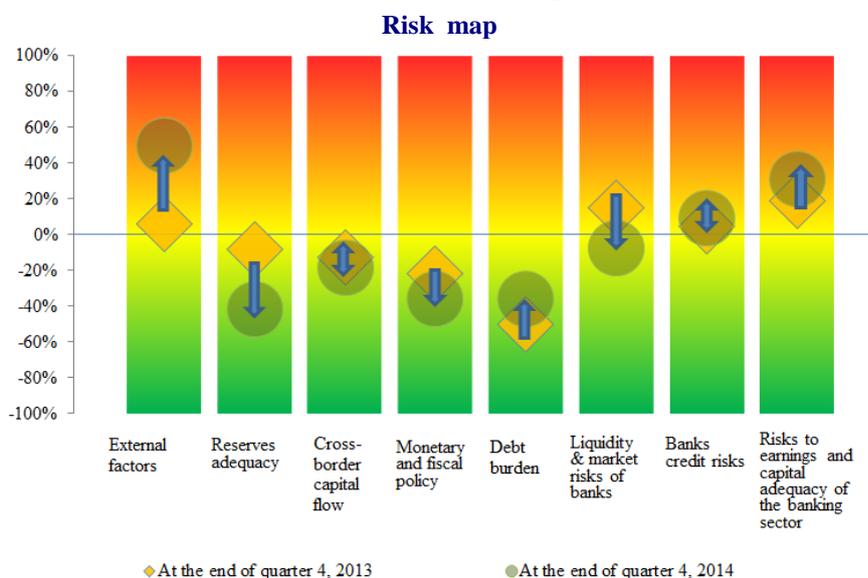


I. Executive Summary

1. The external environment was the main factor that determined financial stability in the Republic of Kazakhstan. Risks coming from the Russian Federation, the largest trading partner and a member of the Customs Union and the Common Economic Space, that are associated with the sanctions imposed against Russia, significant exchange rate fluctuations of the Russian ruble and deterioration of economic situation in the Russian economy as a whole were aggravated by dramatic and massive decline in world oil prices.



Moreover, implementation of the free floating exchange rate of the Russian ruble by the Central Bank of Russia and relatively low world oil prices become a new long-term reality in which the Kazakhstan economy and the financial sector will be functioning.

2. In 2014, the economic growth of Kazakhstan was minimal during the last 5 years and expectations for 2015 are associated with its further slowdown. Amid other countries – members of the Eurasian Economic Union – Kazakhstan is demonstrating higher performance indicators, nonetheless, virtually all of the growth is secured by the production of services whereas the contribution by the production of goods to the GDP growth remains insignificant, as opposed to Kazakhstan's partners in the EAEC.

The economic growth is still financed with own funds of enterprises and the state budget resources. Despite more intensive use of resources of the National Fund, the conservative approach to their spending is ensured by the existence of a fiscal rule¹; this also allows increasing the Fund's assets, both in absolute terms and in relation to the nominal GDP. As a consequence, active counter-cyclical policy of the NBRK and the Government resulted in notable mitigation of risks related to adequacy of reserves in 2014 as well as risks of the fiscal and monetary policies.

In terms of expenditures, the GDP growth model changed in the past year. The net exports factor which was making negative contribution to the GDP growth in the prior years came to the fore instead of household consumption. Measures taken to limit consumer lending and expectations about the NBRK's exchange rate policy topped their part. As a result, in 2015 the Kazakhstan economy will be functioning in the environment of relatively satisfied consumer demand that is related to a short-term shift in the consumption pattern of the population towards the Russian goods at the end of 2014, notably within the Russian Federation, because of a rapid depreciation of the Russian currency and the resulting difference in the price level.

3. Depreciation of the Russian ruble and decline of world oil prices that were observed in the second half of 2014, somewhat offset the positive effect from the Tenge exchange rate adjustment conducted in February 2014. At the end of the past year, the current account balance

¹ Since 2011, the guaranteed transfer to the national budget is fixed in absolute terms at USD 8 bln. At the same time, the amount of the guaranteed transfer to the national budget may be adjusted downwards or upwards up to 15%, depending on the situation in the economy

had been positive. The resultant pricing competitiveness of Russian goods may be offset by identical appreciation of the Russian ruble observed in the first half of 2015 and the growing inflationary pressure in the Russian Federation.

At the same time, risks for the balance of payments are still there and the measures for their minimization and maintenance of the economic growth in the environment of high economic uncertainty represent key objectives of the current economic policy. In doing so, the exchange rate policy is a part of the set of measures aimed to maintain the domestic demand, investment and consumer expenditures of the general public and the government.

4. The past year was characterized by an increasing role of the government in supporting the lending activity of banks. Resources from the National Fund were allocated to provide loans to the SMEs in the manufacturing industry. The UAPF was actively investing pension assets in the long-term financial instruments of banks. Also, regulatory measures were taken both to create conditions for expanding lending capacities of banks, particularly tightening the requirements to investment of funds raised in the domestic market into foreign assets, and to limit excessive lending in certain areas, specifically in consumer lending.

During 2014 as a whole, the lending activity of banks in respect of new loans increased significantly – the 27% growth versus 15.2% in 2013. The growth was secured by virtually all groups of banks – both by those which obtained support from the government and those that raised the necessary resources on their own. Accumulation of the loan portfolio, other assets, including highly liquid assets, was done almost proportionally.

Nonetheless, the governmental role of funding the economy amidst weak banks and low investment activity of the private and foreign capital requires ensuring both increased productivity and accumulation of resources and capacities by the economy that will enable gradual replacement of the governmental support with own funds of economic entities.

5. Active write-offs by banks of non-performing loans resulted in significant decrease in their level to a minimum value for the last 5 years – 23.5%² (the decrease accounted for 10 pp versus the peak value in April 2014). The incentives for active non-performing loan write-offs, in addition to legislative tax breaks, were the NBRK's regulatory and supervisory policy measures – establishing threshold values (15% and 10% of the loan portfolio at the end of 2014 and 2015, respectively)³, monitoring the effectiveness and submission of reports by banks regarding the taken measures aimed to rehabilitate the loan portfolio on a regular basis. At the same time, the decrease of the “old” non-performing loan portfolio is accompanied by accumulation of new problem loans which are past due both more than 90 days and less than 90 days; this may cause pressure on the level of non-performing loans in the nearest future.

This circumstance is indicative of the fact that the quality of credit risk management at banks requires improvement and legislative capacities for managing and writing off problem assets require further refinement including their implementation on an on-going basis.

6. The “depositor run-off” last February demonstrated not only an expectedly high degree of instability of retail deposits under the impact of negative information but also the willingness to act based on a situation on the part of depositors. The conclusions made in the Financial Stability Reports for prior years regarding the lack of excess liquidity in banks proved true once again. As a result, bank liquidity gaps occurring during the period of shock were covered with loans borrowed from the NBRK.

² At July 1, 2015, non-performing loans accounted for 10% of the banks' loan portfolio.

³ Exceeded threshold values were noted among banks which were in the process of reorganization – a transaction on concurrent exchange of assets and liabilities between “Kazkommertsbank” JSC and “BTA Bank” JSC as well as the merger of “Alliance Bank” JSC, “Temirbank” JSC and “Forte Bank” JSC

The absence of an alternative to bank deposits led to redistribution of deposits in favor of the banks which were not subject to the information attack. Moreover, in 2014 the total volume of retail deposits increased, even in light of the effect of the Tenge exchange rate adjustment.

The real estate market, while retaining its investment attractiveness, also continues to be affordable only for a limited number of households and cannot serve as an area for investment of savings for the country's public at large. Due to overestimated appraisals of the cost of housing as well as due to a high cost of financial resources required for its purchase, only few people can take advantage of the real estate as an alternative to bank deposits.

7. Increased dollarization of liabilities as a result of conversion of deposits into foreign currency amidst a low demand for foreign currency loans of banks had reduced banks' abilities in managing their foreign currency position. In these circumstances, long-term cross-currency interest rate swaps made by the NBRK and aimed to provide the Tenge liquidity to banks in order to provide credits to the real sector of the Kazakhstan economy were used by banks as an instrument to hedge foreign exchange risks. The need to repay debt on long-term swaps with the NBRK in the environment of temporary widening of foreign currency position sets new objectives to banks in managing their assets and liabilities with a view to reduce a short balance sheet foreign currency position.

8. In 2014, the financial market of Kazakhstan was characterized by a high degree of volatility both in terms of transaction volumes and in terms of interest rates and yields on various financial instruments; these served as a background for enhanced speculative behavior of the market participants that was not motivated by the operating need of economic agents. The general aspiration of economic agents to convert resources into foreign currency was also visible from continuing dollarization of funds of the general public and the corporate sector. Moreover, during the stress periods the market participants preferred to conduct borrowing operations instead of reverse conversion of foreign currency, with the NBRK being among the lenders.

Concentration of resources of the financial market participants in its money segment was negatively affecting the development of other segments of the market.

9. In the area of regulation, the NBRK's objective is a rapid adjustment to changing environment, risk assessment and management through adequate control and legal support.

In the Kazakhstan market, there appears a new type of small-size short-term and expensive "pay-day" loans to the general public that are provided by non-official financial service providers and are already used in many countries of the world. At present, this type of services is of a small size in Kazakhstan, however, it requires a regular monitoring with a view to assess and, perhaps, to limit credit risks.

The transition to the Basel III framework continues to be an important area of the NBRK's regulatory policy. Bank capital requirements corresponding to international standards came into effect from the beginning of 2015. Assessments made in 2014 regarding LCR and achieved results allow conducting further work on the regulatory support of practical implementation of this ratio in Kazakhstan. The design by the NBRK of the stress-testing methodology for the banking sector liquidity becomes a key element; it will enable a comprehensive and a more accurate assessment of the possibility for discharging obligations in the environment of negative developments in the financial sector or in a certain financial institution, together with the stress-testing of credit risk and market risk. Further, the NBRK will continue to design approaches to the treatment of the stress-testing results as part of its supervisory process in line with an individual risk profile of a bank.

The above mentioned regulatory initiatives represent elements of a broader NBRK's effort for a further development and strengthening of the system of macro-prudential regulation that is critical for central banks of many countries nowadays. In doing so, the nature of macro-

prudential instruments implemented by the NBRK is determined based on specifics of systemic risks and potential threats in each specific case.

10. Increased integration processes that are manifested in the establishment of the EAEU, upcoming accession to the WTO, require building a competitive domestic financial sector in anticipation of a coming opening of “financial” borders after the year 2020. To this end, in 2014 the Concept Paper for the Financial Sector Development of the Republic of Kazakhstan till 2030 was drafted and adopted; its purpose is to increase the financial sector’s efficiency in redistribution of resources in the economy on the basis of best international standards. The Paper provides for implementation of the best international practice in the sphere of regulation, the financial sector consolidation with a view to increase its financial capacities, for the increased affordability of financial services and financial literacy of financial services consumers as well as a number of other issues.

Creation of architecture required to overcome long-term technology challenges is another focal point. At present, reduced business activity of the general public and slowed rates of economic growth in the country incentivize banks to search for new solutions in the provision of banking services, including the development of the payment infrastructure. Banks are actively considering and implementing innovation settlements methods. In general, the banking community still plays the role of a testing site for approbation and implementation of new technologies which enable accelerating the processes of reciprocal payments between various market entities.

11. The establishment of the EAEU involves the deepening of economic integration through harmonization of the legislation, including in the sphere of the financial market. There is an intention to establish a common financial market and ensure a non-discriminative access to financial markets of the member countries⁴ by 2025. Free capital movement between the countries will help increase competition in the financial market where Kazakhstan banks will have to assess their position not on an isolated basis within frames of one country but by taking into account strengths and weaknesses of banks of the EAEU member states.

The main competitive advantages of the Kazakhstan banking sector versus other EAEU member states are a relatively low level of country risk of Kazakhstan, a more competitive financial market in terms of government’s equity participation and, thus, increased role of medium-sized banks with private capital, as well as larger capitalization of the banking sector which will allow absorbing arising risks in case of negative developments.

In Russia and Belarus, the government’s or foreign capital participation determines the balance sheet structure of the banking sector as well as the level of risk appetite. A more competitive market of Kazakhstan encourages banks to find optimal allocation between earning assets and liquid resources required to maintain their operation. In its turn, reliance of Kazakhstan banks on resources attracted from clients is heavier because of the lack of alternative funding sources.

A high share of non-performing loans, despite their minor decrease, does not allow large Kazakhstan banks to rapidly adjust to the changing business environment, as opposed to banks in Russia and Belarus.

Another critical disadvantage is the remaining quite a low level of penetration of banking and other financial services into Kazakhstan’s economy, which, in its turn, enables the banking sector to develop both extensively, increasing the volumes of provided services, and intensively, ensuring the quality of services and implementing modern technologies for provision of such services.

In order to realize the potential of the Kazakhstan financial sector and to increase its competitiveness, it is necessary to resolve the problem of asset quality, increase sustainability of

⁴ Section XVI. Financial Markets Regulation. Treaty on the Eurasian Economic Union (Signed in Astana city on May 29, 2014) (version of 10.10.2014, as amended 23.12.2014)

the funding base, accomplish transition to the Basel III standards and other international financial market standards and fine-tune the business strategies of financial organizations aimed to increase returns on assets and equity.