have a positive impact on equalizing the ratio of attraction and placement of resources due to internal sources of the economy.

At the same time, these complicated conditions create new opportunities and challenges for the Kazakhstani banking system with regard to determining their main factors of growth in the future. First of all, perspective directions of development are resource base diversification, improvement of risk management and management quality based on the international principles of corporate governance.

Figure 4.1.1



Source: NBRK, SARK.

4.2 Structure of the Financial Sector

The world financial crisis emerged in summer 2007 has not cardinaly affect the structure of assets distribution of the financial sector by categories of financial institutions. However, the share of assets of the banking sector which is traditionally the largest segment decreased during the observed period that is caused by consequences of global instability for the domestic banking sector. The share of non-banking sector in the structure of financial sector assets has increased.

The banking sector of Kazakhstan that had been intensively developing in recent years due to inflow of cheap foreign capital, demonstrated the lowest growth rates of assets from October, 2007 to October, 2008 comparing to other financial institutions (9%). As a result, the share of banking system in total assets of the financial sector decreased from 82.0% to 74.2%. Moreover, organizations engaged in certain types of banking operations demonstrated the highest growth rates of assets during observed period which grew almost by 3 times, thereby increasing its portion in the financial sector assets from 4.9% to 12.1% (Figure 4.2.1). It can be explained by the fact that

among such organizations there are organizations whose sole shareholder (participant) is the government. During the instability period such organizations have actively expanded their activity by increasing capitalization on the part of government with the purpose of financial support of priority sectors of economy, small and medium-size business as part of top priority actions of the government on ensuring stability of the social and economic development of the Republic of Kazakhstan.

The analysis of the financial sector development since 2005 shows decrease in share of assets of the banking sector and pension funds, whereas there is an increase in the share of non-banking, insurance sectors and the sector of professional participants of the securities market (Figure 4.2.2). Despite contraction of the share of banking sector in total assets of financial sector, a degree of the banking sector significance for the country's financial sector remains high that can be evidenced by banks presence on the corporate bonds market where considerable part, more than 35% of total corporate bonds were issued by STB as of October 1, 2008. At the same time, over 60% of their total amount is in the portfolio of non-financial sector organizations and other investors (Figure 4.2.3).

In the financial sector the highest degree of concentration is observed in the pension funds sector and banking sector and relatively low level of concentration in insurance sector (Figure 4.2.4). As for institutional structure of the financial sector, the number of insurance companies and professional participants of the securities market noticeably increased during the analyzed period (Table 4.2.1).

Figure 4.2.1

Institutional Structure of the Assets the Republic of Kazakhstan Financial Sector, %

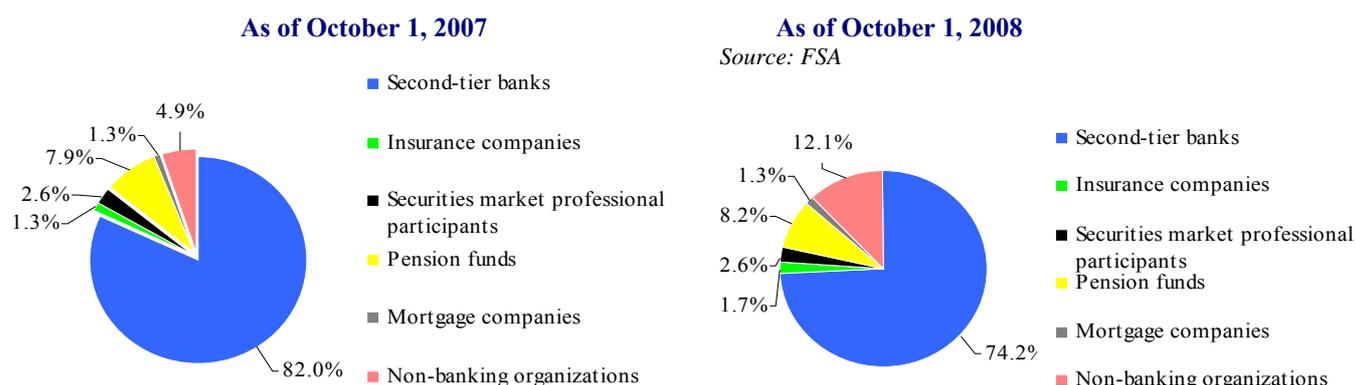


Table 4.2.1

**Institutional Structure of the Financial Sector
(number of financial institutions)**

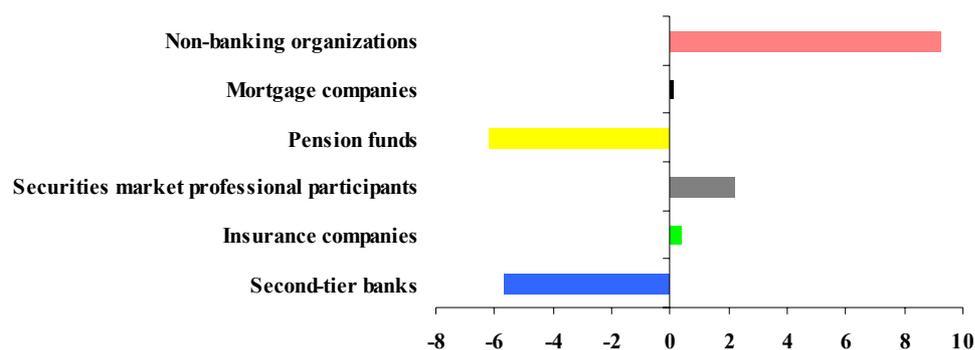
	Jan 1, 2006	Jan 1, 2007	Jan 1, 2008	Oct 1, 2008
Second-tier banks	34	33	35	36
Insurance organizations	37	40	41	44
Actuaries	30	33	44	49
Professional participants of the Securities Market*, including:	130	147	208	217
Brokers-dealers	62	70	106	106
Registrars	18	16	17	15
Pension assets investment management organizations	11	13	11	13
Investment portfolio managers	28	37	61	68
Custodians	11	9	10	11
Transfer agents	0	2	3	4
Auction organizers	1	1	1	1
Accumulation pension funds	14	14	14	14
Mortgage organizations	7	10	12	12
Organizations engaged in certain types of banking operations including investment companies	32	16	23	23
	0	1	4	4

* - number of issued licenses

Source: FSA

Figure 4.2.2

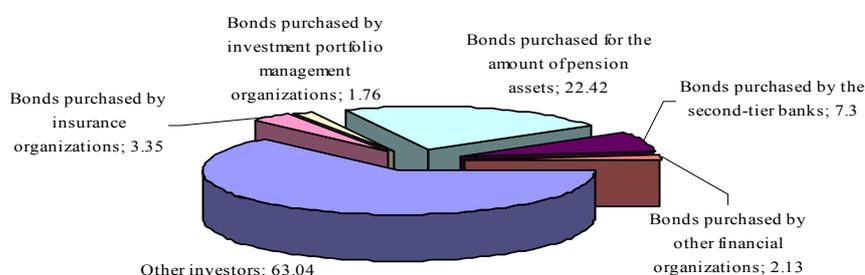
**Change in Share of Financial Sector Assets for the Period of 01.01.2005 - 01.10.2008
(in percentage points)**



Source: FSA

Figure 4.2.3

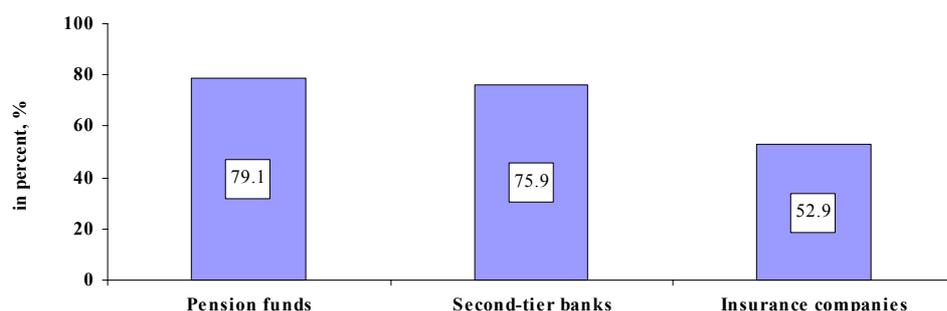
Main Investors at the Corporate Bond Market of the Republic of Kazakhstan (in %, as of October 1, 2008)



Source: FSA

Figure 4.2.4

Financial Sector Segments Concentration in Kazakhstan* (as of October 1, 2008)



*The share of the five largest financial institutions of each segment in the total segment assets

Source: FSA

5. Banking Sector

5.1. Condition, Infrastructure and Concentration on the Banking Services Market

Although the degree of concentration in the banking system of Kazakhstan has consistently decreased in recent years, it remains high in comparison with the average indicator of the European Union countries. Among key indicators, the share of 5 largest banks is especially high in the loan portfolio of the banking system which is explained by more aggressive policy pursued by banks last years both with regard to external borrowings and their further distribution.

World market trends contributed to entering of foreign participants in the Kazakhstani market of banking services.

The banking system of Kazakhstan is characterized by high degree of concentration that remains stable during last years (Figure 5.1.1). The share of 5 largest banks' assets in aggregate assets of the banking system of Kazakhstan was 75.9% as of October 1, 2008 slightly reduced from the beginning of the year by 2.1 percentage points (as of January 1, 2004 – 73.9%). In spite of slight decrease, the indicator of bank assets concentration in Kazakhstan is considerably higher than the average indicator in 20 European countries (Figure 5.1.2).

The degree of concentration of 5 largest banks is especially significant in loan portfolio of the banking system and almost has not changed since the beginning of the current year and has amounted to 79.3%.

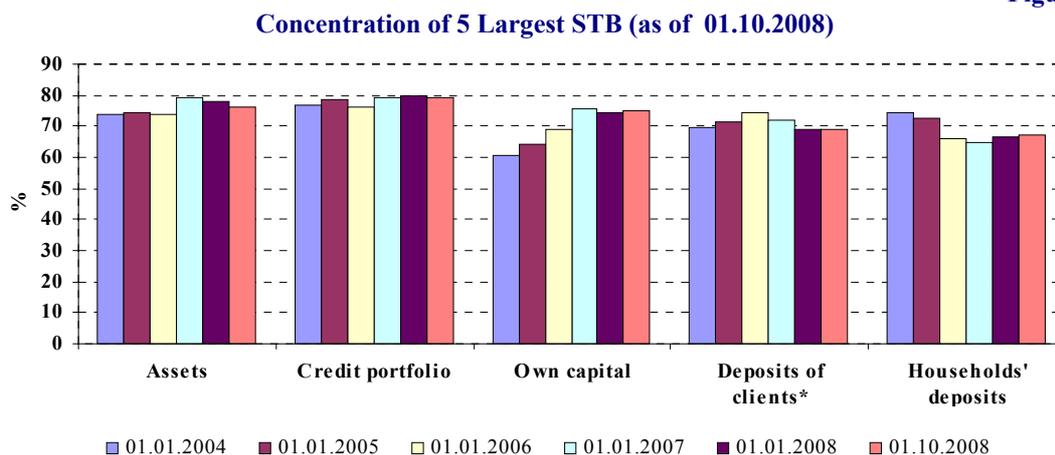
A small increase in concentration of 5 largest banks in own capital of the banking sector was observed from the beginning of the current year that was connected with the response of the banks to the ongoing deterioration of the banking assets quality.

Herfindahl-Hirschman Index used for assessment of market concentration was 1,454 as of October 1, 2008 with regard to banking assets versus 1,486 as of the corresponding date of the previous year.

The overall situation on the world financial markets had an influence on prices for shares of Kazakhstani STB making them attractive for foreign investors. As a result, new shareholders entered the banking system of Kazakhstan, including those from Russia, Italy, South Korea, Turkey, UAE (OJSC Sberbank of Russian Federation, Italian Banking Group UniCredit, Turkish Bank Bankpozitif Kredi ve Kalkinma Bankasi which affiliates Israel Group Bank Hapoalim, South Korean Kookmin Bank, Arab Investment Company Alnair Capital). On the one hand, this indicates an increased interest in the banking system of Kazakhstan; on the other hand, this bears certain risks related to the performance of the parent foreign companies in the background of ongoing instability on the world financial markets. It should be noted that almost all transactions are large acquisitions, which indicates long-term plans of the investors.

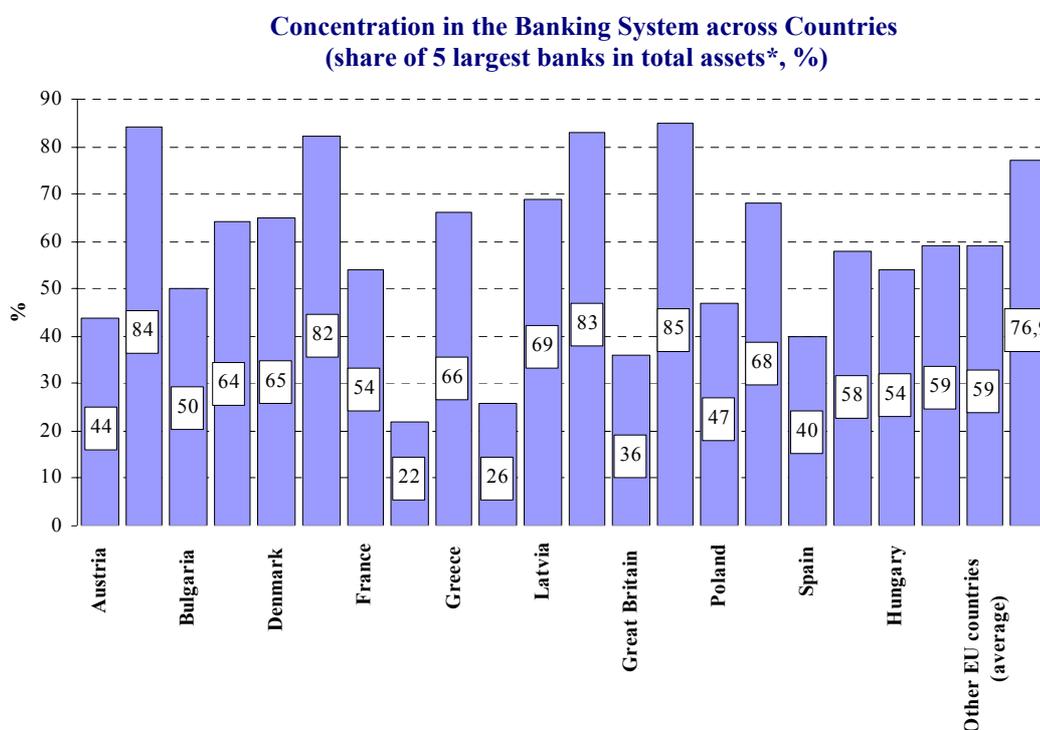
From the beginning 2008, the share of assets of the banks with foreign participation in the aggregate assets of the banking system decreased from 15.8% to 14.8%, that is considerably lower than the level of the Central and Eastern European countries. At the same time, the share of authorized stock capital of the banks with foreign participation in the authorized stock capital of the banking system for the same period increased from 15.4% to 17.6% (Figures 5.1.3, 5.1.4).

Figure 5.1.1



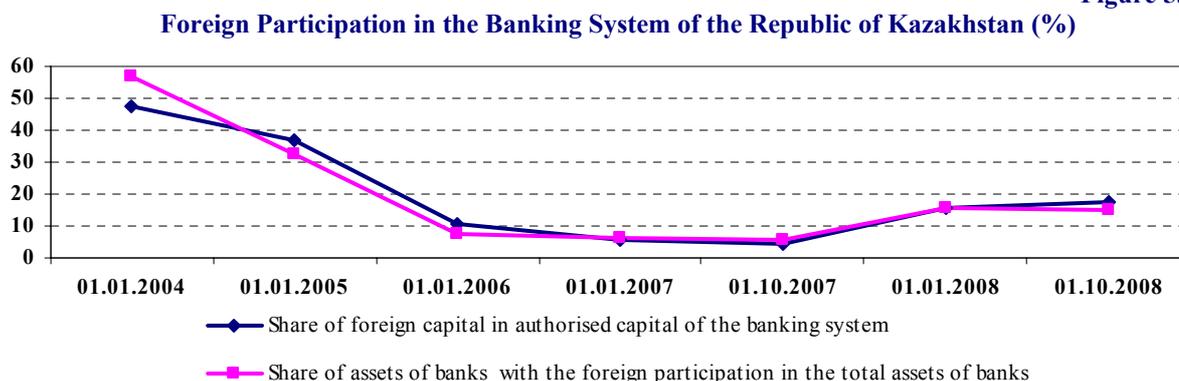
* excluding deposits of special purpose vehicles (SPV)
Source: FSA

Figure 5.1.2



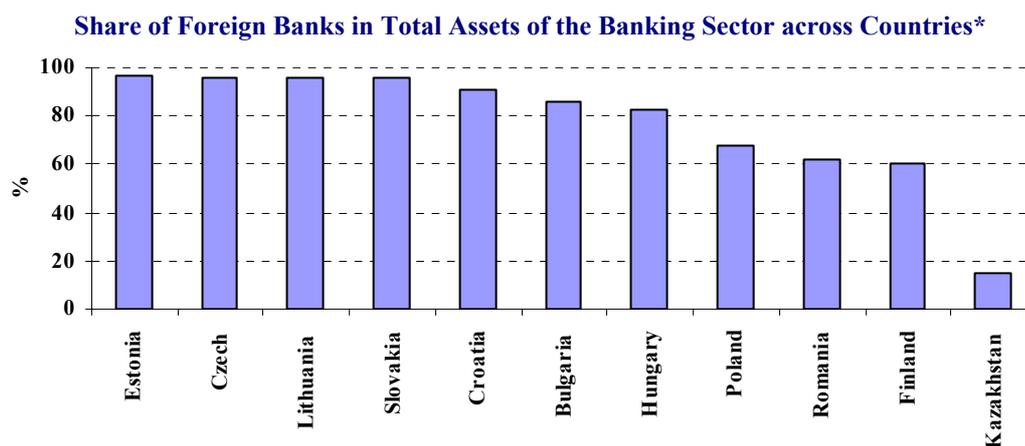
* Data of EU countries for 2006
Source: national sources, ECB, FSA

Figure 5.1.3



Source: FSA

Figure 5.1.4



* data across countries for 2006, 2007
Source: national and other sources, FSA

5.2 Credit Risks

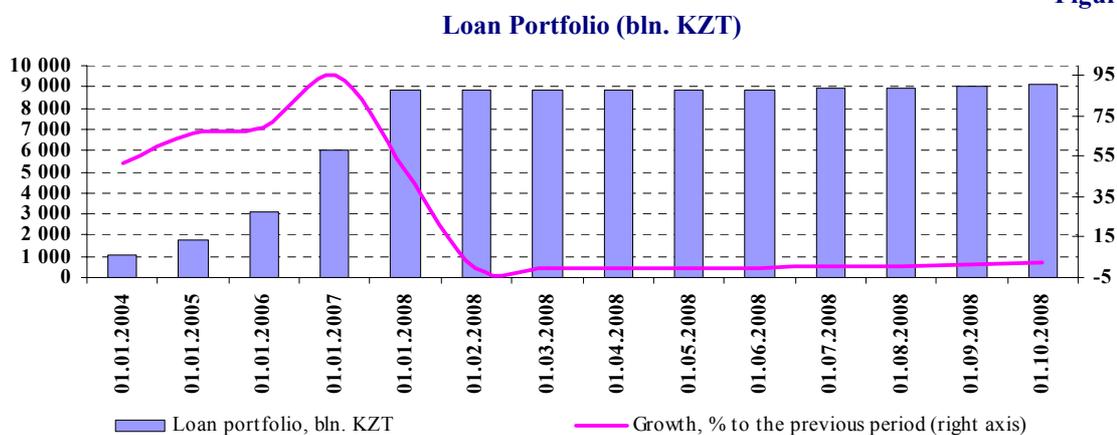
The consequences of the world financial crisis exposed weaknesses of domestic STB and brought to light the problems, especially with regard to quality of assets which were repeatedly indicated by regulatory institutions.

As it was expected, deteriorating quality of the loan portfolio as well as liquidity deficit are the key factors affecting the stable functioning and future developments of the banking sector.

Global instability caused slowdown of growth rates of key indicators of the banking sector, especially its loan portfolio which has demonstrated rapid growth rates in recent years (2005 – 68.9%, 2006 – 95.7%, and 2007 – 48.0%). Thus, from October 1, 2007 to October 1, 2008 loan portfolio of the banks was almost at the level of 2007 having increased only by 4.5% (Figure 5.2.1). At the same time, the volumes of crediting decreased considerably in real estate and construction sectors, as well as crediting of small entrepreneurship entities which functioned in the conditions of stability due to banking resources and were the main factors of economic growth in the last years (Figure 5.2.2). Such situation affected the economic activity and, consequently, the ability to service liabilities to STB. In addition, one of the factors that affected the payment discipline of borrowers is the change in prices in real estate market together with revision of credit terms by banks in the background of decrease of population's real income as a result of increasing inflationary pressure this year.

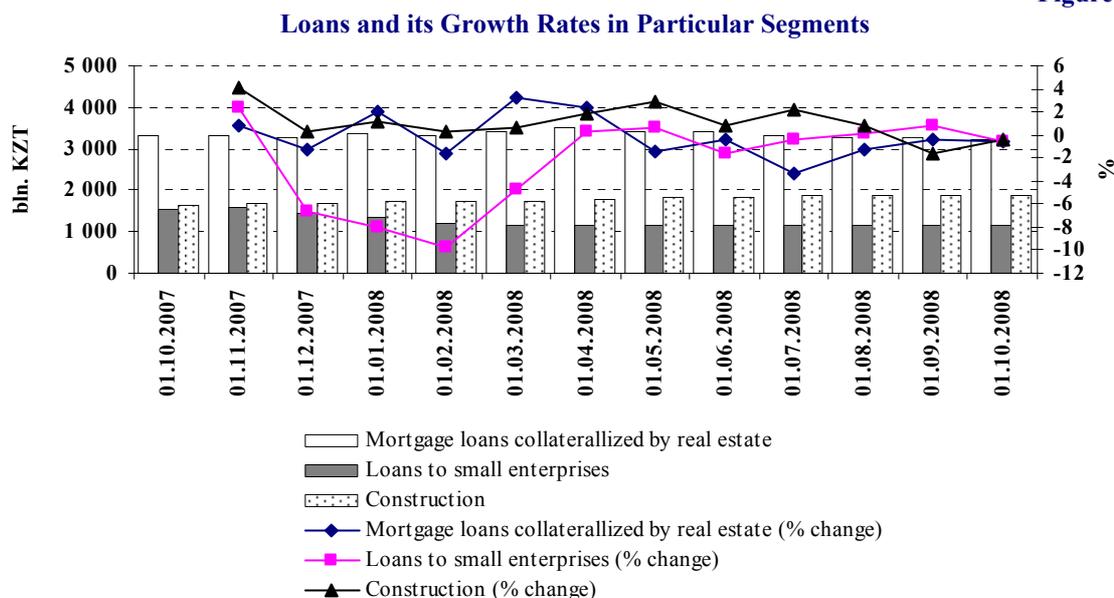
High growth rates of lending 'hide' credits quality as borrowers have opportunities for re-financing. However, in the current conditions an essential decrease in credits to the economy disclosed a real quality of loan portfolio of STB.

Figure 5.2.1



Source: FSA

Figure 5.2.2



Source: FSA

Although the indicators of loan portfolio quality assessment do not exceed critical values, they are characterized by persistent growth in dynamics, threatening to the banking sector stability. These trends show that the situation will deteriorate. As loan portfolio quality worsens the level of reserves increases to absorb potential losses, however its adequacy is doubtful.

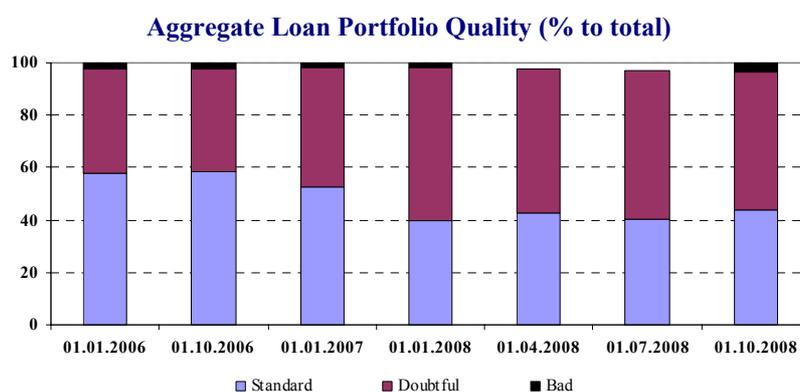
All concerns about high growth rates of assets, as a factor of risk, threatening to their quality in case of economy slowdown, were realized under the pressure of global turbulence on domestic economy. Slowdown of the credit activity of the Kazakhstani banks was accompanied by intensive deterioration of the loan portfolio quality.

Even if the share of standard credits in loan portfolio of the banks increased to 44.0%, the share of bad credits increased by 2.7 times from 1.2% as of October 1, 2007 to 3.3% as of October 1, 2008 which was the highest value last 4 years amounting KZT 300.1 bln. (Figures 5.2.3, 5.2.4).

Sustainable migration of credits to the categories of worse quality loans is observed in the structure of doubtful loans. Thus, if doubtful loans 1 decrease by 27.4% and doubtful loans 2 decrease by 26.9% in the structure of doubtful loans, there is observed an increase in doubtful loans 3 (by 2.7 times), doubtful loans 4 (by 2.4 times) and doubtful loans 5 (by 4.3 times) (Figure 5.2.5).

An increase in overdue indebtedness by 3 times and its ratio to the loan portfolio at 2.9% versus 1.0% as of October 1, 2007 indicates deteriorating quality of loan portfolio (Figure 5.2.6). At the same time, individuals' loans are traditionally characterized by worst quality, and overdue individuals' indebtedness has increased more than by 3.5 times since October 1, 2007, whereas the total overdue indebtedness has increased by 3 times during the same period (Figure 5.2.7).

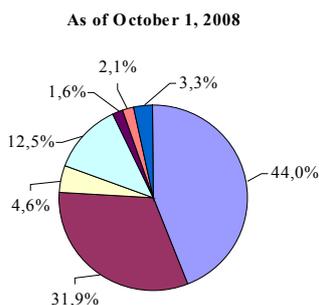
Figure 5.2.3



Source: FSA

Figure 5.2.4

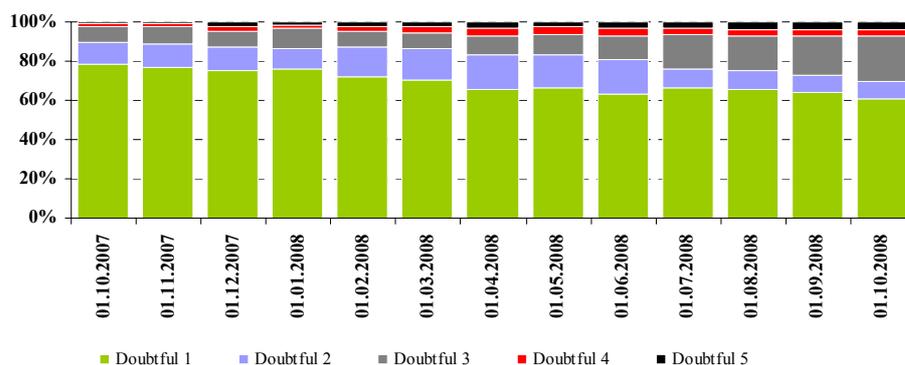
Specified Data on Loan Portfolio Quality



Source: FSA

Figure 5.2.5

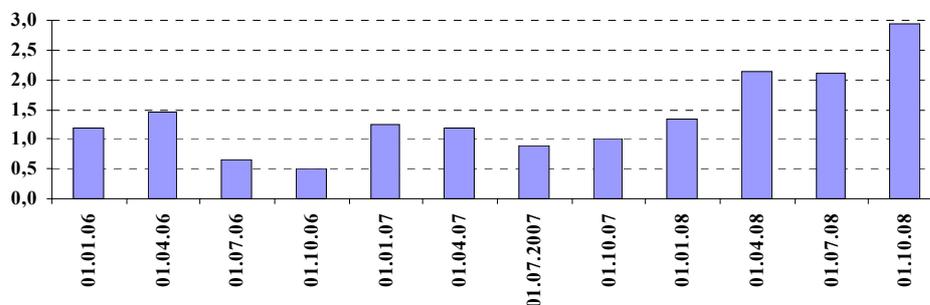
Dynamics of Doubtful Loans Categories (% to total)



Source: FSA

Figure 5.2.6

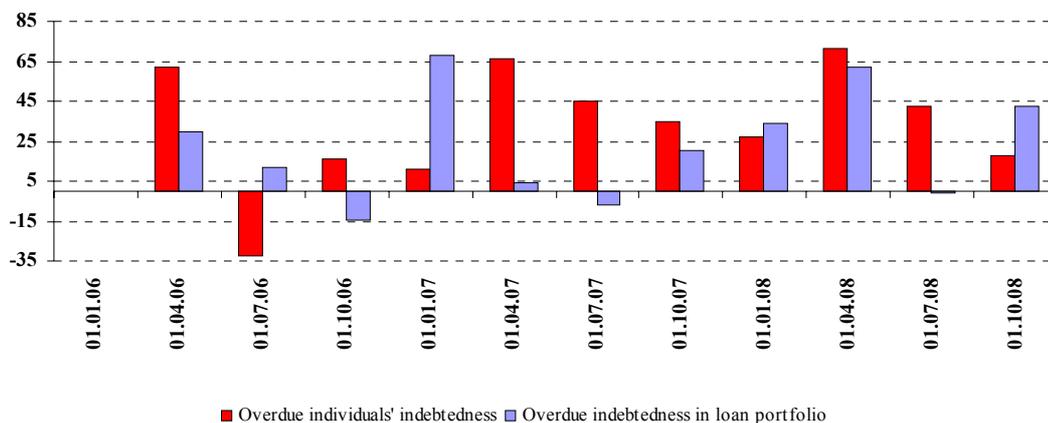
Share of Overdue Indebtedness in Banks' Loan Portfolio (%)



Source: FSA

Figure 5.2.7

Growth Rates of Overdue Indebtedness in Loan Portfolio comparing to Growth Rates of Overdue Individuals' Indebtedness (%)



Source: FSA

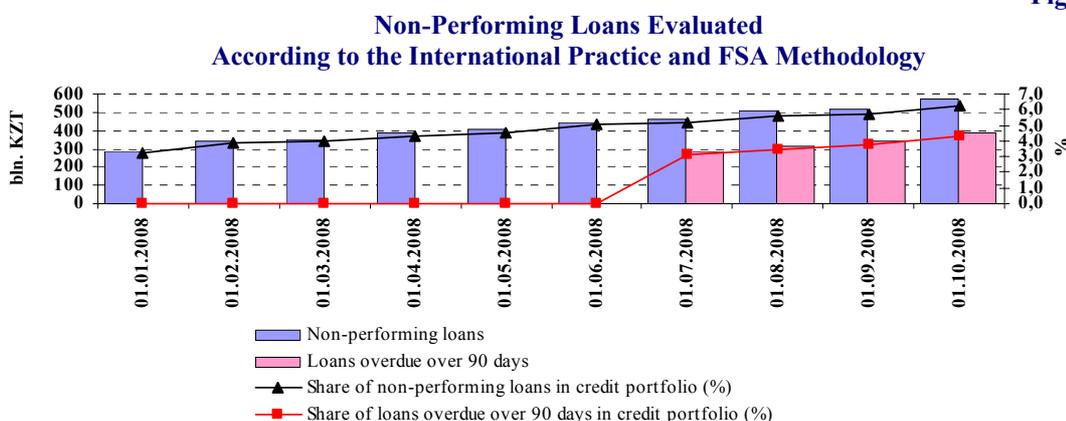
Non-performing loans widely used in international practice to assess loans quality were growing steadily during the whole observed period in the background of slowdown of credits growth.

Non-performing loans calculated according to FSA methodology⁴⁴ have increased almost by 3 times since October, 2007 and have amounted to KZT 570.0 bln. in absolute terms. Their share in loan portfolio of the banking sector increased from 2.3% to 6.3%. Share of loans with overdue payments over 90 days in loan portfolio was 4.3% as of October 1, 2008 and increased in absolute terms by 38% during three months (from the date of implemented reporting – July 1, 2008).

Non-performing loans indicator recommended by the international practice was 1.5 times lower than the indicator calculated according to the FSA methodology. At the same time, the values of non-performing loans calculated according to the both methodologies are lower than the critical level of 10% which is recommended by the same international practice (Figure 5.2.8). However, in comparison with other countries the level of non-performing loans in the Kazakhstani banking system is higher than their level in some countries of Central and South-Eastern Europe and is equal to the level in the countries of South-Eastern Asia (Figure 5.2.9).

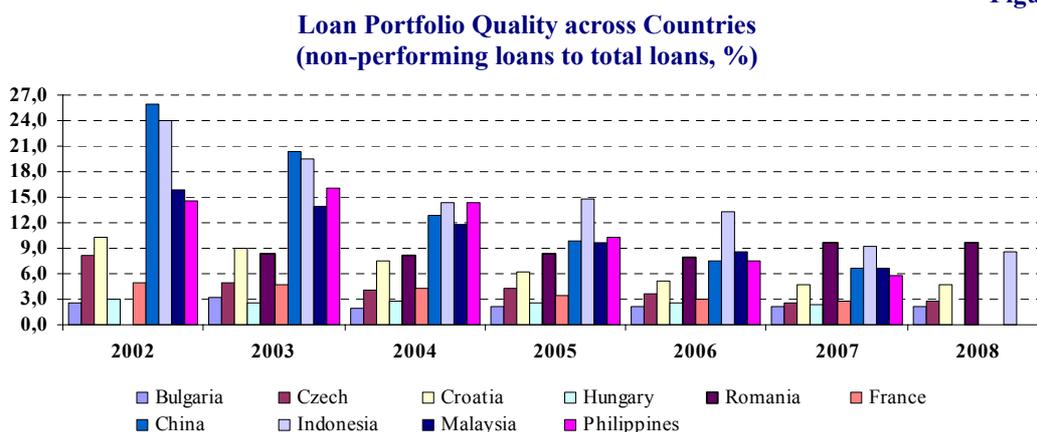
At the same time, under continuing dynamics of non-performing loans (FSA methodology) and loan portfolio observed from the beginning of the year the ratio of non-performing loans to loan portfolio can reach 7.5-8% by the end of 2008.

Figure 5.2.8



Source: FSA

Figure 5.2.9



Source: IMF (GFSR, 2008)

⁴⁴ In accordance with the international practice (IMF, IAS, etc.), the main criteria of loans to be recorded as non-performing loans (NPL) is overdue payments over 90 days. However, it is necessary to take into consideration that aggregate overdue loans are volatile because loans can be restructured or prolonged.

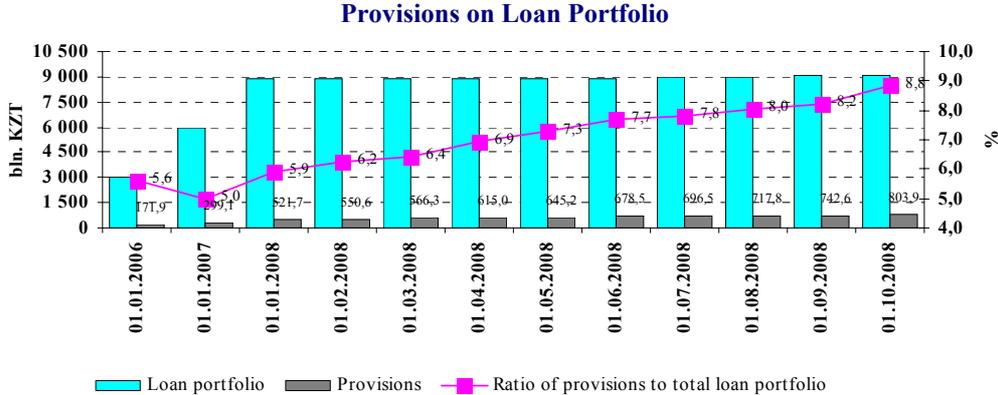
Taking into consideration this fact, FSA calculates non-performing loans as doubtful 5 and bad loans (including provisions on homogeneous loans), thereby guiding not only by the existence of an overdue indebtedness but additional criteria used in loan classification (according to the requirements of existing classification, if there is a loan prolongation or write offs, the category of this loan worsens).

In response to the decrease in loan portfolio quality, the level of reserves increases to absorb possible credit losses. Since October last year provisions have risen in absolute value by 76.8% to KZT 803.9 bln., or 8.8% of loan portfolio (Figure 5.2.10). However, the growth rates of provisions are not comparable with growth rates of non-performing loans, and it is evidenced by gradual decrease in coverage both non-performing loans according to the FSA methodology and overdue loans over 90 days with provisions. If the growth dynamics of non-performing loans continues, there is a risk to lose an ability of STB to absorb potential losses on credits (Figure 5.2.11). At the same time, in comparison with other countries a degree of coverage with provisions is higher than the level in the countries of South-Eastern Europe and South-Eastern Asia (Figure 5.2.12).

Moreover, in the background of low growth rates of loan portfolio and accelerated growth rates of provisions during observed period, coverage of loan portfolio with both collateral and provisions has slightly increased (Figure 5.2.13).

Deterioration of loan portfolio quality is also shown by slight but sustainable growth of credits written off-balance in the conditions of crediting slowdown (Figure 5.2.14).

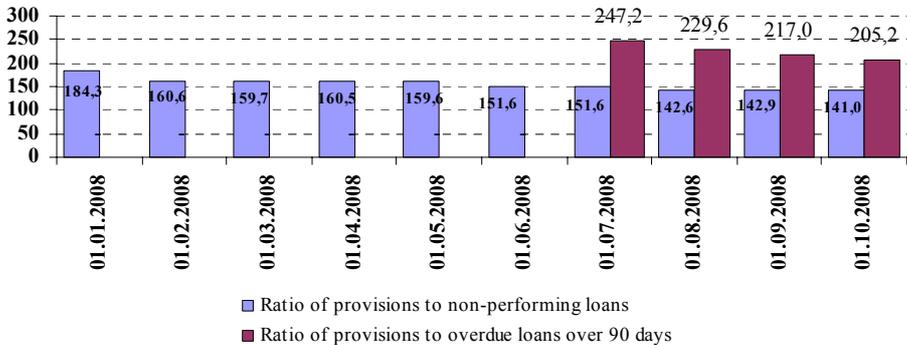
Figure 5.2.10



Source: FSA

Figure 5.2.11

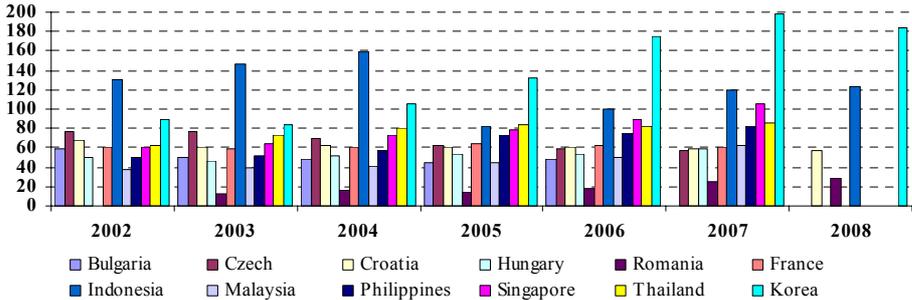
Coverage of Non-Performing Loans and Overdue Loans over 90 days with Provisions (%)



Source: FSA

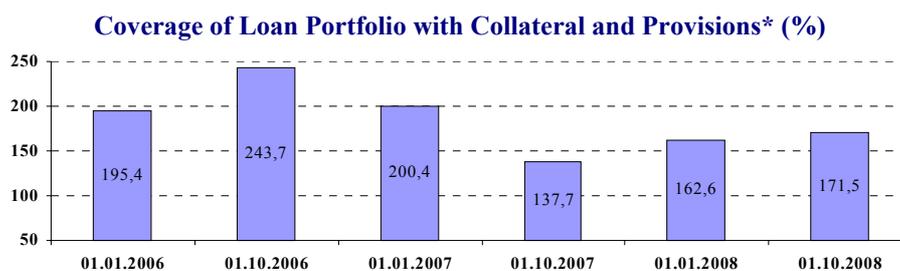
Figure 5.2.12

Coverage of Non-Performing Loans across Countries (provisions to non-performing loans, %)



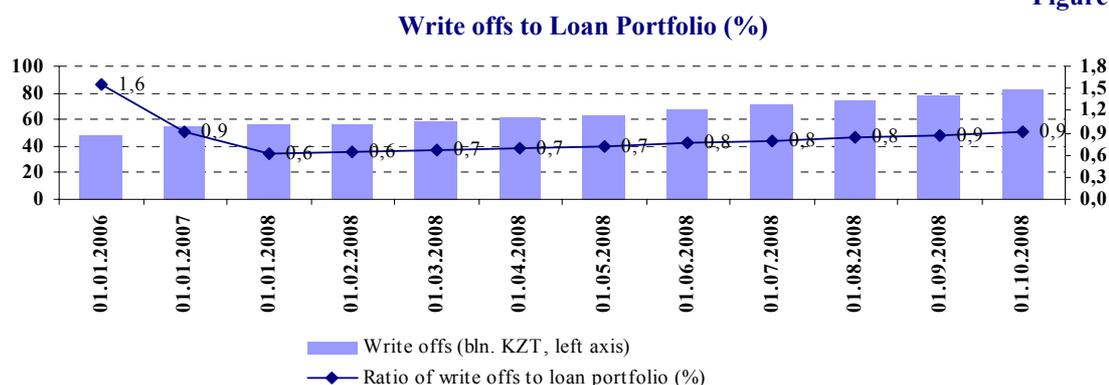
Source: IMF (GFSR, 2008)

Figure 5.2.13



* ratio of aggregated provisions and collateral value to the STB loan portfolio
Source: FSA

Figure 5.2.14



Source: FSA

Overall instability and high concentration of credit risk in the most sensitive and vulnerable segments of crediting exposed some weaknesses in the risk management of Kazakhstani STB.

The economy growth that has been observed in recent years, as well as improvement of the population welfare facilitated increase in consumer demand for credit resources. The improvement of technologies of servicing the population and introduction of the newest banking products for individuals caused a rapid growth of retail crediting, and population's demand for housing caused increase in mortgage loans and credits to construction sector. As a result, it facilitated increase in lending by STB these segments which became the most sensitive to the consequences of global instability.

Share of consumer credits in loan portfolio of banks was characterized by stable dynamics during the observed period and remained almost on the level of corresponding period of the last year, and the share of loans collateralized by real estate decreased by 2.4 percentage points and amounted 35.6%. It should be noted that in the banking system of Kazakhstan the share of loans collateralized by real estate in loan portfolio of STB is in the range of 0.4% to 98% which is unacceptable from the point of view of risk management in spite of the STB sizes. The loans provided to the construction sector were 26.7% in the structure of crediting the sectors of economy, and did not exceed 30% during the observed period (Figure 5.2.15).

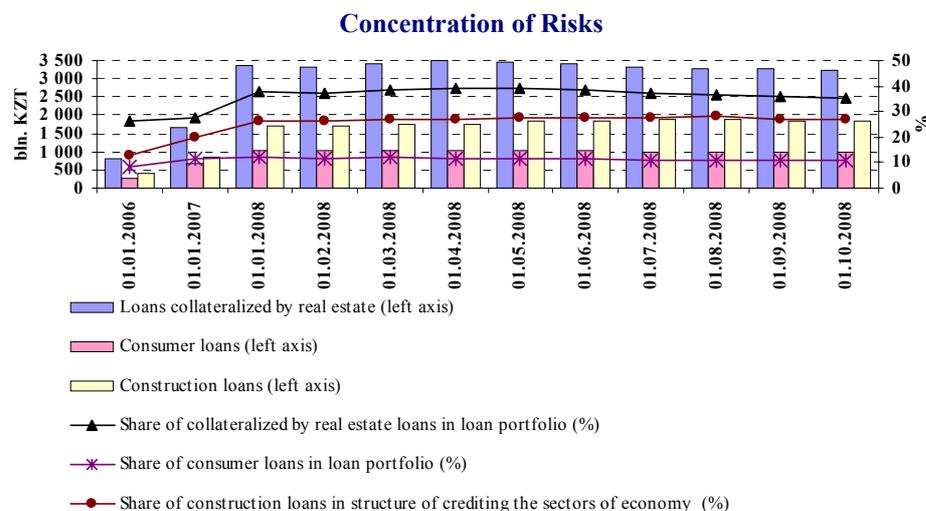
General situation on the world markets facilitated essential 'cooling-down' of the crediting market. Such trends are largely caused by overall situation in the economy and in the banking system and essential tightening of lending requirements by banks, as well as by more weighted approach to the selection of borrowers and also by uncertainty in the real estate market of Kazakhstan.

Along with the construction sector, trade and industry were the most attractive sectors, and their share in the structure of crediting the sectors of economy was 28.7% and 13.0% respectively as of October 1, 2008.

More essential decrease in loans quality of these sectors relative to others indicates higher sensitivity of these sectors to the arisen shocks. Since the beginning of the current year, the share of doubtful loans in the structure of loans provided to construction, trade and industry has increased by

1.5 to 2.3 times, and it has not exceeded 1.6 times in agriculture, transport and communications (Table 5.2.1). This fact is generally confirmed by a considerable increase in ratio of provisions to loan portfolio of each sector with regard to trade, construction and industry (Figure 5.2.16).

Figure 5.2.15



Source: FSA

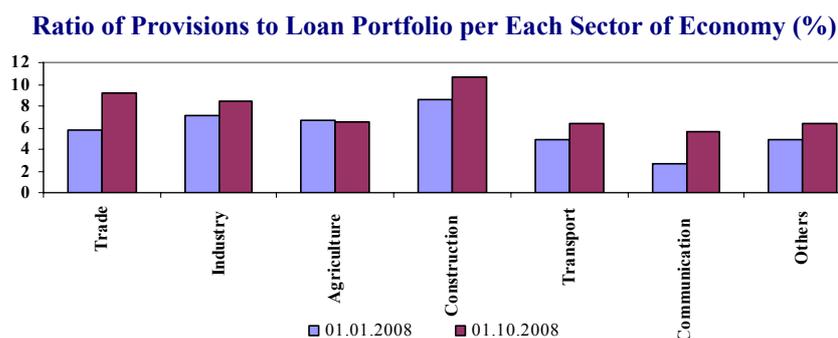
Table 5.2.1

**Structure of Classified Loans
(% to total)**

Classification by sectors of economy	Standard		Doubtful		Bad		Total
	Jan 1, 2008	Oct 1, 2008	Jan 1, 2008	Oct 1, 2008	Jan 1, 2008	Oct 1, 2008	
Trade	39,9	44,1	58,6	53,1	1,5	2,8	100
Industry	51,0	51,8	46,3	44,1	2,7	4,1	100
Agriculture	44,7	55,2	52,8	41,3	2,5	3,5	100
Construction	25,2	36,8	73,2	59,5	1,6	3,7	100
Transport	71,4	68,3	26,3	28,0	2,3	3,7	100
Communication	54,1	39,5	45,5	60,4	0,4	0,1	100
Other	43,8	54,4	55,5	43,9	0,7	1,7	100
Total in the economy	39,0	46,7	59,4	50,3	1,6	3,0	100

Source: FSA

Figure 5.2.16



Source: FSA

High risks of non-repayment of consumer credits were disclosed in the conditions of reduction of lending volumes, deceleration of economic growth and decrease in the population's income which shows high sensitivity to the shocks disclosed in the economy and indicates high degree of risk in this segment. STB should thoroughly assess solvency of borrowers and risks related to retail crediting. At the same time, one of the positive trends of the last years is an increase in the share of mortgage loans where ratio of loan to collateral value does not exceed 70%.

The level of dollarization of the loan portfolio of the Kazakhstani banking system remained stable in 2008.

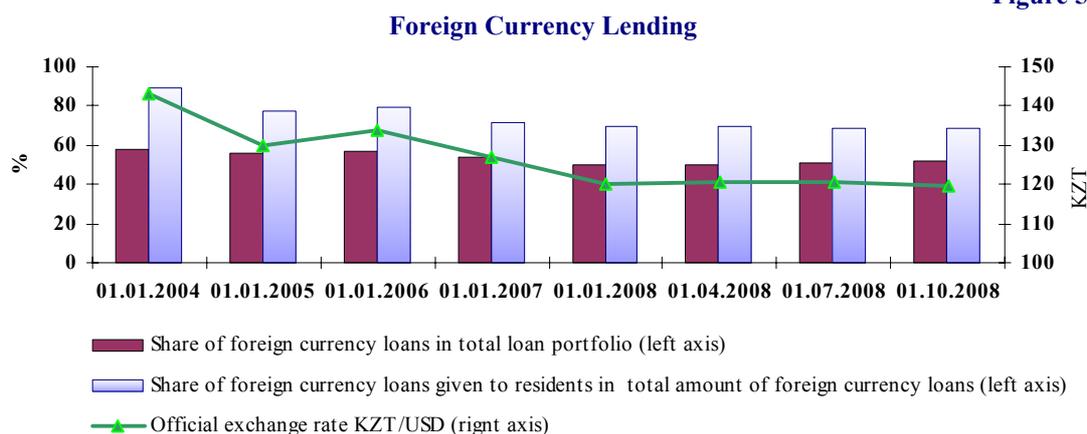
In spite of slow down in growth rates of crediting, Kazakhstani STB continue to pursue strategy of entering the neighboring markets, and in the conditions of uncertainty existing in all world markets it may result in losses if there is a large discrepancy in cyclic development of the economies of countries-partners.

Over the last years, relatively stable dynamics of concentration of loans denominated in foreign currency in the loan portfolio of STB of Kazakhstan has remained. Comparing to the beginning of 2007, the share of loans in foreign currency in loan portfolio of STB of Kazakhstan decreased to 50%. As before, large part of such loans was provided to domestic population. However, from the beginning of 2007, there is observed a gradual decrease in the domestic demand for loans in foreign currency. It can be seen from decrease in share of loans in foreign currency to residents in total loans in foreign currency from 71.1% to 68.7% as of October 1, 2008 (Figure 5.2.20). Analyzing the quality of loans in foreign currency, it should be noted that since last October the overdue loans in foreign currency have increased by 2.4 times against a threefold increase in total loan portfolio. At the same time, with regard to loans in foreign currency to individuals, overdue indebtedness increased by more than 5 times against 3.5 on all loans to individuals.

Expansion of the Kazakhstani STB to the neighboring markets that started at the time of rapid growth, continued during the entire period of the global financial instability. The most attractive country for assets placing, in the opinion of Kazakhstani STB, remains the Russian Federation which has 25.8% in the structure of non-residents lending. Comparing to the last year, although share of loans to Russian Federation slightly decreased in the structure of non-residents lending, it increased by 26% in absolute terms from the beginning of the current year. In addition to Russia, the British Virgin Islands, Luxemburg, Cyprus, USA, Turkey are the main partner-countries (Figure 5.2.21).

Increase in cross-border risks of the banking system of Kazakhstan is also shown by increase in claims to non-residents in aggregate assets of Kazakhstani STB (Figure 5.2.22), as well as increase in share of loans to non-residents both in aggregate claims to non-residents, and in loan portfolio of the banking sector (Figure 5.2.23).

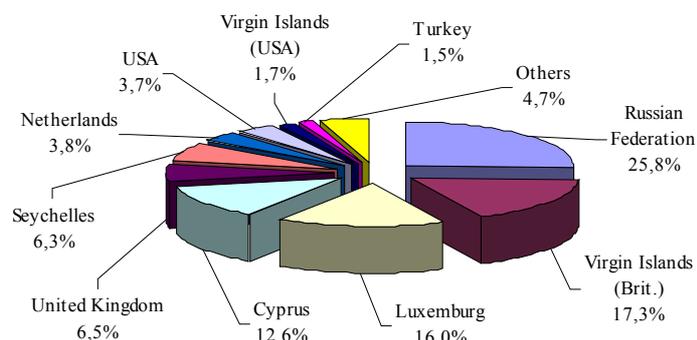
Figure 5.2.20



Source: FSA, NBRK

Figure 5.2.21

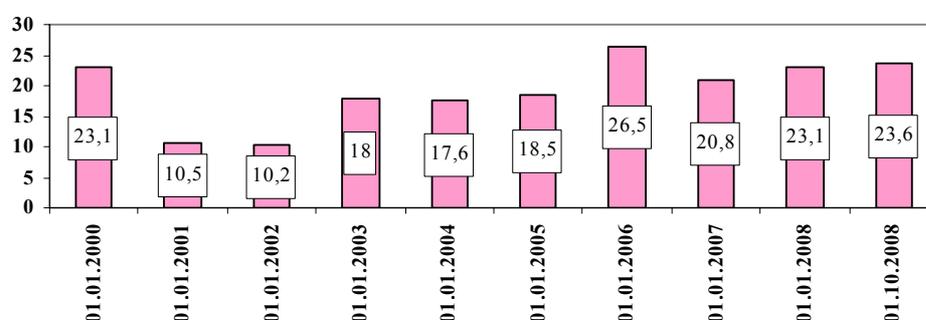
Distribution of Loans to Non-Residents by Country as of October 1, 2008 (%)



Source: FSA

Figure 5.2.22

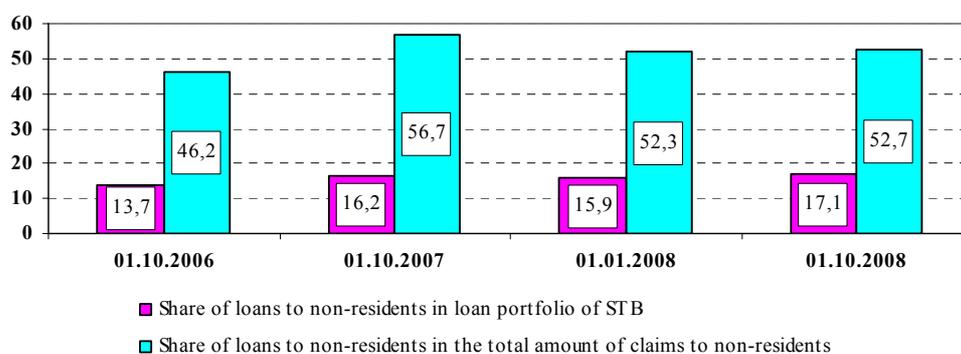
Share of Claims to Non-Residents in Total Assets (%)



Source: FSA

Figure 5.2.23

Lending to Non-Residents (%)



Source: FSA

5.3 Market Risks

In the conditions of instability, along with the credit risk, market risks also become very important. The GAP-analysis shows the presence of liquidity deficit in the short- and medium-term perspective, including foreign currency liquidity. Nevertheless, in general, market risks can be controlled and managed.

Shares of currency assets and liabilities of the banking sector in its aggregate assets and liabilities demonstrate the tendency of consistent reduction. As of October 1, 2008, the foreign currency assets were 51.7% in aggregate assets, foreign currency liabilities were 58.2% in aggregate liabilities (as of October 1, 2007 – 54.3% and 59.2%, respectively). The difference between these

ratios was minus 6.5 percentage points, decreasing from the beginning of the current year (an average amount of difference for the given period is 7.9 percentage points). At the same time, a considerable difference between these indicators was in the second quarter of 2008 which is mostly caused by an increase in liabilities in foreign currency with unchanged level of bank assets (Figure 5.3.1).

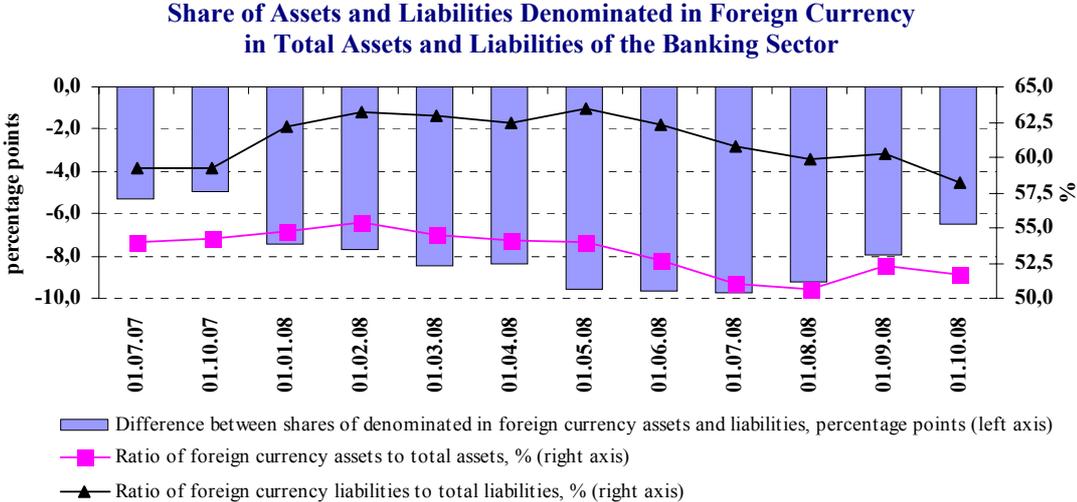
Although there is a gap in foreign currency components of assets and liabilities of STB, during the whole period the coefficients of currency liquidity were maintained with surplus that demonstrates an adequate perception of potential risks (Figure 5.3.2).

It should be noted decrease in ratio of net-currency position to own capital which has been recently amounted to the level much lower than the requirements (Figure 5.3.3).

Banks maintain an essential level of ratio of currency assets to currency liabilities with the terms ‘on demand’ and up to 1 month, and this indicates that currency risk is controlled and managed. At the same time there is a need in currency resources in the range from 1 to 6 months (Figure 5.3.4).

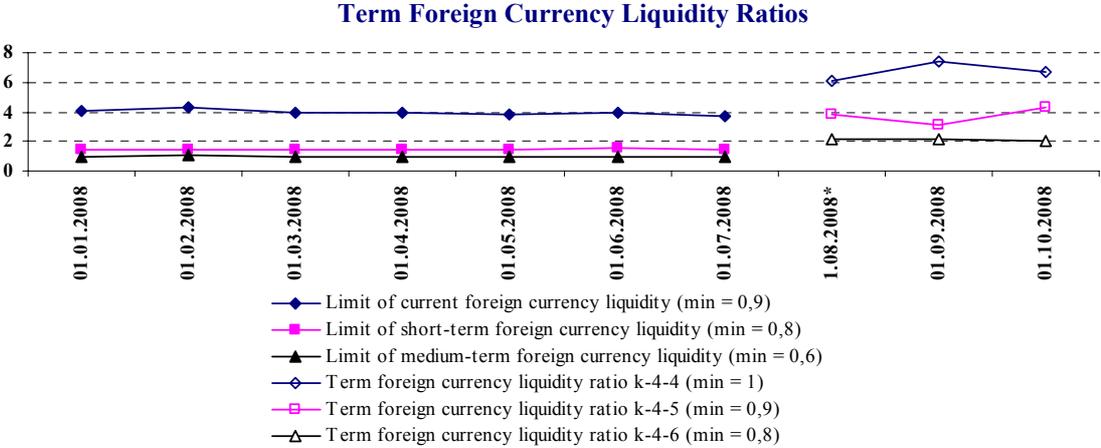
As for the analysis of equivalence of the banks’ aggregate assets and liabilities by remaining maturity, deficit of resources remains in the short-term perspective (up to 1 year) (Figure 5.3.5). As of October 1, 2008, the assets up to 1 month exceeded by 2 time the liabilities with the same term. However, with the terms from 1 to 3 months, this indicator amounted 0.5 versus 1.0 as of the same date of the last year (Table 5.3.1).

Figure 5.3.1



Source: FSA

Figure 5.3.2



* Since July 1, 2008 it has been introduced new term and foreign currency liquidity ratios up to 7 days, and it has been changed the methodology of term and term foreign currency liquidity ratios up to 30 and 90 days.

Source: FSA

Figure 5.3.3

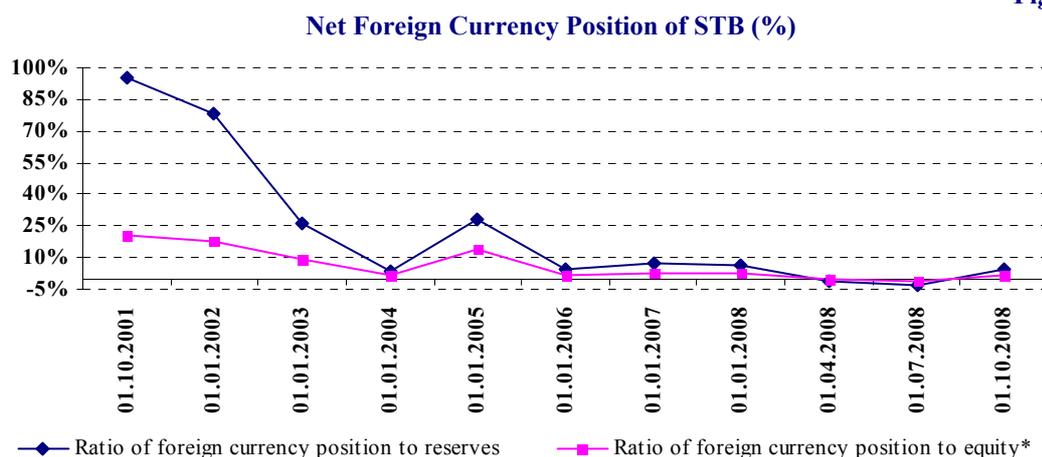


Figure 5.3.4

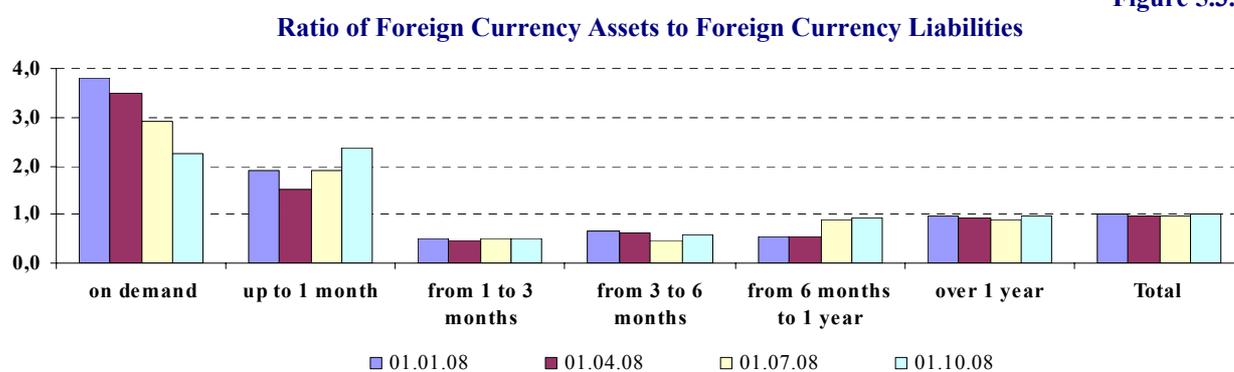


Figure 5.3.5

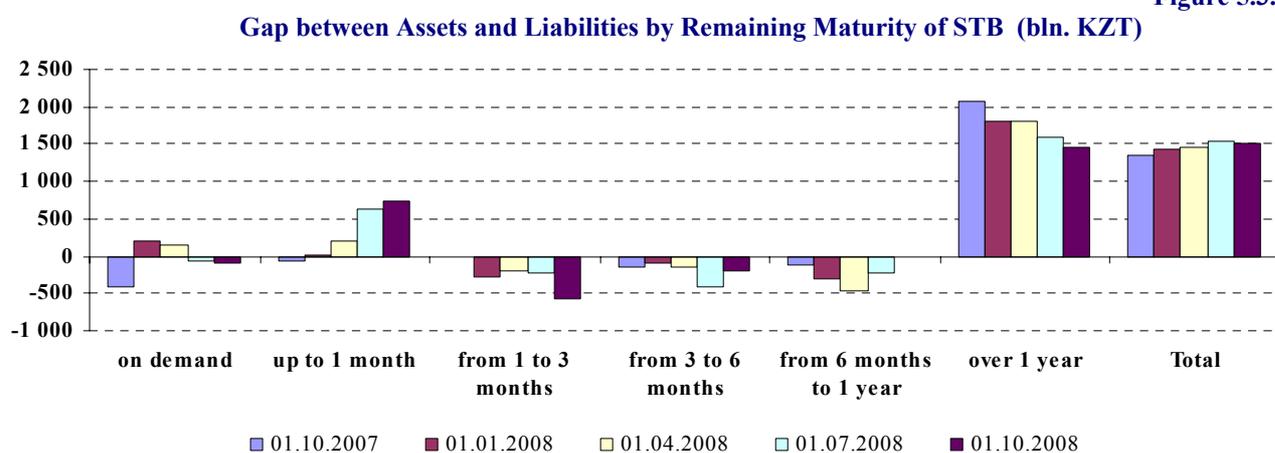


Table 5.3.1

**Assets and Liabilities of STB by Remaining Maturity
as of October 1, 2008 (bln. KZT)**

Period	Assets	Liabilities	Gap between assets and liabilities	Cumulative GAP
On demand	1,378.2	1,479.4	-101.2	-101.2
Up to 1 month	1,583.0	852.7	730.3	629.2
From 1 to 3 months	666.3	1,234.7	-568.4	60.8
From 3 months to 6 months	602.4	809.3	-207.0	-146.2
From 6 months to 1 year	1,065.1	1,066.2	-1.1	-147.3
More than 1 year	6,817.3	5,371.4	1,445.9	1,298.6
Total	12,500.3	10,980.7	1,519.6	1,519.6

Source: FSA

Stress Testing as Instrument of Risk Management

In order to assess sustainability of the banking system FSA makes a sensitivity analysis of unfavorable factors which impact on the banking sector. Such factors as exchange rates, prices for real estate and deterioration of the loan portfolio quality are taken into consideration.

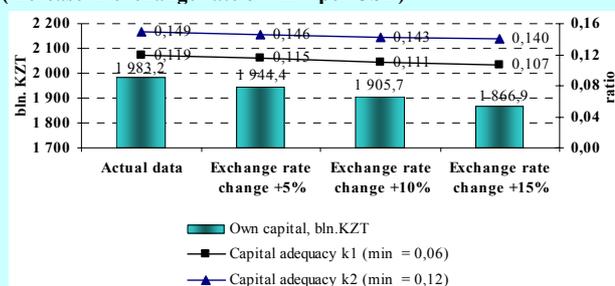
Scenario of Exchange Rate Change

The share of claims and liabilities in USD are the largest in the structure of claims and liabilities in foreign currency of STB. As of October 1, 2008, this indicator was 82%. In this connection, stress testing was carried out on the basis of open currency position on USD.

The scenarios of increase in exchange rate of KZT/USD by 5%, 10% and 15% were considered. Thus, if as of October 1, 2008 exchange rate was 119.84 KZT/USD, then the scenarios imply its increase to 125.8; 131.8; 137.8. Change in credit risk caused increase in provisions by 20% from the difference between actual total assets and calculated total assets.

Stress testing results indicate that under increase in exchange rate KZT/USD by 5% – 15% the required levels of own capital adequacy will be fulfilled by all banks. The ratio of currency net-position to own capital of STB will remain on an acceptable level – 1.9% (Figure 1).

**Figure 1. Stress Testing as of October 1, 2008
(increase in exchange rate of KZT per USD)**

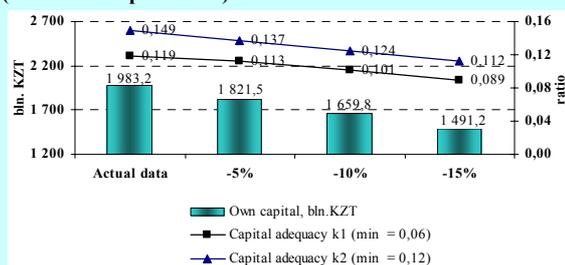


Scenario of Real Estate Price Change

Depreciation of the real estate by 5-15% is the scenario for the assessment of the banking sector's financial condition. In calculation, mortgage loans (collateralized by real estate) at 35.6% in aggregate loan portfolio of STB (as of October 1, 2008) were considered. Thus, if real estate on mortgage loans depreciates by a certain percent, STB will have to form additional provisions for the amount of depreciation.

As a result, devaluation of real estate by 5-15% on mortgage loans will have an essential impact on the financial condition of the banking sector. Violations of the own capital adequacy requirements under depreciation of real estate by 10% is noted in 5 STB, depreciation by 15% – in 7 STB (Figure 2).

**Figure 2. Stress Testing as of October 1, 2008
(real estate depreciation)**



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

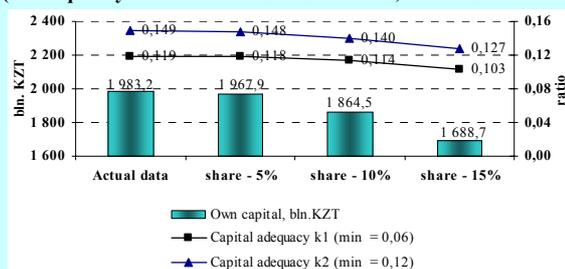
Based on the structure of credits to the economy, as well as the share of bad loans in each sector of the economy, stress testing was conducted in construction, trade and industry. Under stress testing the share of provisions in credits of a particular sector of the economy increased to 5–15%. At the same time, the most considerable influence on change of own capital of the banking sector is made by deterioration of the loans quality in trade.

It should be noted that deterioration of loan portfolio in each sector will not considerably affect the financial condition of STB, and the adequacy requirements of own capital will be fulfilled by STB.

At the same time, when considering the scenario of an increase in share of provisions in loan portfolio in the sectors of economy to 5-15 percentage points, two STB will not fulfill requirements of own capital adequacy

(Figure 3).

Figure 3. Stress Testing as of October 1, 2008
(loans quality deterioration in construction, trade and industry)



5.4 Risks of Liquidity and Sources of STB Funding

2008 has become comparatively difficult with regard to opportunities for refinancing of external borrowings of the banking sector. Nevertheless, the supportive measures of the National Bank of Kazakhstan along with the Kazakhstani banking policy contributed to some mitigation of liquidity and refinancing risks in the conditions of instability. The level of external indebtedness of the banking sector remains high. The narrowness of the domestic market does not allow the banks to settle the problems with liquidity.

Liquidity and refinancing risks in the conditions of limited access to external capital markets and pressure on assets quality required additional incentives in the framework of economic policy.

The liquidity level in the banking system is on an acceptable level. The liquidity ratios before amendments were on an adequate level with a moderate downward trend. The amendments made by the supervisory agency and aimed to regulate the liquidity level up to 7, 30 and 90 days stimulated STB to maintain an adequate level of liquidity for a more short-term perspective. It is proven by essential exceeding of the changed liquidity ratios since August 2008 (Figure 5.4.1).

In general, share of highly liquid assets in aggregate assets of the banking system was between 13.7% and 15.8 % during the current year that is caused by sustainability of liquid assets in the conditions of insignificant growth of the banking assets. In other countries the level of liquid assets in aggregate assets essentially exceeds the value of Kazakhstan⁴⁵.

Value of the funding volatility ratio is inclined to decrease which is caused mostly by comparatively high growth rates of the deposit base comparing to the bank assets and decreasing of external borrowings as a source of financing. Nevertheless, its value continues to be rather high, reflecting thereby inadequate level of deposit base to be used as a main source of funding of Kazakhstani STB (Figure 5.4.2).

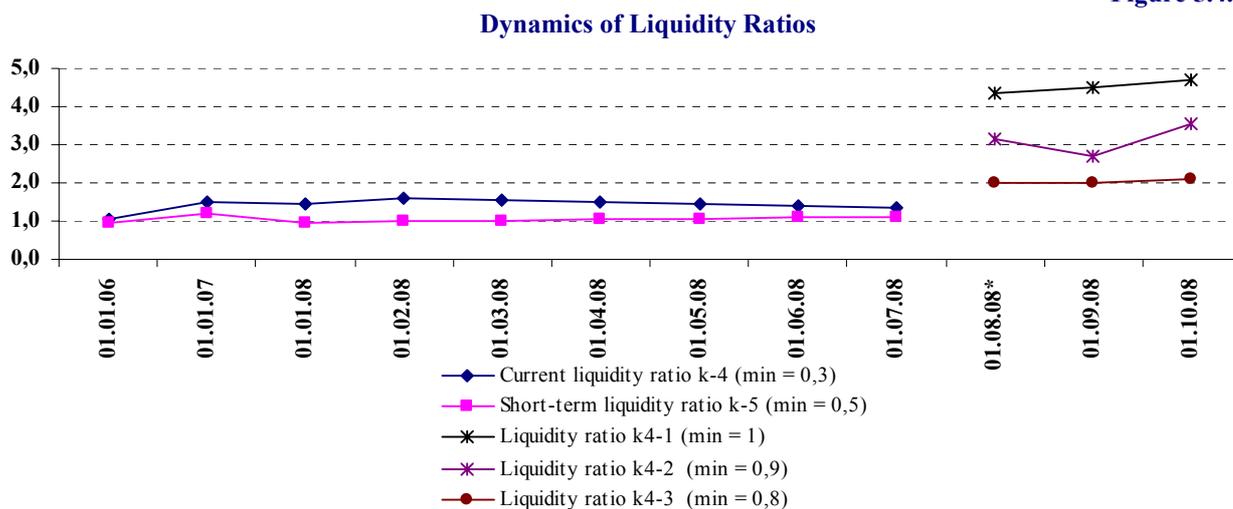
In the structure of STB distribution by interval groups of the liquid assets level since last October the number of banks with relatively high level of liquidity risk (less than 15% of the aggregate assets) has essentially increased. At the same time, a number of banks that have a share of liquid assets in the aggregate assets in the range of 15 to 30% is constant (Figure 5.4.3).

In the structure of high-liquid assets of STB, no essential changes have been noticed since the beginning of the current year. However, over the period the share of funds on correspondent accounts and deposits in NBRK has slightly increased, while the share of government bonds in aggregate high-liquid assets has decreased (Figure 5.4.4).

Liquid assets completely cover the volume of demand liabilities. At the same time, with regard to short-term liabilities of the banks with remaining maturity less than 1 year and demand liabilities, liquid assets are capable to cover only the third part. It indicates the liquidity risk and refinancing risks in close future (Figure 5.4.5).

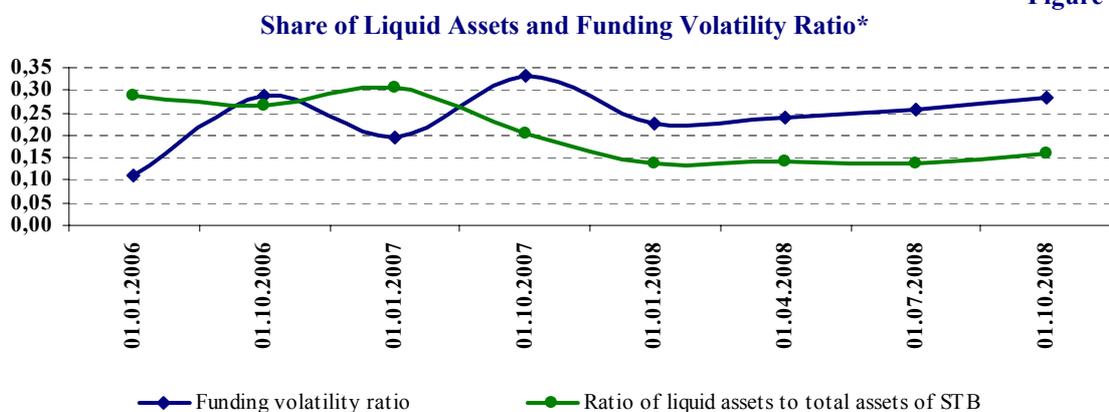
⁴⁵ Data for 2007: national sources, rating agencies.

Figure 5.4.1



* since July 1, 2008 new foreign currency liquidity ratios have been introduced for STB
 Source: FSA

Figure 5.4.2

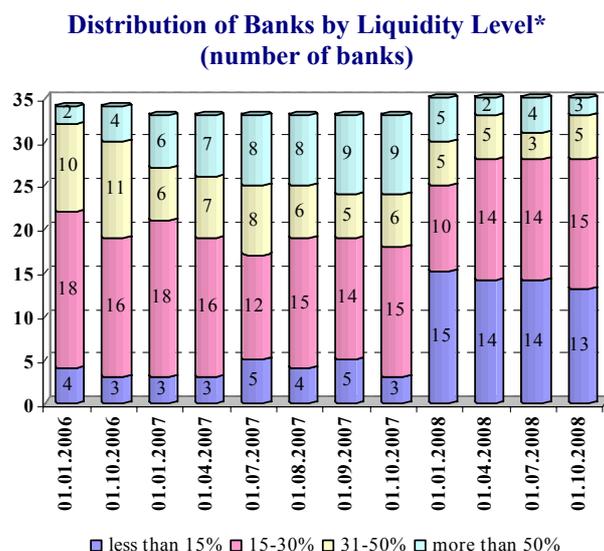


*Liquid assets include money, demand deposits and other short-term assets, securities available for sale and transactions of reverse REPO with securities.

**Funding volatility ratio is calculated as the ratio of difference between deposit base and liquid assets to the difference between total assets and liquid assets.

Source: FSA

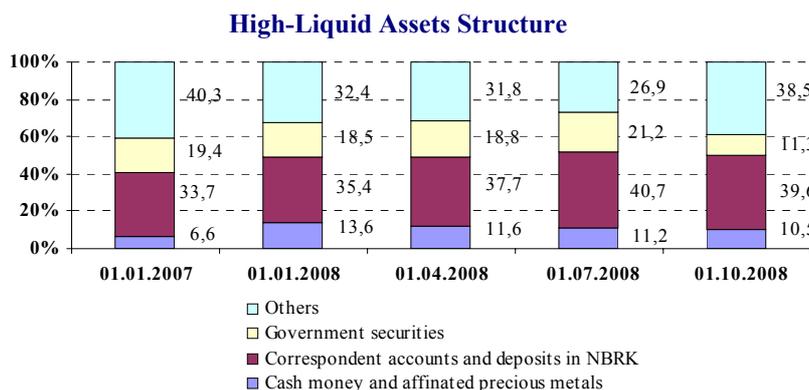
Figure 5.4.3



* share of liquid assets in total assets of STB, %

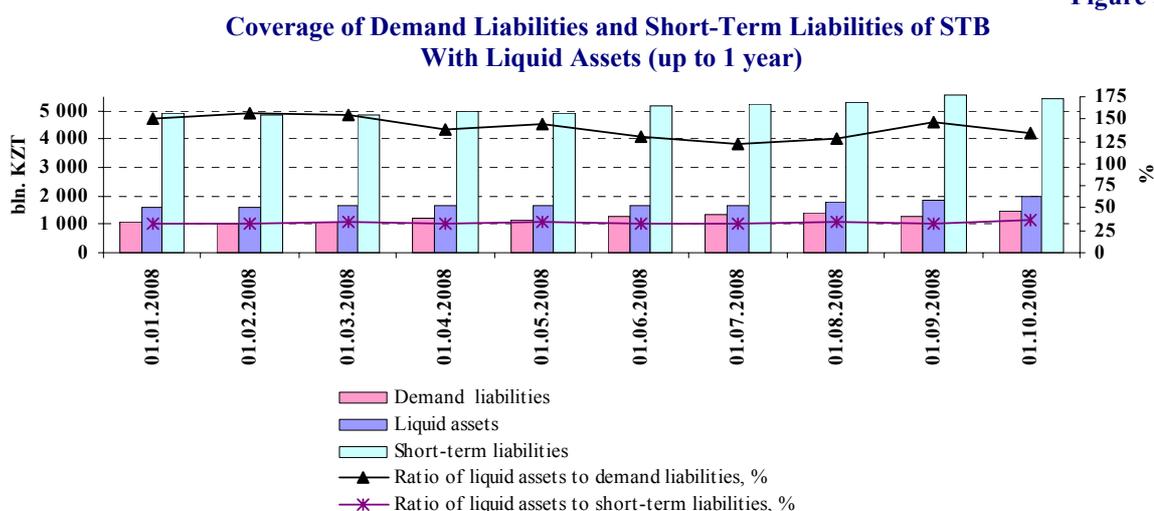
Source: FSA

Figure 5.4.4



Source: FSA

Figure 5.4.5



Source: FSA

In spite of investors' panic caused by financial instability, the deposit base of the banking system is characterized by structural consistency and relatively positive dynamics. However, the deposit base as a source of STB funding remains rather weak. The potential of the STB funding through interbank relations also remains weak. In spite of decline in external liabilities in total liabilities of the banking sector, external funding continues to remain as a key source of financing of the STB activity.

Clients' deposits (without deposits of special purpose vehicles) comparing to the beginning of the current year increased by more than 27% and reached KZT 4,962.4 bln. in absolute terms. The main contribution to the deposit base growth was made by legal entities' deposits, which increased by almost 40% for the same period whereas deposits of individuals increased by only 6.8%. Relatively high growth rates of deposits of legal entities contributed to some increase in their share in aggregate clients' deposits.

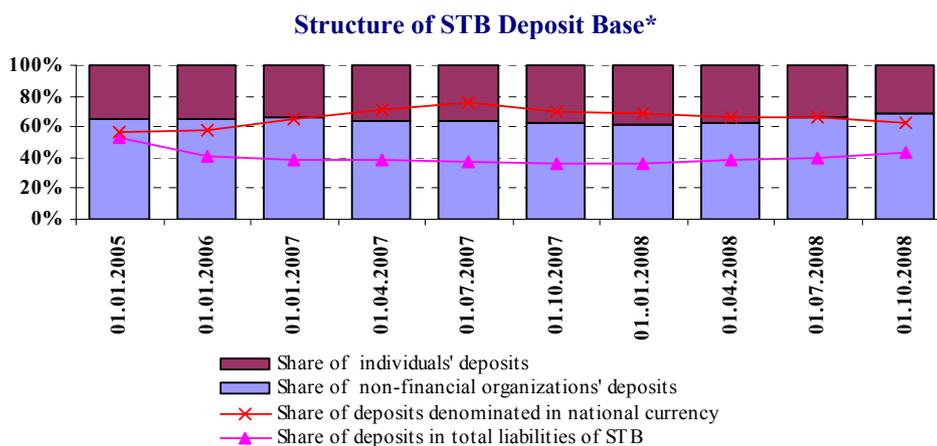
The general growth of clients' deposits resulted in increase in their share in aggregate liabilities of the banking sector. In spite of increase in share of deposits in foreign currency, a prevailing part of the STB deposit base is in the national currency (Figure 5.4.6).

The structure of individuals' deposits also remained unchanged where considerable share is term deposits and conditional deposits. As in the currency structure of overall deposit base, a prevailing part of individuals' deposits has been attracted in the national currency (Figure 5.4.7).

In spite of stable dynamics and consistent structure of deposit base in the banking system, it can not be widely used as a source of funding. It is evidenced by relatively high ratio of loans to deposits used for assessment of STB liquidity, and its downward trend with decline of loan portfolio under a consistent growth of deposit base. We believe that increase in the amount of guaranteed compensation on individuals' deposits up to KZT 5 mln. in the framework of

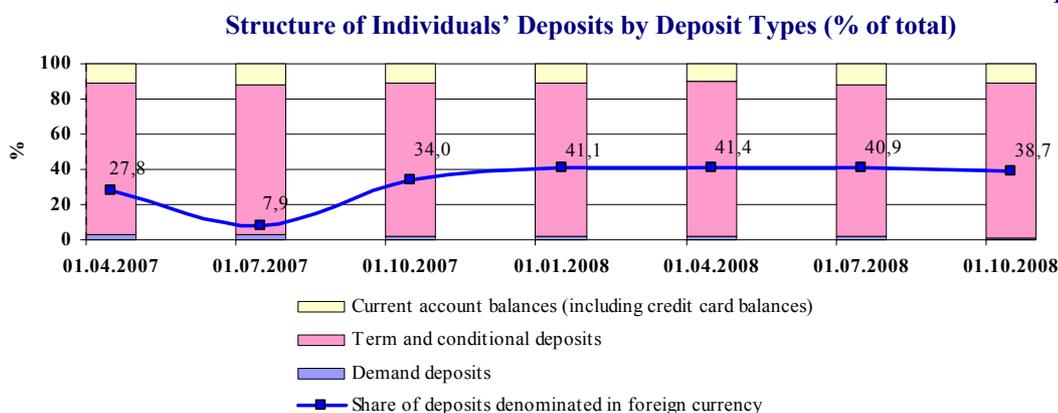
stabilization measures in Kazakhstan will enhance the potential of deposit base as a source of funding (Figures 5.4.8, 5.4.9).

Figure 5.4.6



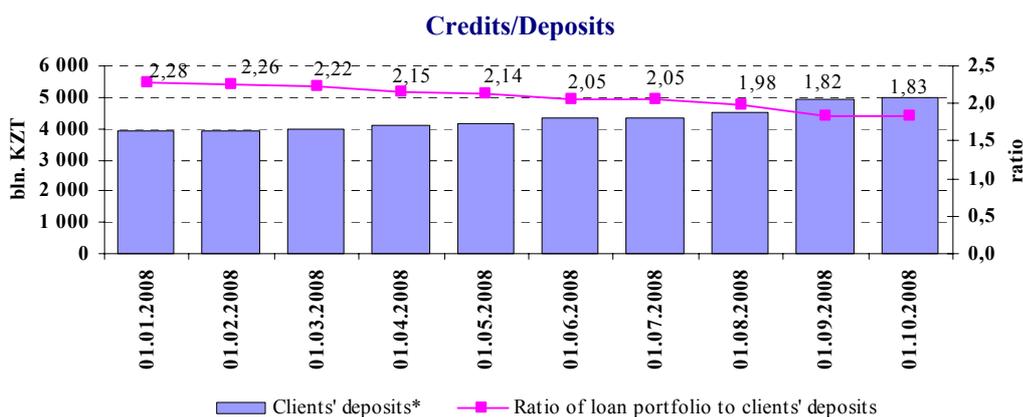
* excluding non-residents
Source: FSA

Figure 5.4.7



Source: NBRK, KDIF, FSA

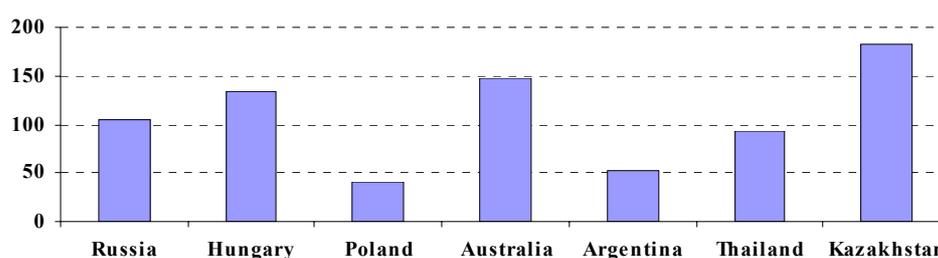
Figure 5.4.8



* excluding deposits of special purpose vehicles (SPV)
Source: FSA

Figure 5.4.9

Kazakhstani STB Compared to Other Countries' Banks: (Credits/Deposits) (%)

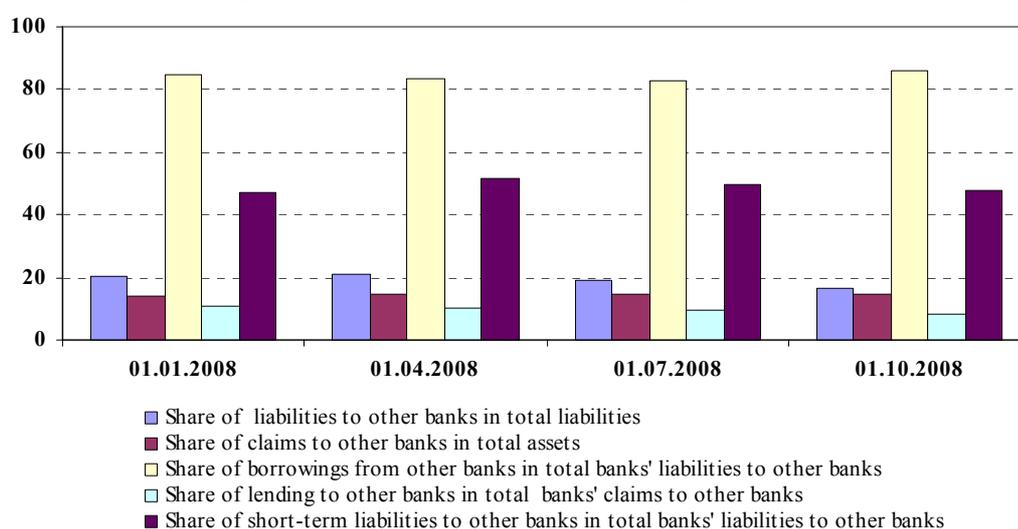


Sources: national sources, rating agencies, FSA (data across countries for 2007-2008, Kazakhstan – as of October 1, 2008)

As for interbank relations, from the beginning of 2008 a share of banks' liabilities to other banks in aggregate liabilities decreased from 20.6% to 16.7% with a slight increase in share of interbank claims in aggregate assets of the banking system from 13.8% to 14.6%. The share of short-term interbank liabilities in aggregate liabilities of the banks is characterized by constant dynamics (Figure 5.4.10).

Figure 5.4.10

Dynamics of Interbank Relations Development (%)



Source: FSA

Since the beginning of the current year instability on the global markets has resulted in decline of external liabilities which have been recently formed the main source of the banking sector growth both in absolute and relative value. On the one hand, it decreases the banking system vulnerability to external shocks, and on the other hand, it increases deficit of liquidity in the conditions of narrowness of the domestic liquidity market. However, in spite of decline in ratio of external liabilities to aggregate liabilities of the banking sector, the level of external indebtedness remains high and comprises a considerable part of aggregate liabilities of STB (Figure 5.4.11). At the same time, there were no essential changes in the structure of external liabilities of the banking sector during observed period (Figure 5.4.12).

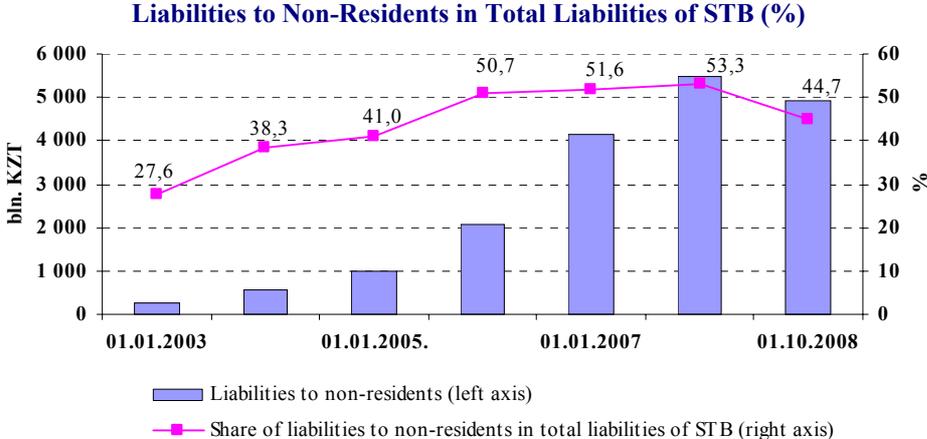
In spite of problems with liquidity, Kazakhstani banks service external loans. Along with the support of the National Bank, they refinance external liabilities on external markets in the conditions of 'closed' external markets. It indicates that Kazakhstani banks have international creditors' confidence.

According to the data of the National Bank of Kazakhstan, as of June 30, 2008, during 2009 STB will have to repay about KZT 1,320.0 bln. (USD 11 bln.) on external liabilities.

Under instability conditions, international creditors can require advanced repayment of external liabilities. Thus, among the covenant terms for advanced repayment of the loans attracted

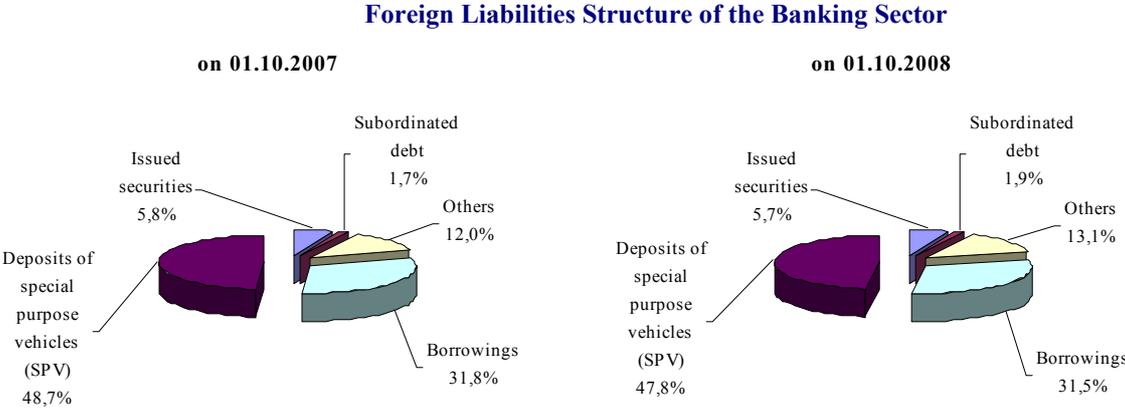
by Kazakh STB from external markets are default, cross-default, bankruptcy/liquidation, legal proceedings, incorrect information, amendments to legislation, nationalization and expropriation, violation of the authorized agency requirements, revocation of a license, essential changes in the structure of shareholders, and significant negative events.

Figure 5.4.11



Source: FSA

Figure 5.4.12



Source: FSA

5.5 Effectiveness of STB Activity and Capital Adequacy

Increase in reservation as a result of deteriorating quality of the loan portfolio along with considerable decrease in bank lending operations contributed to decline in banks’ profitability creating at the same time pressure on capitalization of the banking sector.

STB have received an aggregate net income after income tax in the amount of KZT 71.1 bln. within 9 months of the current year, which is 2.5 times less than for the same period of the last year. It was conditioned by reduction of STB lending operations and essential increase of STB expenses on provisions. The aggregate (gross) income was KZT 2,007.2 bln. (as of October 1, 2007 – KZT 1,269.5 bln.).

Since last October the share of interest incomes has decreased from 70.0% to 54.7% along with increase in the share of non-interest expenses from 55.1% to 69.1% in the structure of STB expenses (Table 5.5.1).

Indicators of return on assets and own capital have decreased since last October by more than 2 times which is connected with decrease in lending operations and pressure by assets quality, increase in interest rates by STB on newly attracted resources to increasing possibility of refinancing external loans due to internal sources of financing under limited access to external capital markets (Figure 5.5.1).

Besides, the indicators of Kazakhstani STB profitability were lower than the average value in the countries of Europe and South-Eastern Asia both return on assets (1.8% in 2008) and return on capital (15.7% in 2008) (Table 5.5.2).

However, the indicators of interest margin and interest spread of the banking system had an upward trend indicating prevalence of interest revenues and interest expenses in the structure of revenues (expenditures) (Figure 5.5.2).

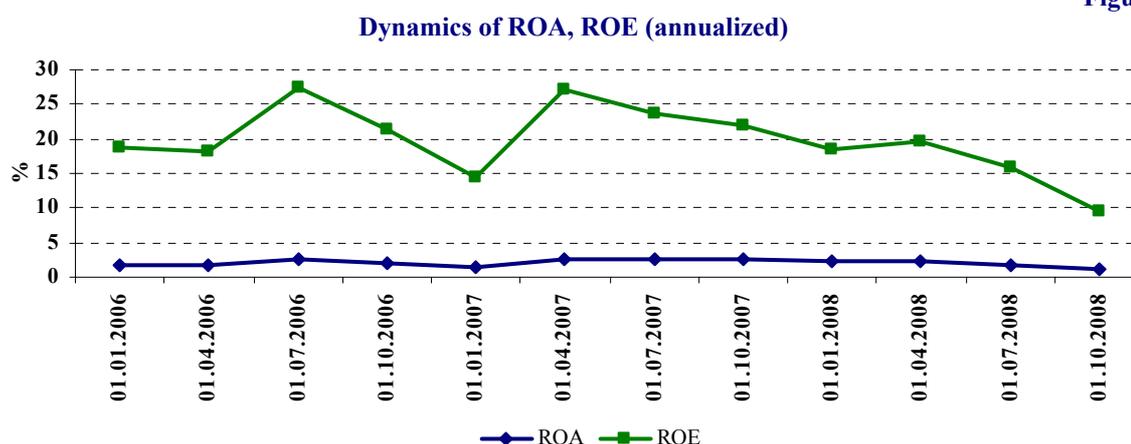
Table 5.5.1

**Banking Sector Profitability
(bln. KZT)**

Indicator	Oct 1, 2006	Oct 1, 2007	Oct 1, 2008	Change (+;-), %
Interest income	422.4	886.7	1,097.9	23.8
Interest expense	230.4	469.9	589.9	25.5
Net interest income	192.0	416.8	508.0	21.9
Non-interest income	189.4	382.7	909.3	by 2.4 times
Non-interest expense	281.3	578	1,320.2	by 2.3 times
<i>incl. allocations for provisions</i>	92.5	15.3	819.9	by 5.2 times
Net non-interest income (loss)	-91.9	-195.3	-410.9	by 2.1 times
Extraordinary items	0.9	0.2	-	-
Net income before income tax	101	221.7	97.1	- 56.2
Income tax costs	12.9	37.3	26.0	- 30.3
Net income after income tax	88.1	184.4	71.1	- 61.4

Source: FSA

Figure 5.5.1



Source: FSA

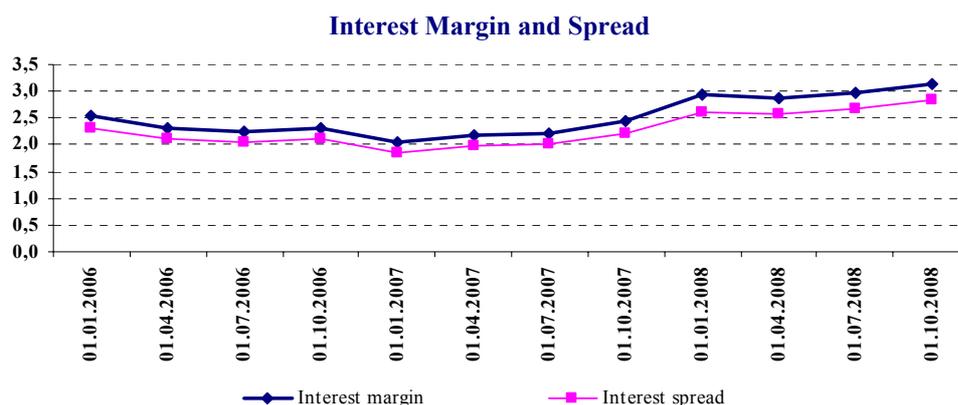
Table 5.5.2

Comparative Analysis of ROE and ROA Indicators across Countries in Europe and Asia

Countries	2003		2004		2005		2006		2007		2008	
	ROA	ROE	ROA	ROE	ROA	ROE	ROA	ROE	ROA	ROE	ROA	ROE
Bulgaria	2.4	19.6	2.1	21.4	2.1	25.0	2.2	24.8	2.4	24.6	2.5	28.6
Czech	1.2	23.8	1.3	23.3	1.4	25.2	1.2	22.5	1.3	24.5	1.4	26.0
Croatia	1.6	14.1	1.7	16.1	1.6	15.1	1.5	13.0	1.6	11.1	1.6	10.0
Hungary	1.5	19.3	2.0	25.3	2.0	24.7	1.8	24.0	1.4	18.1	...	...
Romania	2.7	20.0	2.5	19.3	1.9	15.4	1.7	13.6	1.3	11.5	1.5	15.4
France	0.4	8.5	0.5	10.6	0.6	11.8	0.7	15.5	0.4	9.8	...	...
Indonesia	2.6	...	3.5	22.9	2.5	16.5	2.6	16.4	2.8	17.7	2.7	19.2
Korea	0.2	3.4	0.9	15.2	1.0	18.4	1.1	14.6	1.1	14.6	0.9	...
Malaysia	1.3	15.6	1.4	16.7	1.4	16.7	1.3	16.2	1.5	19.7	...	...
Philippines	1.1	8.5	0.9	7.1	1.1	8.7	1.0	10.6	1.4	11.8	...	...
Singapore	1.0	8.7	1.2	11.6	1.2	11.2	1.4	13.7	1.4	13.4	...	...
Thailand	0.6	10.3	1.2	16.8	1.4	14.2	0.8	8.8	0.1	7.3	...	...

Source: IMF, GFSR, 2008

Figure 5.5.2



Source: FSA

As of October 1, 2008, the banks regulatory capital reached KZT 1,983.2 bln., having increased by 11.4% from the beginning of the year due to increase in Tier 1 capital by 19.2%. At the same time, the Tier 2 capital decreased by 6.2% due to decline in retained income (Table 5.5.3).

At the same time, from the beginning of the current year own capital of STB increased by KZT 94.5 bln. (6.6%) and amounted to KZT 1,519.6 bln. as of the reporting date.

In the structure of Tier 1 capital there was an essential increase in the share of reserve capital and decline in the share of retained net income, which was caused by implementation of measures on reserve capital increase in November 2007. These measures stipulated establishing a minimum amount of reserve capital not less than 2% of the STB loan portfolio subject to classification (previously the amount of reserve capital of STB should have been in total not less than 5 % of STB assets not subject to classification in accordance with the legislation of the Republic of Kazakhstan) which have come into effect since May 1, 2008 (Figure 5.5.3).

Capitalization of the banks remains on an adequate level. Adequacy indicators of the banking sector exceed the indicators accepted in the international practice and stipulated by requirements of existing banking legislation. However, continuing trends in loan portfolio quality require additional incentives in banks' capitalization (Figure 5.5.4).

In comparison with other countries, capital adequacy ratio (k2) of Kazakhstani banks is higher than in some countries of South-Eastern Europe and essentially lower than in Malaysia (Figure 5.5.5).

It should be noted considerable decline in the ratio of regulated capital to bad loans and provisions that was caused by deteriorating quality of the loan portfolio expressed in a considerable increase in bad loans and, accordingly, in increase of reserves. At the same time, the ratio of the regulated capital to doubtful loans and ratio of the regulated capital to aggregate loan portfolio of the banking sector is characterized by constant dynamics (Figure 5.5.6).

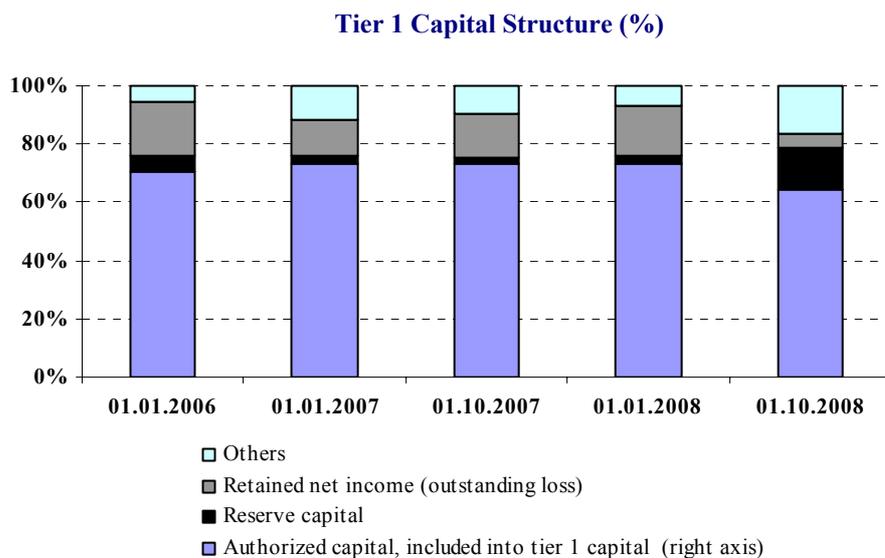
Table 5.5.3

Characteristics of Aggregate Own Capital of the Banking System

Name	Jan 1, 2008	Oct 1, 2008	Surplus, in %
Tier 1 capital	1.284.0	1.530.8	19.2
Authorized capital	.940.2	.985.5	4.8
Additional capital	3.8	4.8	26.3
Retained net profit of prior years	204.9	232.8	13.6
Tier 2 capital	558.9	524.4	-6.2
Retained net profit	216.7	71.2	-67.1
Subordinated debt	460.9	543.7	18.0
Tier 3 capital	1.7	1.2	-29.4
Total own capital	1.780.2	1,983.2	11.4

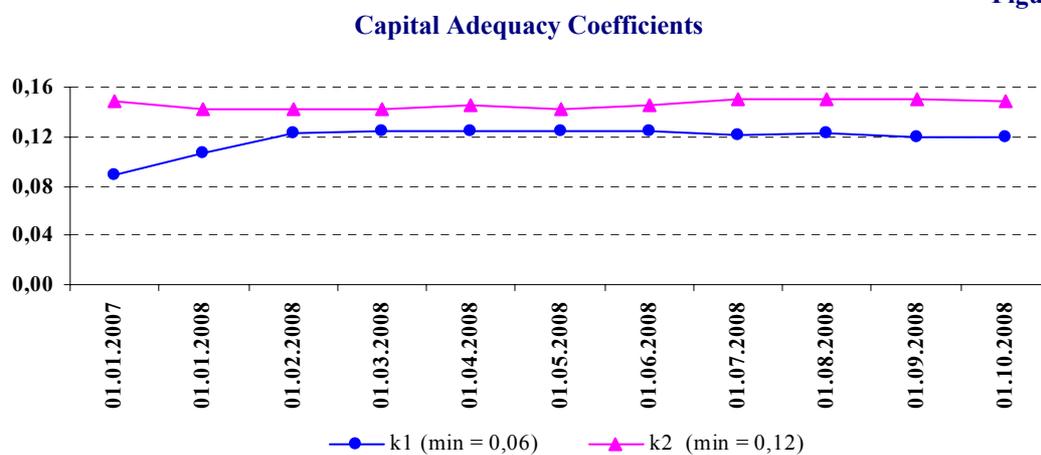
Source: FSA

Figure 5.5.3



Source: FSA

Figure 5.5.4



Source: FSA

6. Other Financial Institutions

6.1 Insurance Sector

6.1.1 The Situation on Insurance Market

The insurance sector of Kazakhstan had been intensely developing in the last years in the conditions of sharp growth of other segments of the financial sector, especially, banking sector as a main consumer of insurance services. In 2008, it slightly slowed down its growth rate. At the same time, appearance of new players in this sector indicates the growth potential of the insurance market in Kazakhstan.

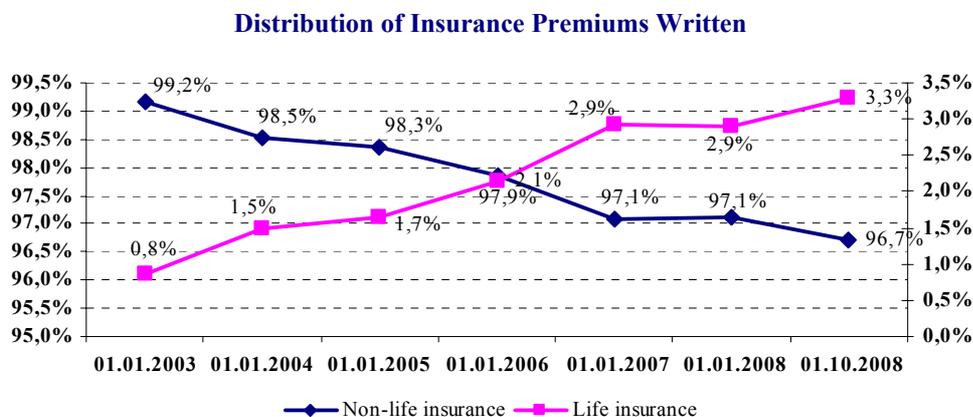
As of October 1, 2008, 44 insurance organizations carried out a licensed activity on the insurance market (as of October 1, 2007 – 40 insurance organizations).

The main indicators of the Kazakhstan's insurance sector demonstrate high rates of growth compared to other segments of the financial sector despite the fact that insurance premiums written by insurance (re-insurance) organizations under direct insurance policies have decreased since last October by 1.5% to 108.8 bln. KZT. Thus, the aggregate volume of assets of insurance organizations reached 281.7 bln. KZT as of October 1, 2008 (56.0% increase compared to October 1, 2007). The aggregate equity capital, having increased since last October by more than 46%, amounted to 162.1 bln. KZT. The volume of insurance reserves has comprised 97.1 bln. KZT, which is by 58.1% more than the volume of the reserves as of October 1, 2007.

A considerable part of insurance premiums falls to general insurance in spite of its gradual decreasing share (Figure 6.1.1.1).

The role of insurance sector in the country's economy remains insignificant which is confirmed by the ratio of the insurance organizations assets to GDP having constituted 1.87%, insurance premiums – 0.72%, equity capital – 1.08%.

Figure 6.1.1.1



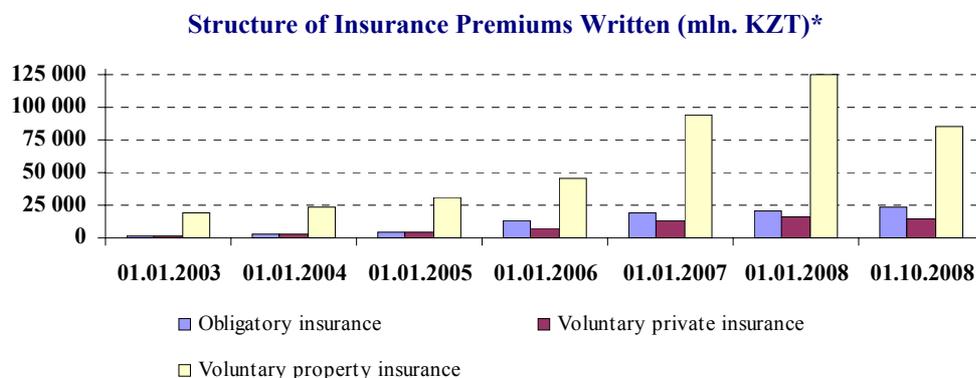
Source: FSA

In the structure of the aggregate insurance premiums written, the premiums on obligatory and voluntary personal insurance have increased by 51.1% and 20.4% respectively since last October, and the volume of premiums on voluntary property insurance decreased by 10.4% (Figure 6.1.1.2).

With the decrease of insurance premiums for the period under review the insurance payments essentially increased (almost by 50%) and was KZT49.6 bln. as of October 1, 2008. The growth of insurance payments on claim was noted across all classes of insurance. A considerable share in the structure of aggregate insurance payments is attributed to payments on voluntary property insurance, mainly insurance against other financial losses, insurance of guarantees and pawns, insurance of loans, property, and transport, including motor vehicles, and motor-third-party liability insurance (Figure 6.1.1.3).

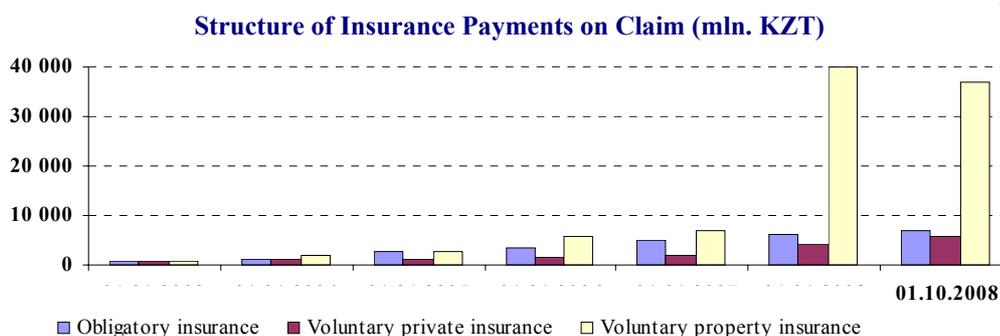
For the most part high rates of the insurance market growth in recent years were observed due to the increase of premiums written in voluntary property insurance, particularly in insurance from other financial losses. In the conditions of essential slowdown of credit active operations of STB, the volume of insurance premiums is decreasing (when consumer loans are granted a mandatory condition is to effect a policy of life and health insurance of a borrower from accidents, collateralized property insurance).

Figure 6.1.1.2



* insurance premiums under insurance and reinsurance policies
Source: FSA

Figure 6.1.1.3



Source: FSA

Bank Risks Insurance

As of October 1, 2008, 20 insurance organizations out of 44 insure the risks related to banking operations (without consideration of the operations with JSC Bank of Development of Kazakhstan).

Risks of banking operations are covered by insurance organizations through insurance against other financial losses, property (except for insurance of transport and cargoes), motor transport, liability insurance (except for liability insurance of owners of motor vehicles), loans, guarantees and pawns (Table 6.1.1.1).

Table 6.1.1.1

Premiums and Payments Associated with Banking Operations, (in thousand KZT)

Name of classes	Premiums/ Payments	Jan 1, 2005	Jan 1, 2006	Jan 1, 2007	Oct 1, 2007	Jan 1, 2008	Oct 1, 2008
Motor vehicle insurance	Premiums	2,340,955	3,227,573	4,969,860	5,148,984	6,589,335	4,134,212
	Payments	933,594	1,110,269	1,150,769	1,297,120	1,818,025	1,734,453
Property insurance	Premiums	10,177,269	14,824,186	21,809,267	23,236,391	32,924,959	22,038,797
	Payments	67,295	2,203,522	1,037,511	1,022,074	1,143,497	734,124
General liability insurance	Premiums	10,496,831	16,628,263	22,639,797	15,579,715	20,580,863	22,084,368
	Payments	699,114	749,818	402,327	369,281	563,567	109,924
Loan insurance	Premiums	no data	no data	616,360	-6,646	207,603	125,618
	Payments	no data	no data	720	0	668	182,237
Guarantee and pawn insurance	Premiums	no data	no data	7,829	4,433	9,109	16,025
	Payments	no data	no data	no data	no data	no data	no data

	Payments	no data	no data	0	0	0	5,760
Insurance against other financial losses*	Premiums	2,206,532	4,364,785	31,414,530	31,717,632	42,241,808	14,424,435
	Payments	355,453	1,362,785	3,418,563	22,333,937	34,947,084	32,857,916

* before adoption of Law of the Republic of Kazakhstan No.128-III dated February 20, 2006 "On Amendments and Additions to Some Regulatory Acts of the Republic of Kazakhstan on the Matters of Insurance"- entrepreneurial risk insurance

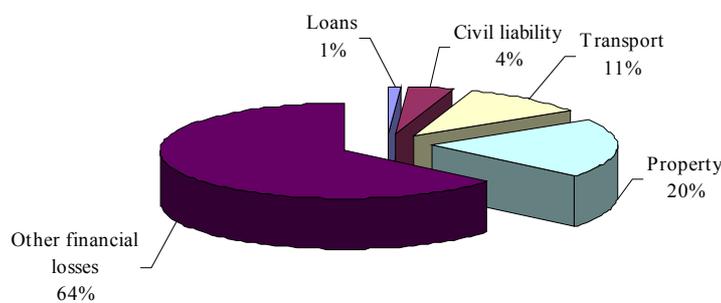
Source: FSA

The total volume of insurance premiums on these classes was KZT62.8 bln. The insurance premiums volume under insurance policies of risks relating to banking operations was KZT13.0 bln.⁴⁶ which is 12% of the total insurance premiums received under insurance policies and 14% of the total insurance premiums received under insurance policies in “general insurance” industry.

The number of existing insurance policies is 275.5 thous., the insurance cover on them is KZT1,138.9 bln., or 4% of the aggregate insurance cover volume on all the policies existing as of October 1, 2008. Out of the total amount of insurance premiums on operations with STB, 40% are the operations where the insured is a client of STB, and the beneficiary is an STB, and 60% are the contracts when the insurer (the insured) and beneficiary is an STB (Figure 6.1.1.4).

Figure 6.1.1.4

Distribution of Insurance Premiums Written under Insurance Policies Covering Bank Risks



Source: FSA

Out of the insurance premiums under risk insurance policies, 99% are the operations between affiliated organizations.

At the same time, the share of insurance (re-insurance) organizations' assets where STB are large participants in the aggregate assets of the insurance sector, and the share of affiliated organizations' premiums in the aggregate insurance premiums remain high in spite of consistent decrease (Table 6.1.1.2).

Table 6.1.1.2

Concentration of Insurance Organizations (%)

	Share of assets of insurance (re-insurance) organizations where STB are large participants, in aggregate assets of insurance sector, %	Share of premiums of insurance (re-insurance) organizations where STB are large participants, in aggregate insurance premiums %
Jan 1, 2003	19.6	—
Jan 1, 2004	82.1	45.7
Jan 1, 2005	70.5	71.8
Jan 1, 2006	70.3	64.8
Jan 1, 2007	67.5	58.3
Jan 1, 2008	62.5	59.7
Apr 1, 2008	60.7	46.1
Jul 1, 2008	61.8	55.3
Oct 1, 2008	57.0	53.2

Source: FSA

⁴⁶ According to the data provided at the request of the authorized body.

Thus, on the whole, the volume of operations related to bank risks is relatively small, except for the volume of operations between affiliated organizations. At the same time, with regard to such organizations, loss on bank risks insurance is covered by other classes of insurance.

In spite of imbalance in the dynamics of insurance premiums and insurance payments, the level of financial stability of the insurance sector remains satisfactory. This is indicated by a growth of share of high-liquid assets in the insurance organizations' assets structure from 55.8% in the beginning of the current year to 64.1% as of October 1, 2008, and positive dynamics in capitalization.

As for the level of concentration in the insurance sector, then starting from last October it was observed a slight reduction of the insurance market concentration on insurance premiums and insurance payments. Five largest insurance companies have 50.3% of the aggregate insurance premiums and 69.3% of insurance payments. The share of five largest insurance companies in the aggregate assets of the insurance market was 52.9% versus 52.5% - as of October 1, 2007.

6.1.2 Re-insurance

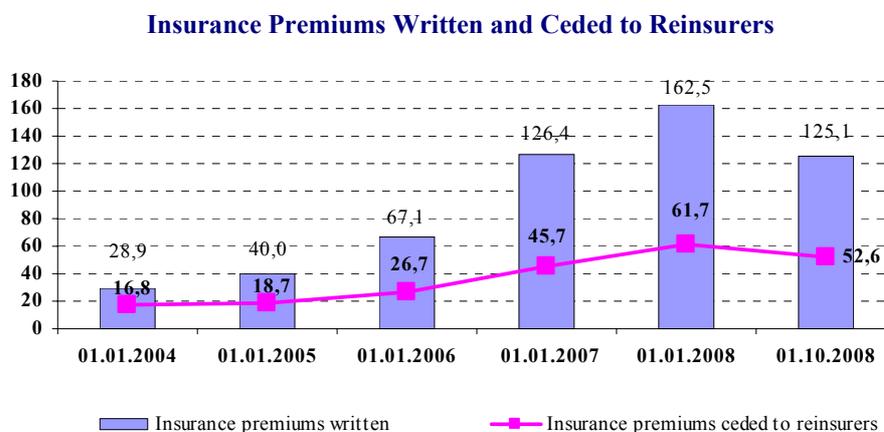
Along with a decrease in the volume of insurance premiums, there is a tendency to decrease of insurance premiums ceded to re-insurance. The share of insurance premiums ceded to re-insurance to non-residents is increasing in the structure of re-insurance.

The insurance premiums ceded to re-insurance reduced from the beginning of the year by 14.7%, and was KZT52.6 bln., or 42% of the aggregate insurance premiums (Figure 6.1.2.1).

In the re-insurance structure, non-residents take a considerable part (Figure 6.1.2.2). Expansion of the trend of risks transfer to non-residents by re-insurance, on the one hand, is positively assessed as one of the risk management instruments of insurance organizations and a method of sharing the best practices in the management practice and new technology. On the other hand, in the conditions of global instability, re-insurance risks are increasing, i.e. failure to meet the obligations by a contractor under re-insurance policies.

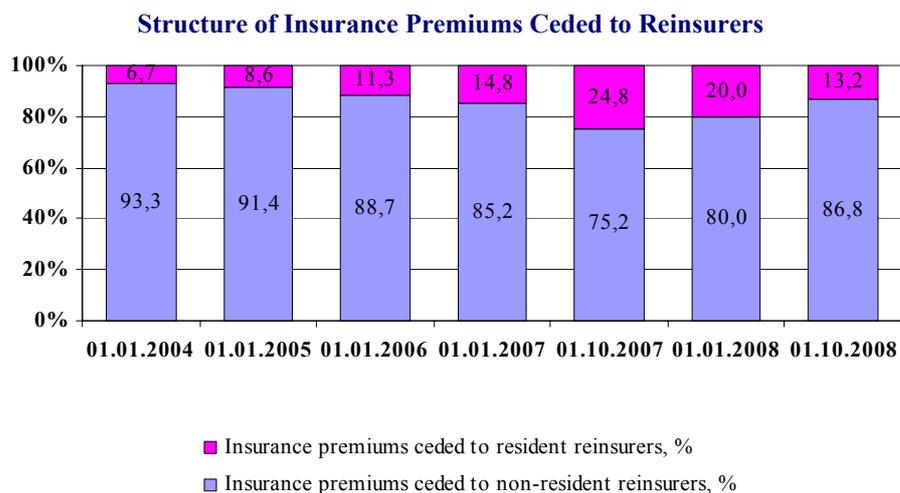
In the country structure of the premiums ceded to re-insurance, a considerable part of the premiums ceded to re-insurance is taken by Russia – 30.2% (as of January 1, 2008 – 13.8%), United Kingdom – 17.5% (6.9%), Germany – 14.3% (15.8%), Sweden – 8.3% (7.1%). Due to objective reasons, the share of premiums ceded to re-insurance in USA greatly decreased and was only 1.3% versus 21.2% as of the beginning of this year. At the same time, the level of interaction of Kazakhstani insurance organizations in risks re-insurance within Kazakhstan is decreasing. This is evidenced by reduction in the re-insurance structure of the share of premiums ceded to re-insurance to local insurance companies from 19.6% at the beginning of the year to 13.2% as of the beginning of this October (Figure 6.1.2.3).

Figure 6.1.2.1



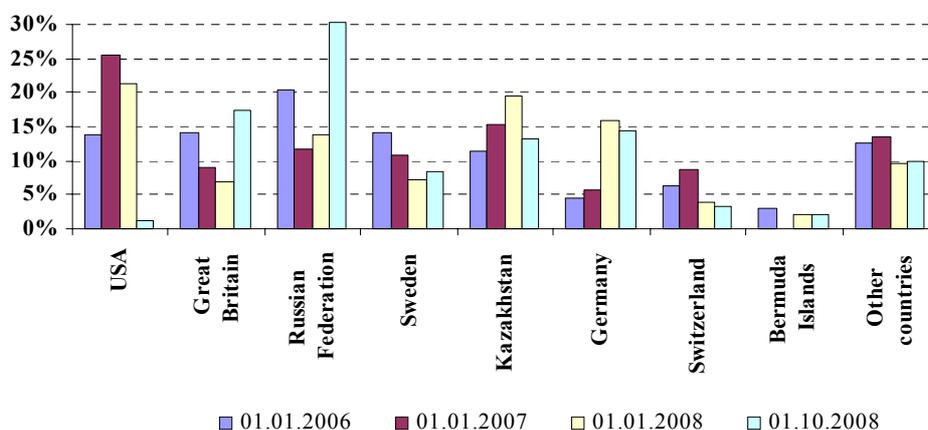
Source: FSA

Figure 6.1.2.2



Source: FSA

Figure 6.1.2.3

Structure of Insurance Premiums Ceded to Reinsurers (per country)

Source: FSA

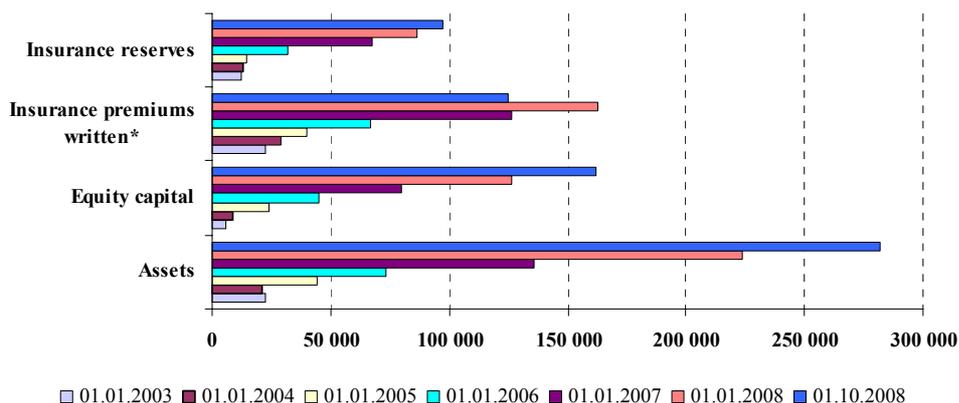
6.1.3 Insurance Sector Profitability

The increased level of insurance payments together with reduction of insurance premiums flow promoted the reduction of return from insurance organizations. Further decrease in the crediting volumes increases the probability of the insurance portfolio loss ratio. At the same time, it includes the possibility of covering losses due to other classes of insurance that are not related to bank risks.

In the conditions of instability on both the world and domestic markets, the dynamics of indicators of the insurance sector development in Kazakhstan demonstrates an overall positive dynamics. The exception is the insurance premiums volume that has decreased since the beginning of this year in the background of a reduction of the growth rates of STB lending (Figure 6.1.3.1).

Figure 6.1.3.1

Major Indices of Kazakhstan's Insurance Market (mln. KZT)

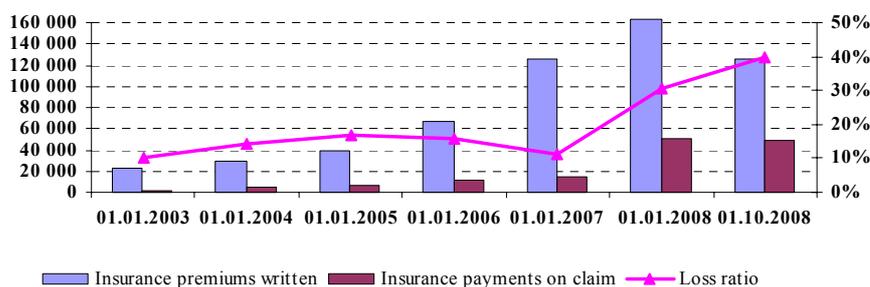


* - insurance premiums under insurance and reinsurance policies
 Source: FSA

The insurance premiums have decreased since the beginning of this year. Now they are practically on the level of 2006, while insurance payments demonstrate a sustainable growth. As mentioned above, only since last October, a growth of insurance premiums has been almost 50%. Following the market trends, the payments to premiums ratio on the insurance market keeps growing. From the beginning of this year, the payments to premiums ratio on the insurance market increased by 1.2 times. It increased by more than 3.5 times comparing to the beginning of the last year (Figure 6.1.3.2).

Figure 6.1.3.2

Loss Ratio on the Insurance Market

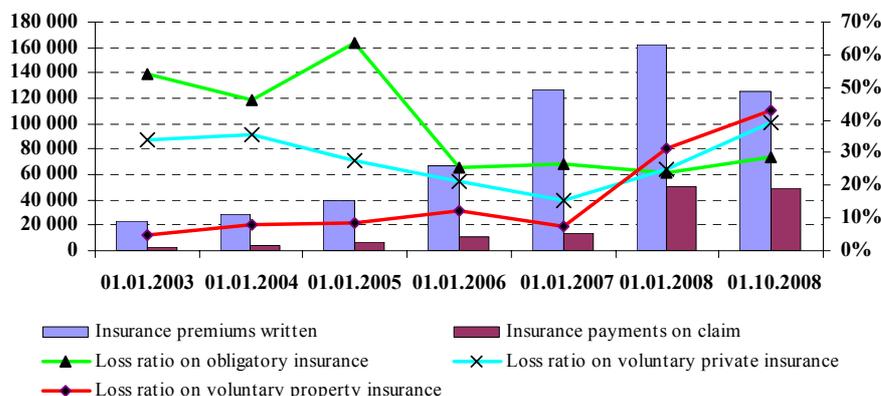


Source: FSA

The value of the payments to premiums ratio on voluntary property insurance essentially exceeds the indicator on the system in general, while on other types of insurance the ratio values are on the level not exceeding the value on the system (Figure 6.1.3.3).

Figure 6.1.3.3

Loss Ratio in terms of Insurance Activity

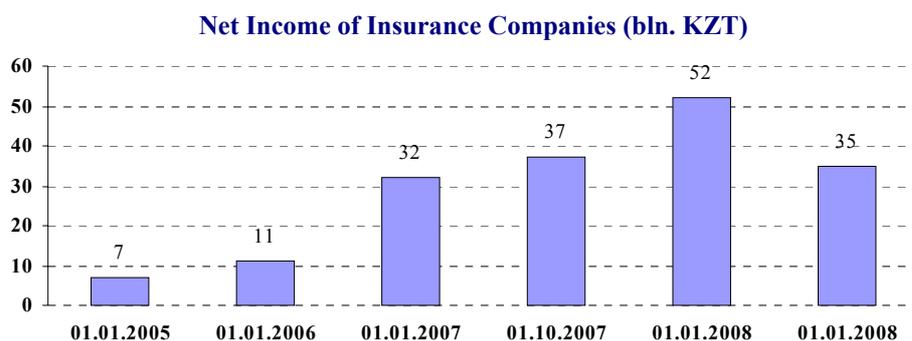


Source: FSA

With further decrease of the rates of banking crediting, it is likely that the expenses of insurance organizations will grow, and in case of no possibility of covering unprofitability at the expense of other classes of insurance (not related to the banking sector), the profitability of insurance organizations will go down which will accordingly affect the level of capitalization. The possibility of retention of the insurance market development potential will depend upon rise in the quality of servicing, improvement of existing products and services, development and introduction of new insurance products, further development of risk management practice.

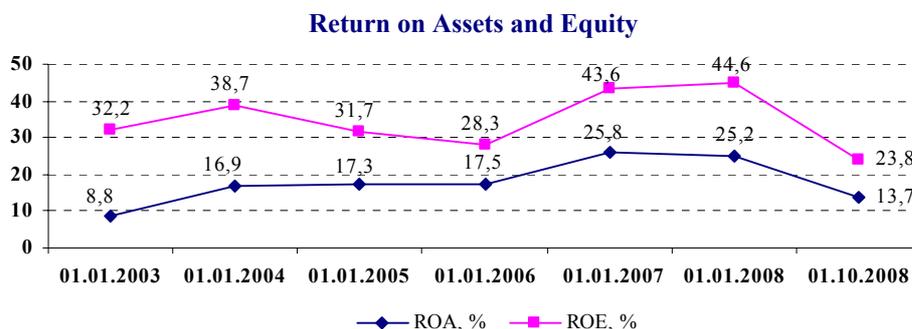
The net profit of insurance organizations in the background of loss ratio increase in the insurance sector decreased by 33% from the beginning of the year. It is lower than the level of the same period of the last year which is caused by consequences of liquidity squeeze for the insurance market in the banking sector (Figure 6.1.3.4). At the same time, the indicators of return on assets and capital of insurance organizations decreased almost by 2 times from the beginning of the year (Figure 6.1.3.5).

Figure 6.1.3.4



Source: FSA

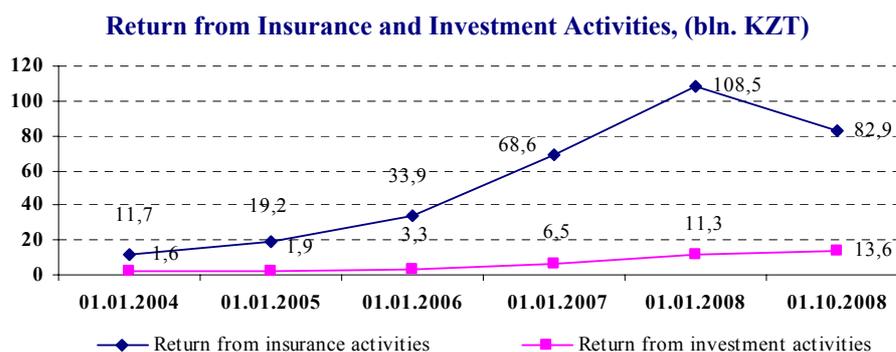
Figure 6.1.3.5



Source: FSA

As far as the structure of insurance organizations' income is concerned, the problems in the country's banking sector promoted the reduction of income from the core business. The investment activity that traditionally takes a small part of insurance companies' income is on the contrary showing a growth. However, in the current conditions, it is early to speak about a turning point in the structure of income of the insurance market (Figure 6.1.3.6).

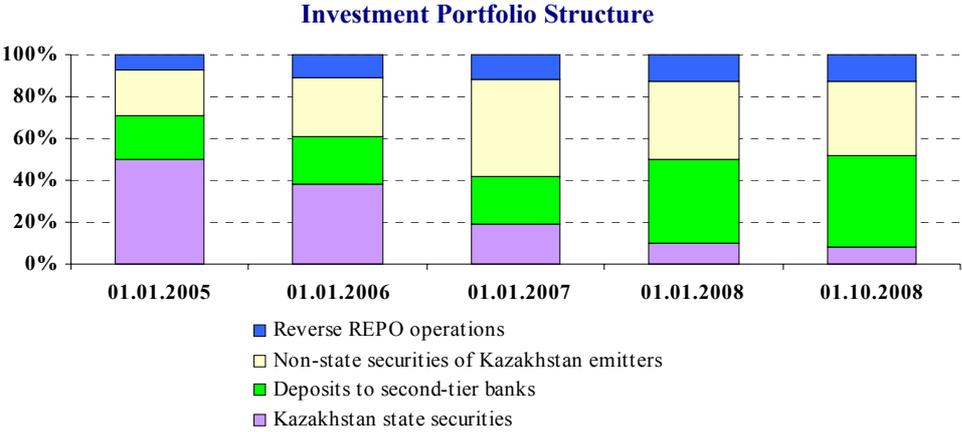
Figure 6.1.3.6



Source: FSA

The tendency to reduction of the share of investment in public securities and non-public securities of issuers in RK remains in the investment portfolio of insurance organizations. At the same time, the share of deposits in second-tier banks is increasing. This is caused by a comparatively low return of public securities and reduction of attractiveness of securities of the non-public sector basically represented by second-tier banks. This low return occurred because of depreciation of the securities value both in the domestic and foreign trade sites, and turbulence of global markets that has worsened in the second half of this year in the background of corporate events in USA and in Europe (Figures 6.1.3.7).

Figure 6.1.3.7



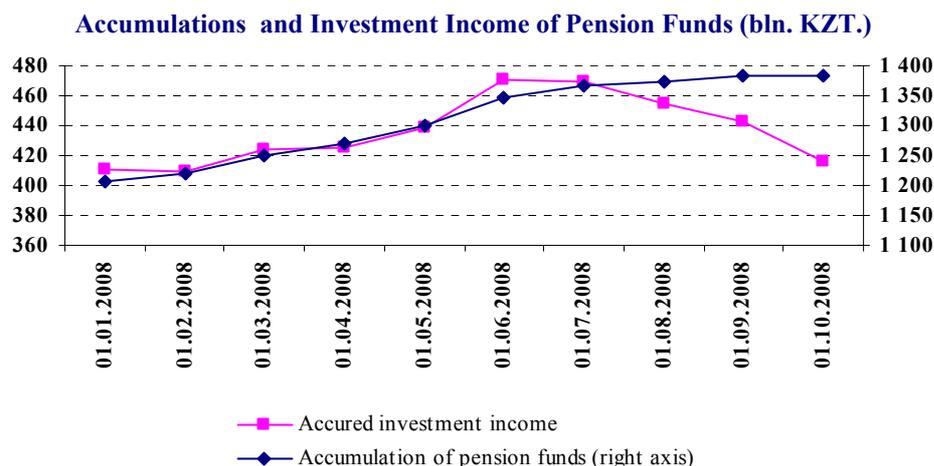
Source: FSA

6.2. Accumulation Pension System

Portfolios of the Kazakhstani accumulation pension funds likewise foreign ones expose high sensitivity to the shocks on both the world and domestic stock markets which deepened in the second half of 2008 in the background of bankruptcy of the world largest financial corporations. The profitability of pension assets substantially went down as a result of depreciation of a number of financial instruments which are in the portfolio of Kazakhstani accumulation pension fund. In the conditions of high tension on the financial markets, the problem of financial instruments deficit essentially aggravated.

As of October 1, 2008, 14 accumulation pension funds operated in Kazakhstan. Pension assets increased from last October by 24.4% and in absolute terms amounted to KZT1,377.8 bln. At the same time, an average monthly increase of pension assets from October 1, 2007 to October 1, 2008 was KZT22.5 bln. Pension savings of depositors (recipients) comparing to the same period of the last year grew by KZT274.5 bln. (24.78%) and amounted to KZT1,382.0 bln. The share of pension accumulations in the country’s GDP increased versus last October by 0.3 percentage points and was 9.2% as of October 1, 2008. Along with that, it should be noted that for the first time since the commencement of the Kazakhstani accumulation pension system operation, this September there has been fixed a reduction of pension accumulations which is explained by essential reduction of the APF investment income due to volatility on the financial markets and related negative trend of market quotations for securities that are in the investment portfolios of APF (Figure 6.2.1). Furthermore, since the second half of the current year, accumulation pension funds showed a negative investment income. Thus, ‘net’ investment income of APF for the third quarter 2008 decreased by KZT34 bln. Also, it is observed a reduction of the share of ‘net’ investment income in the total sum of pension accumulations of depositors (recipients) from 28.1% as of the beginning of the year to 24.46% as of October 1, 2008 (Table 6.2.1).

Figure 6.2.1



Source: FSA

Table 6.2.1

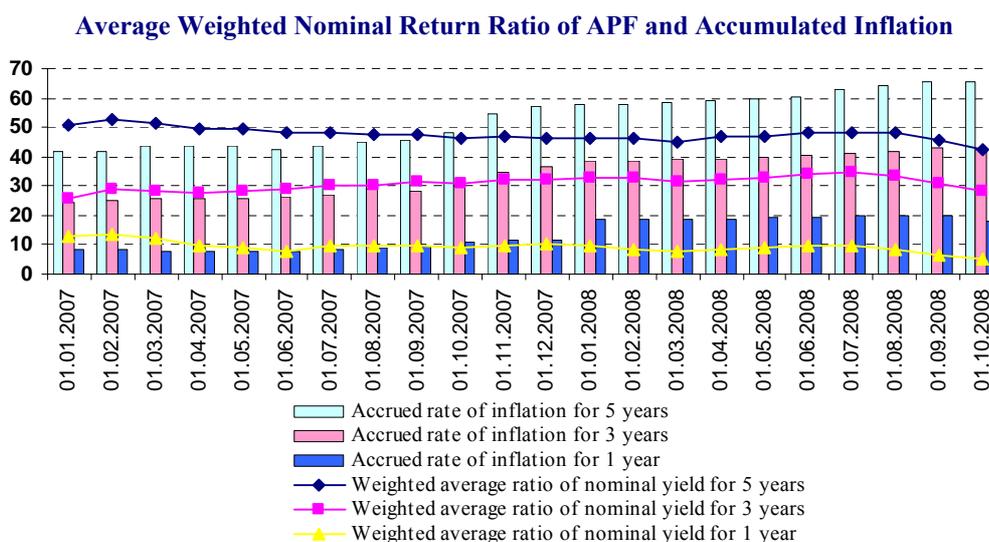
Pension Savings of APF and Investment Income, (bln. KZT)

	Jan1'08	Feb1'08	Mar1'08	Apr1'08	May1'08	Jun1'08	Jul1'08	Aug1'08	Sep1'08	Oct1'08
investment income (per month)	24.1	-1.5	14.1	2.1	12.4	32.2	-0.5	-15.5	-12.2	-26.2
investment income (cumulative)	411.3	409.7	423.8	426.0	438.4	470.6	470.0	454.6	442.4	416.1
'net' investment income	339.3	337.5	350.2	360.1	360.1	386.8	385.8	372.0	361.0	338.0
Pension savings of APF	1,208.1	1,221.4	1,249.8	1,269.3	1,300.1	1,346.7	1,366.4	1,374.4	1,383.3	1,382.0

Source: FSA

The average weighted coefficients of the nominal income on pension assets of accumulation pensions funds showed a sustainable trend to decrease from the second half of this year. As of October 1, 2008, the accumulated inflation rate per year increased the average weighted coefficient of the nominal income per year by more than 3.5 times, whereas the excess of inflation rates for 3 and 5 years over the average weighted coefficients of the nominal income for the same periods was not more than 1.5 times (Figure 6.2.2).

Figure 6.2.2



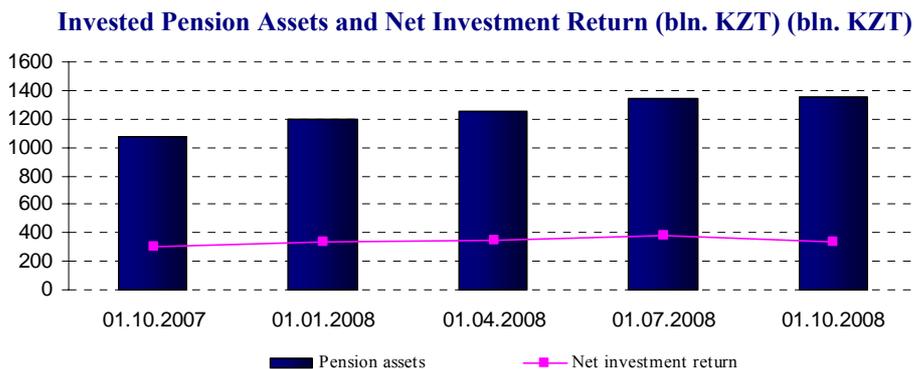
Source: FSA

Although the ‘net’ investment income decreased, the total volume of pension assets demonstrates a positive dynamics which is provided basically at the expense of receiving monthly pension contributions (Figure 6.2.3).

The reduction of an investment income amount is largely caused by essential drop in the value of securities of Kazakhstani and foreign issuers represented in the portfolio of accumulation pension funds that occurred in the second half of this year in the background of corporate events of the USA, Europe and that enhanced volatility on the global stock markets.

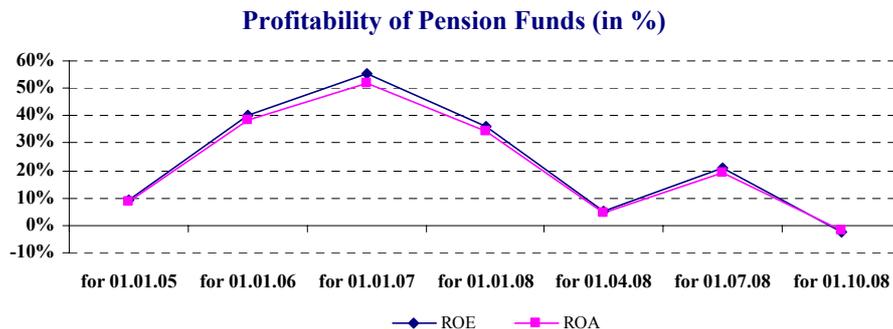
An essential depreciation of the accumulation pension funds portfolio also led to achievement of negative values as of October 1, 2008 in the indicators of profitability and essential increase of accumulation pension funds assets weighted by the degree of credit risk (Figure 6.2.4, 6.2.5).

Figure 6.2.3



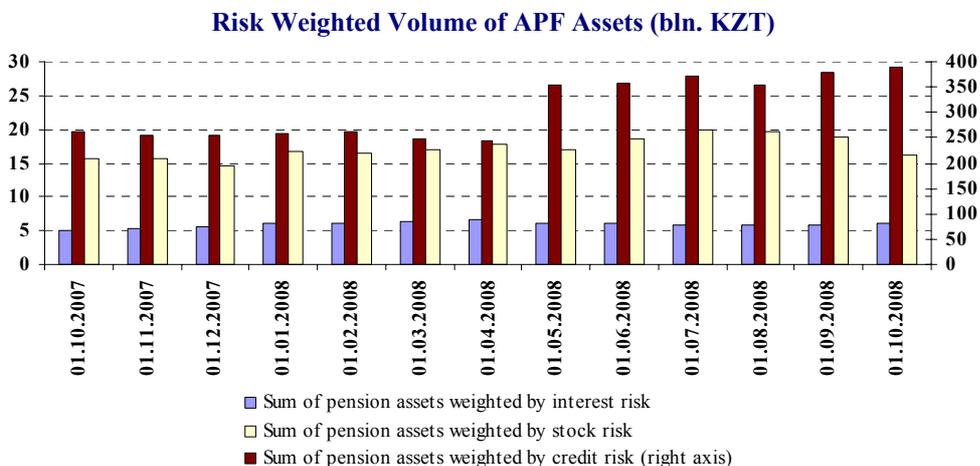
Source: FSA

Figure 6.2.4



Source: FSA

Figure 6.2.5



Source: FSA

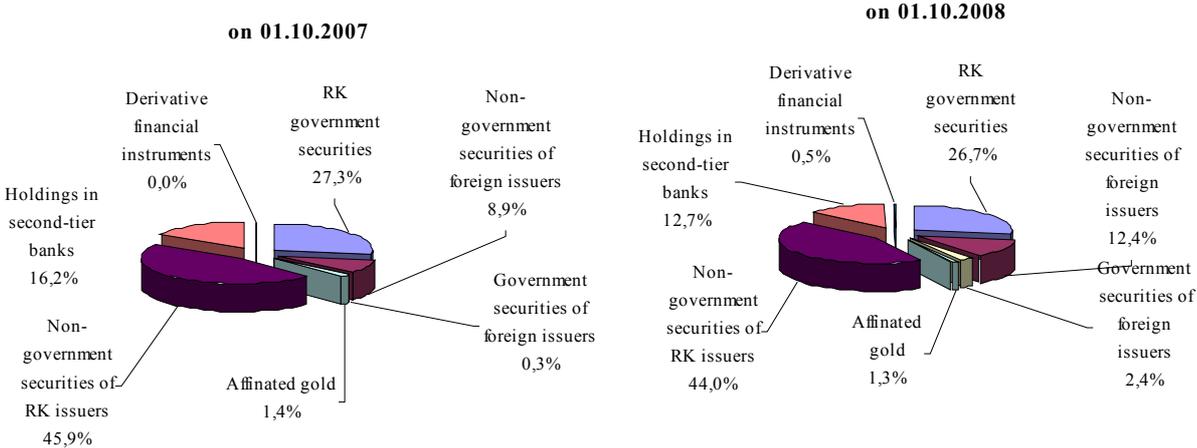
As of October 1, 2008, there was observed a flow of the investments of accumulation pension funds to the external markets, and the increased share of foreign issuers' securities in the structure of the investment portfolio of accumulation pension funds testifies to this. This is largely conditioned by a desire for risks diversification because external markets are represented by a fairly wide list of issuers and instruments meeting the requirements in relation to ratings, reputation available, etc. (Figure 6.2.6). At the same time, since the situation on foreign markets remains rather uncertain and unstable, especially, considering drop in the world stock indices this October, currently accumulation pension funds are restructuring the investment portfolio with the aim of its focusing on the domestic market to a greater extent.

Although the legislation of the Republic of Kazakhstan sets forth a wide list of financial instruments permitted to purchase at the expense of pension assets, taking into consideration the situation on the world stock markets and high volatility of most financial instruments, the accumulation pension funds are currently experiencing lack of facilities for investment.

In the current situation, for the purpose of reducing investment risks, the accumulation pension funds need to adjust the selected investment strategy of pension assets in order to increase the share of financial instruments less exposed to fluctuations of the international stock markets which is possible with enhancement of the risk management system in the accumulation pension funds.

Figure 6.2.6

Structure of APF Securities Portfolio



Source: FSA

6.3. Financial Status of Non-Banking Organizations

The credit activity of the organizations engaged in certain types of banking operations was characterized by more active rates than in the banking sector due to activation of the organizations the sole shareholder (participant) of which is the state in the framework of implementation of stabilization programs of the state on providing support to the real sector and small and medium-size business entities. At the same time, global instability caused reduction of crediting volumes by mortgage organizations.

The non-banking organizations sector comparing to the last year was distinguished by a qualitative and quantitative change of participants due to the improvement of the norms regulating legal relationship between the participants on the market of non-banking organizations⁴⁷. Out of 23

⁴⁷ Resolution of the Board of the Agency of the Republic of Kazakhstan for Regulation and Supervision of the Financial Market and Financial Organizations No. 280 dated December 24, 2007 "On Amendments to Some Regulatory Legal Acts of the Republic of Kazakhstan on the Matters of Prudential Regulation of the Activity of Mortgage Organizations and Organizations Engaged in Certain Types of Banking Operations" (effective since April 1, 2008).

organizations engaged in certain types of banking operations, 11 organizations were represented by organizations with state participation, among them the following may be noted: JSC Sustainable Development Fund “Kazyna”, JSC Entrepreneurship Development Fund “Damu”, JSC KazAgro Finance, JSC Agriculture Financial Support Fund, JSC Agrarian Credit Corporation, etc. (Table 6.3.1).

Table 6.3.1

Number of Non-banking Organizations (units)						
	Jan 1, 2006	Jan 1, 2007	Jan 1, 2008	Apr 1, 2008	Jul 1, 2008	Oct 1, 2008
Organizations engaged in certain types of banking operations	32	16	23	23	22	23
Mortgage organizations	7	10	12	12	12	12

Source: FSA

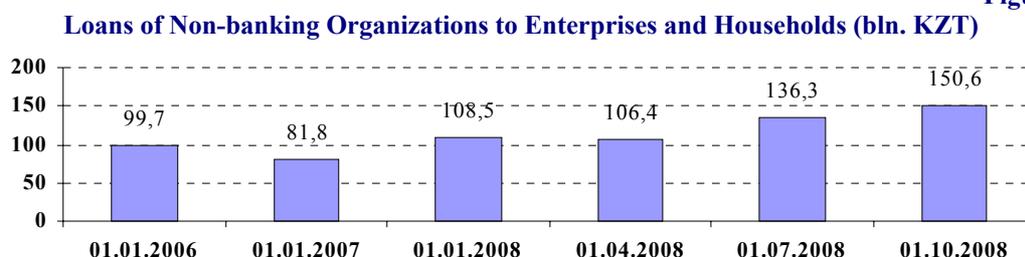
Organizations Engaged in Certain Types of Banking Operations

Comparing to the banking sector, a growth of loans issued by the organizations engaged in certain types of banking organizations was comparatively high relative to the beginning of this year and was 38.8%, or in absolute terms the increase was KZT42.1 bln. (Figure 6.3.1).

In the structure of the credits granted by non-banking organizations, the main part is taken by loans to financial organizations (42.2%) and loans to individuals (33.0%), 24.8% comes to the share of other legal entities (Figure 6.3.2). The increase of the share of loans to financial organizations from 18.9% to 42.2% in the structure of non-banking organizations credits was linked with expansion of crediting on support of the real sector of economy and small and medium-size entities through second-level banks as part of the Top Priority Actions Plan on ensuring stability of the socio-economic development of the Republic of Kazakhstan approved by the Resolution of the RK Government last November that, in turn, has also affected the quality of loan portfolio of non-banking organizations.

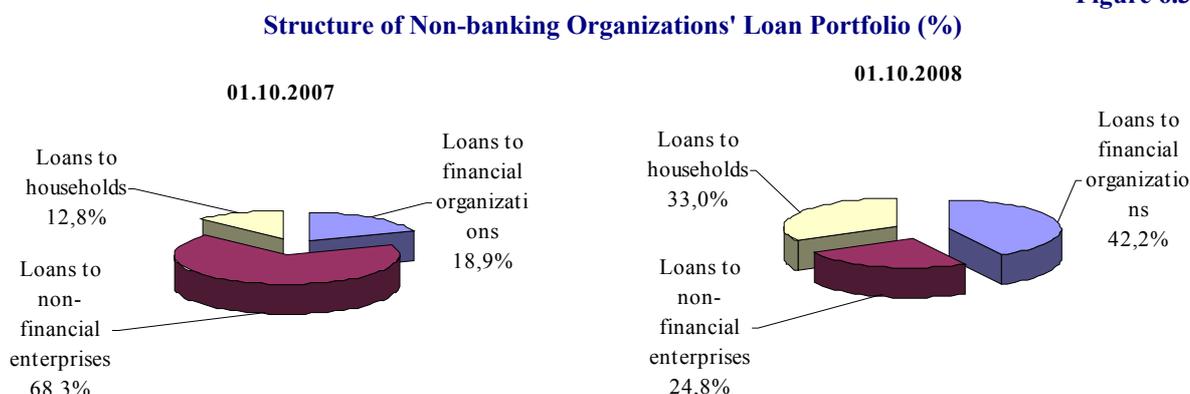
Thus, the loan portfolio quality has changed positively since January 1, 2008. The share of standard loans in the loan portfolio increased from 95.8% to 97.8%, and the share of doubtful loans (from 1.6% to 1.2%) and bad loans (from 2.6% to 1.0%) decreased (Figure 6.3.3).

Figure 6.3.1



Source: FSA

Figure 6.3.2



Source: FSA

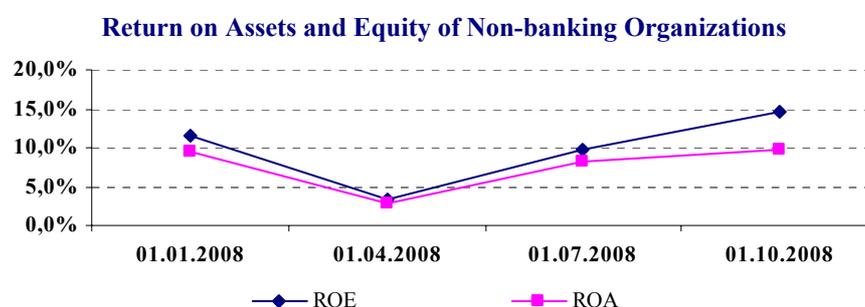
Figure 6.3.3



Source: FSA

Comparatively active crediting by the organizations engaged in certain types of banking operations also affected the indicators of profitability that from July of this year started to demonstrate a positive trend (Figure 6.3.4).

Figure 6.3.4



Source: FSA

The qualitative and quantitative change in the composition of non-banking organizations, establishing prudential requirements for non-banking organizations with state participation in capital revealed possible risks of solvency and liquidity.

The degree of covering liabilities with capital decreased as of October 1, 2008 which is characterized by the growth of a liability to capital ratio in the third quarter of this year comparing to the previous quarter.

At the same time, sustainability to the risk of liquidity is inclined to weaken because the share of short-term assets meant for covering short-term liabilities is noticeably decreasing. The share of high-liquid assets in the total amount of assets was 9.4% which is much lower than the same indicator on the banking system (Table 6.3.2).

Table 6.3.2

Solvency and Liquidity Risks of Non-banking Organizations

	Oct 1, 2006	Oct 1, 2007	Jul 1, 2008	Oct 1, 2008
Share of high-liquid assets in the total sum of assets, in %	13.67	8.13	12.7	9.4
Ratio of short-term assets to short-term liabilities	0.39	1.89	0.46	0.40
Ratio of liabilities to capital	0.76	0.28	0.5	0.6

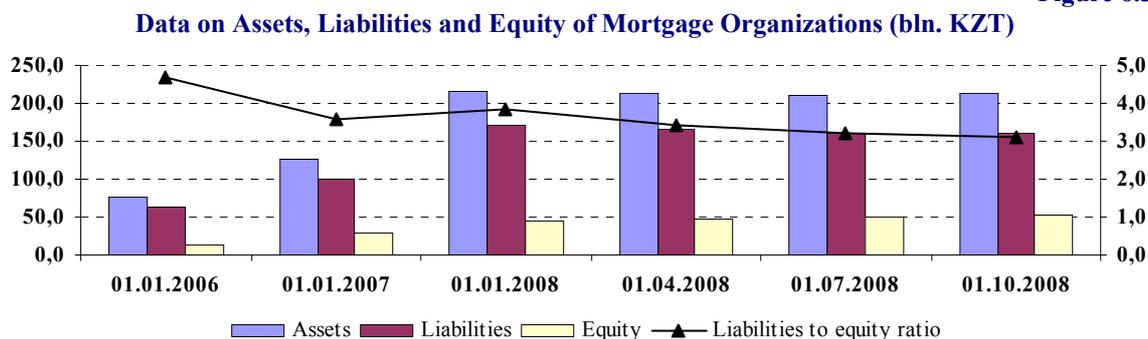
Source: FSA

Mortgage Organizations

This year mortgage organizations have appeared to be under the influence of the tendencies occurring in the banking sector and on the real estate market. In the dynamics of assets and liabilities of mortgage organizations, the latter decreased by 1.8% (from KZT216.1 to KZT212.2 bln.) and by 6.6% (from KZT171.6 to KZT160.3 bln.) respectively in contrast to the similar indicators of the organizations engaged in certain types of banking organizations. The decrease of liabilities was caused by a reduction from the beginning of the year of the loans received from other banks and non-banking organizations by 15.7% and the securities issued by 6.0%.

The mortgage organizations capital grew by 16.4% to KZT51.9 bln. The level of covering of liabilities with capital remains low even with leverage value reduction from 3.85 to 3.09 (Figure 6.3.5) because the capital value covering the liabilities increased only from 26.0% to 32.4%.

Figure 6.3.5



Source: FSA

Dynamics of the loan portfolio of mortgage organizations from the beginning of the current year demonstrates reduction by 5.5% from KZT180.3 to KZT170.5 bln. which was conditioned to a greater extent by reduction of ‘reverse REPO’ operations by 42.5% to KZT9.1 bln. and to a less extent by reduction of loans to clients by 1.9% to KZT161.4 bln. (Figure 6.3.6).

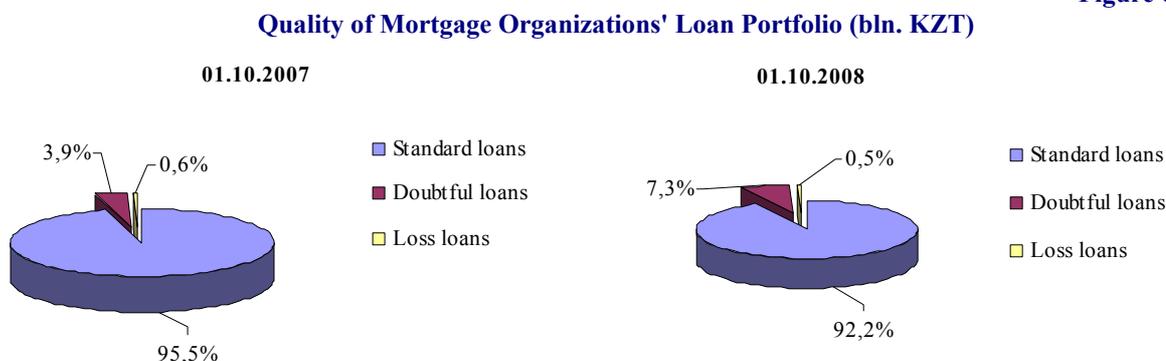
Figure 6.3.6



Source: FSA

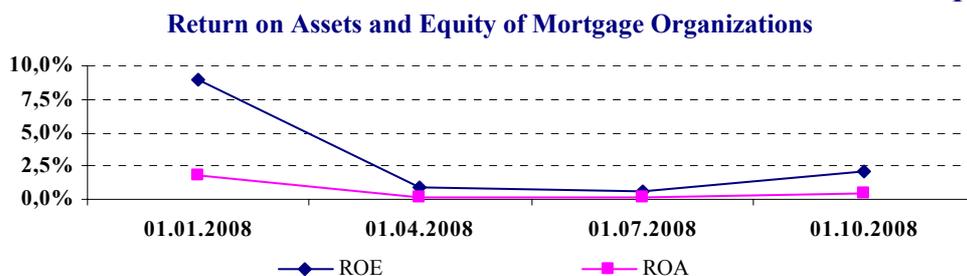
The quality of the loan portfolio of mortgage organizations has undergone a considerable change. In the structure of the loan portfolio from the beginning of this year the share of standard loans reduced by 0.3 percentage points to 92.2% with movement to the category of doubtful loans the share of which increased by 3.4 percentage points to 7.3%. The specific weight of doubtful loans in the loan portfolio insignificantly decreased from 0.6% to 0.5%. In spite of decrease in quality of the mortgage organizations loans, their level remains rather high in comparison with quality of the banking sector loans (Figure 6.3.7). In this background the indicators of profitability of mortgage organizations remain in general positive (Figure 6.3.8).

Figure 6.3.7



Source: FSA

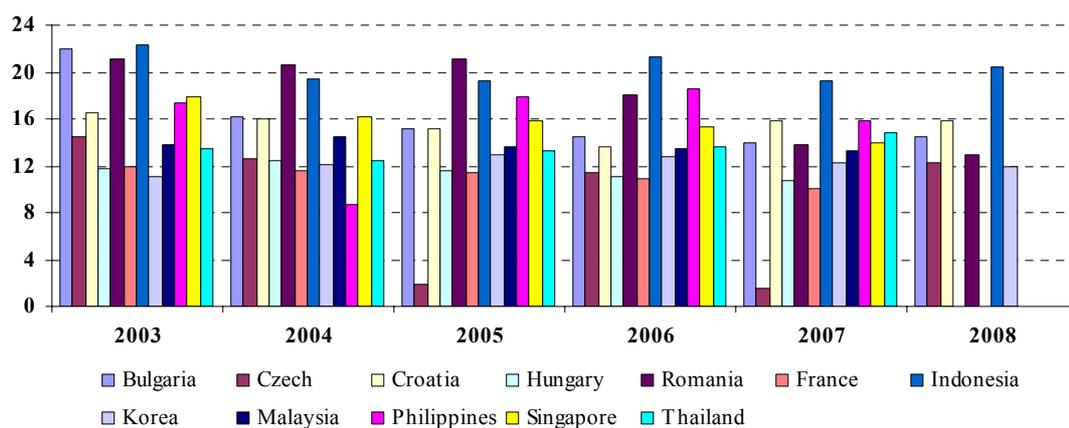
Figure 6.3.8



Source: FSA

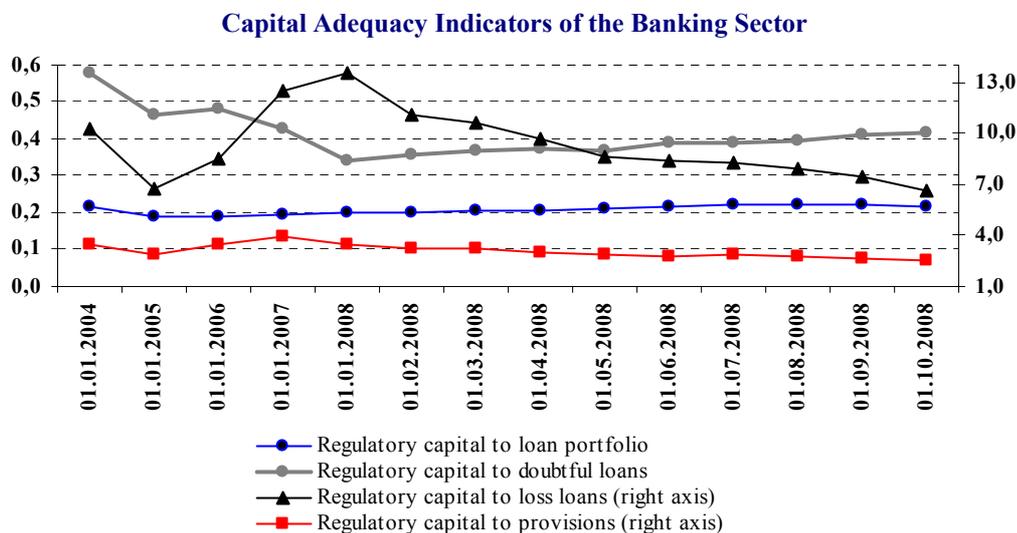
Figure 5.5.5

Capital Adequacy of Banks Across Countries (ratio of regulatory capital to risk weighted assets (k2), %)



Source: IMF (GFSR 2008)

Figure 5.5.6



Source: FSA

7. Financial Market Infrastructure

7.1. Payment Systems

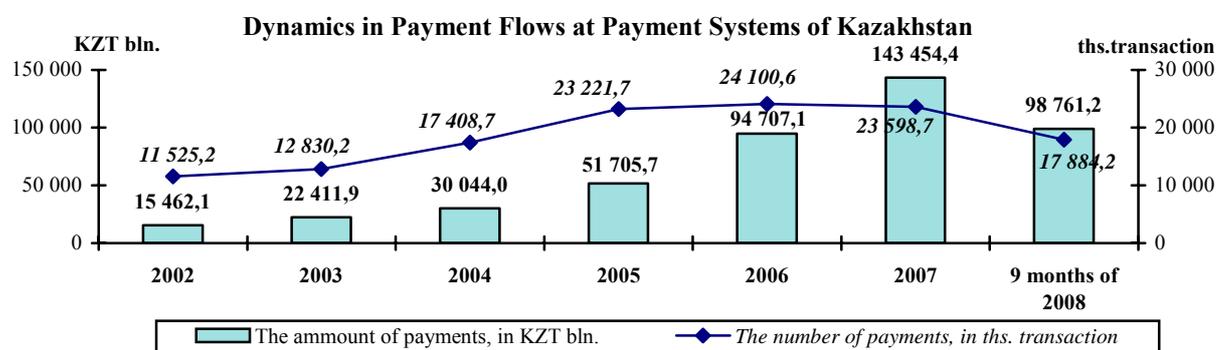
Influence of the global financial crisis on the payment systems of Kazakhstan has manifested itself in the 10.9% decrease comparing to the previous year in liquidity of STB and organizations engaged in certain types of banking operations, which used for payments and money transfers. However, the decrease in the liquidity in the payment system has not entailed growth in STB insolvency, which is related to continuous monitoring of payment systems, use of such methods of risk management as management of turn of payments, money transfers from the correspondent account of the participant to his position in the system and use of interbank credits.

Also in 2008 NBRK paid a special attention to the payment systems oversight with a view of maintenance of their effective functioning that promotes efficiency of use of financial resources and ensure the financial market liquidity.

7.1.1. Development of Payment Systems in Kazakhstan

In 2008 NBRK continued to work on developing the regulatory legal acts in the sphere of payments and money transfers and further development in the payment systems of Kazakhstan. Over 9 months of 2008, 17.9 mln. transactions in the amount of KZT98.8 trln. (Figure 7.1.1.1) were passed via the payment systems. In comparison with a respective period of the last year, the number of payments within the payment systems increased by 3.8% (or 651.0 thousand transactions), with the decrease in the amount of payments by 10.6% (or KZT11.7 trln.).

Figure 7.1.1.1



Source: NBRK

When considering functional features of the payment systems of Kazakhstan it should be noted that each of them has its own designation and directed to certain markets of goods and services.

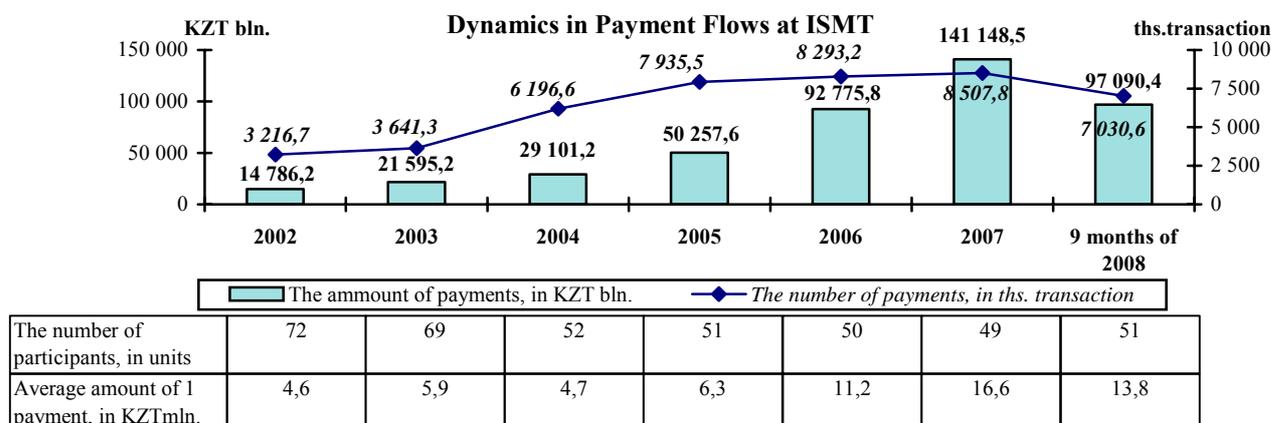
Interbank System of Money Transfers (hereinafter *ISMT*)

The ISMT is a systemically important payment system in Kazakhstan and is intended for passing large and high-priority payments in the country on financial sector operations (payments on transactions with interbank deposits and credits, securities and foreign currency). Therefore, this payment system has a largest share of the total amount of non-cash payments in the country (over 9 months of 2008, 98.3% of the total value of non-cash payments and 39.3% of total volume were passed through ISMT).

On the whole, over 9 months of 2008, 7.0 mln. transactions in the amount of KZT97.1 trln. were passed through ISMT. In comparison with the same period of 2007, the volume of payments

increased by 14.5%, and the amount of payments decreased by 10.7% (Figure 7.1.1.2). An average amount per one payment document in ISMT in January-September 2008 was KZT13.8 mln.

Figure 7.1.1.2



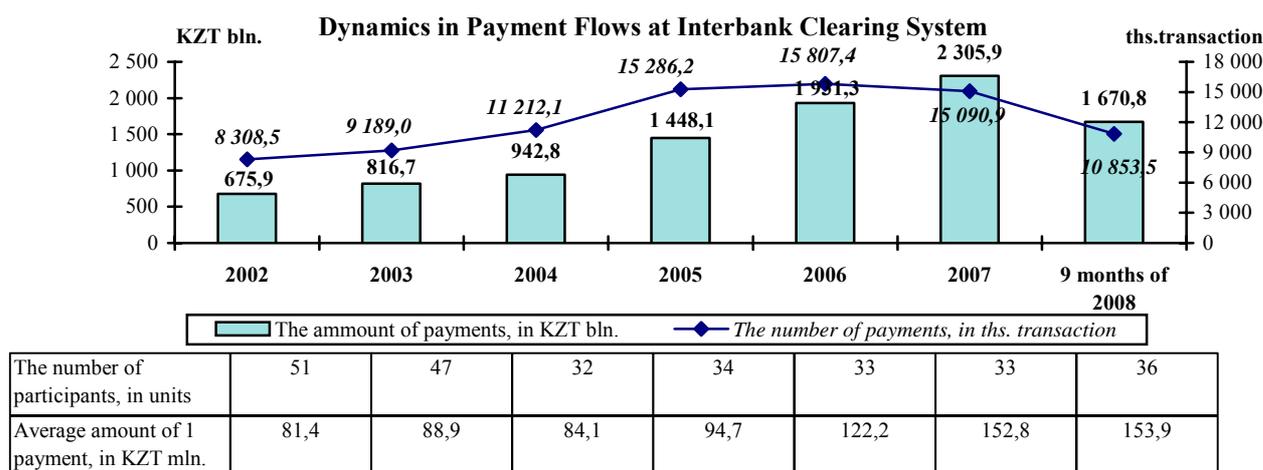
Source: NBRK

Interbank Clearing System

In the Interbank Clearing System the payments are carried out on net (clear) basis and mainly receive retail payments of little amounts, which contributes to passing of more than a half of all non-cash payments through the system (over 9 months of 2008 60.7% out of the total volume of all non-cash payments, or 1.7% of the total value, passed through the system). The system is highly important for the economy due to safety of the main quantitative flow of retail payments in the country. The system is mainly used for economic entities' non-priority and not urgent payments is primarily applied to enter non-priority and non-prompt payments for goods and services, budgetary payments, and the low cost of tariffs make processing of such payments economically efficient.

Over 9 months of 2008, the amount of payments within the system decreased by 0.8% in comparison with the same period of the last year, and the number of payments by 2.2% (Figure 7.1.1.3). An average amount per one payment document in the Interbank Clearing System over 9 months of 2008 was KZT153.9 thousand.

Figure 7.1.1.3



Source: NBRK

7.1.2. Liquidity Risk and System Risk

The main financial risks specific for the payments systems are liquidity risks⁴⁸ and systemic risks⁴⁹ that influence on timely fulfillment of payments. Each system has its own features and risk management methods.

Interbank System of Money Transfers

The ISMT provides settlement of payments in a real time mode within amounts at participants' positions in the system, therefore, rapt attention is drawn to the liquidity risk

To manage this risk the queue management mechanism (the settlement of payment documents priorities and changing queue of payment documents) is being applied and additional money transfers from the corresponding account of the participant to his system position are being carried out. Moreover, NBRK calculates ISMT's money turnover ratio (hereinafter referred to as MTR) and liquidity ratio (hereinafter referred to as MLR), and analysis of their conformity to fixed parameters⁵⁰.

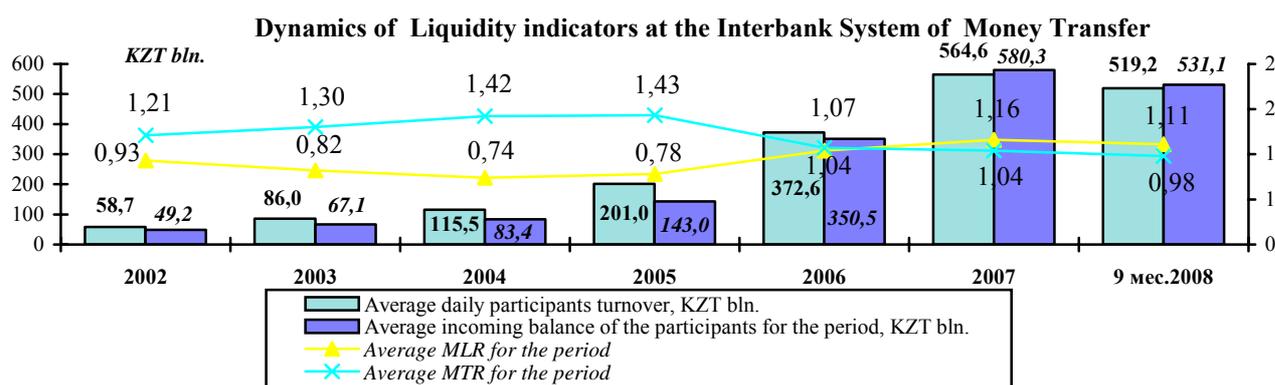
An average daily ISMT' money turnover ratio⁵¹ (MTR) was 0.98. An average system' money liquidity ratio⁵² (MLR) equaled 1.11, with no excess of average monthly MTR and MLR fixed margin parameters.

However, ISMT participants' liquidity is recorded to be falling. An average daily ISMT participants' liquidity (incoming balance in ISMT⁵³, permitting the participants to fulfill payments) over 9 months of 2008 reached KZT531.1 bln, having fallen by 10.9% in comparison with the corresponding period of 2007 (Figure 7.1.2.1).

56.5% of total liquidity value was provided for with the resources of NBRK. An average daily system participants' liquidity, without account of NBRK resources, over 9 months of 2008 reached KZT231.1 bln, which is 49.2% lower than the average turnover sum of the participants.

At the same time monitoring of queue of payment documents contributed to the decrease in the number of rejected payments. Over 9 months of 2008, 9 payments to the sum of KZT133.5 bln. were rejected (withdrawn) due to lack of liquidity in ISMT, with 15 payments to the sum of KZT35.7 bln. rejected for the same reason in the corresponding period of 2007 (Table 7.1.2.1). All rejected or withdrawn payment documents were passed by ISMT participants the same day or on the operational days additionally.

Figure 7.1.2.1



Source: NBRK

⁴⁸ Liquidity risk is the potential that a payer will be unable to meet his obligations to transfer money as they come due.

⁴⁹ Systemic risk is the potential that a payment system participant's default on money transfer will entail a consequent default by other participant or participants of the payment system.

⁵⁰ To manage the liquidity risks the following margins of the system liquidity and money turnover ratios are set within the system: upper bound $MLR > 1.5 @ MTR < 0.5$, lower bound $MLR < 0.5 @ MTR > 1.5$.

⁵¹ Money turnover ratio is directly proportional to debit turnover within ISMT in the system liquidity.

⁵² Money liquidity ratio is the ratio of the system liquidity (incoming remainder of all the participants) to the sum of debit turnover within ISMT and rejected (recalled) payments within ISMT.

⁵³ Incoming balance of a participant is the money remitted by the participant from the correspondent account to the system position.

Table 7.1.2.1

Rejected Payments in Interbank System of Money Transfers

Description	2002	2003	2004	2005	2006	2007	9 months of 2008
Volume, in units	239	163	2,185	27	39	26	9
Amount, KZT mln.	133,890.1	18,206.4	8,995.1	716.6	48,088.6	224,952.2	133,491.2
Number of participants with rejected (withdrawn) payments, in units	20	27	12	8	12	15	7
Number of days in a year when the payments were rejected (withdrawn), in units	48	33	27	9	17	20	7

Source: NBRK

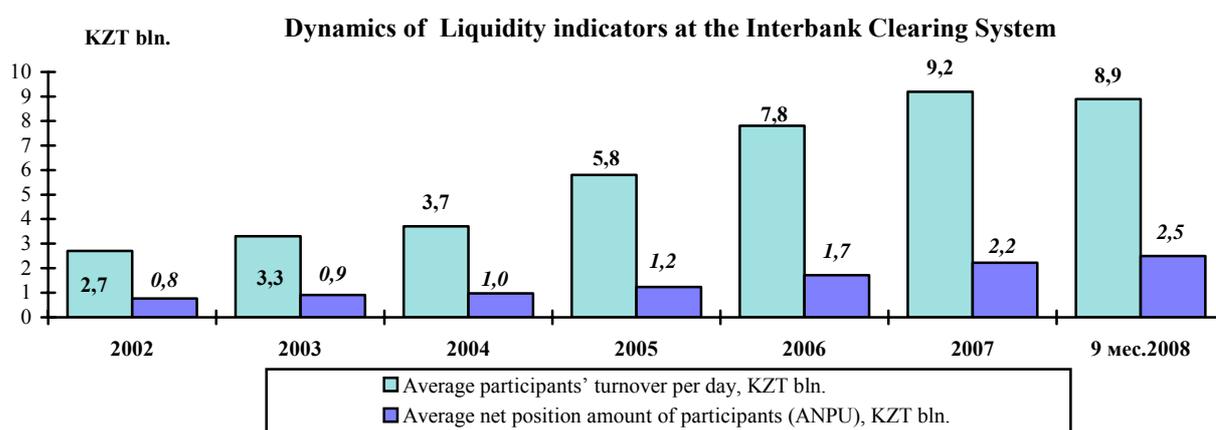
Interbank Clearing System

In order to manage liquidity and systemic risks in the Interbank Clearing System the queue “unwinding” method is applied, when the payment documents for the outstanding sum with a lower priority are cancelled, also the MTR (money turnover ratio) calculation and participants’ net position amount analysis are carried out daily.

Over 9 months of 2008 an average daily MTR was 3.9, being 4.5 in the corresponding period of 2007. The payment value rise in the payment systems coincided with the corresponding increase in the average sum of participants’ net debit position in clearing. In comparison with the corresponding period of 2007 the average sum of net position grew by 15.2% and reached KZT2.5 bln. over 9 months of 2008 (Figure 7.1.2.2). The participants’ net position in clearing compared to the sum of average daily participants’ turnover within ISMT⁵⁴ remains insignificant (0.5% over 9 months of 2007).

However, due to an overall liquidity cutback in the payment system 111 payment documents in the amount of KZT66.6 mln. were cancelled owing to insufficient liquidity over 9 months of 2008 in the Interbank Clearing System (Table 7.1.2.2).

Figure 7.1.2.2



Source: NBRK

⁵⁴ An average sum of the participants’ net debit position corresponds to an average daily amount of participants’ turnover within ISMT, as the calculation of the participants’ net position in clearing is done with the available resources of participants within ISMT.

Table 7.1.2.2

Cancelled payments in Interbank Clearing System

Description	2002	2003	2004	2005	2006	2007	9 months of 2008
Volume, in units	392.0	515.0	164.0	141.0	156.0	47	111
Value, KZT mln.	57.9	107.4	27.8	44.9	83.9	29.9	66.6
Number of participants with cancelled payments, in units	8	9	5	4	1	3	5
Number of days in a year when payments were cancelled, in units	16	10	5	4	1	3	5

Source: NBRK

7.1.3. Operational and Technical Risks

In order to manage technical risks caused by possible breakdowns and failures of software and means of communication, and operational risks caused by possible executive errors of a participant's or an operator's personnel, NBRK applies such methods as the payment system reserve centre, authorised access to servers and communications, verification of the payment system participants, and differentiation of tasks for the personnel of the payment systems operator.

Thus, in 2008 was decided to purchase new servers for the reserve centre with the performance attributes identical to those of the servers at the main payment systems centre. Also carrying out works on creation new reserve centre in Astana, which is to secure sustainable work of NBRK and the payment systems in case of emergency within the main centre area.

In 2008 for providing safety of the working place of the payment systems participants *Alliance Bank JSC*, *Metrocombank JSC*, *Masterbank JSC*, *Tsesnabank JSC* and State Communal Enterprise *The State Centre for Pension Payment* were inspected, and recommendations were provided on organizing a working place, using means of protection and job organization for the personnel of the payment systems.

7.2 Financial System Risk Management

State measures to stabilize the economy and the financial system in 2007-2008 were mostly short-term and not intending to diversify the economic system. However, the measures proved to be efficient enough to mitigate the negative influence of the global financial crisis. One of the state-controlled macro-risk management system weaknesses can be limited possibilities of safety net institutions.

State stabilization measures include both those of providing direct support to the economy and financial sphere and those of regulatory type, among which is a number of adopted laws and legislative acts, and amendments to the prudential norms.

NBRK Measures on Banking System Support

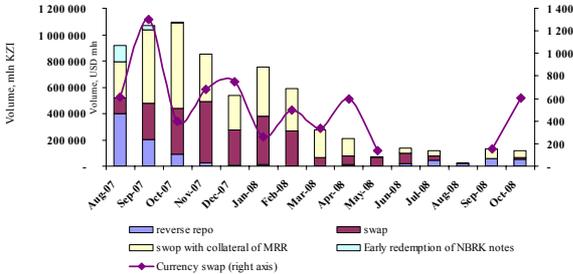
Since August 2007, NBRK has undertaken a row of measures aimed at supporting the banking system liquidity. During August-September STB were actively supported via provision of short-term liquidity in the form of reverse REPO, swap, swap on the security of MRR, and currency swap. During August-October NBRK notes worth KZT162.5 bln. were redeemed ahead of term. Aggregate sums of refinancing in the national currency in 2007 reached KZT4,473.2 bln., and of currency swap USD3.7 bln., during January-October 2008, KZT2.4 bln. and USD2.6 bln. respectively. The total debt of the banks on these operations in the NBRK's balance was KZT20.8 bln. at the end October 2008, and USD155.5 mln. in the foreign currency. Additionally, NBRK brought in a range of regulatory changes aimed at facilitating of gaining the STB liquidity. E.g.,

bank loan limits for loans against pledge of remainders on the correspondent accounts were reduced from not more than 70% of remainder on the day of the request for loan and not more than 70% of an average remainder MRR in the last period under review up to 50%. In November 2007, the Cooperation and interaction agreements on the matters of granting bank loans were signed by NBRK, AFN and STBs. According to this agreement, STBs assumed obligations on maintaining external liabilities and assets volume at a level not higher than that of November 1, 2007, on increasing the authorized capital and running conservative credit and moderate deposit policy.

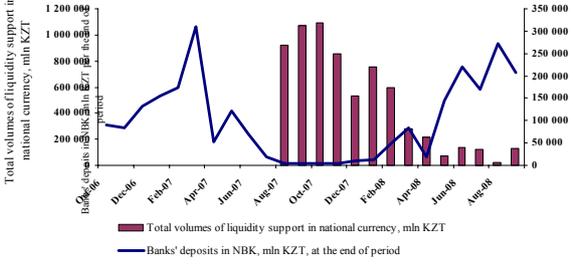
In the end of September 2008, STBs' deposits in NBRK had increased since the beginning of the year (KZT9.9 bln as of the end of 2007) and reached KZT208.3 bln. In 2007-2008, an absolute maximum of this indicator could be observed in the end of March 2007 (KZT309.3 bln.), with a further abrupt fall down, and only KZT4.6 bln worth deposits by the end of August 2007. The situation has changed in the current year: in January-August the deposits grew considerably and reached KZT271.4 bln. by the end of August 2008. Thus, by the August 2008, the banking system had considerable volumes of liquidity; no additional NBRK support was required. (Figures 7.2.1 – 7.2.2).

Figures 7.2.1 and 7.2.2

Liquidity support from NBRK to banking sector



Source: NBRK

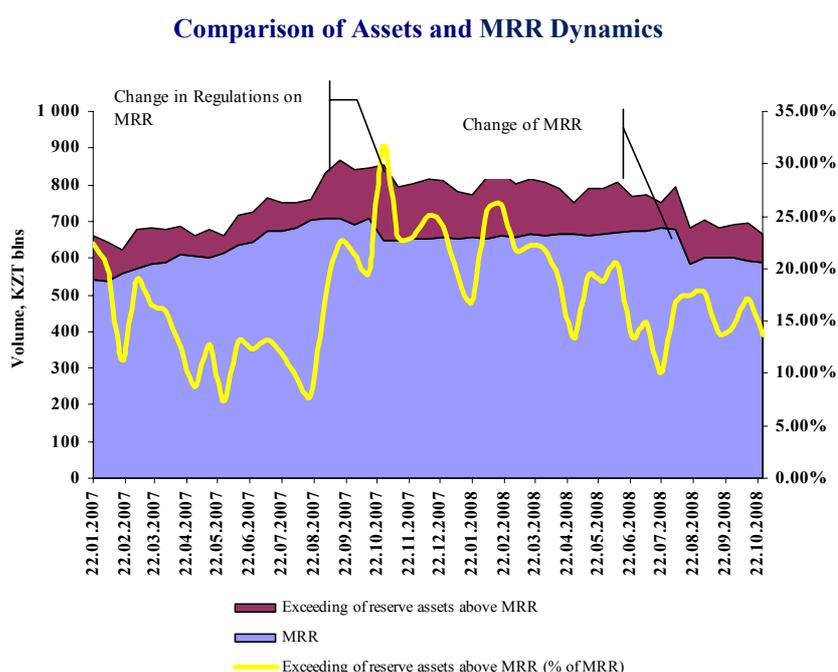


Source: NBRK

In 2008 NBRK have essentially widened the list of possible collaterals for refinancing transactions for two times. On February 4, 2008 the following securities were included in the list of possible collaterals for reverse REPO: Kazakhstani national companies' securities, securities of foreign countries and international financial organizations' securities admitted to purchase by STBs according to the requirements of the Agency for Regulation and Supervision of Financial Market and Financial Organizations. However, in February-March 2008 there were no reverse REPO transactions with STBs, and during the subsequent months their volume was incomparable to that of August 2007. This proved the measure to be a preventive one: in case STBs have an urgent demand in KZT liquidity the volumes of liquidity support can be higher now than if the previous securities list used. Additional possibilities to extend financing are to be acquired due to the adoption of the expansion in the list of assets to be collateral for NBRK's refinancing transactions on May 12, 2008. The list of collaterals for reverse REPO transactions was expanded with certain STBs' bonds issued by May 1, 2008, and agent's debt securities of *Kazakhstan Mortgage Company JSC*.

In August 2007, NBRK brought in changes into Regulations on minimal reserve requirements aimed at reducing the reserve liabilities base and expanding the reserve assets structure to allow STBs to release, by preliminarily estimation, additional KZT150 bln. The amendments came into force on October 9, 2007. They took effect on reserve assets structure, list of internal and other liabilities of STBs, and norms of Regulations concerning control over compliance with the MRR regulations. However, the STBs benefited from the possibility of liquidity release later and not fully, which is confirmed with significant gap between reserve assets and MRR (on October 29 it was estimated as 31.7% of MRR value). A minimum gap between MRR and reserve assets was noticed in May and August 2007 (7.3% on May 28, 7.9% on August 20).

Figure 7.2.3



Source: NBRK

MRR regulations amendments (on internal liabilities lowered from 6% to 5%, on other liabilities from 8% to 7%) that come into force on July 29, 2008 had more significant effect. As of July 21, 2008 an estimated value of reserve assets exceeding MRR reached a local minimum and made up 10.1%, with the decrease in reserve assets from KZT793.7 bln. on August 4, 2008 to KZT683.8 bln. on August 18, 2008. In other words, STBs managed to release more than KZT109 bln. (Figure 7.2.3). For the period from the beginning of October 2007 (1.10.2007) to the end of September 2008 (29.09.2008) the downdrift in MRR or release of resources was about KZT151 bln. Taking into account MRR reduction, potential release of money resources during the period could reach KZT239 bln. The last MRR change in November, 18 was its reduction from 5% to 2% on internal liabilities and from 7% to 3% on other liabilities, which is presumably to allow release of about KZT350 bln.

Prudential and Legislative Measures Implemented by the Agency for Regulation and Supervision of Financial Market and Financial Organizations

Possible negative after-effect of ‘contagion’ demanded amendments in prudential norms in order to lower the financial system risks level. This forced AFN to take a number of measures aimed at decreasing external economic risks, liquidity and capital adequacy risks. (Table 7.2.1).

Table 7.2.1

Anti-crisis Prudential Measures by AFN

Norm	Normative/Legislative act	Adopted as of	Amendments come into force as of	Description of amendments
Reserve capital size	AFN decree No. 256 <i>On amendments to National Bank of Kazakhstan Managerial Enactment No. 70 of February 26, 2000 On min. size of STBs' reserve capital.</i>	November 30, 2007	May 1, 2008	Cut in reserve capital share from 5% of STBs' total assets not to be classified to 2% of credit portfolio to be classified.
Size of attracted and equity asset base of STBs, subject to obligatory placing in	AFN Decree No. 8 <i>On amendments to National Bank of Kazakhstan Managerial Enactment No. 262 as of June 2, 2000 On Regulation on</i>	January 25, 2008	July 1, 2008	Extending base of attracted and equity assets of STBs, subject to obligatory placing in assets in Kazakhstan. In particular, base of attracted liabilities of

assets in Kazakhstan	<i>placing part of bank assets into internal assets.</i>			bank is supplemented with unlimited financial instruments and bonds issued by bank
Imposition of quick and quick currency liquidity <7 days ratios and change in calculation of quick and currency liquidity <30 and 90 days ratios	AFN Managerial Enactment No. 20 <i>On amendments to Decrees of Agency for Regulation and Supervision of Financial Market and Financial Organizations No. 358 as of September 30, 2005 On Regulation on margin values and calculation of prudential norms for STBs</i>	February 26, 2008	July 1, 2008	Admissible level in quick liquidity and quick currency liquidity of <7 days cannot be below 1, <30 days cannot be below 0.9, <90 days cannot be below 0.8.
Increased requirements on min. authorized and equity capitals of STBs	Decree No. 140 of Agency for Regulation and Supervision of Financial Market and Financial Organizations <i>On min. size of authorized and equity capitals of STBs.</i>	September 2, 2008	The amendments will come into force gradually	Requirements to size of authorized and equity capitals of newly created banks increased to KZT5 bln, for operating banks gradual increase in min. equity capital as of July 1, 2009 to KZT5 bln, as of July 1, 2011 to KZT10 bln; for banks outside Astana and Almaty to KZT3 bln and KZT5 bln respectively.
Change in equity capital adequacy coefficients (k1 and k2), cut in the normative value of capitalization index k9	Agency's Decree No. 146 <i>On amendments to Managerial Enactment of Agency for Regulation and Supervision of Financial Market and Financial Organizations No. 358 as of September 30, 2005 On Regulation on margin values and calculation of prudential norms for STBs.</i>	October 2, 2008	Supposedly as of July 1, 2009	Values of equity capital adequacy coefficients should be for $\kappa_1 > 0.06$ and $\kappa_2 > 0.12$, for a bank not having a large individual participant values equity capital adequacy coefficients should be for $\kappa_1 > 0.07$ and $\kappa_2 > 0.14$; for a bank having a banking holding or parental bank as participant, and a rating set according to legislation regulations $\kappa_1 > 0.05$ and $\kappa_2 > 0.10$. For a bank where 50% of placed assets are state-owned, the value of the coefficients is for $\kappa_1 > 0.06$ and $\kappa_2 > 0.12$. Normative value of capitalization index k9 was cut from 4 to 3.

Source: AFN

Additionally, in October 23, 2008, there was adopted Law of the Republic of Kazakhstan No. 72-IV "On Amendments to Some Legislative Acts of the Republic of Kazakhstan on the Financial System Sustainability". The Law is aimed at improving early diagnostic mechanisms of the financial system risks, expanding the authorized body competence in case shareholders of the financial organizations fail to comply with the requirements of the authorized body on improving the financial state of a financial organization. It is also aimed at increasing responsibilities of executives and larger participants of the financial organization with a view of increasing the financial organization responsibility for their liabilities. The following norms aimed at assuring the financial sustainability are to be singled out:

- Increase in the sum of a guaranteed refund on the deposits of individuals up to KZT1 mln. and as a stabilizing measure up to KZT5 mln. till January 1, 2012.
- Ban on reception of deposits from individuals and opening accounts for individuals by STBs not having large participants, i.e. individuals, or a parent bank, or a holding company, not having a particular rating of a rating agency included in the list, and the min. permissible rating established by the authorized body. The ban is planned to be put into force from January 1, 2010.
- Prohibition on the change in rates for the period of three years from the date of the official publication of the Law (October 24, 2008), i.e. STB and the organizations carrying out particular types of bank transactions, having concluded bank loan agreements (including mortgage loan) with individuals have no right to increase the rate above the value established by provisions of agreements during the specified term.
- Norm by which the Government of Kazakhstan upon agreement with the authorized body has the right to make a decision on purchasing by the Government or the National management company of the announced STB's shares in the amount of not less than 10% of total amount of placed shares with the aim of timely reaction to the arisen problems within STB which have manifested themselves in significant violation of prudential norms

and/or other mandatory norms and limits. In case the financial state of STB improves, the Government takes measures on the sale of the acquired shares of STB.

Budgetary Financing of Stabilization Programs

In 2007, KZT122 bln. has been allocated from the budget, of which about USD93.4 bln. (financing the target branches) was implemented as of October 1, 2008. All money allocated in 2007 formed the authorized capital of *Kazyna Sustainable Development Fund* JSC that used it to support the construction sector, small and average business and agriculture.

On the whole, over 3 quarters of 2008, KZT236.1 bln. was allocated to stabilize the economic development, of which KZT155.2 bln. was implemented as of October 1, 2008. (Table 7.2.2).

Table 7.2.2

Stabilization Measures of Government in 2008

Measure description	Allocated resources (bln KZT)	Implementation of resources as of October 1, 2008 (bln KZT)*
Allocated money as of October 1, total	236.1	155.2
Support to agriculture	41.4	27.9
Food security provision (state food reserve formation)	10.3	4.3
Support for building sector and completion of building projects to protect the shareholders, including:	114.5	53.1
<i>Target current transfers to akim of Astana for purchase of accommodation</i>	<i>41.0</i>	<i>14.5</i>
<i>Target transfers to Almaty and Astana for participation in completing building projects with the participation of shareholders</i>	<i>27.2</i>	<i>27.2</i>
<i>Increase in the authorized capital stock of Kazyna Fund to complete building projects in the housing sector</i>	<i>46.3</i>	<i>11.4</i>
Support to small and medium business, including:	70.0	70.0
<i>Increase in the authorized capital stock of Kazyna Fund for preferential financing of entities in small and medium businesses</i>	<i>66.0</i>	<i>66.0</i>
<i>Increase in the authorized capital stock of Social-Entrepreneurship Corporation Ontustyk National Company JSC to support entities of small and medium businesses and agriculture</i>	<i>4.0</i>	<i>4.0</i>

Source: MF

*Implementation in certain cases means the sum contributed to financing of purpose-oriented projects, in other cases the fact of a complete transfer of money to local budgets for regional and municipal programs.

Thus, the sectors receiving priority support are agriculture, construction industry, and small and medium business. Support provided to these sectors can solve the problem of stabilizing the country's economy both in a short and long term. However, this is not aimed at structural reconstructing the economy, in order to decrease the system macro-risks, or reduce disparity in the development of the economy.

Stabilization Measures of Kazyna Sustainable Development Fund JSC (Sumruk-Kazyna National Welfare Fund JSC)⁵⁵

100% of money resources allocated in 2007 from the State Budget to implement stabilization measures were consigned to support the economy through *Kazyna Fund*. In 2008 to implement measures in co-operation with the Fund KZT112.26 bln. was allocated, accounting for 47.5% of total allotments to stabilization programs this year⁵⁶. *Kazyna Fund* became the structure bearing the main responsibility for implementing the stabilization measures. The support mechanism implies placement of capital on the deposits in STBs, and its subsequent allocation to

⁵⁵ According to the governmental order *Measures to implement Order of the President of RK No.669 of October 13, 2008 on founding Sumruk-Kazyna Fund*, the National Holding *Sumruk* merged with the National Management Company *Kazyna*, as a result of which *Sumruk-Kazyna National Welfare Fund* JSC was founded

⁵⁶ According to the Ministry of Finance

end-use financing. The basic directions of *Kazyna* Fund activity are support for the small and medium business⁵⁷, agriculture and construction industry (Table 7.2.3).

Table 7.2.3

Stabilization Activity by *Kazyna* Fund

<i>Economy Description</i>	<i>Forecasted volumes and terms of investment in STB</i>	<i>Rates of bank investment in economic entities</i>	<i>Implementation of money allocated by banks as of October 1, 2008, bln KZT</i>	<i>Effect (as of October 1, 2008)</i>
2007				
Construction sector (completing projects with individual co-investors' participation)	KZT48.8 bln @10.6% to 10.85% ⁵⁸ in 6 STB	15 - 19% ⁵⁹	31.24 (implementation according to plan of financing)	Financing continues for 26 units, completed for 5 units, stopped for 6 units due to lack of collateral or choice of other sources
Small and medium businesses (via <i>Damu</i> Fund)	KZT48.8 bln @10.7% to 10.85% (incl. <i>Kazyna</i> rate of 7%) in 7 STBs (1 st tranche)	Average rates in banks 16.3% - 18.3% (simple average rate 17.7%) at average credit term of 39 months	Complete	1989 projects were financed, and 2332 workplaces created
Agriculture	KZT24.4 bln with the term of 14 months at average rate of 10.22%	Rate <16% term of 14 months (Ministry of Agriculture subsidizes up to 80% of interest)	13.36	34 agricultural projects of priority branches were financed (production of vegetable oil, sugar, dairy products and meat)
2008				
Construction sector (completing projects with individual co-investors' participation)	KZT46.26 bln @10.6% to 10.85% ⁶⁰ in 6 STB	15 - 19% ⁶¹	11.36	Astana: of 37 projects (15.6 thousand flats, 8.5 thousand individual co-investors) 6 are completed (2.6 thousand flats, 1.7 thousand individual co-investors) Almaty: of 14 projects (4 thousand flats, 1.7 thousand individual co-investors) 2 are completed (450 flats, 105 individual co-investors)
Small and medium businesses (via <i>Damu</i> Fund)	KZT50 bln @7.5% (incl. <i>Kazyna</i> rate of 6%) for 84 months ⁶² (money allocated in end-August)	12.5% per project, average credit amount KZT30.9 mln average credit term 47.2 months	Allocated credits worth KZT3.2 bln as of October 1, in October 9.2 bln	As of October 1, 96 projects received financing. In October 306 projects were financed. As of end-October, 703 workplaces were created
Small and medium businesses (via <i>Damu</i> Fund with co-operation of local executive bodies)	KZT28 bln is planned to be invested (as of October 1 <i>Damu</i> Fund was allocated KZT9.4 bln from <i>Kazyna</i> Fund). KZT4.5 bln was placed by <i>Damu</i> Fund in banks; local executive bodies placed KZT6.1 bln @8.46% to 8.51% ⁶³ (with local bodies' money @1.5%) in 4 STB (as of November 1)	Average rate 13.4% at average credit term 13.3 months	Allocated credits worth 1.26 bln KZT	66 projects were financed

Source: MF, MEBP, *Kazyna*, *Damu*

The following projects have also been financed:

- Construction of 4 infrastructure projects in Astana (Stadium, Congress Hall, Concert Hall, Presidential Park) in the amount of KZT12.7 bln. via *Astana Finance* JSC (refund from the state budget in 2009)

⁵⁷ Carried out through *Damu Entrepreneurship Development Fund*, with *Kazyna* Fund allotting money to *Damu* Fund and its subsequent placement in the banks

⁵⁸ Rate on investment of money allocated in 2007 – 2008

⁵⁹ On crediting with money allocated in 2007 – 2008

⁶⁰ Rate on investment of money allocated in 2007 – 2008

⁶¹ On crediting with money allocated in 2007 – 2008

⁶² Money for crediting is allocated with the participation of banks, with 1:1 Ratio

⁶³ Data provided by *Damu* Fund as of 01.11.2008

- Refinancing of 18 large-scale projects in non-raw-material industries from the resources of Development Bank of Kazakhstan, which contributed to granting additional liquidity to STBs in the amount of KZT38.2 bln.

On the whole, at present *Sumruk-Kazyna* Fund (*Kazyna* Fund) rather successfully implements short-term measures to stabilize the economy and mitigate the shocks of fall-down in the financing of the economy. This conclusion is supported by the results in implementing the resources allocated in 2007 for financing the priority branches of economy. However, the current activity of the Fund does not settle the problems of infrastructural reconstruction in the economy and reduction of disparity in its development. For example, with the first tranche transferred in the end of 2007 to support the small and average business 1,200 projects in the sphere of trade were financed to the sum of KZT30.5 bln., with the total amount of 2,005 projects (KZT50.5 bln. including a small share of STB resources)⁶⁴.

Individual Deposits Guaranteeing

At present the government implements a number of measures to develop the system of obligatory deposit insurance. During 2007 – 2008 the authorized capital of *Kazakhstan Deposit Insurance Fund* JSC increased a number of times, and made up KZT6 bln. as of June 29, 2007, KZT16 bln. as of December 25, 2007, and KZT30 bln. as of August 1, 2008. By now NBRK have decided to increase the authorized capital of the Fund to KZT100 bln. The major measure to ensure a high level of trust to the banking system in Kazakhstan, however, is to increase the sum of guaranteed payments of deposits from 700 thousand (98.6% of an aggregate number of accounts) to KZT5 mln. (99.7% of an aggregate number of accounts).

However, the Fund has difficulties with the volumes of the special reserve of compensation which should make not less than 5 % of the sum of all guaranteed deposits according to Law “On Obligatory Guaranteeing of Deposits Placed in Kazakhstani STBs”. As of November 1, 2008 the special reserve of compensation made up KZT33.8 bln., accounting for about 2% of the guaranteed deposit base. Prior to the increase in the guaranteed sum, the special reserve of compensation covered 6.13% of the aggregate sum of compensation for all the STBs, after it this coverage made up KZT5 mln. which accounted for 4.1%⁶⁵.

Support to Mortgage Market

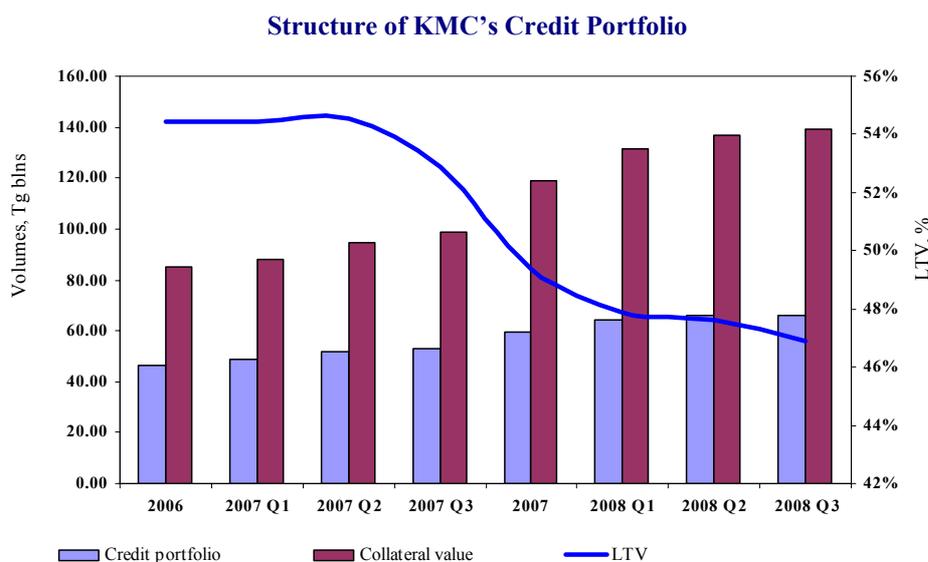
A sustainability of the mortgage market is ensured by *Kazakhstan Mortgage Company* JSC, allotting credits via partner banks. During November 2007-March 2008, in order to develop the mortgage market the authorized capital of the company was increased by KZT11.1 bln. through emission of equities reaching KZT28.9 bln. as of October 1, 2008. Additionally, in 2007-2008 certain resources were attracted owing to the placement of bonds to the sum of KZT12.5 bln., in spite of problems in the banking system with the liquidity, i.e. in August-December 2007. As of October 1, 2008 the aggregate assets of the company reached KZT107.1 bln.

During 3rd quarter of 2007 – 3rd quarter of 2008 the credit portfolio grew from KZT53.12 to 66.2 bln, with the share of standard credits making up 98.4% of it. The LTV ratio witnesses to its certain improvement, as it has dropped from 53% to 47% during the period (Figure 7.2.4). The drop could be due to two possible reasons. The first is an increase in the share of credits allocated via state preferential mortgage programs (state mortgages are lower than average in the market, and the collateral value is market-value). The second lies in shift in preferences of *Kazakhstan Mortgage Company* JSC in credit redemption, i.e. re-buying of more secured credits. Cf. according to AFN as of October 1, 2008 only 40% of LTV mortgages did not exceed 70%.

⁶⁴ Data provided by *Damu Entrepreneurship Development Fund* JSC

⁶⁵ Data provided by *Kazakhstan Deposit Insurance Fund* JSC

Figure 7.2.4



Source: KMC

The institution which guarantees payments of mortgages in Kazakhstan is *Kazakhstan Mortgage Guarantee Fund* JSC partially covering the mortgages. By the end of 3rd quarter of 2008 the aggregate volume of insured mortgages made up about KZT47.7 bln., with 15,196 insured credits.

The Fund mainly guarantees mortgages to buy inexpensive accommodation built within the State Programs with the resources from the state budget on one of the five schemes:

1. 30% of primary mortgage
2. 40% of the sum required by a creditor
3. 50% of the creditor's net losses
4. 100% of the creditor's net losses
5. 40% of the mortgage

It is worth mentioning that since its founding there has not been any payment of insured liabilities yet, mostly owing to the fact that the Fund does not insure any of a mortgage allocated at the Kazakhstani mortgage market. In other words, the Fund is not an institution capable of solving the problems of STBs and mortgage companies, should mass defaults on mortgages.

Action Plan on Stabilizing the Economy and Financial Sector for 2009 – 2010

On November 25, 2008 the Government, the National Bank and the Agency for Regulation and Supervision of Financial Market and Financial Organizations adopted the Action Plan on stabilizing the economy and the financial sector for 2009 – 2010. The resources of the National Fund of Kazakhstan in the amount of USD10 bln. (KZT1,200 bln) will be used to provide for financing the Action Plan. The Action Plan has five directions of activity:

- 1) The financial sector stabilization, with USD4 bln. (KZT480 bln.) allocated.
- 2) The housing sector development, with USD3 bln. (KZT360 bln.) allocated.
- 3) Support of small and medium business, with USD1 bln. (KZT120 bln.) allocated.
- 4) The development of agriculture, with USD1 bln. (KZT120 bln.) allocated.
- 5) Implementation of infrastructure and breakthrough projects, with USD1 bln. (KZT120 bln.) allocated.

The measures on stabilizing the financial sector will, firstly, include buying ordinary shares of the four system-forming STBs in the amount of not more than USD1 bln., with extra USD3 bln. allocated in the form of subordinated debt and via buying of privileged shares. Second,

capitalization of the stress assets fund which is planned to be created via financing from the 2008 budget in the amount of KZT52 bln., and the capitalization will be brought up with the state budget resources to KZT122 bln. Third, the National Bank will continue to support the liquidity level of the banking sector. In addition, the mechanisms of state regulation of the financial sector will be improved, including that of the pension accumulation system.

Sumruk-Kazyna Fund is allotting the sum of USD5 bln. to support the housing market and construction industry. The amount is to be collected through attracting resources from pension accumulation funds and the National Fund. As the pension assets are of great social value their attraction should be done under minimum risk levels.

Programs of crediting small and medium business entities and agricultural sector via STBs will continue to be implemented. And finally, large-scale infrastructure projects worth about USD4 bln., of which 1 bln. will be allocated by the National Fund, and 3 bln. will be raised by *Sumruk-Kazyna* from the external markets, are to be implemented.