
FINANCIAL STABILITY REPORT OF KAZAKHSTAN

December 2006

Foreword

Compared to monetary stability which can be assessed as a low and predictable price level, financial stability assessment cannot be based on one single indicator. Indicators of financial stability include a vast range of issues, and as it follows from the international experience, have to reflect at least the following **aspects of financial stability**:

- (1) financial resources are effectively and timely re-distributed among those, who saves and invests the funds;
- (2) an adequate evaluation and effective risk management are in place;
- (3) financial shocks may be removed by financial system without significant adverse effect.

The final **goal of the analysis of financial stability issues** focuses on identification of situations where the disproportions accumulate that may result in the subsequent corrections of markets, in the problems with financial institutions and their incapability to maintain the continuous operating of financial system and the business activity of real sector.

The implementation of the goal means the performance of the following tasks within the framework of methodological, informational and organizational approaches:

- (1) identification of shocks, risk factors and vulnerabilities of the economy;
- (2) analysis of factors related to financial stability and situations where the risks of the financial system and economy may lead to the emergence of instability;
- (3) assessment of stability of the financial system, i.e. its capability to smooth the development of negative shocks;
- (4) determination of whether the financial system is within the zone of financial stability, or moves close to the border of the zone of financial stability, or is unstable, i.e. out of the zone of financial stability;
- (5) evaluation of adequacy of the regulative measures for the financial system to the existing risks and potential threats;
- (6) determination of necessity to take preventive, corrective or anti-crisis measures;
- (7) initiation of extensive discussion of the financial stability issues among professionals as well as among a broad audience.

Financial Stability Report of Kazakhstan is the first analytical publication of such type in Kazakhstan and is not aimed at solving of all tasks at a time. In particular, **within the framework of preparation of the Report the followings were determined**:

- aims, tasks and approaches to the systematic analysis of financial stability issues,
- problems and risks, which are currently the most important,
- elements of stability and potential threats, and
- most acceptable methodology based on data availability and their format.

As to **practical aspect**, the Report has fixed focus on the most substantial factors of vulnerabilities of the financial system, emphasis on which and discussion of which should lead to searching of more effective instruments of risk regulation. Moreover, the main directions of further work have been determined, which consist of the necessity to implement a more comprehensive and systematic approach to the analysis of problems and development of solutions; of increasing information availability and its quality; of regulatory authorities' closer coordination. This task may be identified as the priority one, implementation of which has been planned for 2007.

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The Financial Stability Report of Kazakhstan has been prepared by the joint working group of the National Bank of Kazakhstan and the Agency on Regulation and Supervision of the Financial Market and Financial Organizations of Kazakhstan headed by the Deputy Governor of the National Bank of Kazakhstan, Ms. G.Z. Aimanbetova.

I. Overview

In 2006 a stable growth of the world economy and a favorable business climate on the world trade markets remain unchanged that ensures a stable external demand, stability of the balance of payments and high rates of economic development in the midterm in Kazakhstan.

Along with the external economic conditions, the growth of income of the business entities, people and the state budget increases the role of the aggregate internal demand as the motivating growth factor.

At the same time, the increase of the aggregate internal demand in the conditions of lower rates of growth of economic productivity has the determining significance for acceleration of inflation and cause the substantial risk for the competitiveness of the external sector.

High liquidity on international markets against the relatively low level of a country risk ensures the additional flow of foreign capital, which together with high prices for oil and metals is a long-term factor of strengthening of the national currency, tenge; and which makes the implementation of the National Bank's task on sterilization of the excess liquidity more complicated. High speculative component on the foreign exchange market together with cancellation of restrictions on the purposes of foreign currency acquisition and provision of free capital movement within the framework of the transfer to the principles of total internal and external convertibility of tenge from 1 January 2007 determines the National Bank's active presence on the foreign exchange market in order to minimize exchange rate risks.

Increase of debt burden of the corporate sector before the credit institutions in the conditions of sufficient liquidity and high level of profitability does not bring a direct threat to the financial stability. Significant growth of external liabilities of the private sector, mainly of the banks, increases the economy's vulnerability to the growth of the world interest rates and to the decrease of demand and prices on international trade markets. In the conditions of reinforcement of the roles of factors which may lead to the increase of foreign exchange and interest rate risks, it is important for the corporate sector to conduct a more active policy of risk hedging, especially exchange rate risks, which is limited presently due to low development of the domestic market of term contracts.

The maximum effect of bank financing in long term is limited by the low effectiveness of bank credits utilization by the enterprises, which are directed mostly to financing of the current needs and circulate in trade, construction and real estate transactions. This factor diminishes the opportunities for the corporate borrowers to maintain the optimum level of solvency on liabilities to the banks if current situation changes.

The refinancing needs will maintain the high level of the banks' external indebtedness in the future. At the same time, the current level of risks of banking system is within the range of control and secured by the high level of internal liquidity. Low level of credit and market risks, high level of banks' profitability may be preserved if business activity level and profits of the corporate sector and households are continuously high.

The risks of banks potential vulnerabilities increase coming from the deterioration of asset quality. The increase of credit risks to the real sector of the economy may be kept down only by maintaining the factors of economic growth in Kazakhstan and effective utilization of the borrowed resources. The followings are the elements of bank vulnerabilities:

- i. high level of indirect risks related with the currency mismatch of the assets and liabilities of the corporate sector and households;
- ii. increase of debt burden of the individuals that outpaces the growth of their available income in the background of relatively low level of savings;
- iii. high dependence of the main bank borrowers' solvency, particularly, in the construction field, on the factors that provide consumer demand and that impede substantial price adjustment for the real and financial assets;
- iv. increase of the credit and market risks related to the export of bank capital to the countries with the higher risk level.

In conditions of the active money payments and high liquidity of the main financial intermediaries there is no possibility of the systemic risk in the payment systems which may occur due to the lack of liquidity. The existing methods of risk management completely meet the requirements of systems and provide for their continuous and effective work.

In general, the comparative assessment of the main indicators of vulnerabilities that were determined by IMF in accordance with the result of analysis of the financial crisis in Asia shows the increase of the risks which are critical for the financial stability of Kazakhstan. In particular, the following risks increase: (1) related to the financial and capital account liberalization; (2) related to the growth of bank credits and first of all, to the sectors oriented to domestic consumer demand; (3) related to the accent on collateral at credit activities; (4) related to the great share of mortgages.

Vulnerability Factors of Financial Sector in Different Countries

	Indonesia	Korea	Malaysia	Philippines	Thailand	Kazakhstan
	December 1996*					September 2006
Recent liberalization of the financial sector	*	*		*	*	*
Recent liberalization of capital account		*				*
Credits to private sector > 100% of GDP		*	*		*	
Credit growth of private sector, real growth > 20%			*	*		*
Accent on collateral in credit activities	*	*	*	*	*	*
Real estate related credits > 20%	*	*	*		*	*
«Non-performing» loans > 10% of all credits	*	*	*	*	*	
Capitalization of the stock market (in % of GDP)	40	30	310	98	56	59.9

* Data on Asian countries is taken for the period preceding the crisis

Source: Financial Supervision Agency(FSA), Financial sector crisis and restructuring lessons from Asia, IMF, 1999

Indicators of Vulnerabilities of the financial sector in Kazakhstan

	Kazakhstan (as of 01.10.06)
Credits to private sector (in % to GDP) ¹	54,1
Credit growth of private sector (in % change) ²	51
Real estate related credits (share in %) ³	33,6
«Non-performing» loans (share in %) ⁴	2,0
Capitalization of the stock market (in % to GDP)	59,9

Source: FSA, National Bank of the Republic of Kazakhstan (NBRK), KASE

Taking into account the mentioned risks and the increase of influence of non-residents on formation of exchange rate (directly, through arbitration between the national currency assets and the foreign currency assets, and indirectly, through growth of external indebtedness of enterprises and financial institutions), the level of international reserves may be assessed as minimally sufficient for provision of external liquidity of the country. In view of the fact that negative currency position of the sector of non-financial institutions is not compensated by the amount of net assets of the Government and the National Bank of Kazakhstan, the level of international reserves

¹ Ratio of credits given to the economy to GDP

² Increase of the aggregate loan portfolio since the beginning of 2006, without adjustment for the inflation rate

³ Share of the credits on real estate in the aggregate loan portfolio of the banks

⁴ Share of non-performing loans

of the National Bank and the assets of the National Fund are not adequate to the exchange rate risks presented in other economy sectors.

Net Foreign Exchange Position of the Country⁵ (bln. of USD)

	2005	2006	
		June	September
Public administration sector	13,15	20,76	21,71
Banks	0,06	0,36	0,40
Non-bank financial organizations ⁶	-0,04	-0,07	-0,11
Non-financial organizations	-22,10	-25,29	-27,12
Households	-0,74	-1,82	-2,29
Economy, in general	-9,67	-6,06	-7,41

Source: NBRK, FSA

Further accumulation of international reserves of the country and conducting a more active contra-cycle policy by the National Bank, Agency on Regulation and Supervision of the Financial Market and Financial Organizations, and first of all by the Government of Kazakhstan corresponds to the general task of financial stability maintenance in the country. It is necessary to undertake an overall assessment of adequacy of existing instruments to regulate the accelerating risks given that financial institutions' assessment of the potential threats is insufficiently full and adequate.

The shift of the accent from the policy of stimulation of high economic growth in general and particularly, growth of financial sector, to the advantage of measures of more effective risks restriction is considered as the priority task on the way to financial stability of the country.

II. Macroeconomic Risks and Risks of Financial Markets

1. External Factors of Financial Stability

Favorable price situation for the main goods of Kazakhstan export is accompanied by a certain worsening of the external financing expressed in the increase of the borrowed fund costs on the world capital markets. This factor together with the reduction of excess liquidity may restrict the possibilities of the corporate borrowers to refinance their liabilities in mid-term.

1.1. Factors of World Economic Demand

In conditions of high prices for oil and other raw commodities, the world rates of economic growth as previously exceed all expectations that are stimulated by favorable conditions on financial markets and by the continuous adaptive macroeconomic policy in many countries. Since the risks related to in-action increase over time, the main task of the world economy policy is to use the generally favorable market environment for the purpose of overcoming global imbalances of the current account, inflation and dependence of economies on volatility of oil prices.

In general, the world rates of economic growth remain at a rather high level.

In 2005 according to data of the International Monetary Fund (IMF) the world economy increased by 4.8 %, although it was lower than highest rate of the previous year – 5.8 % (Figure 1.1.1). In 2005 the GDP of China increased by 9.9 %, USA – by 3.5 %, Japan – 2.7 %, Euro-zone – 1.3 %.

⁵ By the end of period

⁶ The figures vary from the data provided in Section III due to the use of different classifications for the purpose of non-duplication:

1) for calculation of foreign exchange position of the country the sector classification is applied;

2) data of Section III includes all organizations holding a license for certain types of bank operations

In the first half of 2006 the world economy did not suffer any fundamental changes in comparison to 2005 due to the main factors of the economic development in the world. As it follows from IMF forecast, the growth of world economy in 2006 and 2007 will be at the level of 4.9% and 4.7 %, respectively. In particular, it is expected that the rate of US GDP growth will decrease to 3.4 % in 2006, while there will be a certain growth in Euro-zone and Japan to 2 % and 2.8 %, respectively.

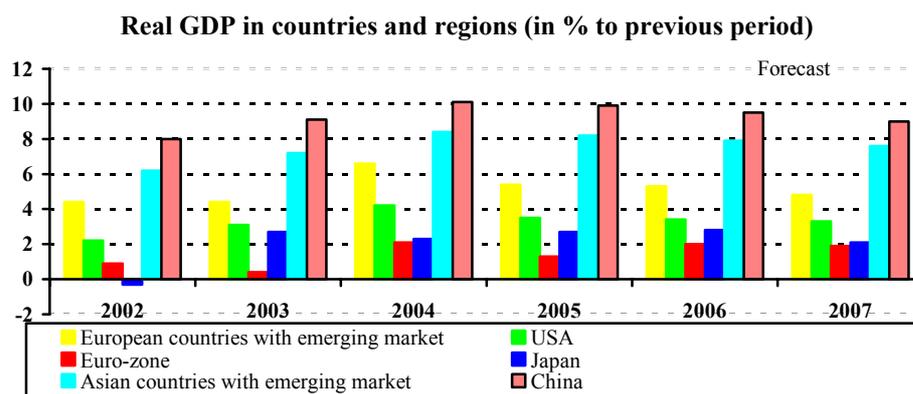
There is a certain reduction of deflationary pressure in the economy of Japan. However, the increase of the growth of private sector consumption as the result of improvement of conditions on labor market may still destabilize the situation in the economy.

Low level of domestic consumption in the region, oil prices fluctuation and possible reduction of world demand for the goods of the region remain the main risk factors for Euro-zone.

The activity in the emerging developing countries leded by China, which demonstrates the substantial economic growth, remains very high. Thus, as predicted by IMF, the real growth of China's GDP will be equal to 9.5 % in 2006 as opposed to 9.9 % in 2005. The economic growth of China is caused by high domestic demand and growing surplus of current account. Together with the growth in the IT sector, this stimulates the acceleration of activity in other countries of the region.

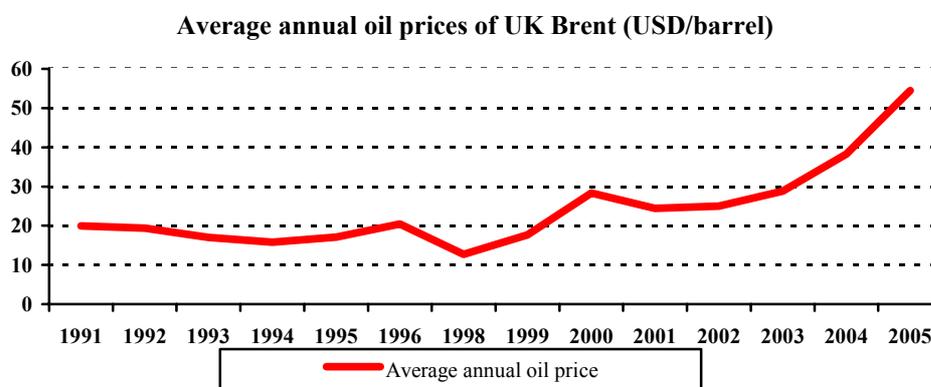
In Middle East and CIS countries high oil prices strength their budget accounts and current account, and the countries are generally cautious to the expenses in comparison to the preceding periods of the price increase.

Figure 1.1.1



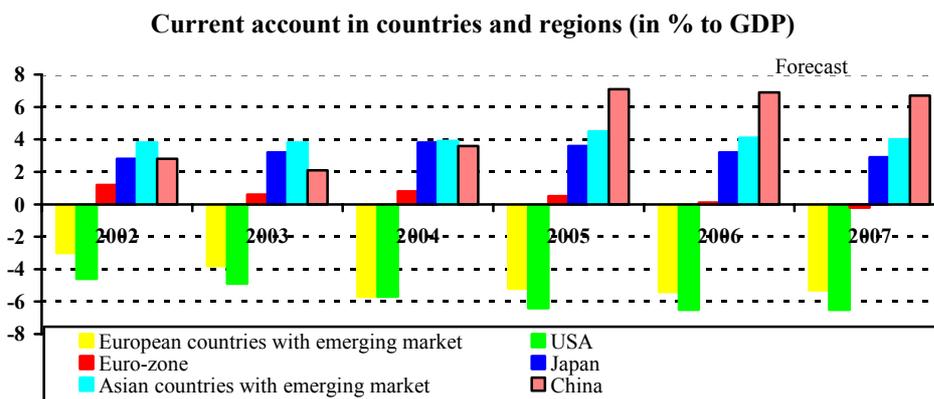
Source: IMF

Figure 1.1.2



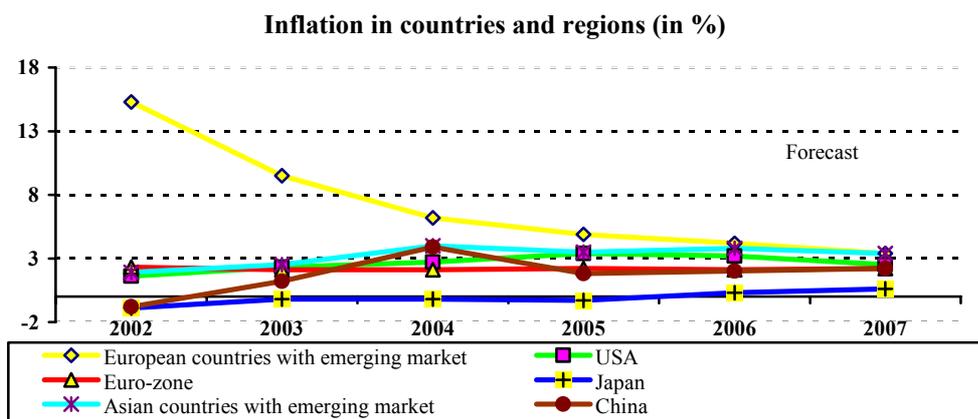
Source: IMF

Figure 1.1.3



Source: IMF

Figure 1.1.4



Source: IMF

In 2005-2006 the oil and metal markets demonstrated a confident accelerating dynamics. Geopolitical tension and rapid increase of demand from China, India and the USA were the prerequisites for increase of prices.

According to data of IMF the average world price to Brent oil was equal to 54.4 US dollars per barrel in 2005, which is 42.1 % higher than the price in 2004 (Figure 1.1.2). Price for copper has increased by 28.4 % and became equal to 3679 US dollars per ton, the average annual price for lead became equal to 975.3 US dollars per ton, the price at the end of the period increased by 16.5% in comparison to the beginning of the year. The average price for zinc came to 1380 US dollars per ton and increased by 45.2 % over the year. In comparison to 2004, the average annual price for aluminum decreased by 10 % and came to 1897.4 US dollars per ton.

In the first half of 2006 prices in world markets continued to grow. In particular, the world price for Brent oil has increased by 32.7 % in comparison to the relevant period of 2005 and came to 65.9 US dollars per barrel in average. Prices for copper have increased by 82.5 %, silver – by 54.8 %, gold – by 38.3 %, lead – by 19.2 %. Prices for zinc have increased in 2.1 times.

From the data of OPEC and International Energy Agency, despite the highest raw material prices, the world demand for oil in 2006 will increase by 1.9%-2.2% and will come to 84.9 – 85.18 million barrels per a day, in average. As previously, the USA, China and India will demonstrate the highest demand in 2006.

Certain vulnerabilities factors remain in the world economy which may lead to global imbalances.

As the IMF experts believe, it is necessary to pay attention to the following factors:

1) Remaining growth of the current account deficit of the USA while there is a major surplus in the oil exporting countries, China, Japan, in some small industrially developed countries and other Asian emerging market countries (Figure 1.1.3).

It would be possible to reduce the risks substantially by taking coordinated measures in the main regions including measures on reduction of current account deficit, fiscal deficit and stimulation of private savings in the USA; structural and other reforms aimed at increasing the aggregate domestic demand in the countries which have a surplus; a higher flexibility of exchange rates in China and some other countries in order to provide appreciation of the exchange rates.

2) Possible intensification of inflation pressure in the world economy as the result of cyclic increase of import oil prices (Figure 1.1.4.).

3) High and fluctuating oil prices. As predicted by IMF the average spot price for oil (Brent, Dubai and West Texas) will come to 69.2 US dollars per barrel in 2006 and to 75.5 US dollars per barrel in 2007.

Influence of the increase of oil prices on the world economy remains moderate, partially because the inflation expectations remain rather stable and the existing increase of oil prices is caused by the high world demand for it. However, there are three reasons for concern in the long term.

First, the effects of recent price shock probably have not shown up in full, especially if producers and consumers still consider it as a temporary, not a permanent shock.

Second, since the levels of extractive industries are still low, the market remains vulnerable to shocks due to geopolitical uncertainty in the Middle East.

Third, since the prices are more and more affected by problems of supply, negative influence is likely to become more substantial than earlier, especially, if the influence of the prices on base inflation increases. If the mentioned scenario becomes real the developing oil importing countries would come to a difficult situation where they would not be able to improve their position in such circumstances by compensational increase of prices for non-raw commodities. This calls for the necessity of further improvement of mid-term balance of demand and supply in oil markets, including eliminating the obstacles for investments into extraction and manufacturing; provision of full reflection of changes of external oil prices in the domestic prices; reinforcement of resource-saving measures; and finally improvement of data on oil markets which is very important. Such measures would also help to reduce the price fluctuation in the short term having made the markets less vulnerable to shocks.

1.2. World Money Market and Capital Market Trends

Global increase of interest rates has led to decrease of the level of liquidity in the external money markets, to reduction by investors of their positions in the more risky instruments such as shares of developing markets, which may adversely affect the countries depended strongly on external funding.

In order to restore the economic situation and avoid deflation caused by collapse of stock market, by aggravation of geopolitical situation, by weakening of consumer confidence and consumer demand, the Federal Reserve System of the USA (FRS) has decreased the interest rates from 6.5 % to 1.75% over 2001. In following years the FRS continued decreasing the rates which had come to 1 % by June 2003 and remained constant until May 2004 (Figure 1.2.1). Reduction of prices of mortgage credits and companies' funding following the decrease of rates has increased the income of consumers and corporate sector which finally led to substantial growth of consumption and investments.

Since mid-2004 the FRS has started increasing the interest rates in order to prevent the increase of inflation having the general growth of economy. The increasing utilization of energy resources in the conditions of economic growth together with the increase of prices for energy has burdened the inflation pressure. In the period of mid-2004 to end of 2005 the interest rates increased from 1% to 4.75%. In 2006 the FRS increased the base interest rate twice – in March and in June 2006 by 25 basis points to 5.25%. As the result, the GDP growth slowed down in the second quarter of 2006 (its growth came to 2.6 % as opposed to 5.6 % in the first quarter) and

deceleration of inflation in that period have caused suspension of rates increase by the FRS that noted that it would observe the further development of the economy and the level of prices in the country.

In its official statement, traditionally accompanying the announcement of decision of the Open Markets Committee the FRS states that the economic growth becomes moderate in comparison to the intensive dynamics in the beginning of the year. The growth slowdown reflects the coolness of real estate market and the low effect of increase in interest rates and prices on energy resources. The subsequent increase in interest rate will depend on inflation and economic growth forecasts.

The European Central Bank (ECB) tightens its monetary policy moderately due to the substantial disproportions in the structure of Euro-zone economies and continues to watch at the development of the economy in order to assure the price stability in mid and long term (Figure 1.2.2). In 2006 the ECB increased the interest rate several times, which currently comes to 3.25%, in consequence of publication of the positive economic data in Euro-zone. Further increase of the interest rates by ECB is generally expected by the market participants and predictable due to the high risks of inflation acceleration.

Figure 1.2.1

Targeted interest rate of FRS (%)

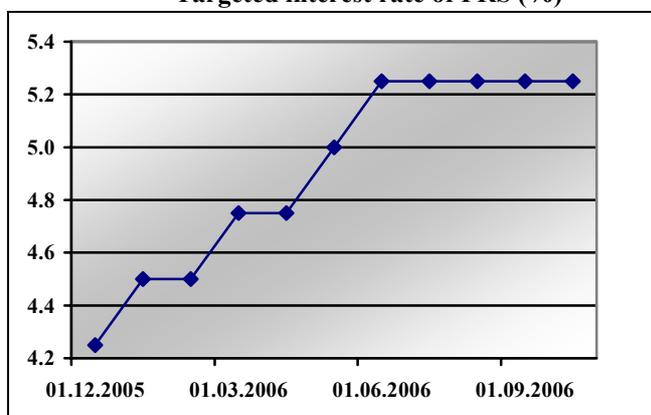
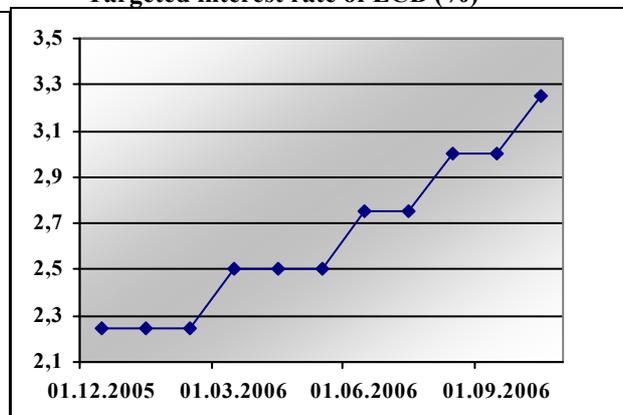


Figure 1.2.2

Targeted interest rate of ECB (%)



Source: Bloomberg

Source: Bloomberg

Figure 1.2.3

Main currencies exchange rates
(1 unit of currency per 1 USD)

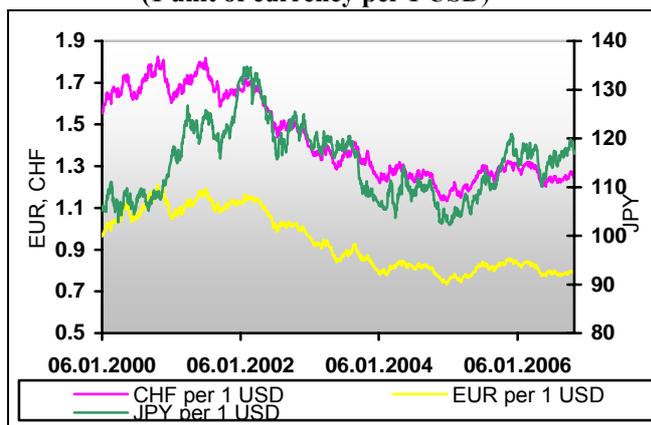
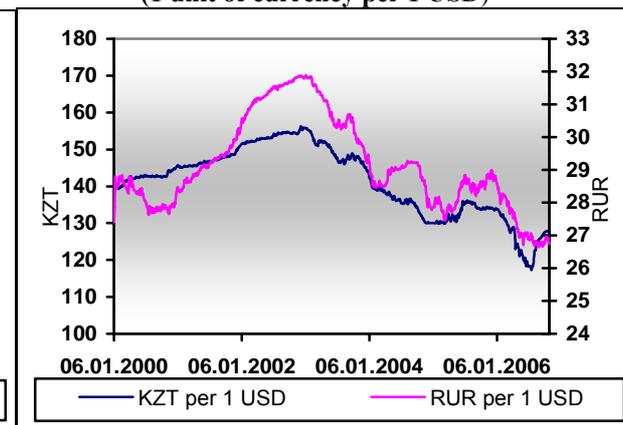


Figure 1.2.4

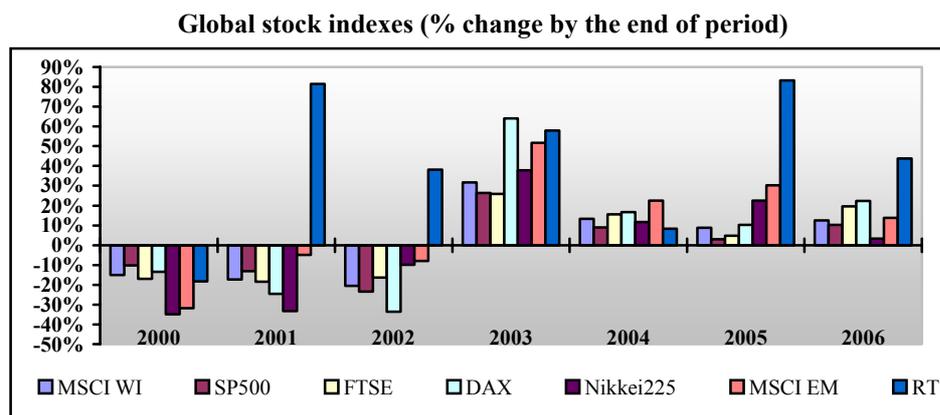
Russian ruble and tenge exchange rates
(1 unit of currency per 1 USD)



Source: Stock Exchanges of countries

Source: KASE, MICEX

Figure 1.2.5



Source: Bloomberg

There is a high level of uncertainty with respect to the future trend of change of the key world currencies exchange rates while the fundamental factors of decline in US dollar against the other currencies of developed countries persist. While there is a general long term trend of strengthening of tenge and Russian ruble, the short term changes in the exchange rate reflect the dependence on world exchange markets.

Dynamics of economic growth, interest rates and overvaluation of the role of main factors of the world economy vulnerabilities were directly reflected in the actions of participants of the world exchange market (Figure 1.2.3). During the increase in a differential of interest rates between Euro-zone and USA, the investors have forgotten the fundamental risks of the main world economy for a while that stimulated an increase in the value of US dollar in the world exchange markets. In 2006 the expectations of interest rates' increasing cycle to its end by the FRS, as well as gradual tightening of ECB monetary policy together with revising by some central banks of their policy with respect to allocation of reserve assets have forced the market participants to pay attention again to the risks of non-sufficient capital inflows for funding fiscal deficit and current account. As a result, US dollar has decreased by 7 % to euro by the end of October 2006. Nowadays due to the different factors that are able to influence the value of world currencies there is an uncertainty in the future dynamics of US dollar.

General factors influencing the economy of Kazakhstan and the Russian Federation in particular, high inflow of foreign exchange in the form of export income and investments determine the long term trend of ruble and tenge appreciation (Figure 1.2.4). At the same time there is a growth in volatility of daily exchange rate of ruble and tenge that generally reflects certain increase in the level of dependence between the exchange markets of Russia, Kazakhstan and key world currencies.

There is a slowdown and a certain stabilization of the growth rates of share indexes of developed and developing countries (Figure 1.2.5).

Improvement of economic situation in the USA due to gradual decrease in interest rates in 2001-2004 and profits growth of companies and positive expectations regarding their future income have stimulated the growth of share indexes. As the result, the indexes in the USA and Europe increased by 26% and 37%, respectively in 2003. In 2006 US and European stock markets increased by 10% and 22%, respectively. There was a certain decline in May-June that was caused by aggravation of geopolitical problems, by anxiety about the growth of inflation and future growth of interest rates in the USA. The stock markets stabilized in the third quarter after the US GDP came to 2.6% in the second quarter, as opposed to 5.6% in the first quarter that allowed the investors to assume that the FRS has suspended its policy of increasing the interest rates which would not be able to affect economy of the country adversely. The growth of the companies income had a positive effect to the index of Great Britain FTSE 100 that increased by 19.5 % in 2006. Nikkei 225 in Japan has increased only by 3.3%. The insignificant growth is explained by

uncertainty of the investors in further growth of the economy. Moreover, the US GDP decline had an adverse effect on shares of the Japanese companies whose export is oriented to the USA mainly.

Index of shares in developing markets grew by 14% in 2006, which is quite lower than in previous year. The main reason of index slow-pace is that the global increase in interest rates has led to decrease in volumes of liquidity. Investors started reducing of their positions in the more risky instruments such as shares of developing markets. Moreover, decrease in liquidity adversely affects the countries, which strongly depend on external funding, e.g. Turkey and Hungary. Favorable macroeconomic situation had a positive effect to the dynamics of share indexes of Russia. RTS index has continued growing from the beginning of 2006, despite the reduction of growth rates which came to 43% by the end of October of 2006. The growth of raw material prices, the increase of consumer services in the financial and telecommunication sectors, as well as the liberalization of access to shares of "Gazprom" became the main reasons for index acceleration in 2006.

Despite the fact that the FRS has increased interest rates in the USA during the last two years, the levels of yield of the US government securities (GS) remain historically low. The cross-flow of investments from the US to Europe and other countries is a main risk factor for the US economy due to tendency of the countries with emerging market economy to diversify own international reserves.

While in the beginning of 2000 the yield of 10-year US bonds was equal to 6.4 %, by the end of October 2006 it became equal to 4.60%. It should be noted that interest rates were equal to 6.5% in 2000 and came to 5.25% in 2006. Among the GS of developed countries the US Treasury bills as previously, remain the main investment instrument especially for central banks of Asian countries. Unwillingness of the latter to introduce free floating exchange rate for their currencies has led to substantial growth of the reserves in US dollars. Therefore, the Asian investors remained the main purchasers of the US GS for many years. However, the central banks of Asian countries have recently started declaring on possible diversification of their reserves that may lead to further weakness of US dollar and growth of Treasury bills income. This may also cause the cross-flow of investments from the US to Europe and other countries, which is the main risk factor for the US economy.

In general, the yield of GS of the developed countries grew by 50-70 basis points in 2006 and the main growth took place in the short-term sector of the yield curve. The noteworthy fact of 2006 is that the yield curve of the US GS has taken a negative slope. That was due to investors who started leaving the short-term sector, which responds to the increase in interest rates, to the long-term securities, which in turn reflect the investors' expectations regarding the future inflation level and the economy growth. Taking into account that the further growth of interest rates was predicted at the market, the highest growth was determined in the yield of GS with a term of payment up to 5 years. The investors though preferred to invest to the long-term securities since their yield was higher than the inflation level. It was expected that inflation in future would remain at the acceptable level. Moreover, the investors are uncertain about the development of the US economy in the longer term. Therefore, they preferred to keep staying on the long segment of the curve. In addition, a more stable level of yield of the long-term securities is explained by the fact that pension funds and insurance companies taking into account their term liabilities invest more to the securities with the term of payment more than 10 years.

Investors started reducing their positions globally in the risky assets.

JP Morgan EMBI+ index, which includes GS of developing markets, for the last five years has grown by more than 100%. Rapid economic development of countries with developing markets, high level of liquidity, investors' confidence in the further growth of the economy of these countries and expectations of acquisition of high income from investments in securities of developing markets despite the higher level of risk of such investments as opposed to the ones of developed countries (Figure 1.2.6) have led to the growth of GS of such countries.

Moreover, except for GS emitted in US dollars the investors started investing in securities emitted in local currencies. In 2006, after the extreme growth in the first quarter, index EMBI+ declined and its yield for the quarter came to -2.14%, while its yield in the first half of 2006 was equal to -0.69%. Shares of developing markets and securities emitted in local currencies have reduced most of all. As it was stated above, decline in indexes of developing markets was dictated by increase in interest rates in many countries, by reduction of liquidity available for investments.

Kazakhstan sovereign risks maintain at a constantly low level.

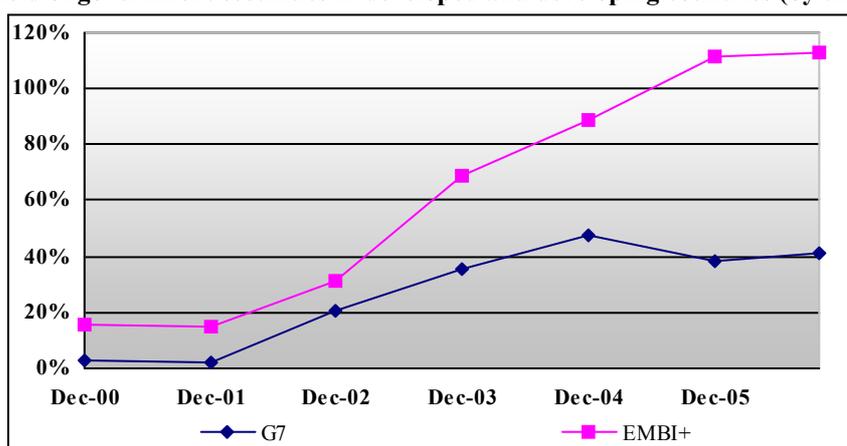
On the date of issue, 27 April 2000, the yield of Kazakhstan Eurobonds (XS0111078183) was equal to 11.125%, while the yield of the US GS (US9128272U52) was equal 6.544% respectively. The spread between these two yields was equal to 4.58%, which was rather natural and caused by low country rating of Kazakhstan of «B1» according to Moody's and «B+» according to Standard & Poor's at that moment.

Subsequently, the spread between the yields had a tendency for tightening (Figure 1.2.7). One of the main factors of influence was the rise of credit rating of Kazakhstan. During the period under consideration the rating agencies changed the credit rating of the country as follows:

- in 2001 – to «Ba2» (Moody's), «BB» (Standard & Poor's), «BB» (Fitch);
- in 2002 – to «Baa3» (Moody's), «BB+» (Fitch);
- in 2003 – to «BB+» (Standard & Poor's);
- in 2004 – to «BBB-» (Standard & Poor's), «BBB-» (Fitch);
- in 2005 – to «BBB» (Fitch);
- in 2006 – to «Baa2» (Moody's), «BBB» (Standard & Poor's).

Figure 1.2.6

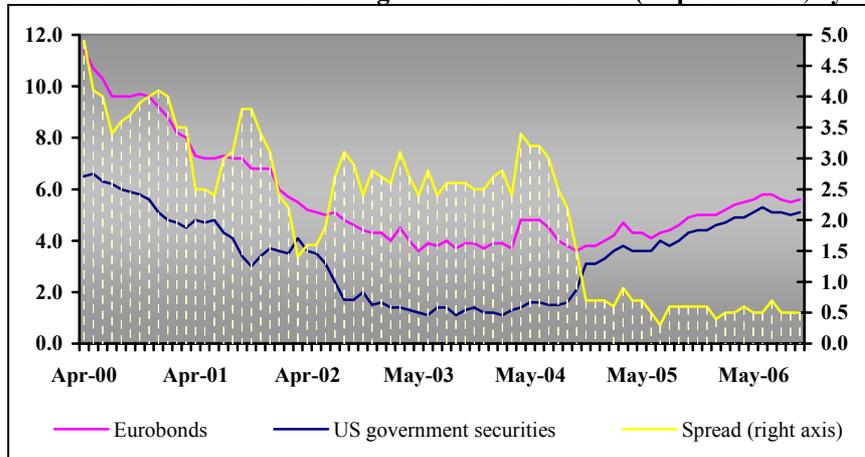
Cumulative yield of government securities in developed and developing countries (by the end of period)



Source: Bloomberg, JP Morgan

Figure 1.2.7

Yield spread of Kazakhstan eurobonds and US government securities (% per annum, by the end of period)



Source: NBRK, Bloomberg

2. Macroeconomic Environment and Economic Conditions in Kazakhstan

The determining factor for financial stability is the probability of the economy to maintain the stable rates of economic growth that do not stimulate the acceleration of inflation and do not cause imbalances in the domestic markets of goods and services and imbalances in the external sector of the economy. Adherence to these conditions ensures the stability of government finance, corporate sector and households finances.

2.1. Sustainable Economic Development

Nowadays there are no factors that may substantially slow down business activity in mid-term.

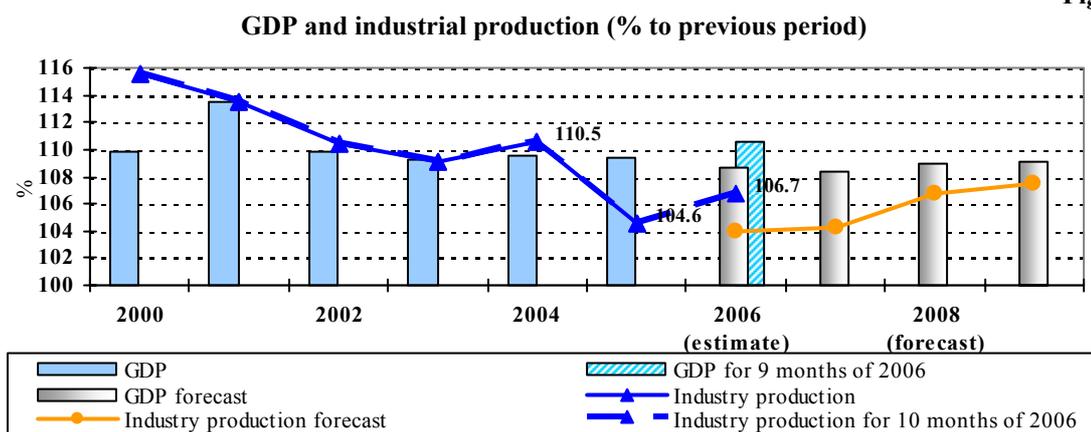
Favorable conditions in the world markets of goods and assets generally ensured a stable growth dynamics of GDP at the level of average 10% per year in 2000-2005 (Figure 2.1.1). In accordance with the results of 9 months of 2006 the growth rates of GDP continued conforming to the mid-term trend (10.6% in comparison with the same period of the previous year). The factors of growth of internal consumption expenditures (mainly, household expenditures) and gross capital formation have the determining value for the real economic growth in Kazakhstan (Figure 2.1.2). As a result of increasing expenditures there has been an expansion of aggregate demand for the goods of industrial sphere and to a greater extent for services (Figure 2.1.3). At the same time when the high world prices for oil and other raw commodities ensured the growth of extractive and manufacturing industries, the growth of consumer demand has influenced directly on business activity in construction, hotel and restaurants services, transport, communications, trade and real estate activities.

The favorable external factors and a tendency of advanced growth of the manufacturing industry during the last two years are important conditions for the maintenance of economic growth at the level of 8.3-9.1% per year in 2007-2009. At the same time increase in the share of gross capital formation from 18.1% in 2000 to 30.7% in 2005 is a favorable factor for financial stability of the economy in long term.

While there is a general stability of the fiscal budget, certain risks connected with substantial growth of budget expenditures and adequacy of the National Fund of Kazakhstan (National Fund) maintain in case of worsening of external factors.

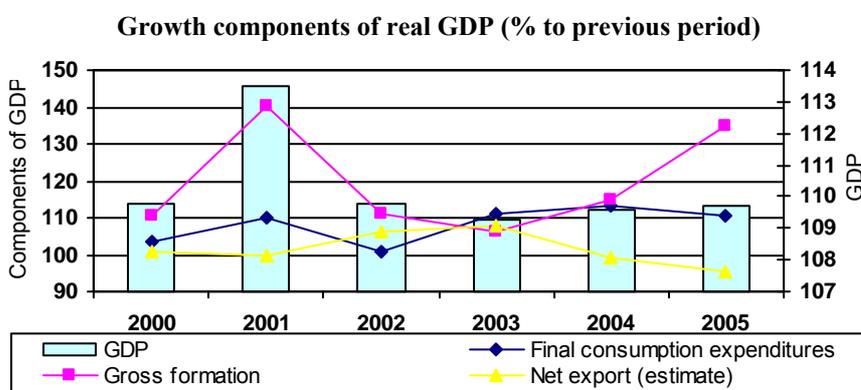
High rates of economic growth and the level of world oil prices ensure excess of fiscal revenues over the forecasted values. At the same time share of petroleum sector has essentially reduced in the structure of the fiscal revenues (from 21% in 2005 down to 14% upon 10 months of 2006). According to the results of 2006 the further decrease in petroleum earnings is expected, which is connected with the full transfer of such earnings to the National Fund and absence of the budget need in the guaranteed transfers. Fiscal expenditures have financed mainly the current needs of the state (73.5% following the results of 10 months of 2006), 43.3% of which were directed to wages, pensions, allowances and other social payments. Expenditures connected with increase in future costs (capital expenditures, credits, acquisition of financial assets) were equal to 26.5% of the whole expenditures of the fiscal budget. At the same time despite the increase in fiscal expenditures, which advanced the rate of economic growth, and reduction of tax burden to economy, the deficit of the fiscal budget did not exceed 1% to GDP for the period of 2000-2004, moreover, there has been noted a surplus in 2005 and 2006 (Figure 2.1.4).

Figure 2.1.1



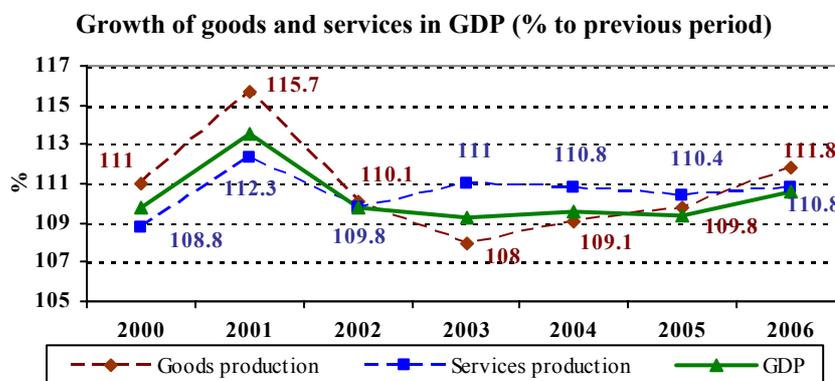
Source: Statistical Agency of the Republic of Kazakhstan (SARK),
Ministry of Economy and Budget Planning (MEBP)

Figure 2.1.2



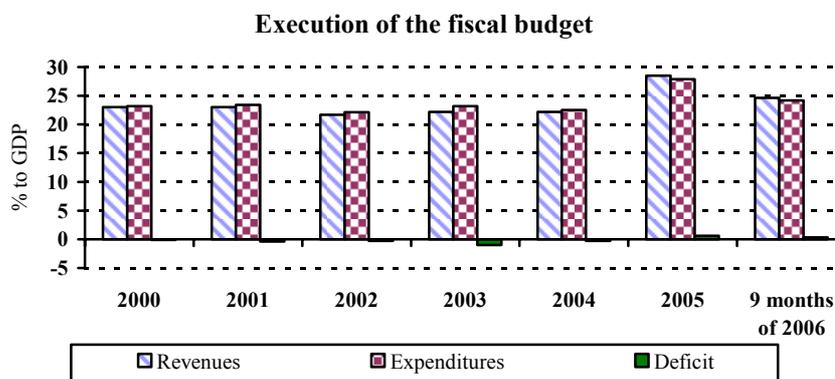
Source: NBRK, SARK

Figure 2.1.3



Source: SARK

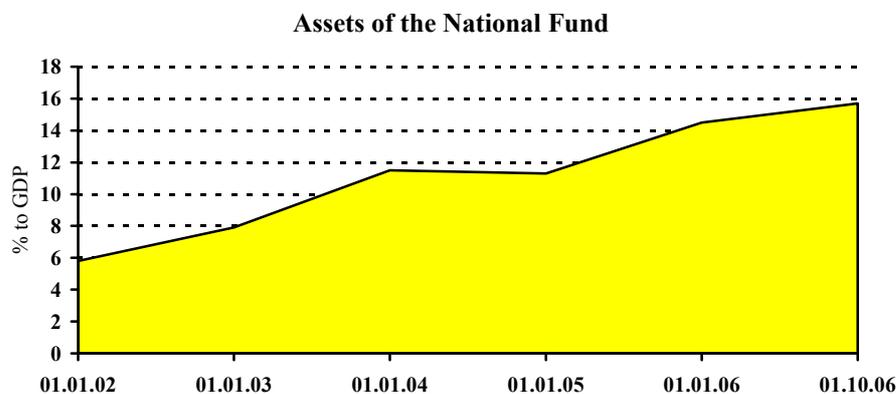
Figure 2.1.4



Source: Ministry of Finance

The National Fund created in 2001 guarantees an additional “cushion” (in a view of ability of the Government to perform its financial liabilities in case of worsening of market situation of the world export prices). Favorable market situation in the world commodity markets ensured the growth of the National Fund up to 11.5 billions of US dollars (as of 1 October 2006) or 15.7% to GDP (Figure 2.1.5). Shift to a new procedure of formation of the National Fund from July 1, 2006 where the returns from petroleum sector are directly transferred to the National Fund and may be used only for the purposes of financing the development budget makes the structure of finances of the Government more stable (Box 1).

Figure 2.1.5



Source: NBRK

Box 1

New procedure of formation and use of the National Fund of Kazakhstan

Since July 1, 2006 the scheme of functioning of the National Fund has been changed. According to this scheme the following earnings are transferred to the National Fund:

- 1) Direct tax earnings from enterprises of petroleum sector (corporate income tax, excess profit tax, royalty, bonuses, production sharing, rental tax on export of crude oil and gas condensate);
- 2) Returns from privatization of the state property related to the mining and manufacturing industries;
- 3) Earnings from sales of agricultural land;
- 4) Investment income from the management of the National Fund;
- 5) Other returns and income not prohibited by the national legislature.

Before, these earnings were accumulated in the republican budget unless the volume stipulated by the Law on the Republican Budget to the respective year was reached, and only the excess funds were transferred then to the National Fund. According to new scheme, the earnings of petroleum sector are directly transferred to the National Fund.

The National Fund may be used in following ways:

- 1) As a guaranteed transfer from the National Fund to the republican budget for development programs in respective financial year;
- 2) As the aimed transfers exercised from the National Fund to the republican budget for the purposes determined by the President of Kazakhstan;
- 3) For covering of expenses related to the management of the National Fund and its annual audit.

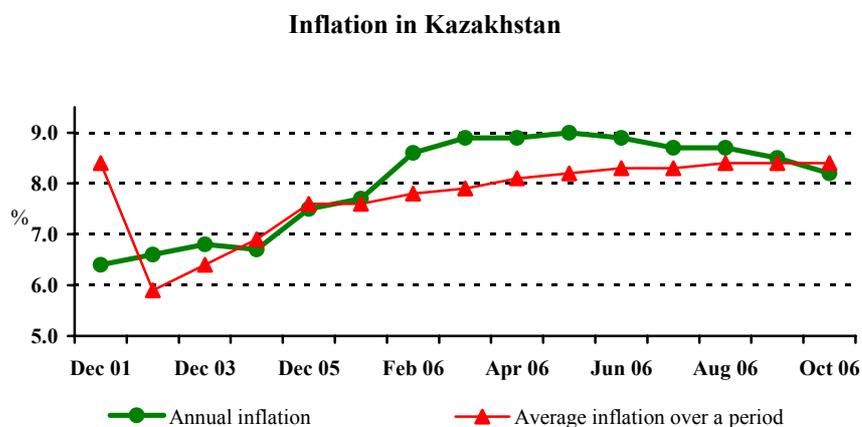
From the date of implementation of the new scheme of the National Fund till September 2006 the guaranteed transfers to the republican budget from the National Fund were not practiced.

In conditions where other key macroeconomic indicators demonstrate positive and stable dynamics, the existing inflation level is not critically dangerous. Inflation process in Kazakhstan is affected by the factors caused by high economic growth.

From 2001 to 2004 inflation remained at a relatively stable level within the limits of 6-7%. However, starting from 2002 there is a certain acceleration of inflation processes in the economy of Kazakhstan. Following the results of 2005, the inflation reached the point of 7.5%, in 2006 its level of 8.5% is expected (Figure 2.1.6).

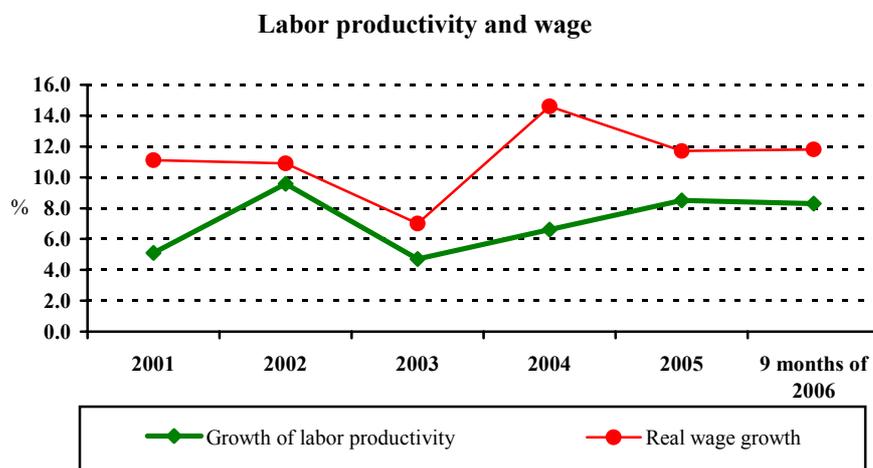
High level of aggregate demand as a result of increase in incomes of population, companies and state outpacing the growth of productivity in the economy (Figure 2.1.7), as well as active fiscal policy strengthen the influence of volatile factors on inflation not connected with the monetary policy of the National Bank in short-term.

Figure 2.1.6



Source: SARK

Figure 2.1.7



Source: NBRK, SARK

2.2. Sustainable External Sector of the Economy

Competitiveness of external sector of the economy remains at relatively acceptable level. However, the risks related to imbalanced growth of wage and labor productivity in the real sector of economy rise.

The period of stabilization of real exchange rate from 2000 to mid-2001 was replaced by decline in real costs of the national currency in basket of currencies of the countries-main trading partners during next two years by 13% (Figure 2.2.1.). The strengthening of euro in relation to the US dollar and a lower level of inflation in comparison to the rate of price increase in the Russian Federation were the determining factors during that period.

As opposed to the previous years, when the real exchange rate reflected the situation on world exchange markets, the internal factors in particular, strengthening of tenge against the US dollar and acceleration of inflation became more important during 2003-2006. As of September 2006, appreciation of the real effective exchange rate to the currencies of foreign countries for the period of three years came almost to 30%. This growth of the effective value of tenge was not compensated by the real depreciation of tenge against the currencies of CIS countries, and mainly

against ruble that caused the increase of the aggregate index by 18% for the period from June 2003 to September 2006. As a result, the index by the end of September was 3.6% higher than the index of December 2000 accepted as the basic level of competitiveness.

At the same time the competitiveness level shall not be assessed without taking into account the changes of productivity of economy and increase in the production costs, mainly increase in wages (Figure 2.2.2). In particular, growth rate of productivity in industry in 2000-2005 was 5% higher in average than the growth rate of productivity of the biggest trading partner-countries. Outpacing of productivity growth was noted with respect to the Russian Federation also, which is more significant taking into account the similar structure of industry of both countries. Intensification of productivity growth stimulates the real appreciation of the national currency, ceteris paribus (Balassa-Samuelson effect), not worsening of external competitiveness. Moreover, wage growth in industry of the Russian Federation for the period of 2000-2002 was 1.7 times higher than the change of the labor costs in Kazakhstan, which may influence on competitiveness in terms of the unit labor costs (ULC).

In 2003-2005 there was a turning point in tendency – wage growth in industrial sector of Kazakhstan outpaces the Russian Federation's one and productivity growth in industry becomes higher. As a result, the favorable situation with relative labor productivity is almost totally compensated by the changes of relative wage.

The growth of payments of income to foreign creditors under conditions of active external borrowing strengthens the risks of excess costs growth over productivity in the real sector of economy. In long term it may reinforce the potential of negative effect of the relative changes of tenge's exchange rate and the vulnerabilities of balance of payments when the world prices for energy resources substantially decrease.

Absence of imbalances in the real value of the national currency has provided for a rather balanced situation in the external sector of economy up to this moment. Inflow of a long-term capital as direct foreign investments stimulated by the growth of yield of investments due to favorable dynamics of prices in the world goods markets overcompensates the outflow of foreign exchange under the current account transactions and short-term financial transactions (Table 2.2.1). Despite almost fivefold rise of short-term external debt, its share in the gross external debt does not exceed 17% at the end of June 2006 and remains at acceptable level. This tendency is typical for developing countries and countries with developing markets – their share of a short-term external debt was equal to 20% in average within the group of countries in 2005.

In general, the temporal structure of capital inflow, where the long-term capital takes priority, excludes the probability of fast and large-scaled outflow of foreign investments in case of significant changes of external economic conditions determining financial stability. At the same time in conditions of substantial overall growth of external indebtedness and of increase in concentration of export on the raw commodity group, the risks related to the borrowers' ability to serve the external liabilities increase in case of significant price reduction in the world trade markets.

High internal foreign exchange liquidity stimulates the growth of investments abroad – over five years the growth of external assets was twice as fast as the growth of external liabilities of the country (Figure 2.2.3). Due to the conservative strategy of investing the funds of the National Fund and a rather low yield of financial operations of banks in foreign countries the total yield of investments abroad remains low compared with the income gained by foreign investors in Kazakhstan. This leads to certain risks of inefficient utilization of the borrowed resources in funding of foreign assets in the conditions of significant growth of external liabilities.

The risks of external solvency of Kazakhstan reflect the solvency risks of the private sector to some extent, and particularly of the financial sector.

The liquidity growth in the world capital markets in conditions of low world interest rates has enabled the banks to use effectively the competitive advantages in the CIS region. The external debt of financial sector, which has increased six times during last three years, came up almost to

40% of the gross external debt of the country (Figure 2.2.4). Later on, the needs of liabilities refinancing will determine the high level of external debt of financial sector in long term. Taking into account the financing properties of the extraction of natural resources oriented at gaining of financial results from the increase of oil extraction in mid-term, high concentration of external debt in these sectors has less risk for the solvency of Kazakhstan in comparison to the risks of financial sector.

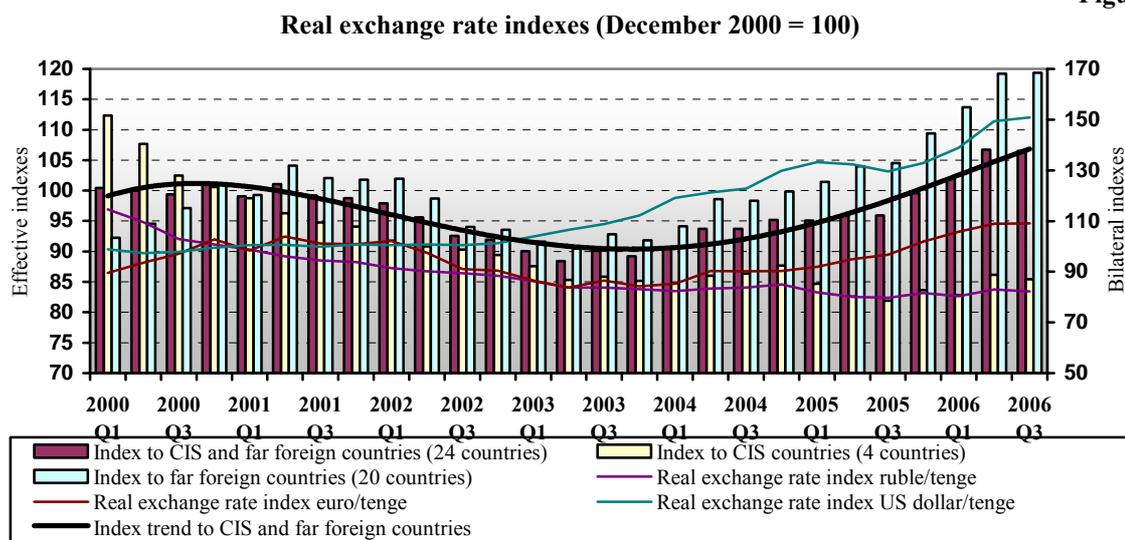
In view of financial stability the banks' capability to allocate effectively the funds attracted from the external capital markets and to assess adequately the risks, affects the potential capability of the whole country to perform its liabilities to foreign creditors.

Regionally the external debt is distributed equally among the main world capital markets.

Within the structure of external debt by creditor countries the priority role is played by the developed countries which hold approximately 85% of external debt (Figure 2.2.5). Despite the high dependence of capital markets on each other, the effect of potential specific shock for each region will be smoothed by proportional allocation of external liabilities between markets of the USA, Great Britain and Euro-zone.

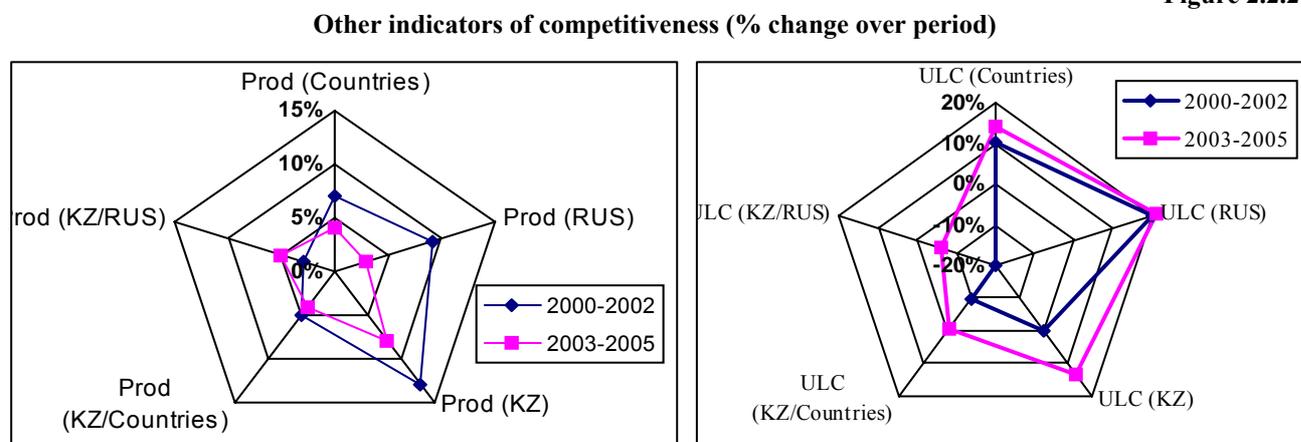
The probability of shock spreading on less stable markets of CIS, Eastern and Central Europe and China through bilateral financial channels is low. However, this does not exclude the possible changes of investors' preferences and re-assessment of risks of all developing countries and countries with emerging market, including Kazakhstan, in case of financial crisis in one of the countries of the group.

Figure 2.2.1



Source: NBRK, SARK, Central banks and statistical agencies of other countries

Figure 2.2.2



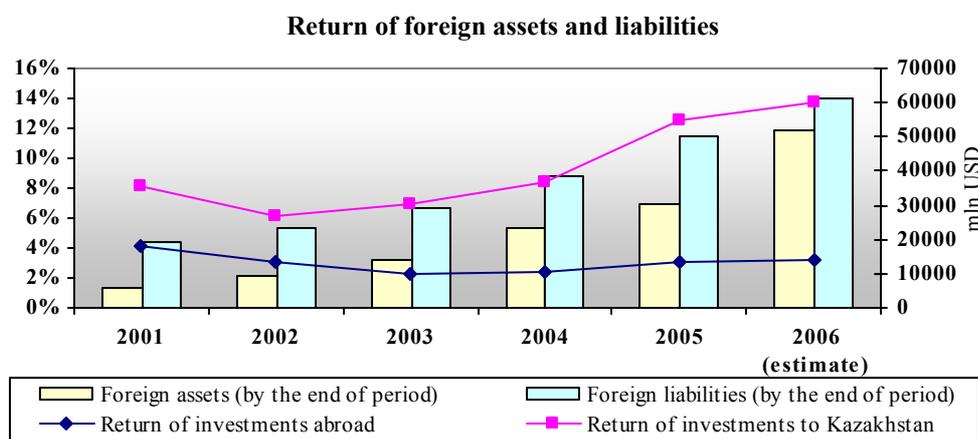
Source: NBRK, SARK, Central banks and statistical agencies of other countries

Table 2.2.1

Indicators of balance of payments and external debt sustainabilities	Average value		2006 1 st half
	2000-2002	2003-2005	
Current account (% to GDP)	-2.8	-0.5	0.6
FDI excluding current account (% to GDP)	12.4	8.3	8.3
Short-term capital flows (% to GDP)	-2.2	-5.7	-1.0
Indicator of openness of the economy	78.8	80.3	76.9
Indicator of concentration of the export structure	63.4	71.5	76.0
Indicator of concentration of the import structure	37.9	37.7	41.6
Gross external debt (% to GDP)	70.8	76.0	80.9
Short-term external debt (% of the total external debt)	8.5	14.2	16.9
Long-term external debt (% of the total external debt)	91.5	85.8	83.1
Gross external debt (% to export of goods and services)	143.1	147.2	153.4
Memorandum items:			
Income of non-residents from FDI in Kazakhstan (% to GDP)	5,0%	6,1%	9,8%
Share of a short-term external debt in the total debt of developing countries and emerging market countries	14%	18%	

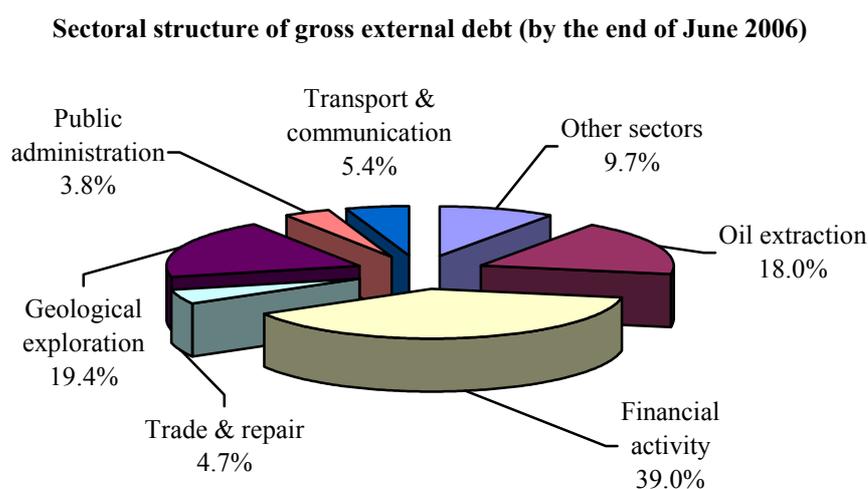
Source: NBRK, IMF

Figure 2.2.3



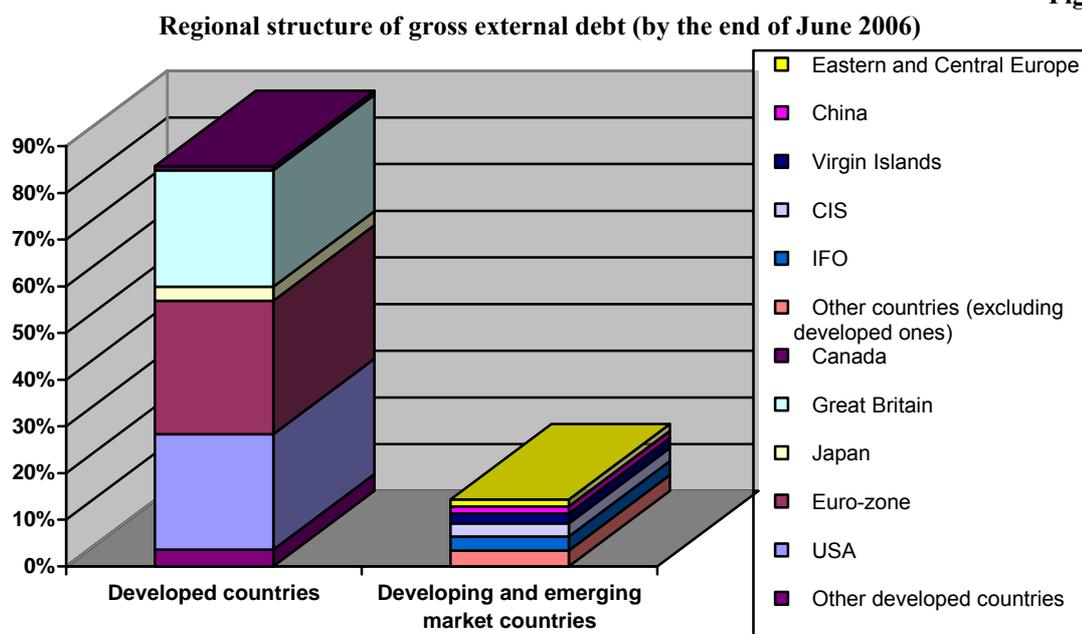
Source: NBRK

Figure 2.2.4



Source: NBRK

Figure 2.2.5



Source: NBRK

2.3. Liquidity, Solvency and Foreign Exchange Risks of the Public Sector

Due to the absence of necessity of the Government to finance the fiscal budget as well as the stable inflow of foreign capital, which is sufficient for financing trade operations, the level of liabilities of public sector is insignificant and determined by tasks of the excess liquidity sterilization.

During the period of 2002 – 2005 the total debt of public sector has shown the stable tendency of decrease and, first of all, due to the decrease of liabilities to foreign creditors. In the first half of 2006 the necessity of the excess liquidity sterilization caused the increase of liabilities of the Government and the National Bank to the level of 19.8% to GDP by 30 June 2006 in comparison with 9.3% to GDP by the end of 2005, which conforms to the level of liabilities by the end of 2000 – 22.2%. The notes of the National Bank played the determining role in connecting the monetary funds in the first half of 2006. Ministry of Finance of the Republic of Kazakhstan also has maintained the necessary level of emission of treasury bills increasing the duration of government securities what was caused by high liquidity at the banking sector and investment instruments deficit at the corporate market. As the result, the structure of debts to residents has been equally distributed between the National Bank and the Government.

The debt structure has changed fundamentally in view of the distribution among the external and domestic liabilities (Figure 2.3.1). The public external debt for the first half of 2006 does not exceed 12% of the total liabilities of the Government and the National Bank (30% by the end of 2005) in comparison with 70% in 2000. The public external debt, which is approximately equal to 2.5% to GDP, is secured by long-term financial liabilities for 94%. Generally, the reduction of external indebtedness with insignificant participation of non-residents at the government securities market (Figure 2.3.2) ensures the high level of external solvency of the public sector.

The level of international reserves of the National Bank currently is at the minimally required level sufficient for smoothing the moderate external price shocks at the world commodity markets as well as for maintenance of the minimal level of external liquidity. Stability improvement at the cost of further gradual saving of international reserves meets the tasks of the policy on provision of financial stability in view of ability of the National Bank to adequately respond to the growth of demand for foreign currency in case of significant external shocks.

During the last years a stable growth of international reserves of the National Bank is being observed. This is determined mainly by substantial foreign currency inflow to the republic from trading and financial operations of residents. 2005 year became the only exception, when the substantial growth of foreign assets of residents and active redemption of external liabilities against the background of current account deficit caused the decline in the level of international reserves of the National Bank.

However, in 2006 the growth of international reserves recommenced and reached the point of 14.183,2 million US dollars by 1 November 2006. The main reason for the growth was the purchase of foreign currency at the domestic market by the National Bank for the purpose of the capital inflow sterilization. As the result, the net currency reserves (FCC) have increased in 2.1 times up to 13.027,6 million US dollars. Assets in gold have grown by 17.3% as the result of transactions conducted by the National Bank and gold cost increase.

In view of international reserves of the National Bank as a factor providing for the acceptable level of external liquidity and confidence in the country's ability to perform its external liabilities there are the following measures of their adequacy (Figure 2.3.3):

1. Import-based measures of reserve adequacy⁷.

The expected growth of the reserves of the National Bank in accordance with the results of 2006 will not compensate the increase of import transactions that actually means the downturn of the measure as compared to the previous year to the level allowing to finance the import of goods and services within a three-month period. The value of the measure is close to the average value and the median value of reserves of the member countries of IMF and traditionally considered as the minimally sufficient level.

A range of researches emphasizes the expediency of maintenance of reserves at the level of six-month import for countries where the currency receipts directly depend on the world prices for raw commodities. At the same time, taking into account the assessments of the long-term tendency of the world prices development and accumulated funds of the National Fund this recommendation is not exactly correct with respect to Kazakhstan.

2. Debt-based measures of reserve adequacy.

It should be noted that within the system of measures of reserves adequacy the import-based measure of reserve adequacy is less priority, since the appropriate level of reserves cannot be determined without taking into account the capital movements.

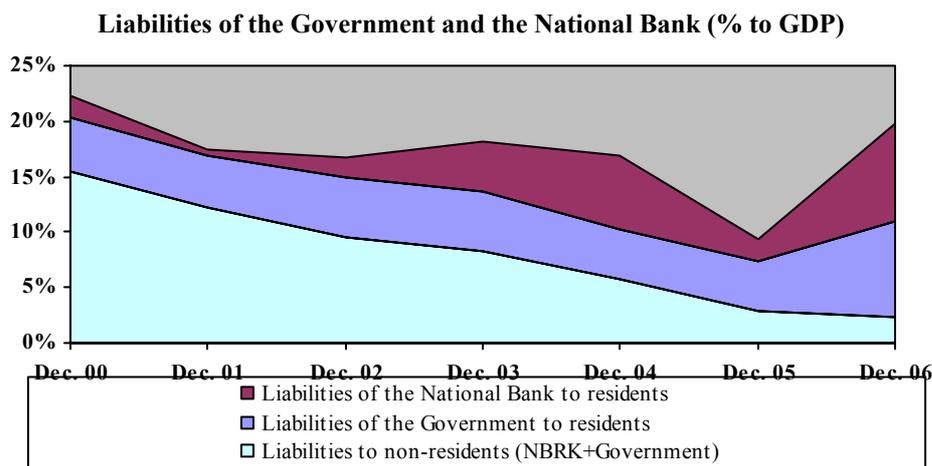
In view of the country's ability to perform its external liabilities the ratio, whereby the level of international reserves must be sufficient for the performance of liabilities on serving the debt in the conditions of absence of new financing within 1-2 years or the value of ratio must be at the level of 1-2, becomes more important. («Gwidotti Rule»).

The measures of reserve adequacy are calculated in relation to (1) the actual stock of the short-term debt and (2) actual payments of the principal and interests on the short-term and long-term total external debt.⁸ The first measure ranges within 0.9 – 2.4 during the period of 2000-2006, coming to 1.4 in 2006, while the second one is characterized by a rather stable dynamics at the level of 0.4 on the average over a period. Taking into account the structure of capital inflow and the dependence of the foreign liabilities service volumes from project execution in the oil and gas industry as well as from world oil prices these measures will reflect mainly the range within the actual level of reserves adequacy is situated.

⁷ For the purposes of conformity of the 2006 data to the same indicator for previous years, the indicator for 2006 has been calculated taking into account the assessment of volumes of import and international reserves of the National Bank in total per annum according to the data of preliminary assessment of the paying balance and data as of the end of October 2006, accordingly.

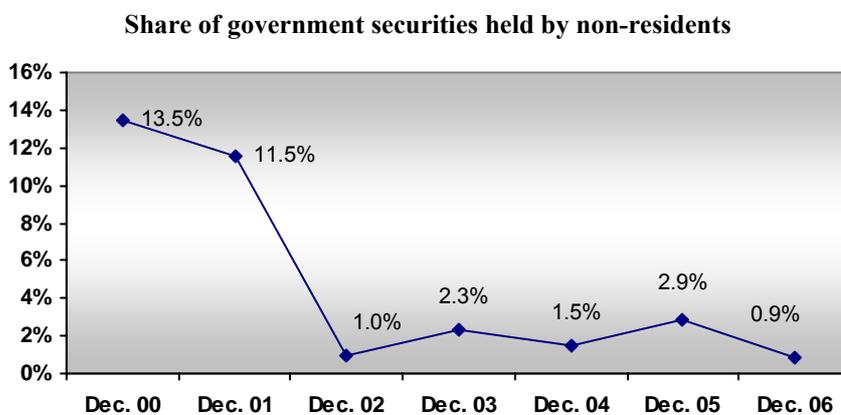
⁸ Payments of principal and interests as of the first half year of 2006 are expressed in the annual level with the adjusted coefficient.

Figure 2.3.1



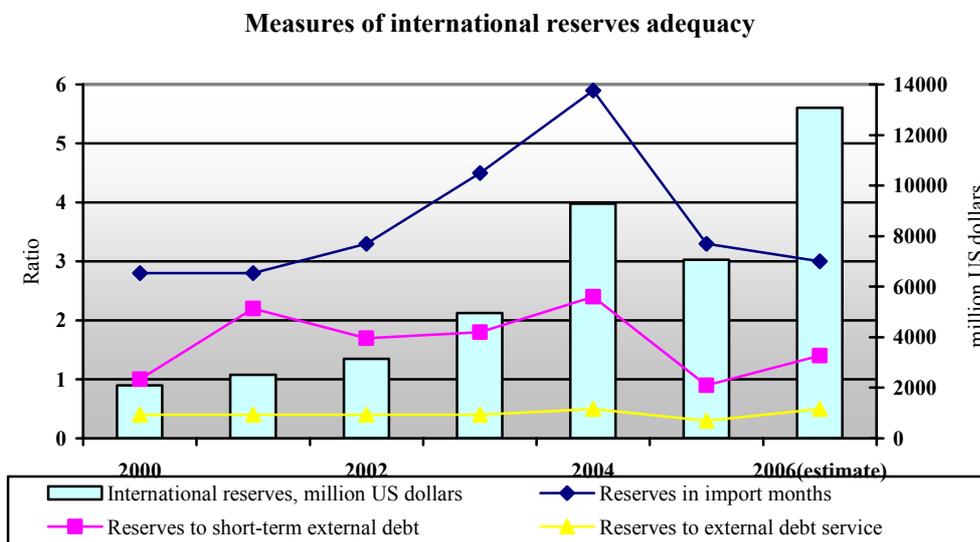
Source: NBRK

Figure 2.3.2



Source: NBRK

Figure 2.3.3



Source: NBRK

The absence of Government necessity in attracting the external sources for financing budget expenditures, the accumulation of funds in the National Fund and the National Bank's international reserves growth provide the stable net currency position of the public sector.

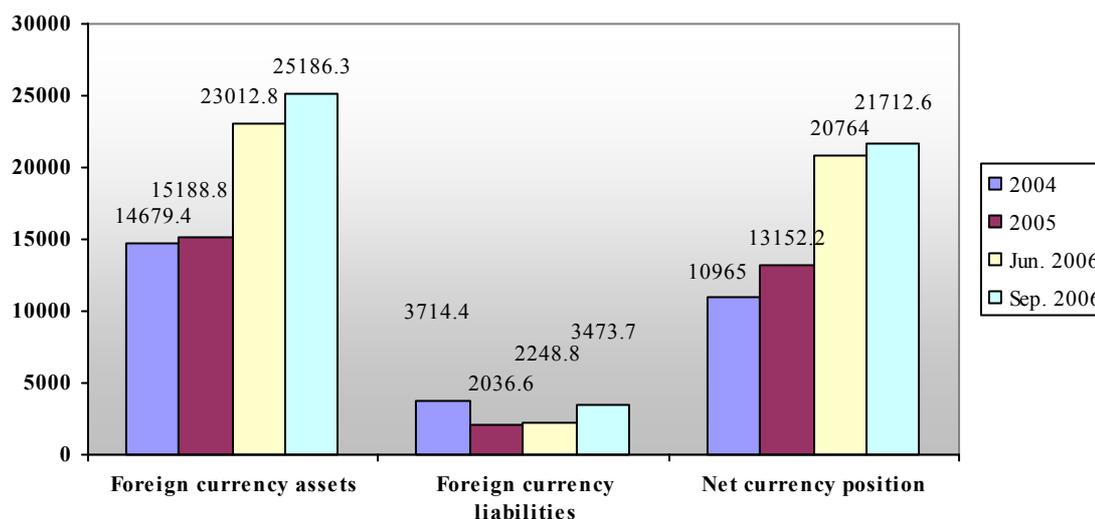
Reduction of foreign currency liabilities by 6.5 % and increase in foreign currency assets by 72 % during the period from 2004 to September 2006 (-40 % and +57 % at of the first half of 2006) caused the further strengthening of the net currency position (Figure 2.3.4). By the end of

September 2006 the foreign currency assets exceeded the liabilities 7.3 times comparing with 4-times exceeding by the end of 2004.

The change of external assets and liabilities, and first of all, the accumulation of assets in the National Fund have the main influence on the net currency position. The currency position of domestic assets and liabilities remains negative at a rather low level and doesn't exceed 7 % of the positive net currency position of external assets and liabilities (the significant increase in domestic foreign currency liabilities occurred in the third quarter of 2006 in consequence of changes of calculation mechanism and minimum reserve requirements).

Figure 2.3.4

The Government and the National Bank net currency position
(million US dollars, by the end of period)



Source: NBRK

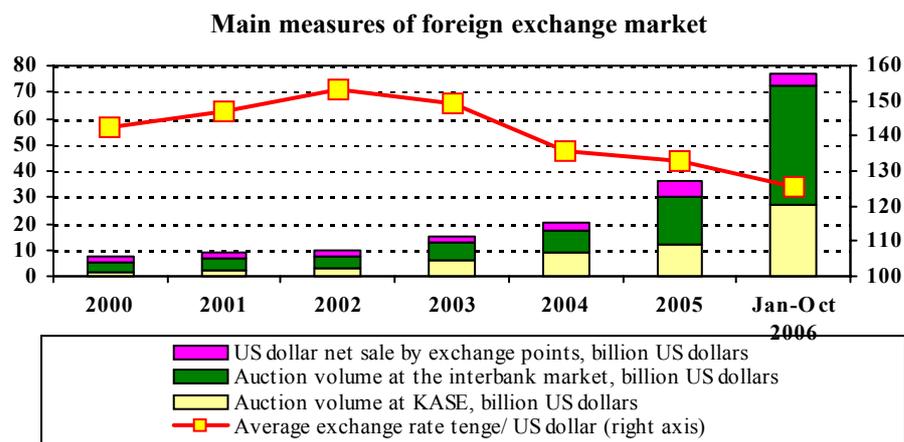
2.4. Structure and Liquidity of Financial Market

2.4.1. Domestic Foreign Exchange Market

Generally, Kazakhstan's domestic foreign exchange market is the most developed one owing to the high level of economy openness. The US dollar dominance, high speculative component of foreign currency demand and supply (Box 2) and insufficient development of the foreign exchange risks insurance market can be related to the moderate risks of the domestic foreign exchange market.

The tendency of nominal strengthening of tenge against the US dollar was outlined in 2003 for the first time (Figure 2.4.1.1). Following the results of 2003 the growth of the nominal exchange rate of tenge against the US dollar (by 8.03 %) was fixed first time in the history of the foreign exchange market existence in the Republic of Kazakhstan. Excluding 2005 the further tendencies of tenge strengthening remained.

Figure 2.4.1.1

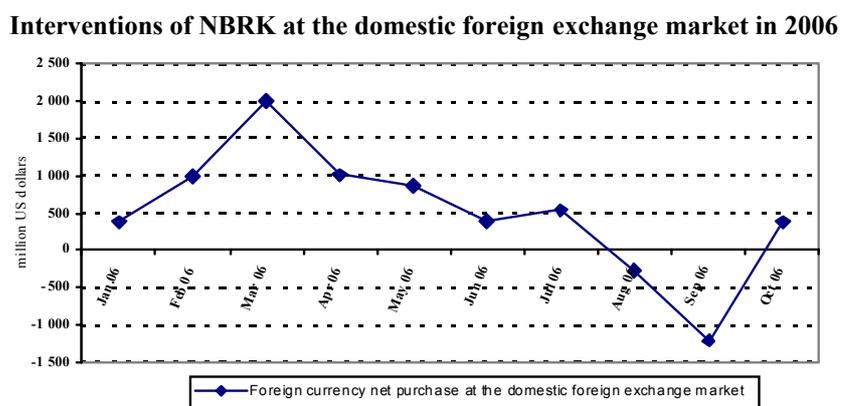


Source: NBRK, KASE

The significant increase in volume of transactions at the domestic foreign exchange market is overviewed during the last 2 years. For the period of 10 months of 2006 the volume of exchange auctions in dollar position was 27.0 billion US dollars increasing 16.6 times comparing with 2000. At the over-the-counter market the volume of transactions with US dollar during 10 months of 2006 increased 12.6 times comparing with 2000 and reached the point of 45.2 billion US dollars. In the structure of over-the-counter market the transactions between the non-resident banks prevail (increase by 11.5 times, 36.9 billion US dollars) although the participation of non-resident banks grows at leading rates (increase by 21.5 times, 8.2 billion US dollars). Transactions with Russian rubles and euro have insignificant share in turnover of stock and over-the-counter segments of foreign exchange market. The most active participants of tenders with foreign currency at KASE are the Kazakhstan People’s Saving Bank JSC, Subsidiary Joint-Stock Bank ABN AMRO Bank Kazakhstan JSC, TuranAlem Bank JSC and Kazkommertsbank JSC.

Since 2000 the National Bank of the Republic of Kazakhstan (hereinafter - National Bank) mainly acts as a foreign currency buyer (excluding 2005, when the coefficient of participation of the National Bank was «-1.2 %»). The National Bank took a more active part in 2003 and 2004, when its coefficient of participation was equal to 17.0 % and 20.3 % respectively. The net purchases of foreign currency for tenge by the National Bank at the KASE and the interbank market came to approximately 5.1 billion US dollars for the period of 10 months of 2006 (Figure 2.4.1.2).

Figure 2.4.1.2



Source: NBRK

Generally for the period of 10 months of 2006 the coefficient of participation of the National Bank at the foreign exchange market was approximately 7%. The necessity of the National Bank participation at the domestic foreign exchange market is determined by the necessity of conversion of the National Fund funds and as determining factor by the high share of the

speculative component in the market participants' behavior (Box 2). The exchange rate volatility leads to the exchange rate risk appearance, which is worsened by the underdevelopment of the forward transactions market.

Box 2

Demand and supply formation at the domestic foreign exchange market

According to the reports of demand and supply sources at the domestic foreign exchange market, which are presented by banks each month since the second quarter of 2006, more than 70 % of foreign currency receipts to the accounts of resident-banks' clients account for the share of non-residents' receipts. At the same time payments for goods and services (more than 80 %) prevail in receipts of non-residents while receipts of residents are mainly formed at the cost of transactions of internal foreign currency borrowing.

The volumes of sales of foreign currency for tenge exceeded 11.2 billion dollars for the third quarter of 2006 while approximately 94% of these sales account for the share of resident-banks' clients. More than a half of amount in foreign currency, which resident clients sell, accounts for the share of 100 largest enterprises of the real sector, mainly extractive industries.

Currently the main currency of settlements for raw commodities trade transactions is the US dollar. Despite the tendency for extended use of the Russian ruble and euro in settlements with CIS countries and the European Union the share of these currencies in export proceeds remains low - less than 5% of the overall volume of currencies sold by clients to banks. The parity of supply and demand on euro and the Russian ruble is mainly defined by necessity of import settlements that defines the constant excess demand for them in transactions between banks and clients.

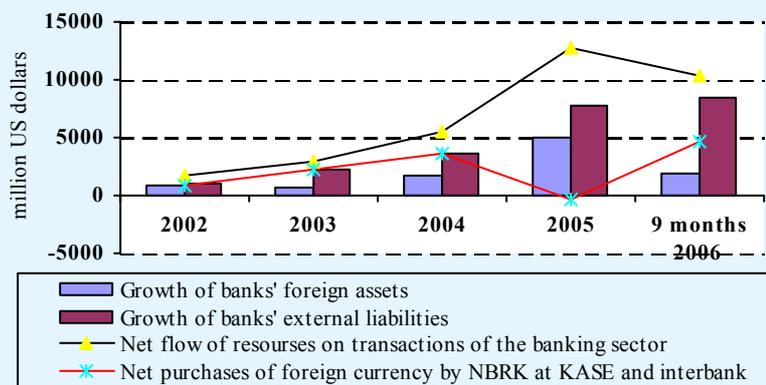
In contrast to euro and the Russian ruble the volumes of sales of the US dollars by exporters are more defined by the tendencies of change in exchange rate of tenge to the US dollar than by transactional demand. Thus, in June and July of 2006 the net sales of the US dollar by the clients of banks were equal to 1.3 and 1.2 billion US dollars respectively when the tendency for strengthening of tenge in relation to the US dollar was constant. In August 2006 the tendency changed and due to increase of the exchange rate of the US dollar to tenge the volume of net-purchases rapidly reduced to 0.6 billion US dollars in total per month. In September the US dollars purchase volume by banks' customers exceeded the volume of currency they sold – the US dollars net-purchase to clients exceeded 1.2 billion US dollars. At the same time foreign currency incomes on the accounts of resident banks clients from the goods and services export were growing during the third quarter. 3.87 billion US dollars were received on accounts of residents for settlements for goods and services with non-residents in July 2006, 4.22 billion US dollars in August and 4.28 billion US dollars in September.

Obvious aspiration of export enterprises for yield management due to the speculative transactions at the domestic foreign exchange market also causes the high level of uncertainty of currency supply and demand balance at the domestic foreign exchange market. In the long run outlook the cancellation of restriction of foreign currency purchase at the domestic foreign exchange market since 1 January 2007 may lead to the risk of increase of supply and demand balance volatility for foreign currency since speculative transactions at the domestic foreign exchange market will become available not only for export enterprises. At the same time this risk is significantly limited by low potential of non-primary industry enterprises in conducting transactions on purchase and sale of foreign currency in volumes able to influence significantly to the domestic foreign exchange market.

Interaction between external borrowing volumes carried out by banks and currency supply volumes at the domestic foreign exchange market may be demonstrated by comparison of the balance of payments data on growth of assets and liabilities of the banking sector and data on net purchases of the National Bank at KASE and interbank market.

Practically all currency resources distributed by banks in the country and not supported by transactional demand for currency form excess supply at the domestic foreign exchange market. From this point of view 2005 was the most favorable year when advanced repayment of external liabilities (both by the public sector and private non-financial sector) and overseas asset investments formed high transactional demand for currency and provided smoothing the situation at the foreign exchange market.

Net attraction of resources by banks and the interventions of National Bank at the foreign exchange market



Source: NBRK

It should be noted that currency resources distributed by banks to the domestic economy also force the domestic foreign exchange market from the side of supply. For instance, according to the data of banks balance sheets the foreign currency assets of banks increased by 5.07 billion US dollars in the third quarter of 2006 including the growth of the external foreign currency assets by 1.5 billion US dollars and the growth of the internal foreign currency assets by 3.56 billion US dollars. At the same time the main growth of the internal foreign currency assets was due to loans and borrowings granted to residents in foreign currency (2.3 billion US dollars). According to the report data on demand and supply among 100 largest enterprises of the real sector the foreign currency funds received by enterprises as export currency proceeds and borrowed funds extremely exceed the needs in foreign currency for settlement with non-residents. Thus, attraction of the foreign currency loans by the real sector is determined not so much by the necessity of currency costs coverage as by the availability of credit resources.

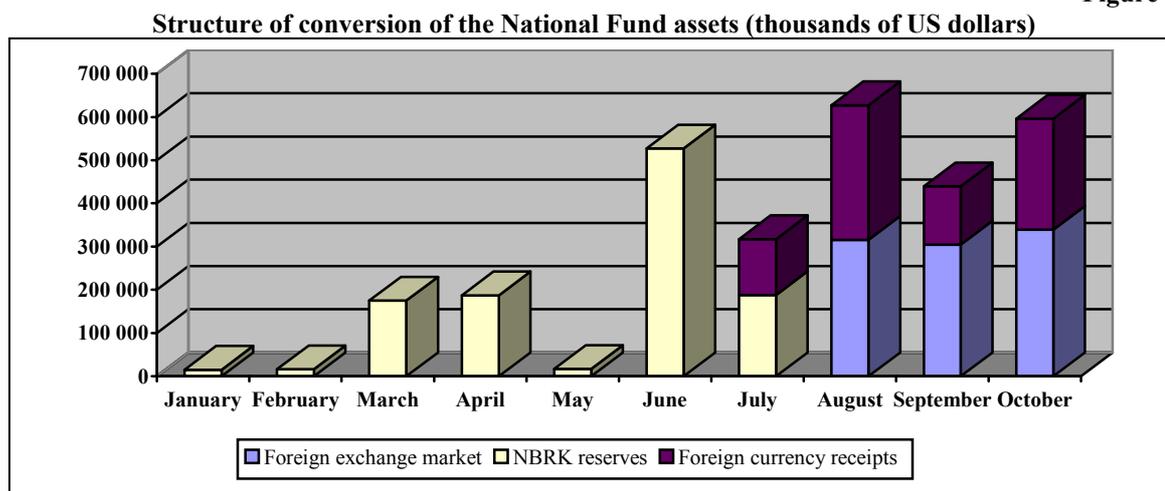
In terms of maintaining of the high level of world prices for raw commodities the foreign currency supply formed by export enterprises significantly exceeds the demand of a real sector for foreign currency. In the structure of demand for foreign currency prevails the requirements of financing for import of goods and services - approximately 80% of the total amount of withdrawal from accounts by the clients of banks - resident for settlements with non-residents. Generally, only in the third quarter of 2006 in settlements between the clients of banks - residents with non-residents receipts exceeded withdrawal by 1.1 billion US dollars. In this case the further growth of banks' external borrowings strengthens the risk of destabilization of the situation at the domestic exchange market due to excessive capital inflow.

The new order of the National Fund formation since 1 July 2006 will promote a more effective sterilization of the currency assets inflow to the domestic foreign exchange market.

The Rules of conversion and reconversion of the National Fund assets were accepted within the framework of transfer to the new principles of formation and use of the National Fund assets. According to these Rules receipts in national currency to the National Fund may be converted both from the funds of the National Bank's international reserves and by means of foreign currency purchase at the domestic foreign exchange market.

From the beginning of transfer to the new scheme of formation and use of National Fund assets the conversion of proceeds in national currency was realized by means of foreign currency purchase at the domestic foreign exchange market (Figure 2.4.1.3).

Figure 2.4.1.3



Source: NBRK

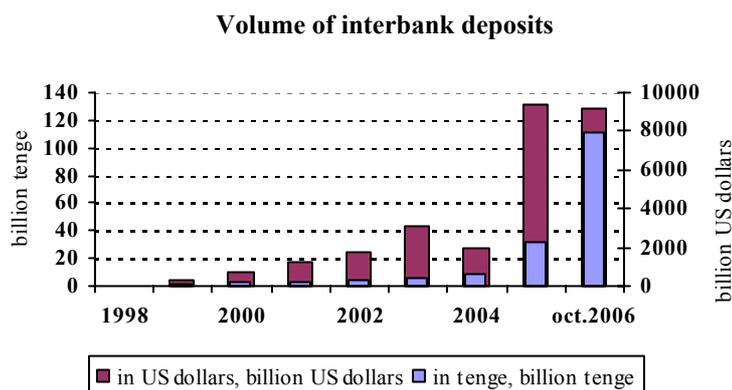
The advantage of given method of conversion of the National Fund assets in tenge is that the purchase of foreign currency at the market by the National Bank counteracts to its sales at the domestic market including sales for paying taxes of raw commodities sector to transfer to the National Fund.

2.4.2 Domestic Money Market

Generally, the volumes of money market both on placed interbank deposits and granted interbank loans are growing every year due to the necessity of the second-tier banks to manage the current liquidity. It is also observed a decline of the annual average weighed interest rate for interbank loans and interbank deposits that reflects the overall high level of liquidity of financial institutions.

During the period of 2002-2005 the short-term borrowings at the interbank money market remained as one of the main instruments of banks' current liquidity regulation. For the period of 9 months of 2006 the volume of interbank deposits in national currency increased to 7981.9 billion tenge (Figure 2.4.2.1).

Figure 2.4.2.1

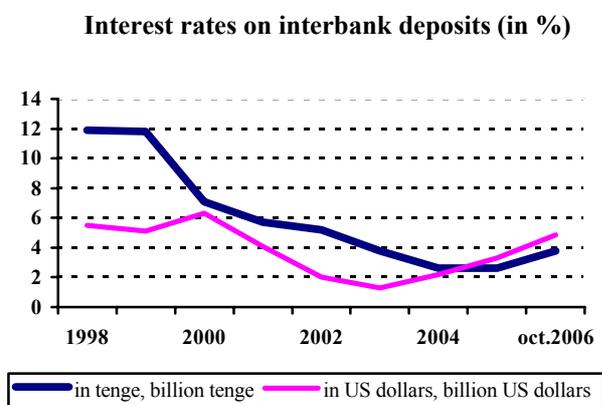


Source: NBRK

The dynamics of the average weighed interest rate on interbank deposits in tenge had a tendency of reduction from 1998 to 2004. While the annual average weighed interest rate on interbank deposits in tenge was equal to 11.89% in 1998, it reduced to 2.57% by the end of 2004 (Figure 2.4.2.2). For the period of 9 months of 2006 the annual average weighed interest rate on deposits in national currency was equal to 3.78%.

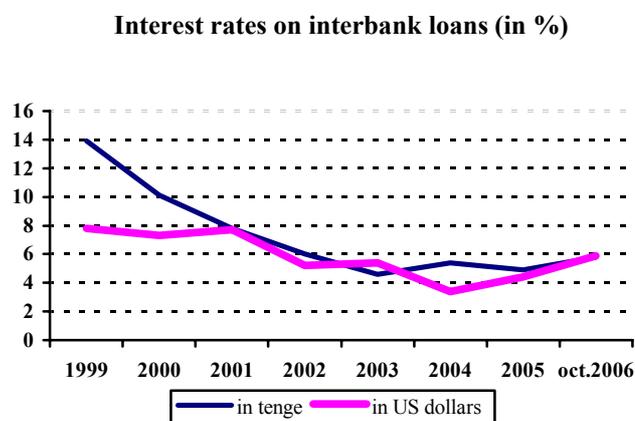
Banks were demonstrating high activity on placed deposits in the US dollars at the interbank market since deposits in dollars remained as the main instrument on the interbank money market of short-term borrowings in foreign currency for the considering period. Thus, the volume of deposits placed in the US dollars was equal to 129.1 billion US dollars for the period of 9 months of 2006 and the annual average weighed interest rate on placed deposits in the US dollars reduced to 4.86%.

Figure 2.4.2.2



Source: NBRK

Figure 2.4.2.3



Source: NBRK

The volume of granted interbank loans in tenge at the interbank money market for the period of 9 months of 2006 increased twice as compared to 1999 and came to 10.6 billion tenge. The volumes of granted interbank loans in the US dollars in this period have grown three times as compared to 1999 and came to 590.4 million US dollars. Generally, there was a reduction of the annual average weighed interest rate on interbank loans both in tenge and the US dollars from 1999 till 2004 (Figure 2.4.2.3).

During the last years characterized by the high banking liquidity the National Bank has been actively conducting transactions on liquidity withdrawal and as the main transactions were the emission of short-term notes, attraction of banks' deposits and mechanism of minimal reserve requirements.

First, it was related to the policy of interest rates. Accordingly, the policy of subsequent reduction of official rates, which was typical for the previous years, was substituted by the policy stabilization and increase in conditions of increase of the bank liquidity. In 2005-2006 the official refinancing rate was gradually increased from 7.0% up to 9.0%, and the interest rates on deposits of the second-tier banks were increased from 3.5% up to 4.5%.

Moreover, during the period of 11 months of 2006 there was issued short-term notes for the amount of 3,172.2 billion tenge; the volume of payment for 11 months of 2006 came to 2,982.0 billion tenge. As the result, the volume of outstanding notes increased to 358.4 billion tenge by the end of November. It should be noted that along with the high bank liquidity the reason for sharp increase was the reduction of terms of the short-term notes circulation and accordingly the transfer of volumes of notes previously issued for shorter terms. Thus, the duration on short-term notes was systematically reduced to 28 days by the end of November 2006.

The dynamics of effective yield on short-term notes for the period of 1998 - 2006 had a tendency of reduction. Thus, the average weighted effective yield on short-term notes was equal to 21.58% in 1998, while in 2005 it was equal to -2.31%. There has been a gradual growth of effective yield on short-term notes during the 2006 and it reached the point of 4.41% on the last auction in December.

The National Bank continued increasing the volumes of transactions on attraction of deposits of the second-tier banks with changing the procedure of the minimum reserve

requirements formation. During the period of 11 months in 2006 the volume of attracted deposits in tenge increased more than 3.3 times as compared to the previous year up to 7.697,8 billion tenge, the volumes of attracted deposits increased 76.4 times as compared to 2002.

2.4.3 Securities Market

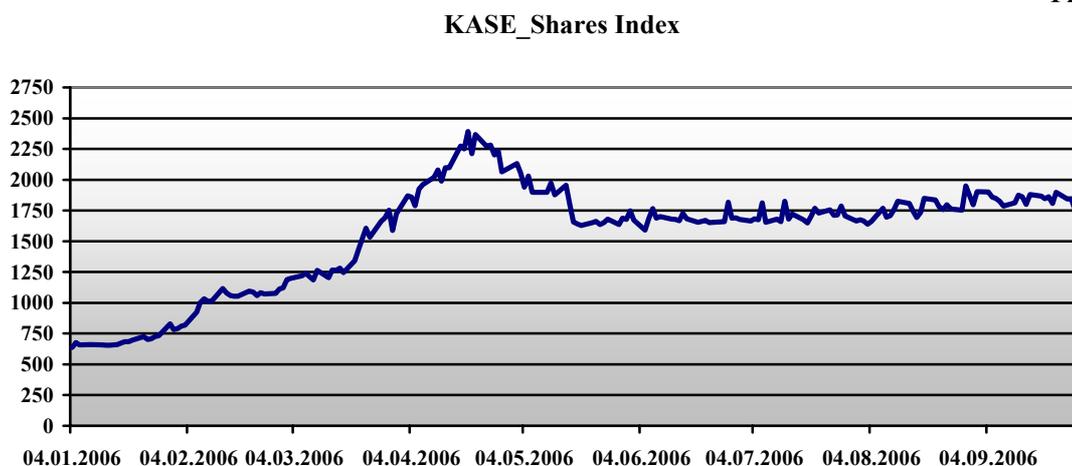
Mitigation of requirements to the issuers on the securities market has slightly increased its role in the sources of funds attraction. At the same time such factor may have direct influence on increase of risks of investors conducting transactions on the securities market, and first of all, the institutional investors.

Activation of the tenders at the stock market is characterized by progressive dynamics of growth of KASE_Shares Index which reflects the change in quotation of demand for shares of the stock exchange's «A» category of official list taking into account market capitalization of their issuers (Figure 2.4.3.1).

The positive dynamics of index reflects the growth of shares capitalization (Figure 2.4.3.2). As opposed to the previous years, this was reached mainly due to the growth of shares value in the trading system of Kazakhstan Stock Exchange JSC (KASE) as well as extension of the chartered capital of the listing companies. Thus, the total market value of shares traded at the KASE has increased 2.5 times from the beginning of this year and the share of stocks in the total capitalization of the stock market increased from 53.9% at the beginning of the year up to 70% as of 1 October 2006.

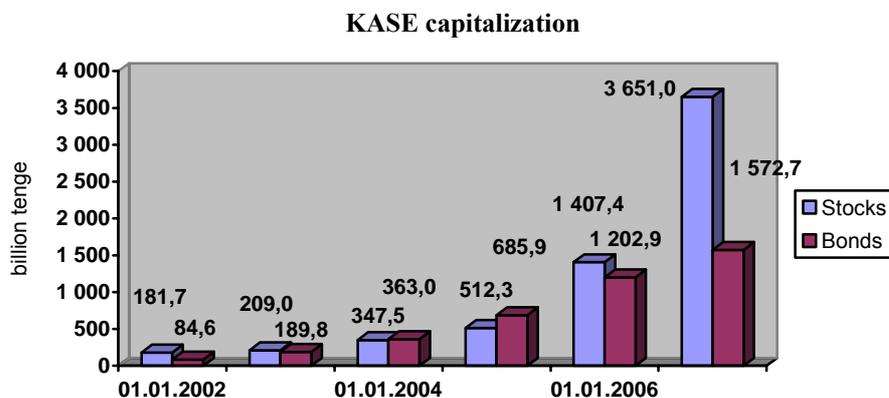
The growth of capitalization of the corporate bonds market as before was caused by extension of the list of securities passed the listing procedure at KASE. It should also be noted the recent reduction of yield index of corporate bonds (Figure 2.4.3.3).

Figure 2.4.3.1



Source: KASE

Figure 2.4.3.2



Source: KASE



Source: KASE

Volatility of yield indexes of shares and corporate shares leads to increase of liquidity risk and interest risk, which in case of crises events may adversely affect to the quality of the investments portfolio of the stock exchange participants, especially such main institutional investors as pension funds.

The number of existing share issues reduced by 34.2% from the beginning of 2004. First of all it is related to the increase in number of cancelled issues of shares due to voluntary reorganization or liquidation of joint-stock companies that must have brought the amount of their chartered capital up to 50,000 monthly calculated indexes stipulated by the law on republican budget for the respective financial year within three years from the date of putting the Law of the Republic of Kazakhstan “On Joint Stock Companies” No. 415 dated 13 May 2003 into execution. At the same time the number of existing issues of non-government bonds on 1 October 2006 increased by 27,9 % as compared with the beginning of the current year. The most active and creditworthy participants of the market are the banks represented 45% of existing issues of non-government bonds.

The increase in the number of issues and issuers was stimulated by mitigating of requirements to issuers and their securities authorized for circulating on the stock exchange. In particular, the requirements to the legal form of the issuer to be officially listed at the highest category were extended by inclusion of limited liability partnerships. In addition, the requirements to the amount of equity capital and volumes of sales of the issuers to be officially listed at the stock exchange were reduced for the category succeeding the highest category.

2.5. Finances of the Corporate Sector and Household Sector

2.5.1. Corporate Sector of Economy

2.5.1.1. Sources and the Structure of Financing

The role of the banking sector in financing of the corporate sector of economy is actively growing.

During the period of 2004-2005 as compared to 2002-2003 it is observed a tendency of more active growth of debt instruments in the structure of financing of the corporate sector of economy (nonbank legal entity) as opposed to the equity capital, which is equal to more than 37% per year in average (Figure 2.5.1.1.1). During the first half of 2006 this tendency became stronger and the rates of growth of liabilities came to almost 24%, which was 1.4 times higher than the growth of equity capital.

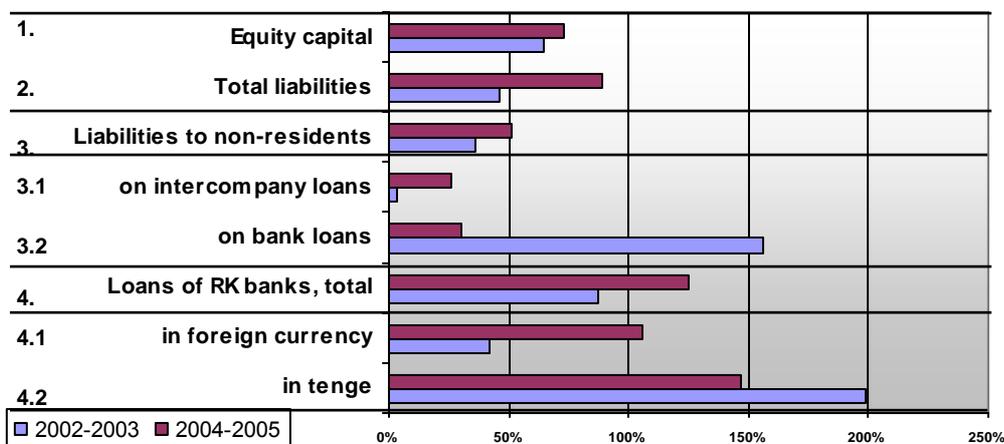
In general the liabilities to non-residents predominate within the structure of finances in the corporate sector of economy.⁹ Indebtedness to non-residents for a period of 2001-2005 has increased twice and the external liabilities were growing more intensively in the period of 2004-2005. Oil field development projects ensure a high level of external liabilities and objective predominance of foreign affiliated companies within the structure of the enterprises' indebtedness. At the same time foreign financial institutions whose share in external liabilities increased up to 6 in 2005 %, have started taking a more active position due to the decline of economic risks of Kazakhstan (Figure 2.5.1.1.2).

Along with keeping the tendency of external liabilities growth the role of Kazakhstan's banks loans is becoming more important. In 2002 the share of banks loans did not exceed 9% in the total structure of financing, while in 2005 the share of bank financing came up to more than 13% of the assets of enterprises. A higher growth of loans of domestic commercial banks gradually leads to increase in the replacement ratio of enterprises liabilities to non-residents, which is equal approximately to 58% by the end of the first half of 2006¹⁰. The banks loans were growing at the higher rates in 2004-2005 as compared to the foreign banks loans whose share in the total bank financing ranges within 7-11%. The growth of loans in tenge substantially advances the increase in foreign currency loans that has led to an equalization of the currency structure of liabilities to banks. The share of foreign currency loans reduced from 72% in 2001 to 51% by the end of September 2006 (Figure 2.5.1.1.3). At the same time the ratio between the rates of growth of loans in foreign currency and tenge is setting against tenge – the growth of banks loans in tenge reduced while the foreign currency loans is increased 2.5 times during the period of 2004-2005 as compared to the previous two-year period. Against the background of the general growth of loans in view of terms of payment, the banks prefer to grant long-term loans in tenge and short-term loans in foreign currency that led to increase of long-term loans share by 15% up to 65% in the total amount of bank loans.

The change of tendency of rapid strengthening of tenge against the US dollar in the first half of 2006 to the exchange rate reduction in the third quarter of 2006 has shown that short-term bank loans in foreign currency are the most subjected to influence of the dynamics of the exchange rate of tenge. During the period of July – September the growth of short-term loans in foreign currency was equal to 22% as compared to reduction by 5% in the first half of 2006. At the same time due to the banks necessity to maintain the currency position against the background of growth of external liabilities, the rates of growth of long-term loans in foreign currency remain at the same level.

Figure 2.5.1.1.1

Structure of finances of the corporate sector of economy
(% change for the period)



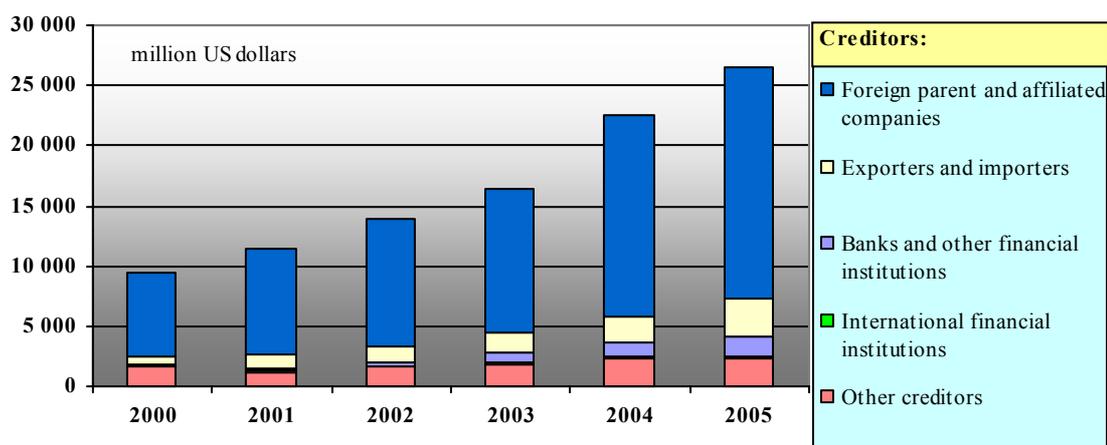
Source: NBRK, SARK

⁹ Liabilities to non-residents are calculated in accordance with the methodology of external debt formation, i.e. include the investments in capital having a debt nature.

¹⁰ Ratio of liabilities on loans to banks to liabilities of enterprises to non-residents.

Figure 2.5.1.1.2

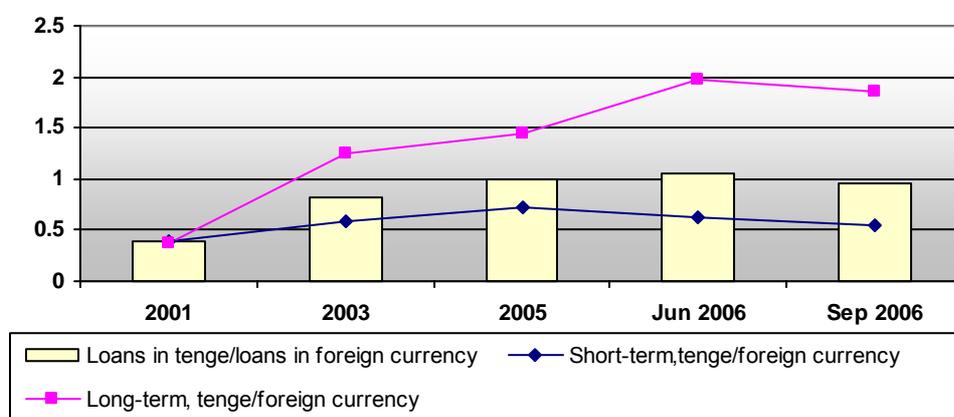
Liabilities of the corporate sector of economy to non-residents



Source: NBRK

Figure 2.5.1.1.3

Structure of bank loans according to terms and types of currency (ratio by the end of the period)



Source: NBRK

Despite the increase of the role of the bank financing, it is still mainly used for financing the current needs of enterprises than for the long-term investments to production development.

In Kazakhstan there are substantial distortions in the logical chain of economic interrelationships between the availability of bank loans, rates of growth of investments and the volumes of production from the beginning of 2000 which lead to increase of risks and do not cause reduction of crude orientation of the economy in the long term outlook. In particular, the excess of the total volume of loans over the investments to the fixed assets by the rates of growth and the absolute value witnesses that the credit resources received from banks at the less extent are invested to the fixed assets of the enterprises and are circulated mainly in the trading sphere and real estate operations (Figure 2.5.1.1.4). Specifically, the major volume of loans is directed to the construction and trading. Real estate operations have a major part in the structure of investments after the extracting sector. Moreover the part of borrowed funds is equal only to 8.1%, while the equity funds of enterprises and organizations are financing 56.5% of investments to the fixed assets.

The data of monitoring of the real sector enterprises¹¹ confirm the specified tendency. In particular, despite the growth of the number of enterprises benefiting the bank loans for funding their fixed and floating assets (Figure 2.5.1.1.5), the relatively lower part of enterprises which are

¹¹ Monitoring of enterprises of the real sector is undertaken by the NBRK, the enterprises represent various industries and participate in the monitoring on a voluntary basis.

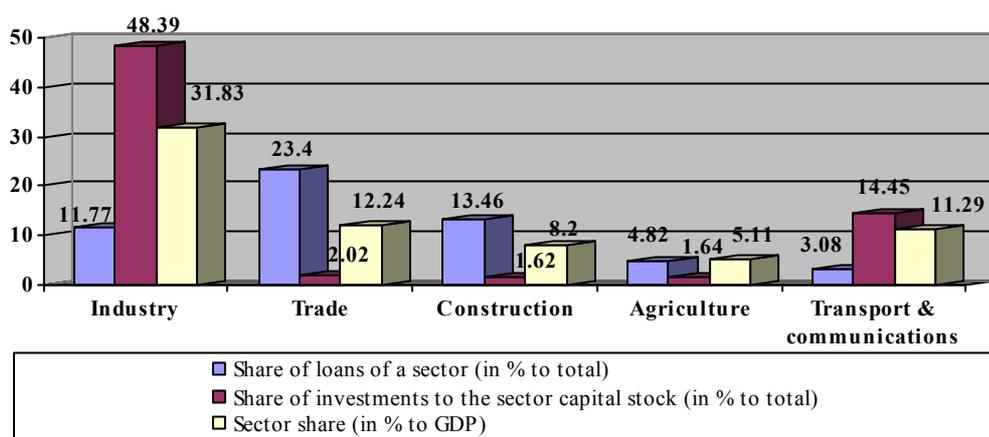
used the loans for funding the investments is an evidence of a more prudent attitude of banks and enterprises to the long-term investments at the cost of the borrowed funds.

As the result of such structural distortions in the bank crediting and investments to the fixed assets, there is a deformation in the rates of growth of GDP's industrial element, where the construction is leading sector in the production sphere (with the growth of 35.2% by 9 months of 2006 as compared to the same period of 2005) to the detriment of industry and agriculture while the trade, financial activity and communications are developed in the services sphere.

A lower part of the overdue debts of enterprises (2.8%, in average for the last 3 years) in the total volume of accounts payable to banks against the background of a growing dynamics of the granted loans is evidence of the improvement of the financial situation and other indicators of the industrial and economic activity of enterprises.

Figure 2.5.1.1.4

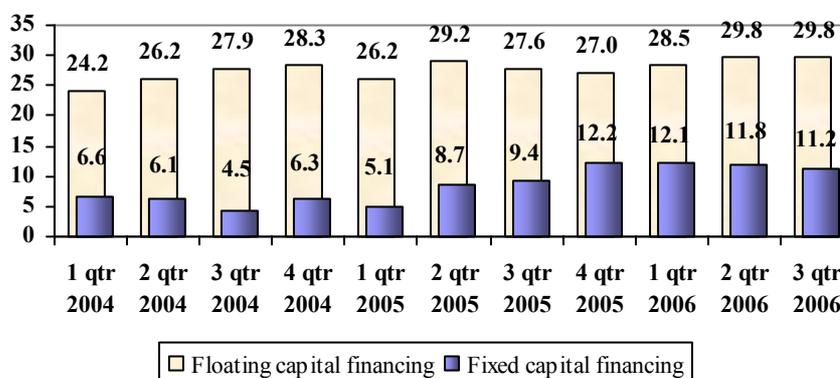
Loans, investments and structure of GDP for the period of 9 months of 2006



Source: SARK

Figure 2.5.1.1.5

Share of enterprises using loans (in %)



Source: NBRK

2.5.1.2 Main Characteristics of Business Activities

2.5.1.2.1 Large and Medium Enterprises¹²

In general, despite the worsening of a range of measures in the first half of 2006, there is a positive dynamics of the main financial indicators of large and medium enterprises whose assets were equal to 66.4% of the total assets of the corporate sector of economy in 2005 (Figure 2.5.1.2.1). There has been noted the growth of liquidity management risks and the necessity of increase in effectiveness of use of assets for maintenance of defined growth rates of business.

¹² The number of employees more than 50 person

In view of liquidity, the current financial performance and the current activity of enterprises are characterized as relatively stable.

The current liquidity ratio¹³ remains at the level of more than 1 that shows a favorable financial performance of enterprises from position of liquidity. In this regard, while in 2002 the current liquidity ratio was equal to 1.2, in 2005 such indicator increased by 6.7% and became equal approximately to 1.3¹⁴. Generally the adequate level of the current liquidity is supported by the positive dynamics of the critical liquidity ratio¹⁵, which becomes close to the recommended level of this indicator¹⁶, and in 2005 it was equal to 0.96. At the same time, according to the results of the first half of 2006 the current and critical ratios have slightly decreased. In case of further reduction of the current assets in comparison to the current liabilities, the lack of the most liquid assets for repayment of short-term liabilities of enterprises may become crucial that would require attraction of additional sources for floating asset financing, and first of all, in the form of bank loans.

An aggressive sales policy of enterprises requires the growth of effectiveness of assets use and therefore, the growth of the capital investments for its maintenance.

For a four-year period there have been no essential changes of indicator of the asset turnover ratio¹⁷. The value of the indicator at the level of 0.7 in 2005 shows that each asset money unit has brought less than 1 profit unit in the reporting period.

Since 2002 an increase of the average period of repayments of accounts receivables¹⁸, which was equal to 1112 days in 2005, is observed. In the first half of 2006 as compared to the same period of 2005 the tendency of worsening of the indicator remained. Taking into account the positive dynamics of the yield indicators of the corporate sector of the republic, it may be assumed that mitigating of the credit policy of the enterprises against the background of high demand is a determining factor in the dynamics of this indicator.

The decrease of the storage period of inventory¹⁹ down to 68 days or by 27% may also be additional evidence of a favorable consumer demand, more aggressive sales policy and, as the result, reduction of the periods of keeping the production in the warehouses. In the first half of 2006 there has occurred a certain tendency of worsening of this indicator as compared to the same period of 2005 – the amount of turnover days of the inventory has increased by 6% and came to 84 days.

In view of the financial stability, large and medium enterprises have a resource for the growth of the borrowed capital share as an important source of development. At the same time the sectors ensuring the largest growth of granted bank loans show a value of debt burden which is critical for default probability.

Debt burden ratio²⁰ isn't significantly changed during the four-year period and was equal to 0.54 by the end of 2005. At the same time the ratio of financial dependence on borrowed capital

¹³ Current liquidity ratio is a ratio of the current assets to the current liabilities of enterprise; it characterizes the opportunity to pay short-term liabilities to creditors timely.

¹⁴ According to the world practice, the ratio must be within the limits of 1-2, i.e. if the current assets exceed the current liabilities then the company is considered as successfully operating in view of liquidity. Excess of the current assets over the current liabilities more than twice is not recommended, since it may reveal the irrationality of the structure of use of finances and capital.

¹⁵ The critical liquidity ratio is a ratio between the difference of the current assets and inventories to the current liabilities; it shows the ability to generate a sufficient quantity of funds for payments of current liabilities without relying on the sale of inventories, i.e. the most liquid current assets.

¹⁶ In accordance with the international standards the ratio value of critical liquidity must be equal to or more than 1.

¹⁷ The asset turnover ratio is a ratio between the incomes from sale of final production to the average total assets and shows how effectively the company uses its assets.

¹⁸ Average period of repayment of receivables is a ratio between the numbers of days in the reporting period (360) to the asset turnover ratio (ratio between the incomes from sale of production to the average to two years of debts receivable). It shows how many days are required for repayment of debts receivables.

¹⁹ Average turnover period of inventories is a ratio of the number of days in the reporting period (360) to the asset turnover ratio (ratio of the cost value of the production sold to the average IS for the two-year period). It shows the number of days required for production and sale of goods.

²⁰ Debt burden ratio is a ratio of liabilities to assets. It reflects the share of borrowed funds in assets financing sources.

(leverage²¹) in 2005 to 2002 reduced by 2.7 % down to 1.13 that indicates the relatively low level of dependence of enterprises on attracted funds and low probability of crisis development by the South-East Asia scenario²². In the first half of 2006 the leverage growth by 13.7 % was marked in comparison with the same period of 2005 when the leverage increased to the point of 1.25.

In 2005 the average leverage indicator in the republic was low, but according to the sectoral breakdown the highest level of dependence on borrowed funds in 2005 was marked in textile and clothing industry - 13.7, production of leather, leather goods and shoes - 21.1, hotels and restaurants - 18.43. Accordingly the lowest leverage level was fixed in coke, oil products and nuclear materials production - 0.53, metal manufacture and final metal items production - 0.37, vehicles and equipment production - 0.8, transport and communications - 0.64. Default probability in the sectors with the highest leverage indicators may be compensated only by the high and stable expected cash inflow.

Interest payments coverage ratio²³ inversely depends on leverage – the high value of ratio indicates the relatively low share of borrowed capital or reflects the high profitability level. In 2005 this indicator was equal to 12.2, having increased by 63.1 % as compared to 2002 that indicates the financial risk reduction. The growth of interest payments coverage ratio was caused by more rapid income growth rates than the growth of liabilities and therefore, interest expenses.

Thus, the financial situation of enterprises excluding separate sectors generally may be characterized as stable. At the same time the further growth of the borrowed capital in the sectors oriented to the domestic consumer demand will increase the integrated risks for financial stability.

In view of profitability and cost effectiveness the substantial improvement of financial results of enterprise is being reported. It is required to raise the effectiveness of use of different sources of financing including borrowed capital.

The stable growth of profitability and cost effectiveness indicators was observed in 2003-2005. The annual growth of return on equity (ROE), return on assets (ROA) and profitability ratio²⁴ for the period was within the limits of 18-21 % on average. At that return on equity increased by 65.7 % in 2005 as compared to 2002, return on assets – by 76.2 %, cost effectiveness – by 72.4 % having composed 40 %, 19 % and 27 % by the end of 2005, accordingly. In general the high level of cost effectiveness in the republic in 2006 remained the same. The determining factor in increase of profitability during the last years was the growth of income²⁵ of enterprises in sectors that use a favorable price environment at external export markets and domestic consumer market. The value of indicators of assets turnover and capital multiplier for profitability increase is insignificant that shows the maintenance of low efficiency of enterprises' production and commercial operations.

²¹ Leverage is a ratio of liabilities to equity capital. Along with the debt burden ratio it characterizes the financial stability and determines the default probability of enterprise under debt contracts.

²² Particularly, according to the results of analysis of the reason of the financial crisis in South-East Asia appearance in 1997 it was found that after the leverage reaches the level of 2 enterprises payment capability risks and financial crisis appearance probability begin to increase.

²³ Percentage payments coverage ratio is determined as incomes before taxes to fee costs ratio; it characterizes the enterprises' ability to generate enough incomes volume to cover percentage costs.

²⁴ Profitability ratio is determined as a ratio of incomes before taxes repayment to incomes from ready production sale.

²⁵ The analysis is based on profitability components assessment starting from ratios:

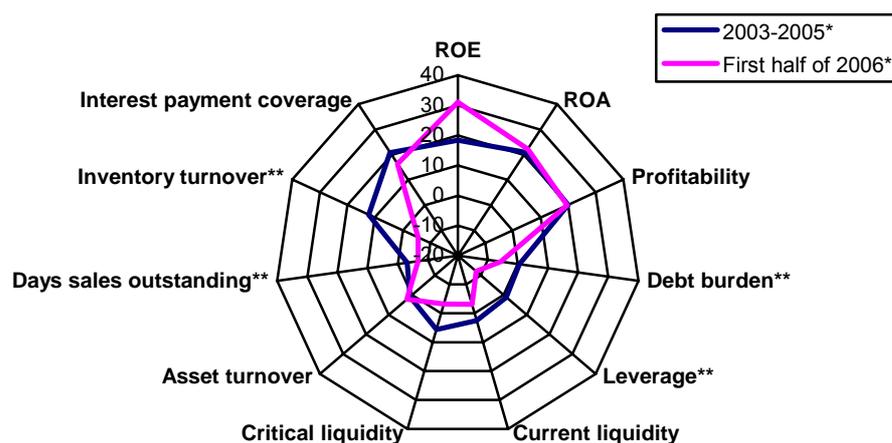
ROE = Profitability Ratio * Assets Turnover Ratio * OC multiplier

ROA = Profitability Ratio * Assets Turnover Ratio

OC Multiplier = ratio of assets to equity capital

Figure 2.5.1.2.1.1

Change of main financial indicators of large and medium enterprises



* (1) average year indicators changes calculated for 2003-2005

(2) changes in the first half of 2006 comparing with the same period of 2005

** Positive change means index improvement and on the contrary

Source: NBRK, SARK

2.5.1.2.2 Small Enterprises²⁶

Positive tendency of alteration of profitability and cost effectiveness indexes compensates a little the risk related to the high level of small enterprises indebtedness.

Favorable business climate of prices on external and domestic markets also lets to increase significantly earnings and profit of small enterprises characterized by the most significant assets growth in the period of 2002-2006. The significant improvement of profitability and cost effectiveness of small enterprises was the result for the last years. Since 2004 ROE, ROA and cost effectiveness indexes become positive (Table 2.5.1.2.2).

From the position of the financial stability indicators the structure of debt burden and leverage of small enterprises have some definite features. In contrast to the large and medium enterprises the share of liabilities in the total assets of small enterprises is very high. Particularly, this indicator was equal to 84.2% in 2005. The indicator grew by 5% in the first half of 2006 comparing to the same period of 2005.

Small enterprises also have the high ratio of liabilities to their equity capital, though the tendency for their reduction was noticed for last years. For example, in 2002 the leverage of medium and large enterprises was equal to 1.2 while small enterprises had such indicator at the level of 12.8. In 2005 the leverage of small enterprises reduced by 58.5% to 5.3 while medium and large enterprises had this index at the level of 1.1. For the last years the significant reduction of leverage was noticed that reduced a risk of default. But in the first half of 2006 in comparison to the same period of 2005 this indicator increased by 56.6% and came to 10.4.

It is important to note that the asset turnover indicators of small enterprises are more than 1, i.e. each money unit of the assets returned more than 1 profit unit, and generally have a tendency for improvement in contrast to the large and medium enterprises. Thus, the average period of repayment of receivables reduced by 8.8% in 2005 as opposed to 2002 and was equal to 111 days. GMR turnover period reduced by 15.5% and was equal to 39 days. Improvement of turnover indicators shall be reflected on liquidity growth.

The policy of stimulating the credit financing of small and medium enterprises along with the significant growth of equity capital lets small enterprises to find more effective composition of use of equity capital and borrowed funds which is reflected on profitability indexes.

²⁶ Employees quantity not more than 50 persons

Table 2.5.1.2.1

Main indicators of small enterprises financial stability

	2002	2003	2004	2005
Equity capital profitability, %	-21.04	-6.22	19.94	32.88
Assets profitability, %	-2.11	-0.53	2.36	4.91
Leverage, ratio	12.81	9.46	6.44	5.32
Equity capital multiplier, ratio	13.81	10.46	7.44	6.32

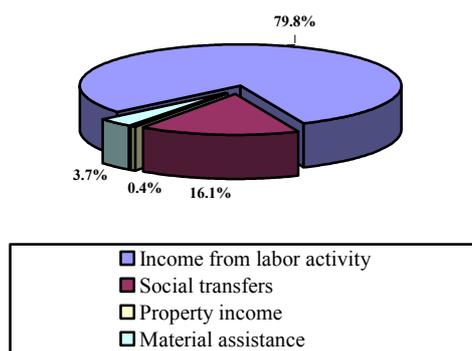
Source: NBRK, SARK

2.5.2. Financial Opportunities of the Household Sector

Despite the favorable dynamics of employment and incomes of population the high propensity of individuals to consume increases the risks of population solvency on financial liabilities to banks.

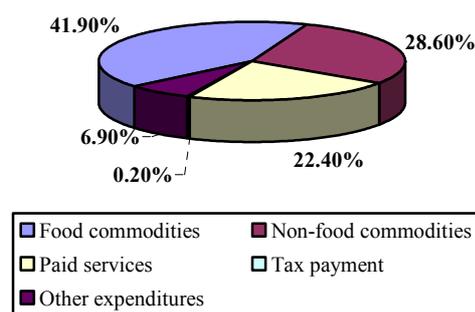
The significant growth of nominal money income per head with the average annual increase by 19.5 % was observed in 2000-2005. In the second quarter of 2006 the indicator also increased by 23.4% in comparison to the same period of the last year. In terms of financial situation of the household sector the incomes from the labor activity, which are equal to almost 80% of the households disposable income, play a key role (Figure 2.5.2.1). Accordingly, the capability of the household sector to count upon bank loans and be liable for its liabilities depends directly on wage dynamics and the population employment.

Structure of cash income of population in the second quarter of 2006



Source: SARK

Figure 2.5.2.1
Structure of cash expenditures of population in the second quarter of 2006



The most significant growth (1.5 times) of the average monthly wage in the economy for the period from the first quarter of 2004 till the second quarter of 2006 occurred against the growth of employed population with the average increase by 0.7 % per quarter. At the same time the sectors which have benefits mostly due to the growth of domestic demand and prices for the real and financial assets, provide the highest increase in employment. For example, the most significant growth of employment at that period was in the construction (2.9 % per quarter on average), while the growth came to 5.7 % in the second quarter of 2006. As a result some decline in unemployment to 7.7% occurred in the period of 2004-2006.

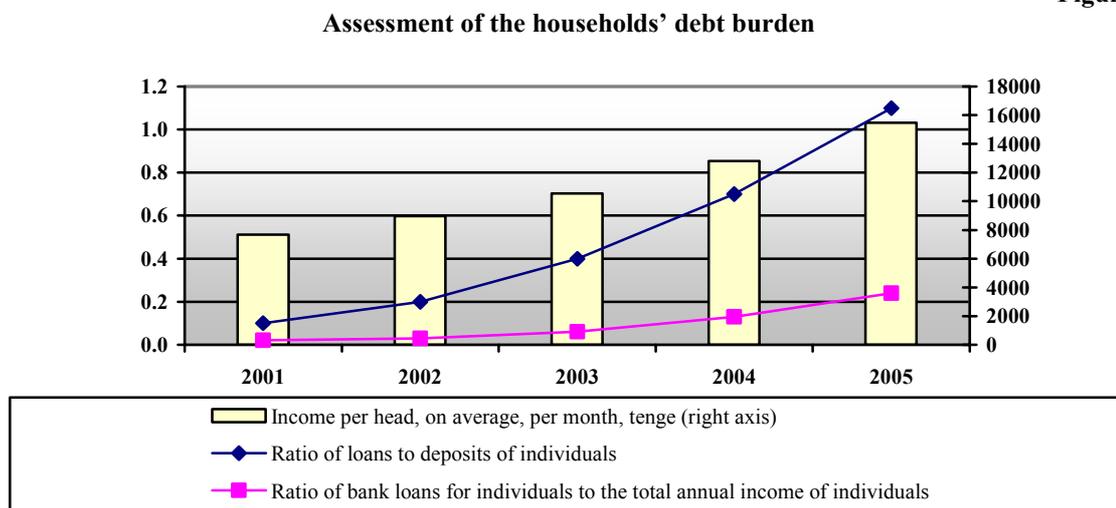
The wage growth against the background of increase in employment and decline in unemployment for that period was the factor which favorably influenced to the financial stability of household sector. At the same time the high level of differentiation between the sectors of the economy, in the result of which the monthly average wage for example in the sector of “Subsidiary activity in the spheres of financial intermediary and insurance” was 4.6 times higher in the second quarter of 2006 than in the economy in average, and was 2.2 times lower than average level in agriculture, and remains as factor that limits financial opportunities of population and potential growth of banks’ resources base.

From the other side in case of decline of population financial opportunities the ability to be liable for liabilities is limited by the high share of consumer expenditures which are at the level of

approximately 93% of the total expenditures. Accordingly the growth of consumer prices is the additional vulnerability factor and its role banks credit risks may be determined only by the propensity of population to reduce expenditures for goods and services in case of solvency deterioration.

An additional factor of potential risk for financial stability in mid-term is the leading growth of bank loans to individuals in comparison with the growth of disposable income and deposits of individuals that generally reflects the increase of the consumer expenditures role as the internal factor of economic growth (Figure 2.5.2.2).

Figure 2.5.2.2



Source: NBRK, SARK

III. Financial Intermediary Institutions

3.1 The level of financial relations development and the role of financial sector

Indicators of financial relations development get into their stride displaying the increasing role of financial intermediation and decrease of gap in development of financial relations with the East European countries.

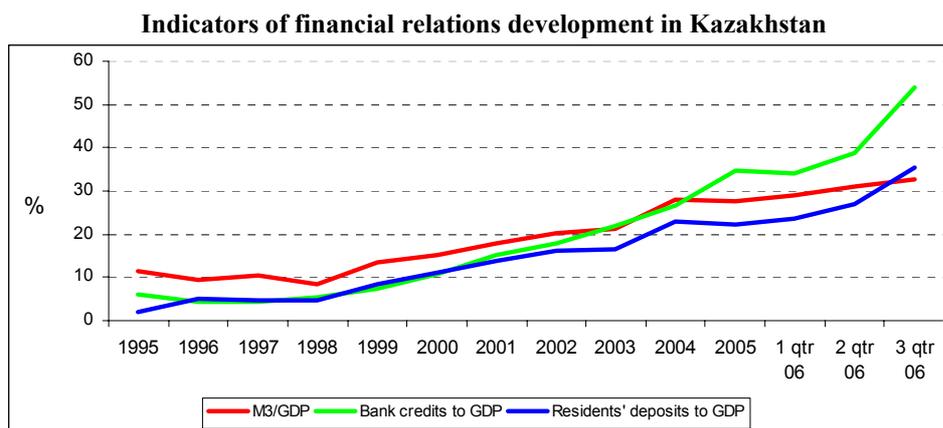
The deposits to GDP ratio is one of the qualitative indicators for the level of financial relations development. It increased by 17 times over a period of 1995 up to the 3rd quarter of 2006 comprising the meaning of 35,4% on the 1st October 2006 (Figure 3.1.1).

The credits to GDP ratio is also characterized by dynamic growth for the period of 1995 up to the 3rd quarter of 2006. It marked the point of 54,1%, having increased by 9 times. The combination of solvent demand growth for loans and the banks' resource base in deposits and external borrowings lead to intensive lending of real sector economy.

The growth of money supply to GDP ratio by 3,8 times over the period of 1995 up to the 3rd quarter 2006 was not as significant as compared to other indicators. It reached the point of 32,6% on the 1st of October 2006. At the same time the growth of residents' deposits prevailed in the structure of money supply growth. Its share increased to 82% by the end of October 2006.

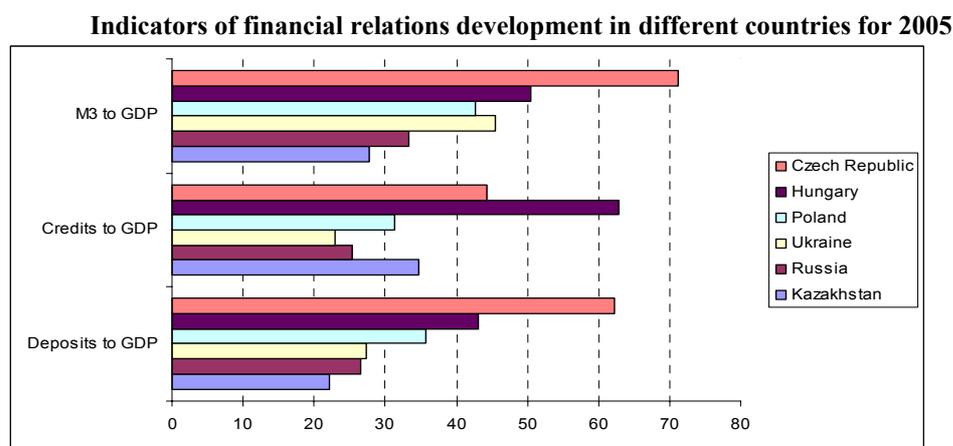
The growth of these indicators in Kazakhstan, as compared to the same indicators' growth in CIS and East Europe, increases the role of financial relations to the standards of some East European countries (Figure 3.1.2).

Figure 3.1.1



Source: NBRK, SARK

Figure 3.1.2



Source: NBRK, IMF

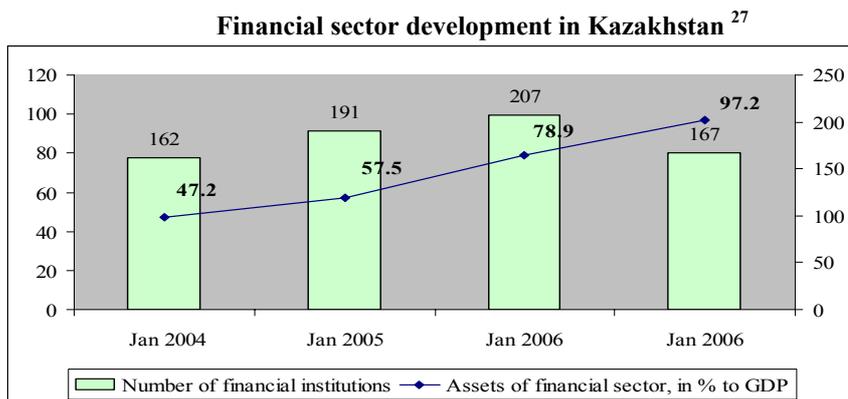
The assets of financial institutions are increasing along with economic development. The advanced dynamics of the assets of financial institutions, in comparison to the GDP growth, increases the exposure to macroeconomic risks, which first of all relate to the credit activities growth accompanied by considerable increase in prices of assets.

The growth of relative indicators of the financial sector assets reflects the increasing role of financial sector for the national economy (Figure 3.1.3). The relation of the real and financial sectors strengthens accordingly, which increases the risk of interdependent recessionary tendencies in its turn. At the same time the number of financial institutions in banking, insurance and pension sectors remained stable.

The level of financial intermediation, characterized by the ratio of the assets of financial sector to GDP and the rate of exposure to the systemic crisis, was higher in Asian countries, which experienced the crisis of financial system in 1997-1999 (excluding Indonesia), than in Kazakhstan (Figure 3.1.4).

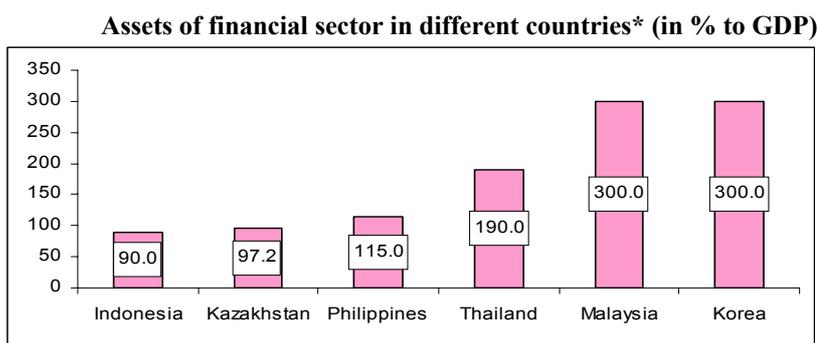
Reduction in interest rates and introduction of the newest bank products determined the increase in value of credit loans and the growth of assets of the second-tier banks consequently. The positive dynamics of banking sector has been reflected by relative indicators of banking market development. Particularly, the ratio of the aggregate assets of the second-tier banks to GDP is currently equal to 75.4 % (Figure 3.1.5). In relation to this indicator Kazakhstan is approaching the recently accepted European Union countries. Regardless the high rates of growth of the credit loans the ratio of credits to economy to GDP is lower than those in the Asian countries, which experienced the crisis (Figure 3.1.6).

Figure 3.1.3



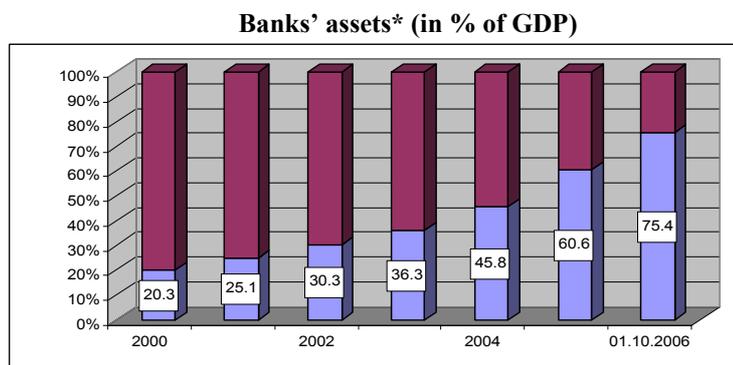
Source: FSA

Figure 3.1.4



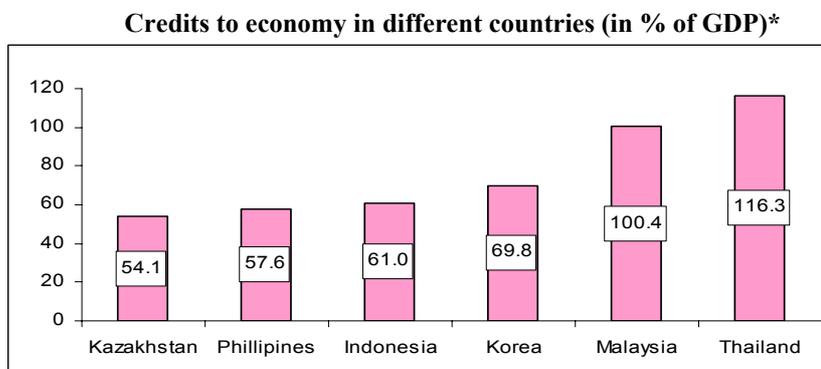
* the data of South-East Asia - in pre-crisis period, of Kazakhstan – as of 01.10.2006.
Source: FSA, IMF

Figure 3.1.5



* GDP: for the period of 2000-2005 – SARK data, for 2006 – MEBP forecast
Source: FSA, SARK, MEBP

Figure 3.1.6



* data on the South-East Asia - in pre-crisis period, on Kazakhstan – as of October 2006.
Source: FSA, NBRK, IMF

²⁷ the number of organizations that are subject to regulation and supervision has reduced since December 2005

3.2 Financial sector structure

The main part of assets of the financial sector is concentrated in the banking sector. Decline in the second-tier banks financial position can negatively affect other sectors of financial market.

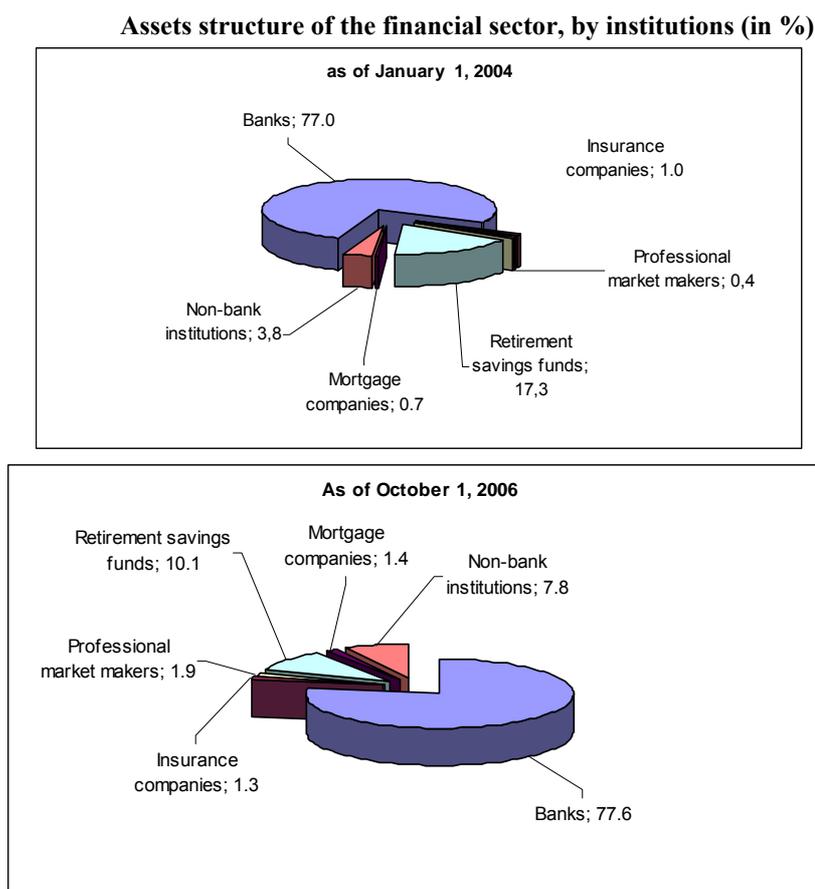
The banks have the maximum resource volume in the structure of the financial sector. The share of the second-tier banks assets in the aggregate assets of the financial market remains stable. At the same time there was an increase of assets share of professional stocks market participants and organizations performing separate types of banking operations during the last 3 years. While the share of pension fund assets decreased and the share of insurance sector remained stable for the same period (Figure 3.2.1).

The influence of banking sector upon other financial market sectors is characterized by its presence at the corporate bond market. Thus, on the 1st October 2006 approximately 60 % of active corporate bonds were emitted by banking sector. The share of institutional investors (accumulative pension fund, APF, insurance organizations, etc.) holding corporate bonds is 48.9 % (Figure 3.2.2).

Thus, the banking system crisis (including the decrease of the banks' ability to execute the liabilities on bond loans) might have negative effect on stability of other financial market segments. It might have greater negative effect on indicators of profitability of pension funds in consequence of significant part of banks financial instruments in pension funds investment portfolio.

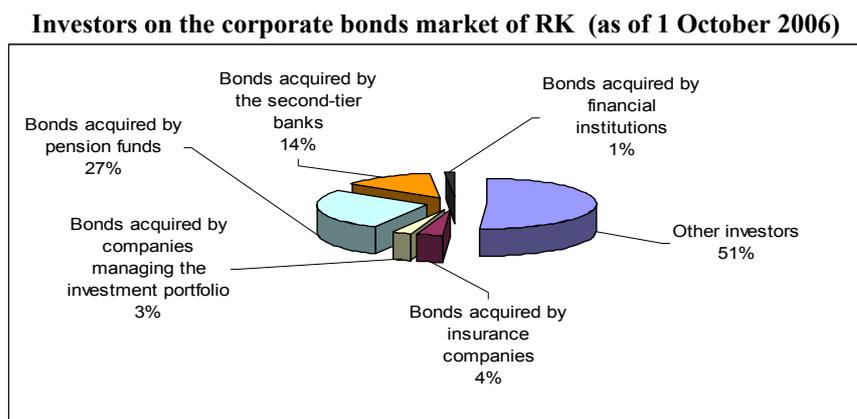
At the same time the fact that some financial organizations are the banks' affiliated companies or the part of the banking conglomerates enforces the exposure of the whole financial sector to systemic crisis.

Figure 3.2.1



Source: FSA

Figure 3.2.2



Source: FSA KASE

The share of assets of five largest financial institutions remains stable in the banking sector and retirement savings system along with the downward trend in the insurance sector.

"Moderately concentrated" banking and pension services markets reduce the exposure to systemic risk, while "low concentrated" insurance sector is marked by strong competition on the one part and growing exposure to systemic risk on the other part.

Reduction of the share of foreign capital in authorized capital of Kazakhstan banks decreases the influence of external shocks.

In terms of the high capital concentration and low competition the large institutions are able to determine the policy on the financial services market.

The banking sector and retirement savings systems are characterized by prevalence of assets' share of five largest institutions (Figure 3.2.3). According to international practice it is more preferable to have few banks with high assets share, as they operate with less costs and appear to be more stable(Box 3).

Decreasing trend of the share of five largest insurance companies in the gross volume of insurance premiums written characterizes the growing competition in the insurance market, but the increasing exposure to systemic risk at the same time.

One of the market concentration level indicators is the Herfindal-Hirshman index. The effect of using Herfindal-Hirshman index gives an opportunity to measure the weight of first-rate financial institutions. According to given index calculations the banking sector (1 345) and the pension (1 554) services sector are "moderately concentrated" with lower concentration of insurance sector (702) at once. Besides during the concerned period the values of indexes have a tendency for reduction.

Banking sector concentration

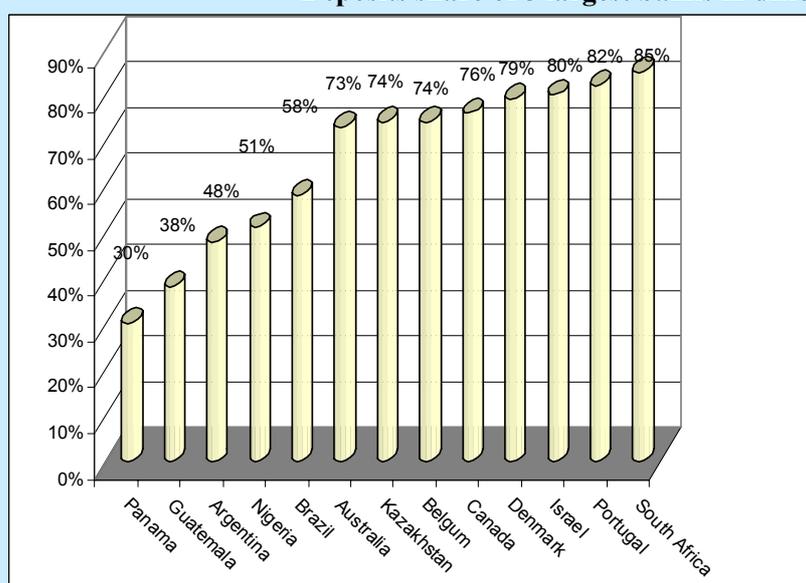
The research including the World Bank's research shows that:

1. Approximately 73 % of deposits are concentrated in five largest banks in Australia, 74 % in Belgium, 76 % in Canada, 79 % in Denmark, 80 % in Israel, 82 % in Portugal and 85 % in South Africa. Unlike the above-named countries the concentration level on five largest banks in developing countries is lower, thus, 48 % in Argentina, 58 % in Brazil, 38 % in Guatemala, 51 % in Nigeria, 30 % in Panama.

2. Less concentrated banking sectors are more subjected to financial crises than more concentrated banking sectors with few large banks. Moreover, competition and concentration reduce the banks fragility that provides the banking system stability. Assets of 10 small banks are equal to 1 % of the total volume of assets of the banking sector assets while such share has no a tendency to increase.

3. The average value of concentration ratio of the banking sector equals 0.72 in 79 countries and 0.62 in Kazakhstan. Since the 90s of the past century till the present time the tendency of the capital concentration increase in the banking sector is being observed in the world. It is connected with aggravation of competition that makes banks search the ways for further extension of transactions conducted, reduction of costs and enhancement of efficiency. As the result of this the process of bank merger and takeover is widespread. At the same time the concentration level is rather high in the countries whose population level is comparable to the population level of Kazakhstan.

Deposits share of 5 largest banks in different countries



	Countries	Concentration index
<i>Europe</i>	Sweden	0,89
	Greece	0,79
	Netherlands	0,76
	Portugal	0,46
	Belgium	0,64
<i>Africa</i>	Cote d'Ivoire	0,96
	Cameroon	0,95
	Mali	0,91
	Zambia	0,84
	Tunisia	0,63
<i>South America</i>	Chili	0,49
	Ecuador	0,4
	Guatemala	0,37
<i>Asia</i>	Sri Lanka	0,86
<i>Australia</i>		0,65
<i>Kazakhstan</i>		0,62

Source: FSA, International Financial Organizations

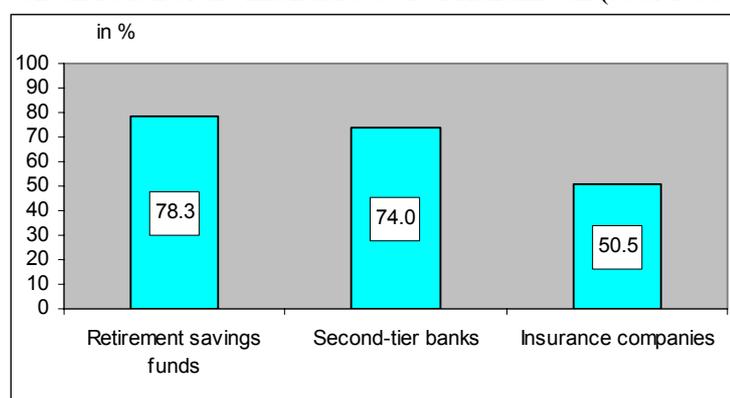
Foreign participation in bank capital is another important index of national banking development. The stable growing dynamics of foreign participation in authorized capital of the banking system and increasing assets' share of such banks have been observed during 2001 – 2003. However, the index of foreign participation has sufficiently decreased recently (Figure 3.2.4). In order to clarify the terms of residents and non-residents participation in bank capital a number of requirements to non-residents, including total share of foreign capital in authorized capital of all kazakhstani banks, have been annulled. The procedures of bank capital formation have been simplified as well.

Decrease of foreign participation in the authorized capital of kazakhstani banks during the liberalization of foreign investors' access to the national financial market can not be considered as the "escape of foreign capital";

Reducing of foreign capital part in the aggregate assessed capital of Kazakhstan banks during the liberalization of foreign investors access to the national financial market can not be considered as the "escape of foreign capital" but is the consequence of two first-rate national banks' assessed capital increase accompanied by the reduce of non-residents part in these banks. Generally the reduce of foreign capital part decreases the banking system susceptibility to external shocks.

Figure 3.2.3

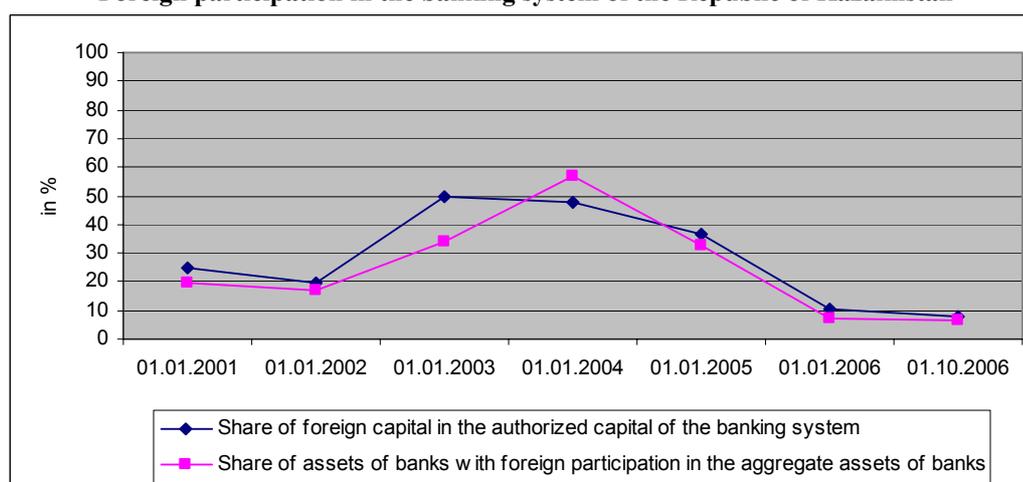
Segments concentration of the financial sector of Kazakhstan (as of 1 October 2006)*



* the assets share of 5 largest financial institutions of each segment in the aggregate assets of a segment
Source: FSA

Figure 3.2.4

Foreign participation in the banking system of the Republic of Kazakhstan



Source: FSA

3.3 Banking sector

3.3.1 Credit risks

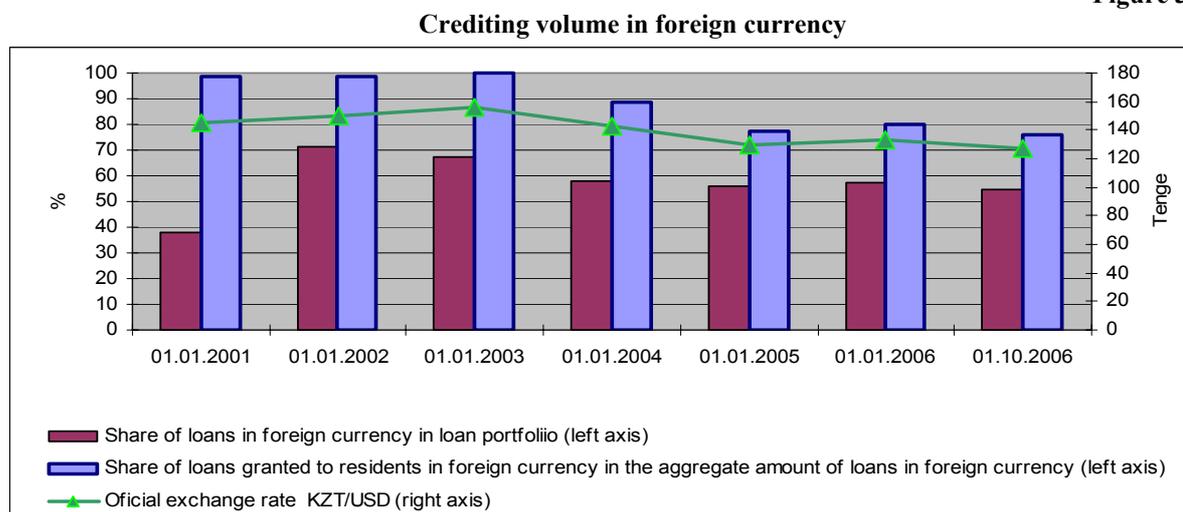
More than a half of loans are granted in foreign currency, the national economy obtains three-quarters of them.

The national currency adjustments observed during the long period are "balanced" by the positive dynamics of decrease in the share of loans granted in foreign currency.

Rapid growth of the second-tier banks crediting provided the growth of loans granted in foreign currency. The most part of credits in foreign currency has been received by the country residents and the remaining part has been directed to satisfy the external demand that a little improves bank risks diversification level concerned with national currency fluctuations.

Against a background of general crediting increase reducing the weight of loans in foreign currency has been concerned with the tendency of national currency enforcement (Figure 3.3.1.1). Such an indexes dynamics is evidence of adequate risk perception by the second-tier banks. At the same time the part of loans in foreign currency is still rather high that in case of national currency course significant change will lead to re-assessing the banks assets and reducing their stability and also the increase of lenders' credit risks whose main income currency doesn't correspond to the currency of banks liability.

Figure 3.3.1.1



Source: FSA, NBRK

The expansion of native banks to CIS countries in 2003-2005 caused the growth of demand to non-residents weight in the aggregate assets. At the same time this growth has a tendency to decrease since the beginning of current year.

Granted to non-residents loans are concentrated in Russia Federation (40 %) that causes a higher level of country risk which is compensated just by sufficiently low loan weight in loan portfolio.

The expansion of Kazakhstan banks out of the republic has been outlined few years ago at the background of increasing the republic's international rating from speculative to investment, increasing the trust of foreign investors to the resident banks of the Republic of Kazakhstan and as a consequence the availability of relatively cheap funding.

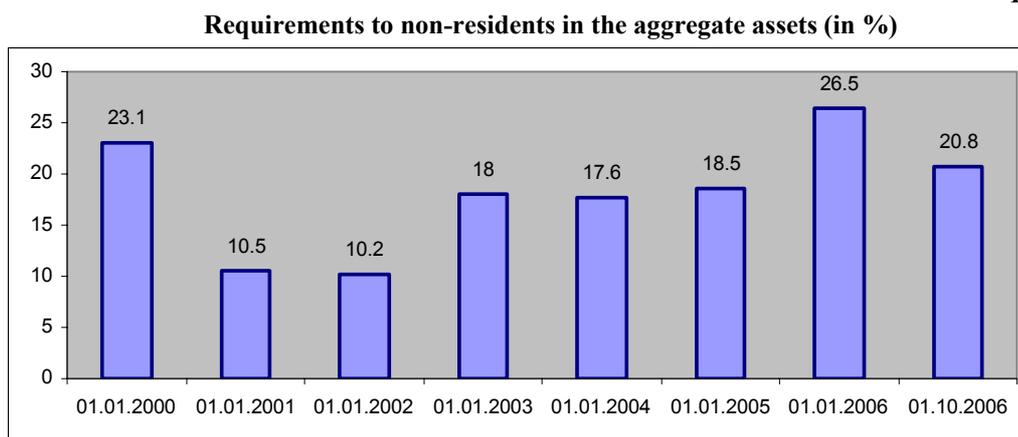
In part after the dynamical increase of claims to non-residents weight in the aggregate banks assets since the beginning of the year the decrease of this index is observed (Figure 3.3.1.2).

Expansion of Kazakhstan banks on external markets may be considered as a risk diversification method in terms of low percent margin at internal market, but puts on guard the fact that these external markets differ with higher than in Kazakhstan risks level - economical, political and structural. So, from the beginning of the current year the increase of loans weight granted to

non-residents both in total sum of claims to non-residents and in banking sector loan portfolio has been noted that leads to the crediting risk increase which is concerned with worsening of economical situation in crediting countries (Figure 3.3.1.3)

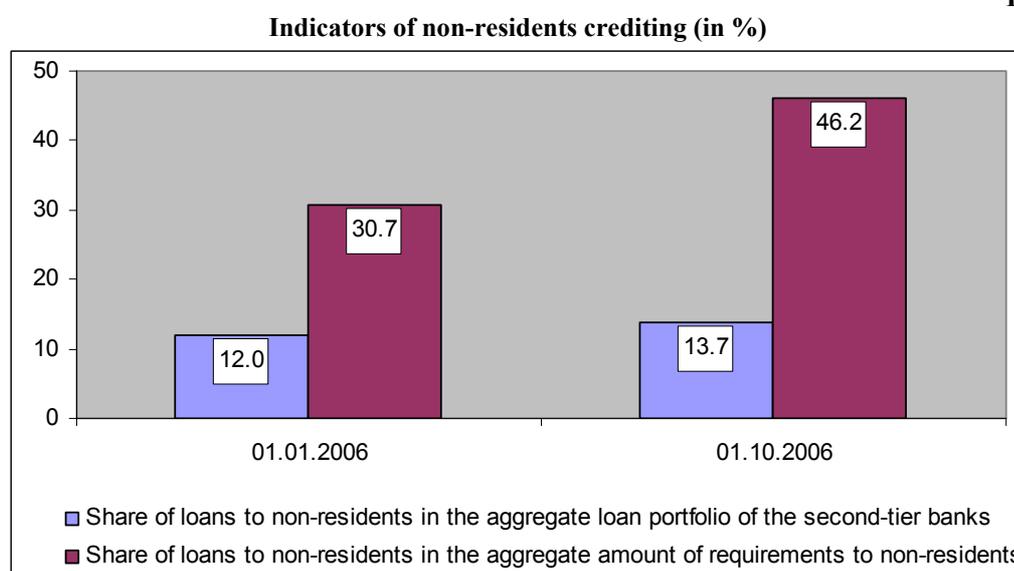
At the same time the widening of Kazakhstan second-level banks activity in Russia is observed; these banks increase their presence after Kazakhstan factories. Granted to Russia Federation non-residents loan concentration level causes higher level of country risk for banks (Figure 3.3.1.4). At the same time Russia's dominating position as a direction of non-resident crediting is caused by close trade and economic relations of two countries. In part the level of country risk is minimized by the higher independence rating of Russia. By the way the part of such credits in the aggregate loan portfolio is about 4 %, so it can be concluded that banking system has sufficient ability to resist the crisis phenomena in Russia.

Figure 3.3.1.2



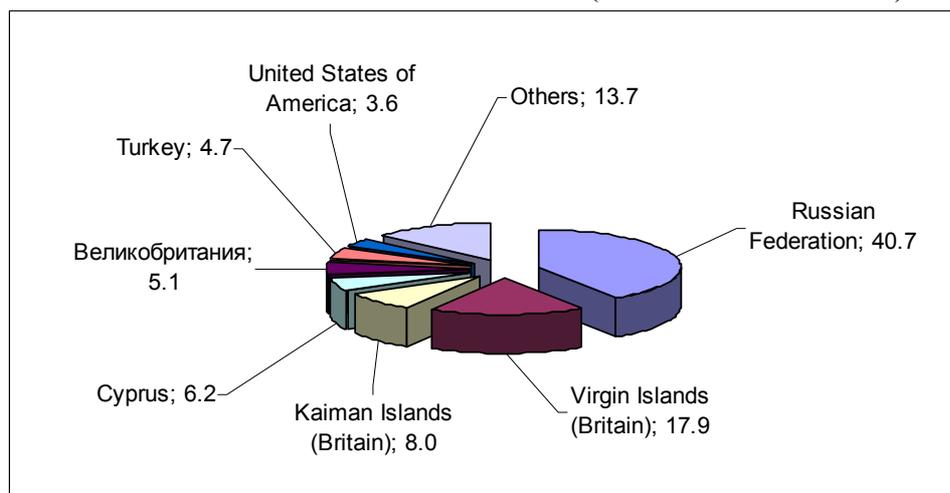
Source: FSA

Figure 3.3.1.3



Source: FSA

Loans to non-residents in different countries (in % as of 1 October 2006)



Source: FSA

Loan portfolio in accordance with concentration indices by the trades is within the limits of "gentle" concentration.

Diversification of loan portfolio is of vital importance for determination of banking sector liability to structural changes in economics. At the base of loan concentration index calculation by the Herfindal-Hirshman index²⁸ may be concluded that loan concentration level of banking sector is moderate (Table 3.3.1.1).

Table 3.3.1.1

Loan concentration (Herfindal-Hirshman index)

Data	Index	
01.01.2004	total	1 592
	in foreign currency	1 464
01.01.2005	total	1 404
	in foreign currency	1 252
01.01.2006	total	1 431
	in foreign currency	1 245
01.10.2006	total	1 466
	in foreign currency	1 375

Source: FSA

The level of "doubtful" and "loss" loans is at the acceptable level and the level of "standard" by the majority of main creditable trades is higher than in banking system in general (Table 3.3.1.2).

The influence of mineral resources prices fluctuations to the crediting risk level is limited because crediting of transnational companies is realized at the expense of mother companies and investment of loans at international capital markets. But sufficient risk grow is observed; it is consequent to accordance of loans to building industry.

High rates of economics grow stimulate increase of credits demand from the direction of corporate clients. Today 70 % of loans in Kazakhstan are granted to corporate clients. At the same time population crediting is growing in advanced rates. It's necessary to note the growth of demand to retail credits, particularly mortgage in consequence of rapid house-building development.

In the general structure of banking system loan debts during the last time the part of credits granted to industry factories (particularly oil, gas and metallurgy industry) was not more than 10 %

²⁸ The index is calculated with consideration of joining the sectors to the groups; mineral resource industry, manufacturing industry and other industries, agriculture, trade, transport, building. The part of other trades separately is not significant. At the same time totally other trades compose about 40 %

because many of them either get funds directly from international mother companies and banks, or finance their activity by mean of their own money flow. In this context the level of crediting risk concerned with mineral resources prices fluctuations is not considerable. Much more funds arrive to the trades marginally consequent with oil and gas and metallurgy complexes that may increase potential crediting risks in case of continuous landslide of prices at world goods markets.

The highest level of loss credits is in the transport sector. At the same time the share of this sector in the aggregate loan portfolio is not considerable that reduces consequently the probability of all banking sector destabilization emergence related to the worsening of this sector solvency.

At the same time banking sector is more liable to the vulnerability factors by the credits granted to the trade factories (10 % of banking system loan debts). At the same time the increase of current lending to building factories and rapid housing supply in primary market may lead to reducing the housing prices that accordingly will negatively influence on building industry profitability.

The volume of lending under real estate collateral has grown to 33.6 % of the aggregate banking system loan indebtness – consequently the risks related to potential destabilizing of real estate market (Figure 3.3.1.5). Within the most negative (but unlikely) scenario of reduction or collapse of real estate prices may lead to bankruptcy of series of banks or even to the crisis of banking system in general.

One of the parameters giving a signal of worsening the quality of loan portfolio and decrease the banking system stability is the part of "non-performing" credits. The weight of such loans in the aggregate Kazakhstan's banking system loan portfolio is much lower than in Asia countries in precise-period that on current stage shows the absence of alarm signals of system crisis appearing (Figure 3.3.1.6).

Table 3.3.1.2

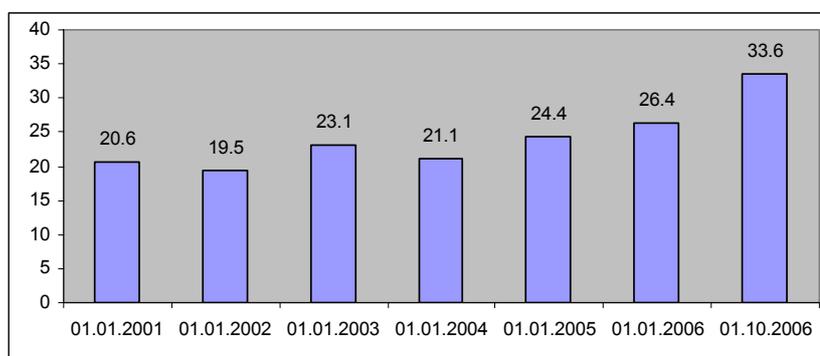
Structure of classified loans

Classification by economic sectors	in percent						Total
	Standard		Doubtful		Loss		
	01.01.2006	01.10.2006	01.01.2006	01.10.2006	01.01.2006	01.10.2006	
Trade	54.3	60.4	44.2	37.1	1.5	2.5	100
Industry	60.9	57.8	37.2	40.2	1.9	2.1	100
Agriculture	38.5	50	57.7	47.7	3.8	2.3	100
Construction	38.1	43.3	59	54.3	2.9	2.4	100
Transport	57.8	60.4	40.2	30	2	9.6	100
Communications	82.9	69.9	17.1	29.3	0	0.8	100
Others	65.7	61.9	32	36.7	2.3	1.4	100
Totally in economy	58.2	59.2	39.5	38.8	2.3	2	100

Source: FSA

Figure 3.3.1.5

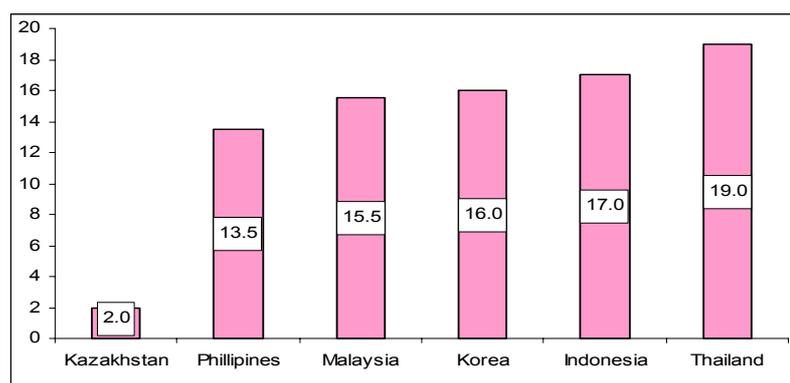
Share of loans secured by collateral in bank loan portfolio (in %)



Source: FSA

Figure 3.3.1.6

Share of "non-performing" credits in loan portfolio* (in %)



* data on South-East Asia - in pre crisis period, on Kazakhstan –as of 1 October 2006
(in accordance with accepted classification part of non-performing loans is presented)

Source: FSA, IMF

High level of business activity and high rates of economic growth can result in low level of risks.

Managing crediting risks of the banks is one of the most important elements of internal risks management systems of each financial institute and generally from the point of view of financial stability assessment. The role of this risk increases with the growth of economy credits part in bank assets structure. Generally banks crediting risks are at acceptable level with the part of non-performing credits to economics' corporate sector (excluding financial sector) at the level of 2.08 % in total part of loans to the state by 1 October 2006.

At the same time the effectiveness of such type of risk management better to assess through the factors which can determine the risk of lender, particularly: (1) high level of yield; (2) low level of debts (leverage); (3) high quality of provision leaved as a deposit and (4) the specifics of debtor's activity from the point of view of business's ability to return stable and predictable interest which is enough to serve its liability. Excluding the last factor others are directly consequent with the assessment of debtors' potential solvency.

Analysis of solvency factors which has been carried out by 2005 when significant increase of economy credits has been noted displays that in spite of the current risk low level there is a potential vulnerability of banks in worsening of corporate debtors financial state in case of decreasing the rates of economic growth and solvency level of consumer demand (Table 3.3.1.3).

Table 3.3.1.3

Credit risks related to the corporate sector of economy in 2005

Sector	ROE,%	ROE change, 05/04	Leverage	Bank loans classification, share in % (as of 01.01.06)			Share of enterprises in the aggregate amount of enterprises, which stopped their activity	Contribution of the sector to the aggregate growth of credits
				Standard	Doubtful	Loss		
Trade	17.11	-32.86	10.07	54.30	44.20	1.50	29%	16%
Industry	62.80	12.39	1.11	60.90	37.40	1.90	11%	10%
Agriculture	-10.76	-9.09	2.49	38.50	57.60	3.80	10%	3%
Construction	11.44	-25.96	6.65	38.10	59.00	2.90	8%	10%
Transport	4.24	-4.85	0.73	57.80	40.20	2.00	4%	3%
Communications	43.25	-36.49	0.71	82.80	17.10	0.00	0%	0%
Other	30.12	10.99	2.17	65.70	31.90	2.30	37%	33%
Totally in economy	39.46	5.91	1.74	57.46	40.31	2.24		75%

Source: NBRK, FSA, SARK

Particularly the highest level of corporate leverage is observed in trade, building and agriculture sectors, in other words in sectors which has almost half determined banks credit growth.

If till present time factories of this sector excluding agriculture provided a high profitability and stable capital inflow then in case of changing this tendency the risk of their solvency would increase. According to the organization and activity if these sectors factories and organizations operating within them are more mobile that can cause an increase of bankruptcies and worsening the quality of banks loan portfolio in unfavorable scenario.

Analysis of banks financing level and of profitability of large-scaled and middle-sized factories approves the risk above. The banks are trying to credit more profitable economy sectors though their part in loan portfolio is lower. At the same time there is a problem consequent with "opaque" accounting that rather trouble risk assessment for the banks (Table 3.3.1.4).

Table 3.3.1.4

Profitability of the corporate sector and bank financing²⁸								
Sectors	2004			2005			ROA change	Sector share in liabilities to banks
	ROA,%	Liabilities to banks / Assets	Liabilities to banks / Total liabilities	ROA,%	Liabilities to banks / Assets	Liabilities to banks / Total liabilities		
Positive ROA change								
Fuel-energy useful minerals exploitation	32.93	2.99	5.72	44.38	3.78	7.18	11.46	11%
Textile and clothing industry	-5.71	51.86	59.23	-3.54	58.12	62.36	2.17	3%
Woodworking and wood items production	0.03	11.67	12.80	3.29	29.69	34.44	3.26	0%
Chemical industry	-12.39	19.89	17.90	-5.07	22.82	27.62	7.32	1%
Production of other non-metal mineral products	17.90	24.26	39.60	18.56	25.91	47.66	0.66	2%
Metal manufacture	32.27	2.87	8.83	34.13	3.27	12.04	1.86	3%
Machines and equipment production	3.56	14.82	20.31	7.00	13.23	16.18	3.44	1%
Electrical equipment production	6.54	18.77	29.64	9.05	23.07	34.99	2.52	1%
Vehicles and equipment production	8.14	10.47	21.58	18.05	13.55	30.42	9.91	1%
Construction	5.25	13.42	17.33	7.63	14.92	17.84	2.38	10%
Totally in the group	28.39	5.34	10.26	35.79	6.70	12.54	7.40	33%
Negative POA change								
Agriculture, hunting and forestry	0.97	6.16	11.38	-2.27	8.61	14.02	-3.24	2%
Fishery, fish-breeding	-5.33	5.45	11.62	-10.65	3.93	7.68	-5.33	0%
Mineral resource industry excluding fuel-energy minerals	33.21	15.98	44.03	32.83	16.04	28.35	-0.38	3%
Food production, including drinks and tobacco	5.96	29.11	45.48	2.66	31.50	45.98	-3.30	10%
Production of leather, leather items and shoe making	-3.32	23.37	28.72	-7.17	24.04	25.17	-3.85	0%
Paper- pulp industry; publishing	12.51	40.20	54.25	8.24	29.16	45.57	-4.27	1%
Coke, petroleum products and nuclear materials production	6.48	3.48	9.73	2.54	3.58	10.28	-3.94	1%
Rubber and plastic items production	2.06	32.78	40.25	-9.17	27.39	35.13	-11.22	0%
Other industry sectors	1.52	14.21	16.82	-0.69	50.91	59.70	-2.21	1%

²⁸ Extract of legal entities data whose workers are more than 50 persons composing 75 % of middle and large enterprises assets generally in RK.

Production and distribution of electrical energy, gas and water	0.73	9.30	18.39	-3.65	13.66	26.91	-4.37	6%
Car, household goods and personal demand items trade and repair	8.30	30.84	36.17	8.16	28.61	34.06	-0.15	16%
Hotels and restaurants	12.73	54.77	54.55	8.65	45.34	47.80	-4.08	3%
Transport and communications	8.92	8.71	24.32	6.15	11.03	28.22	-2.77	24%
Totally in the group	8.09	13.75	28.63	5.48	15.84	30.60	-2.61	67%
Totally selectively	18.41	9.38	18.71	21.45	10.97	20.84	3.04	100%

Source: NBRK, SARK

Because of population prosperity improvement and application of the newest banking products for natural persons the increase of population credits to GDP volume ratio and the parts in banks loan portfolio are observed.

Population crediting increase kindly affect the level of banks loan portfolios diversification but the risks consequent with the worsening of general economical situation and currency courses fluctuations should be taken into consideration.

Consumer credits quality worsening is determined by reduce of limits in getting a credit and by increasing the express-crediting without leaving anything as a deposit. Creating of credit offices and application of modern consumer solvency assessment systems will help to reduce the risk consequent to population crediting.

Economy growth and particularly population prosperity improvement characterized by increase of average salary caused an increase of demand on crediting resources from the direction of population (Figure 3.3.1.7). Perfection of population serving technologies and application of the newest banking products for natural persons caused a rapid development of such a crediting type. So, just from the beginning of current year the volume of loan debt by the natural persons credits increased almost 2 times and their parts in banks loan portfolio is still increasing (Figure 3.3.1.8). During the growth of natural persons crediting also increased their payment in foreign currency. But at the background of the tendency of national currency strengthening decreases also the weight of loans to population in foreign currency that rather decreases the level of currency risk consequent to significant currency courses fluctuations.

Attendant to economy growth increase of population income, investment attraction of real estate investments, increasing the population in big cities causes the growth of real estate prices. So according to the data of Statistics Agency the prices for secondary real estate in multiple dwellings have grown stable though a little bit non-uniform; the demand hasn't decreased even during the common season fluctuations. At the same time the growth of housing square meter price at the secondary market in 2005 in average was about 50.3 % and 39.5 % during the 10 months of 2006 (Figure 3.3.1.9).

Existing population demand on houses caused an increase of mortgage credits. Today the share of population mortgage lending credits in second-level banks loan portfolio is 7.43 %. At the same time the share of mortgage, where the provided mortgage to collateral ratio is less than 60 %, in the aggregate sum of provided mortgage lending loans is 2.55 %. This index characterizes an acceptable risk level (Table 3.3.1.5).

In spite of built houses growth the demand on real estate has a tendency to grow. In case of sudden housing price reduction there is a big probability of inability of lenders to serve their credits liabilities. Such an event can lead to reduction of prices and deposit property liquidity decrease. At the same time today rather conservative approach of banks to classifying loan portfolio and provision forming is observed. It lets the banks to avoid huge loss.

Granted to consumer purposes credit remains which in world practice are treated as the most risky, just within the 9 months of 2006 increased 2 times and reached 540.9 billion Tenge (the part of loan portfolio by 1 October 2006 is 11.7 % against 8.5 % by 1 January 2006) (Figure 3.3.1.10). Also it is fair towards the consumer credits to notice that usually in world practice they are the most

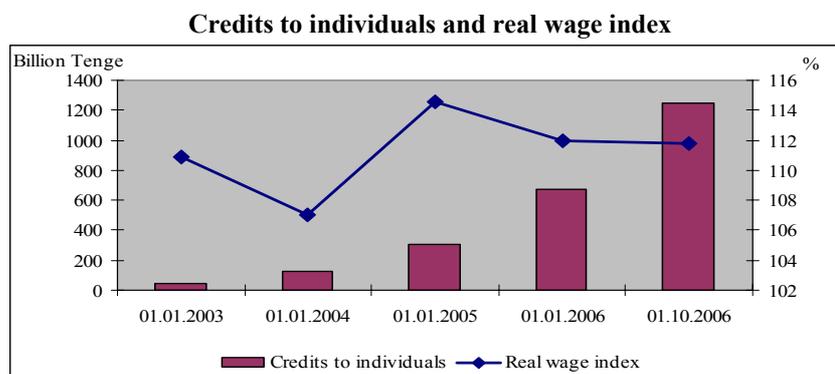
expensive credits, fee rate of which in developed countries almost an order higher than official refinancing (accounting) rates of central banks.

In part cashless settlement system development and widening of services provided to plastic cards holders caused their increase since the beginning of 2004 almost 2 times (Figure 3.3.1.11). While increasing the number of payment cards holders the number of delay in debt repayment by crediting limit is also growing. But the part of cards number which has repayment delays is rather low. Banks risks in these services are minimized because the main deposit provision is client's salary.

The softening of access criteria to crediting resources to the population and increasing volume of express crediting without deposit provision caused the loan portfolio of consumer credits quality worsening (Figure 3.3.1.12). In time considering composing economy situation and the new stage of competitive struggle for a client should be waited an increase of such a crediting type volume which can lead to unavoidable assets quality worsening and particularly consequent to crediting natural persons. At the same time with appearing of the first crediting offices possessing crediting histories of banks clients the improvement of client solvency assessment systems with the following proper level assets quality support is expected.

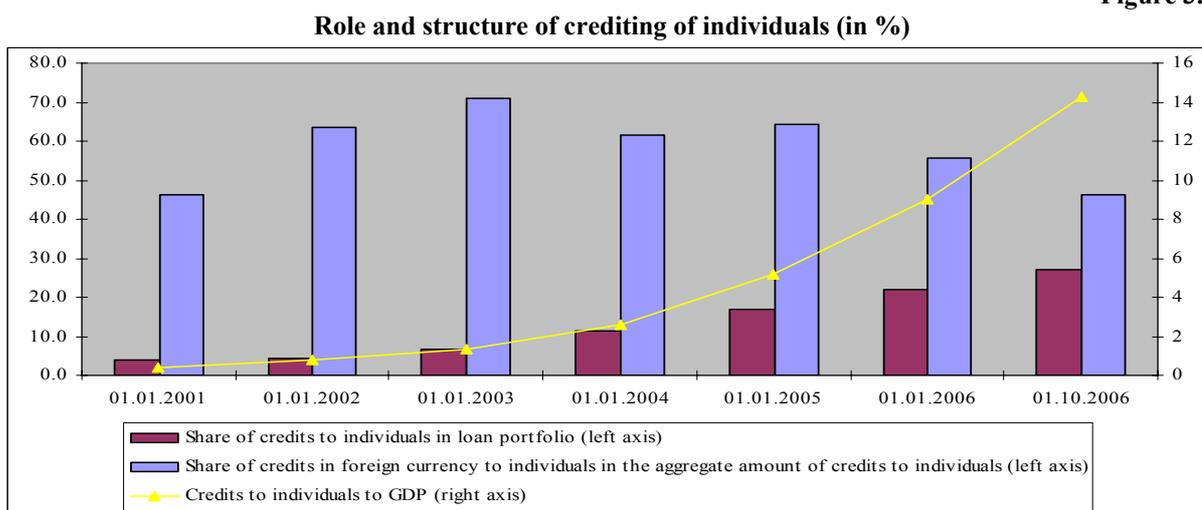
General economy shocks able to cause a reduce of population solvency, reduction of real estate prices and instability of currency exchange courses are the main factors of the risk for banks related to population lending.

Figure 3.3.1.7



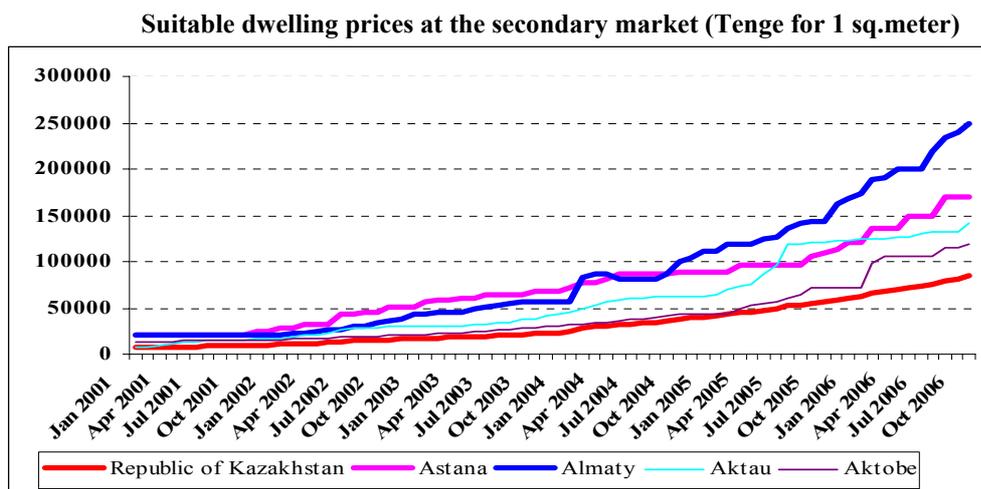
Source: FSA, SARK

Figure 3.3.1.8



Source: FSA, SARK

Figure 3.3.1.9



Source: SARK

Table 3.3.1.5

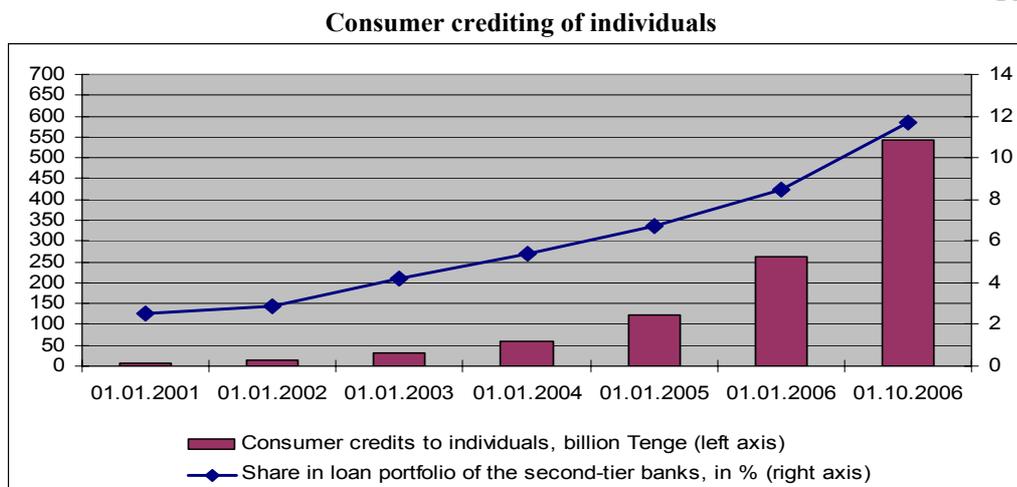
Mortgage lending indicators*

	as of 01.10.2006r.	
	billion Tenge	in %
Loans, total	4 629.80	100
Mortgage housing loans housing, including	344.4	7.43
Mortgage loans not exceeding 60% of the value of collateral	8.8	2,55*

*share in the aggregate amount of mortgage loans for housing

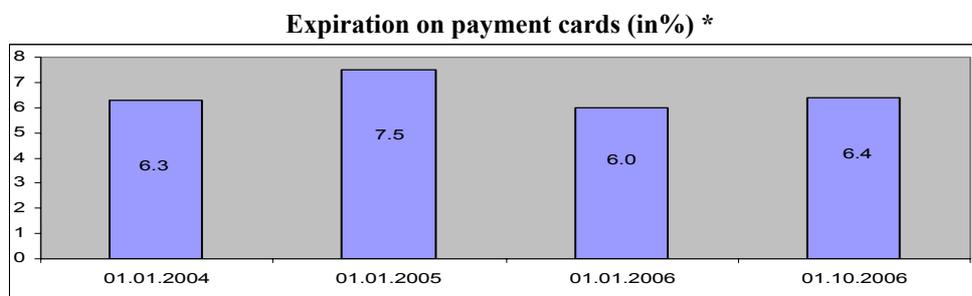
Source: FSA, NBRK

Figure 3.3.1.10



Source: FSA

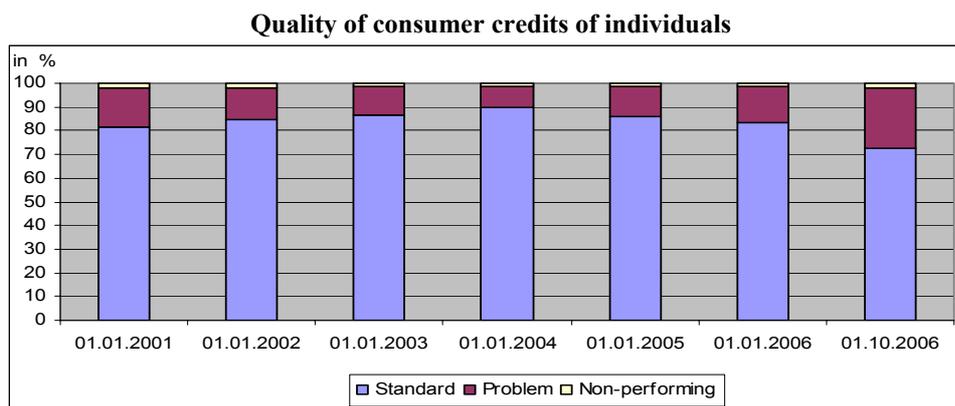
Figure 3.3.1.11



* the number of payment cards holders made an expiration by credits in percent of the aggregate payment cards holders amount. Credit payment card should be taken both as debit payment card with credit limit and purely credit payment card permitting its holder realize payments within loan sum vested by issuer.

Source: NBRK

Figure 3.3.1.12



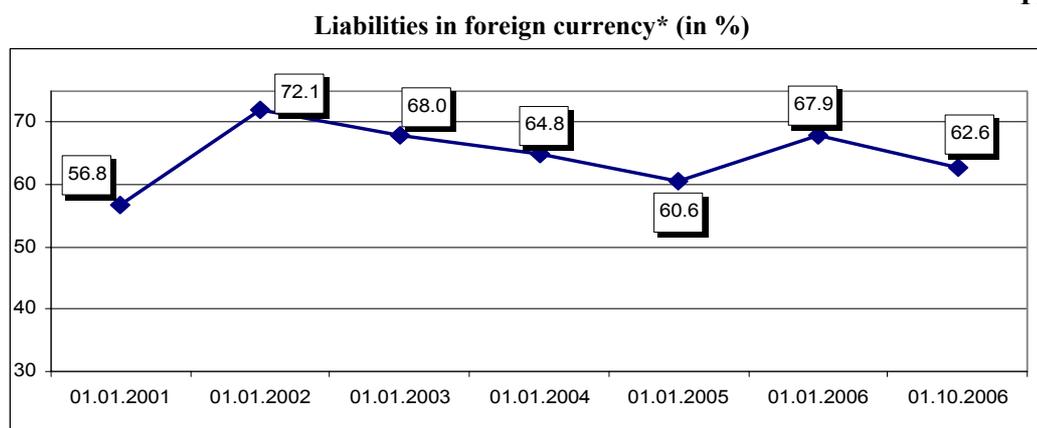
Source: FSA

3.3.2 Market risks

The second-tier banks retain the sufficient "safety margin" in covering the currency risk that is connected with the low relative indicators of the net-positions to the capital and reserves.

Since 2003 bank liabilities in foreign currency exceed assets denominated in foreign currency. Alongside with that the share of liabilities in foreign currency in the aggregate bank liabilities has the tendency to reduction since the beginning of the year (Figure 3.3.2.1) that is related to strengthening of requirement to currency positions, introduction of requirements of external borrowings attraction and minimum reserve requirements with respect to liabilities to non-residents.

Figure 3.3.2.1



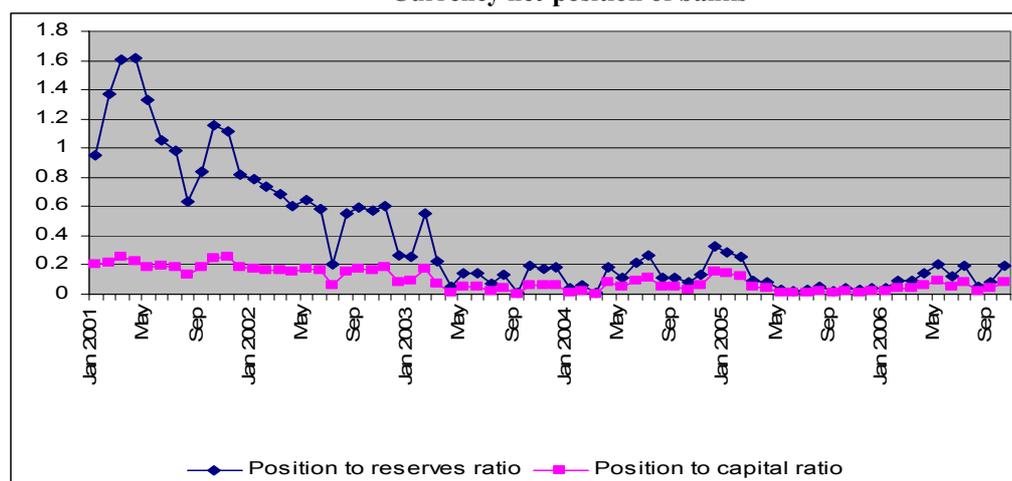
* Ratio of liabilities in foreign currency to the aggregate liabilities

Source: FSA

Decrease in relative indicators of currency positions leads to decline in the level of the second-tier banks exposure to the currency risk (Figure 3.3.2.2). At that, the ratio of the currency net-position to equity capital generally in the banking sector equals 8 % while the standard for a separate bank is 25 %, which displays the sufficient " safety margin" of banking system in case of exchange rate swing.

Figure 3.3.2.2

Currency net-position of banks



Source: FSA

The ratio of demand assets to liabilities and conditional demand liabilities is at the acceptable level that reduces the level of risk related to the rise in the interest rates on attracted liabilities.

As of 1 October 2006 the ratio of demand assets to liabilities and conditional demand liabilities is at the point of 1.13 that displays the sufficient liquidity of banking sector.

The fluctuation of interest rates on borrowed funds at the capital markets is one of the factors affecting the banking activity yield. Particularly the increase in interest rates on attracted external borrowings by 2 % will cause the increase in interest expenses. At that scenario non-compliance with the equity capital adequacy ratio k1 and k2 by the second and the fifth second-tier bank, respectively, will be observed.

The analysis of terms of assets pay-back and repayment of liabilities displays that in case the term is up to one year the GEP-position is negative, i.e. in the short-run there is a probability of the permanent demand for funds attraction at the market that determines the exposure to the interest risk and the risk of insolvency (Table 3.3.2.1). The negative GEP shows that in the concerned period a bank has more liabilities than assets sensitive to interest rate, i.e. interest rate development will lead to reduction of the net interest income. In case of the term, which is more than one year where GEP is positive the net interest income increases in case of interest rate development.

Table 3.3.2.1

Financial assets and liabilities subject to interest rates changes *

	01.01.2005	01.01.2006	01.10.2006
Financial assets (million Tenge), including	2 738 237	4 579 368	6 644 986
up to 1 month	662 357	1 231 009	1 684 161
up to 3 month	876 998	1 545 864	2 045 826
up to 1 year	1 500 311	2 532 935	3 074 949
Financial liabilities (million Tenge), including	2 387 007	4 016 967	5 860 545
up to 1 month	776 879	1 134 268	1 672 384
up to 3 month	998 333	1 385 701	2 128 768
up to 1 year	1 570 336	2 376 694	3 090 427
Aggregate assets	2 687 479	4 515 052	6 578 061
Difference between financial assets and financial liabilities to the aggregate assets ratio (in %)	13.07	12.46	11.93
up to 1 month	-4.26	2.14	0.18
up to 3 month	-4.51	3.55	-1.26
up to 1 year	-2.61	3.46	-0.24

* Calculation by terms was made on cumulative basis

Source: FSA

3.3.3 Liquidity risks and the structure assets financing

Indicators of the banking sector liquidity are in excess. Short-term liabilities are almost totally covered by short-term assets and this also decreases the level of liquidity risk.

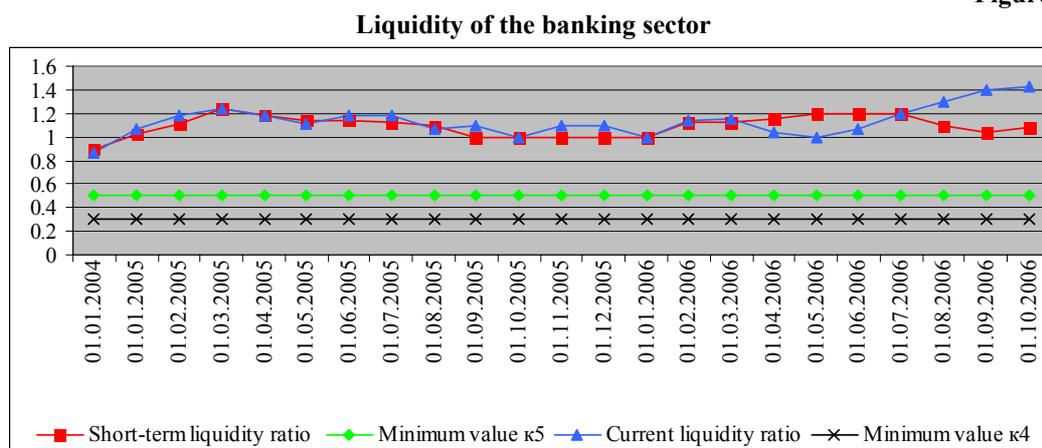
Attraction of the "cheap" capital at international markets strengthens the level of diversification of the structure of assets financing. Reduction of the ratio of requirements for non-residents to liabilities to non-residents characterizes the increase in the national economy crediting including long-term crediting.

The dependence on external financing increases the bank instability connected with external shocks. At the same time the positive dynamics of reduction of the portion of external liabilities in the aggregate liabilities of banks is observed in consequence of introduction of requirements related to liabilities and currency positions.

As of 1 October of the current year the level of liquidity of the banking system remained in excess. The current liquidity aggregate ratio was equal to 1.43 by 1 October 2006 while the minimum standard for a separate bank was 0.3, the short-term liquidity ratio was equal to 1.08 while the minimum value was 0.5 (Figure 3.3.3.1).

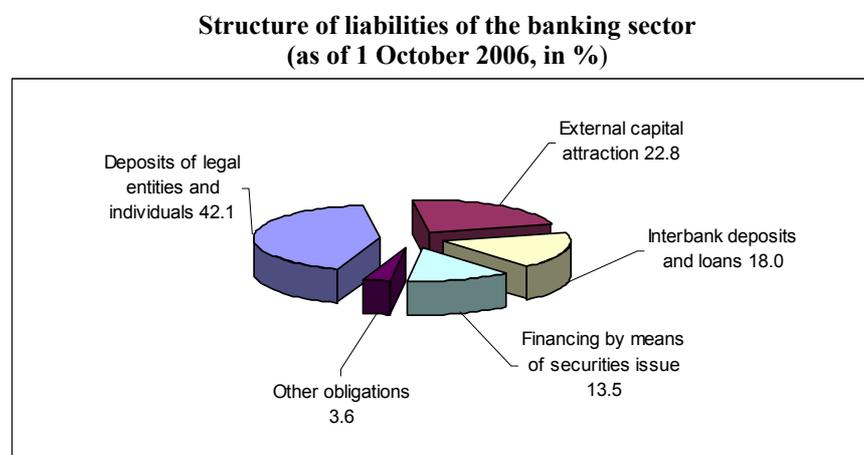
Household deposits in the second-tier banks grow rapidly boosting the replenishment of banks resources base and the growth of their drawing potential due to the internal savings inflow. As the growth of borrowed deposits remains behind the growth of crediting the banks are focused on assets financing by means of promissory notes issue at external capital markets and external capital attraction in the form of credits and syndicated loans. At present such method of attraction of financial resources is profitable for banks because of low interest and long-term repayment periods (Figure 3.3.3.2).

Figure 3.3.3.1



Source: FSA

Figure 3.3.3.2



Source: FSA

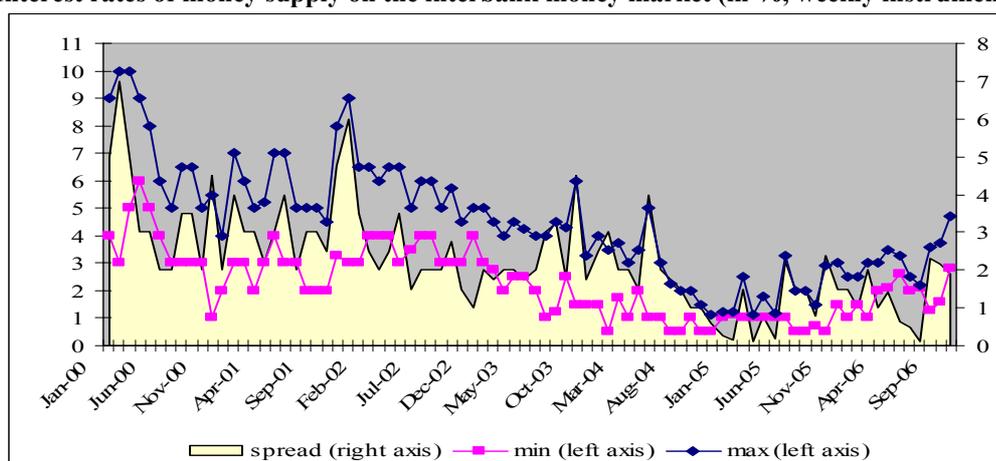
At the same time the threat of worsening of bank assets quality as the result of potential decline in Tenge exchange rate remains as a large part of credits is denominated in foreign currency. In addition, the wish of banks to attract external borrowings will remain in the future that is connected with exclusively favorable conditions for attraction of borrowed capital at foreign markets by the banks of the Republic of Kazakhstan.

The counter-partners risks have a tendency to decrease from the point of view of analysis of interest rates on the interbank money market.

The spread between the maximum and the minimum rate of money supply for a week decreased from 3.54 % on average in 2000 down to 1.33 % on average in 2006 (Figure 3.3.3.3). The significant monthly spread volatility during the year reflects the high liquidity of the banking sector in general and, as a consequence, its insignificant role in bank financing.

Figure 3.3.3.3

Interest rates of money supply on the interbank money market (in %, weekly instruments)



Source: NBRK

3.3.4 Financial condition of the banking sector

The rapid growth of the second-tier banks assets requires a corresponding increase in capitalization.

Generally the capital adequacy indicators in the banking system are in excess. At the same time the capital adequacy indicators of the largest banks are at the level close to the minimum standards.

Undistributed profits and subordinated debt instruments are still the main sources of capital increase. The portion of shareholders' contributions to the capital increase declines from year to year. At the same time the growth rates of banks assets advance the growth rates of equity capital of banks.

The indicators of capital sufficiency and adequacy directly depend on asset quality, management quality and sum of risks incurred by the bank (Table 3.3.4.1).

Table 3.3.4.1

Capital adequacy					
	as of 01.01. 2003	as of 01.01. 2004	as of 01.01. 2005	as of 01.01. 2006	as of 01.10. 2006
Equity capital (billion Tenge)	161.2	233.6	346.8	584.8	896.7
k1 ratio	0.09	0.09	0.08	0.08	0.09
k2 ratio	0.17	0.17	0.16	0.15	0.15
equity capital/assets	0.14	0.14	0.13	0.13	0.14

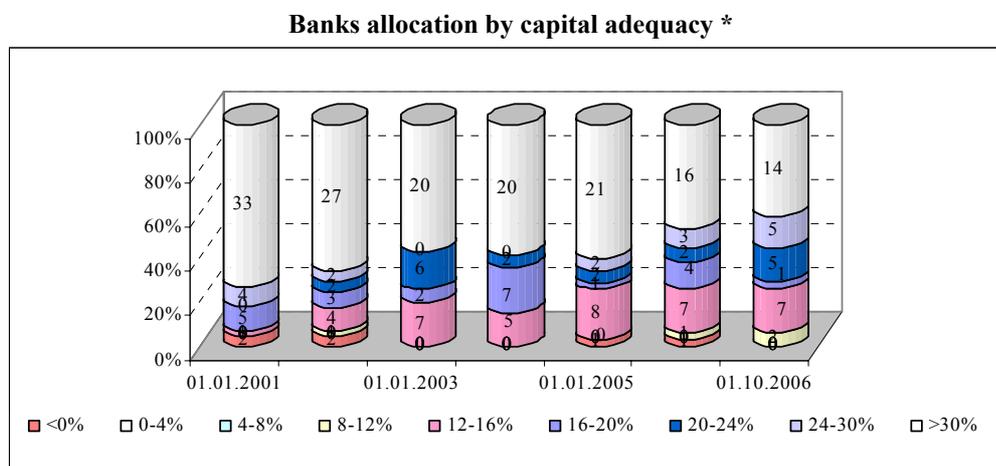
Source: FSA

Since 2002 the equity capital adequacy ratio k1 has not substantively changed and currently remains at the excessive level at the established standard, which is equal to 0.06 for a bank and 0.05 for a bank whose participant is a banking holding.

At the same time the adequacy ratio k2 has a stable tendency to decrease. Mostly it is associated with bank asset quality degradation and particularly with granted loans.

Analyzing the bank allocation through the level of k2 ratio (Figure 3.3.4.1) it should be noted the insignificant increase in the number of banks that are within lower limits of ratios. The indicators of capital adequacy of the largest banks with relation to k2 ratio have become close to the minimum required standards (at the standard of 12 % and 10 % for a bank whose participant is a banking holding).

Figure 3.3.4.1



* Number of the second-tier banks with k2 ratio within stated limits

Source: FSA

The positive dynamics of growth of earning yield of assets and equity capital is observed in the banking system during the last years.

As of 1 October 2006 the second-tier banks earned the net aggregate income in the amount of 88.1 billion Tenge that is 4.3 times higher than at the beginning of 2003 (as of 1 October 2005 - 53.1 billion Tenge). The aggregate amount of income as of the same date was 613.0 billion Tenge having increased 2.5 times in comparison to the amount of income as of 1 January 2003 (as of 1 October 2005 - 334.6 billion Tenge). The aggregate amount of expenditures for the period from the beginning of 2003 till September 2006 increased 2.3 times up to 524.9 billion Tenge (as of 1 October 2005 - 281.5 billion Tenge) (Table 3.3.4.2).

It should be noted that in the period of 9 months of the current year the net after-tax income earned by banks was 65.9 % higher than in the same period of the last year.

Table 3.3.4.2

The banking sector profitability

	billion tenge				
	01.01.2003	01.01.2004	01.01.2005	01.01.2006	01.10.2006
1	2	3	4	5	6
Interest income	103.7	140.9	212.6	342.1	422.5
Interest expenses	43.2	60.8	93.9	180.1	230.4
Net interest income	60.5	80.1	118.7	162	192.1
Non-interest income	144	89.6	110.6	151.1	189.4
Non-interest expenses	183.4	137.8	191.3	229.8	281.3
Net non-interest loss	-39.4	-48.2	-80.7	-78.7	-91.9
Extraordinary items	1.3	1.3	1	-0.6	0.8
Net income before income tax	22.4	33.2	39	82.6	101
Income tax expenses	1.8	4.4	7.3	9.3	12.9
Net income after income tax	20.6	28.8	31.7	73.3	88.1

Source: FSA

In the structure of the aggregate level of income the most considerable part belongs to interest income. Thus, as of October 1, 2006 the ratio of interest income was equal to 69.0% having

increased from 41.6 % as of January 1, 2003 that indicates the growth of dependence of the second-tier banks income on interest income.

In the interest income structure the most significant part belongs to interest income on loans given to clients (83.32 % or 117.4 billion Tenge) and to interest expenses upon claims of clients in the structure of interest expenses (70.38 % or 42.8 billion Tenge).

In the period from the beginning of 2005 the increase in ratio of the banking sector profitability occurred. Thus, as of October 1 of the current year the ratio of net before-tax income to the aggregate assets (ROA) on an annualized basis was equal to 2.3 % (as of 1 October 2005 - 1.8 %), the ratio of net before-tax income to equity capital was 23.9 % (as of 1 October 2005 - 16.9%). It is important to reckon the interest rate spread as one of the factors affecting the second-tier bank income when considering the bank profitability (Table 3.3.4.3).

Table 3.3.4.3

Spread of interest rate on credits and deposits (in %)

	12.01		12.02		12.03		12.04		12.05		09.06	
	Tenge	FC*	Tenge	FC*	Tenge	FC*	Tenge	FC*	Tenge	FC*	Tenge	FC*
Spread on non-bank legal entities												
Fixed period, including	9.7	6.3	8.7	6.8	11.4	8.7	10.3	7.7	9.7	7	9	6.1
up to 1 month	...	...	...	...	11.8	6.6	10.9	4.6	11.3	5.7	8.8	1.1
from 1 to 3 months	10.6	12.8	12.3	9.1	11.4	6.7	9.2	4	9	4.6	9	6.6
from 3 months to 1 year	7.9	5.6	8.6	3.1	7.6	9.2	10.1	8.9	8	8.2	7	6
from 1 year to 5 years	7.1	7	8.1	6.9	5.7	8.6	3.9	4	4.1	5.3	4.7	6
more than 5 years	8.6	13.3	11.2	8.5	12.4	3.7	12.3	5.4	12	5.6	7.3	7.6
Spread on individuals												
Fixed period, including	11.7	12.3	10.5	10.2	9.4	10.8	10.2	9	10.6	8.1	10.8	7.3
up to 1 month	...	...	...	...	11.4	16.3	14.7	9.4	17.7	11.5	13.4	13.7
from 1 to 3 months	12.7	12.2	14.2	11	15.7	11.7	15.9	16.3	15.1	2	22.4	9.9
from 3 months to 1 year	11.8	12.4	13.3	10.6	12.7	11.8	14.3	12.9	17.1	8.7	16.2	10.1
from 1 year to 5 years	7.7	9.9	9.5	11.1	9.2	9.8	8.5	8.4	9.4	10.3	11.9	7.3
more than 5 years	2	9.2	0.1	7.1	4.4	11.3	6.3	4.4	10.2	9.4	8.4	10.8

*freely convertible currency

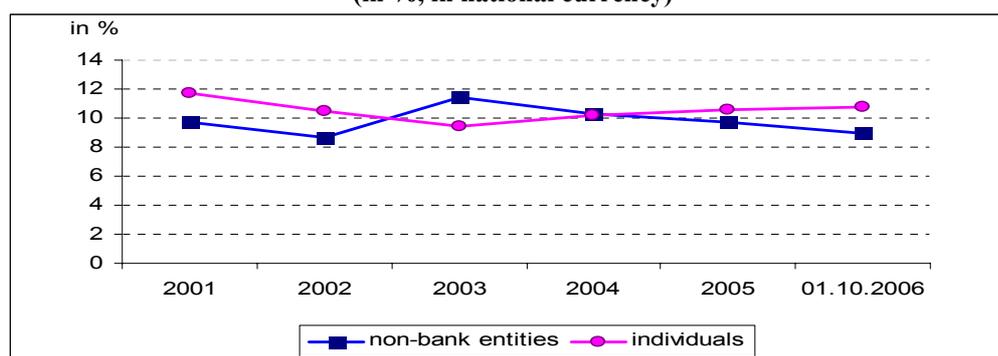
Source: NBRK

With relation to transactions with individuals (deposit and credit transactions) the difference between the instruments was 10.5 % and 9.6 % in FC on average in the period of 2001-2006; as for transactions with non-bank legal entities – it came to the point of 9.8 % in Tenge and 7.1 % in FC correspondingly.

Generally the dynamics of the interest rate spread has downtrend on transactions in national currency held with non-bank legal entities and a growth trend on transactions with individuals (Figure 3.3.4.2). It is necessary to note that the spread growth on transactions with individuals began in 2003 and continues during 2006 that reflects the increase in the role of bank products of higher risk level as well as adequate perception and reflection of such products in price of services. In contrast to that, the spread on transactions with non-bank entities has started reducing since 2003 and maintains this tendency during 2006.

Figure 3.3.4.2

**Spread between interest rates on credits and deposits
(in %, in national currency)**



Source: NBRK

The tendency of profitability spread reduction displays the improvement of competition in the banking sector.

The reduction of the ratio of operating costs to undistributed earning reflects the increase in effective bank management of such costs.

Despite the real growth of interest income from 46.1 billion Tenge in 2000 to predictive 563.3 billion Tenge in 2006 the profitability spread has a stable tendency to reduction (Table 3.3.4.4). It is mostly connected with the interest rate reduction on loans. The banks of the country credit the population more actively, offer new products and technologies. All that happen at the background of increasing competition between both the banks in the internal and external financial markets and also due to the alternative source of financing development.

Table 3.3.4.4

Profitability spread

	2000	2001	2002	2003	2004	2005	2006 assessment
Interest income	46 131	73 372	103 710	140 891	212 614	342 297	563 269
Average interest yield assets (for 2 years)	307 294	511 008	851 317	13 076 692	2 047 050	3 380 827	5 481 308
Ratio, %	15.01	14.36	12.18	10.78	10.39	10.12	10.28
Interest expenses	18 659	30 142	43 155	60 788	93 905	180 542	307 214
Average (for 2 years) liabilities on interest expenses	314 990	528 461	740 055	1 137 814	1 895 550	3 143 848	5 146 594
Ratio, %	5.92	5.7	5.83	5.34	4.95	5.74	5.97
Profitability SPREAD	9.09	8.65	6.35	5.44	5.43	4.38	4.31

Source: FSA

Despite the profitability spread reduction the banks profitability increases that is confirmed by the ROE growth from the point of 9.0 in 2000 to 23.9 expected in 2006. According to this data the conclusion of operating expenses optimization may be made. This conclusion is approved by the ratio of operating expenses to undistributed earnings (Table 3.3.4.5). Thus, this ratio was at the level of 18.1 in 2000 and at the level of 6.0 in the third quarter of 2006.

Table 3.3.4.5

Effectiveness of operating expenses management

	01.01.2001	01.01.2002	01.01.2003	01.01.2004	01.01.2005	01.01.2006	01.10.2006
Operating expenses	1 191 223	155 774	228 883	203 551	293 018	430 162	524 890
Undistributed earnings	6 580	6 667	20 497	28 305	31 122	70 120	88 116
Operating expenses to undistributed earning ratio	18.1	23.4	11.2	7.2	9.4	6.1	6.0

Source: FSA

3.4. Other financial institutions

Insurance (reinsurance) companies' assets are represented mostly by high-liquid assets - money, bank deposits and securities.

The level of capitalization of domestic insurance companies has increased within the framework of triennial plan of stage-by-stage capitalization.

The dynamics of insurance premiums ceded to reinsurers, including to non-residents, has a stable tendency for reduction.

The tendency of growth of the high-liquid assets, the insurance companies' capitalization and the capital turnover increase is being observed since the beginning of 2002.

The changes in the supervision and regulation system and increasing requirements to the investments of assets of insurance companies caused the growth of share of the high-liquid assets in the structure of the aggregate assets of insurance companies.

The insurance market appeal may be explained by the low loss ratio of insurance activity that determines the positive dynamics of indicators of assets and capital profitability (Figure 3.4.1). The analysis of the income structure shows that the major part of income is accounted for the insurance activity. Thus, the part of investment activity income reaches the point of 10.5 % of the aggregate income of insurance companies.

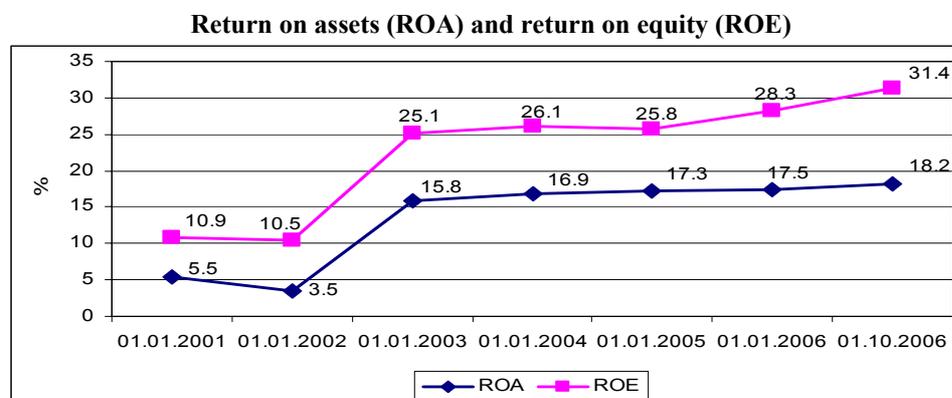
Along with the capitalization of the Kazakhstan insurance market the net retention of insurance companies gradually increases. The dynamics of insurance premiums ceded to reinsurers, including to non-residents, has a stable tendency for reduction. This indicator was equal to 65.1 % in 2000 and for the period of 9 months of the current year it was 37.9 % (Table 3.4.1).

The fact that the major part of funds accumulated in insurance companies remains inside the country stimulates the rise of investment potential of domestic investors. However, this tendency may lead to the reduction of risk diversification and accumulation of risks in our country, taking into consideration the exposure of some regions to natural disasters, such as earthquakes, landslides and mudflows. The major part of premiums ceded to reinsurance referred to the following countries: the USA - 22.8 %, Russia - 13.1 %, Sweden - 12.4 %, Switzerland - 12.3 %, Great Britain - 8.9 % (Figure 3.4.2).

High rates of insurance sector growth, its development due to appearance of new obligatory types of insurance let this sector of financial market to be considered as perspective. But it is necessary to mark the high risks related to transfer of own risks by banks to affiliated insurance companies and affiliation of the largest insurance companies to bank conglomerates.

The rapid growth of insurance market was stimulated by increase in obligatory types of insurance and the growth of consumer and mortgage lending. From the other side, considering that the pricing system of obligatory types of insurance is rather strict, the risk of their adequacy increases at alteration of prices for real and financial assets.

Figure 3.4.1



Source: FSA

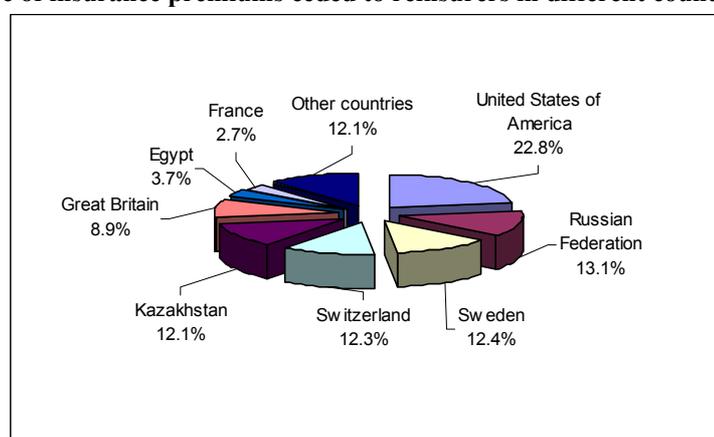
Table 3.4.1

Indicators of insurance market stability							
	01.01.2001	01.01.2002	01.01.2003	01.01.2004	01.01.2005	01.01.2006	01.10.2006
High-liquidity assets to the total assets ratio	52.9	40.6	48.8	60.2	76.7	75.7	75.2
Share of equity capital in the total assets	50.6	33.7	62.7	64.5	67.1	61.7	58
Level of insurance reserves coverage by equity capital	1.5	0.6	2.9	2	3	1.7	1
Loss ratio	14.8	15.9	10.2	15.3	18.6	19.8	16.1
Share of insurance premiums ceded to reinsurers in the aggregate insurance premiums	65.1	68.6	74.2	58.1	46.8	39.7	37.9
ROA	5.5	3.5	15.8	16.9	17.3	17.5	18.2
ROE	10.9	10.5	25.1	26.1	25.8	28.3	31.4

Source: FSA

Figure 3.4.2

Structure of insurance premiums ceded to reinsurers in different countries (in %)



Source: FSA

The share of non-performing loans in loan portfolio of non-bank institutions is much lower compared to the banking sector.

Solvency risks are brought down that is determined by the equity capital excess over liabilities.

Due to the insufficient level of the current liabilities coverage the exposure of non-bank institutions to liquidity risk is substantial.

Successful development and stability of the economy in Kazakhstan depends mainly on the government actions directed to support of separate sectors; particularly, agricultural sector and small business enterprises by means of their crediting. In this regard the role of non-bank institutions in the national economy significantly increases; it relates to the totally-owned government institutions in particular.

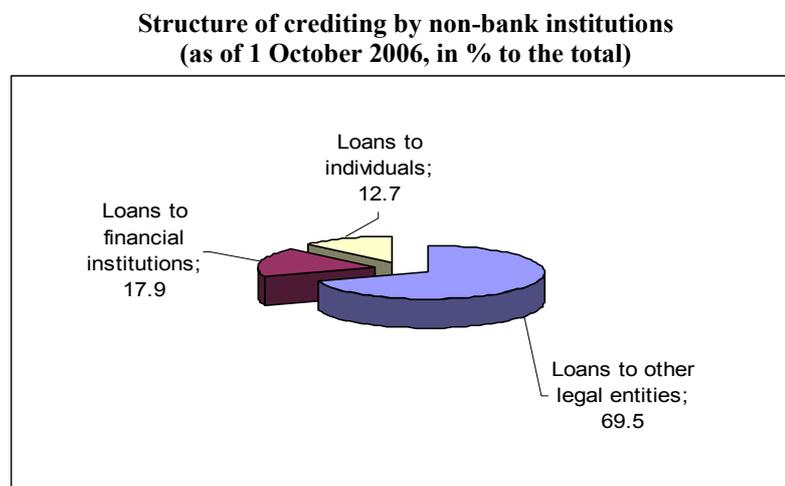
Approximately 70 % of loans granted by non-bank institutions were granted to legal entities. Loans granted to banks and other non-bank institutions were equal to 17.9 % and credits obtained by individuals amounted to 12.7 % of loan portfolio (Figure 3.4.3).

The quality features of loan portfolio of non-bank institutions are higher en masse compared to the same indicators features of the banking sector. Particularly, the share of standard loans is 94.7 % of loan portfolio and the share of non-performing loans is 1.1 % of loan portfolio (Figure 3.4.4). Generally the level of credit risks is reduced by government guarantees on credits granted and the sufficient level of equity capital.

It is necessary to note that the ratio of liabilities to equity capital (leverage) is also at the minimum level (0.76) in regards to solvency risk. This indicator reflects the high level of solvency

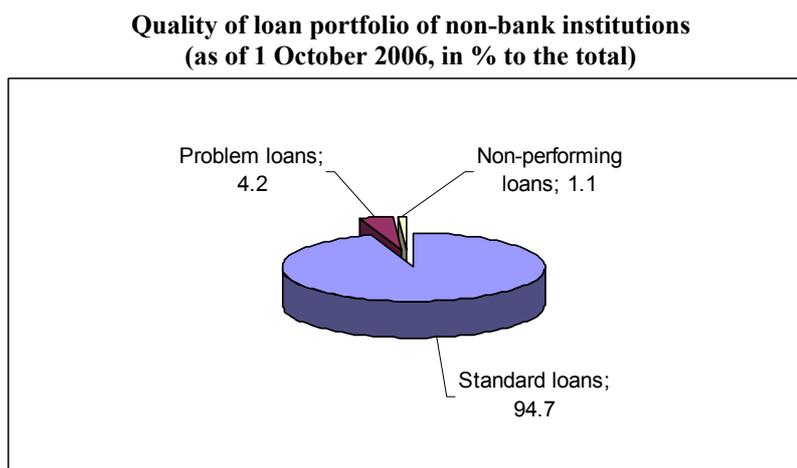
of non-bank institutions. At the same time the insufficient level of the current liabilities coverage by liquid assets is observed that may cause a temporary deficit of liquid funds. Thus, the ratio of short-term assets to short-term liabilities was equal to 0.39 as of 1 October 2006 and the share of liquid assets in the total assets reached 13.7 % that indicates a considerable exposure to the liquidity risk (Table 3.4.2).

Figure 3.4.3



Source: FSA

Figure 3.4.4



Source: FSA

Table 3.4.2

Solvency and liquidity risks of non-bank institutions

	01.10.2006
Share of liquid assets in the total assets, in %	13.67
Sort-term assets to short-term liabilities ratio	0.39
Liabilities to equity capital ratio	0.76

Source: FSA

The level of currency risk of other financial institutions is covered by the value of equity capital and is currently at the acceptable level (Table 3.4.3).

It is important to note that the rapid growth of assets and liabilities in foreign currency is being observed recently in regards to exposure of insurance companies to the exchange rate fluctuations. First of all, it is associated with an increase of foreign securities in investment portfolio and a growth of liabilities to non-residents under reinsurance contracts. In general, insurance companies are less exposed to currency risk than the second-tier banks; it is characterized by the currency net-position to equity capital ratio at the level of 6.6 %. The currency net-position in the insurance sector is long, i.e. the assets exceed the liabilities in foreign currency and this leads to an increase of asset revaluation risk due to the significant strengthening of the national currency.

The increase in the currency net-position to equity capital ratio this year has been determined by surpassing increase in non-bank institutions' foreign currency liabilities. In its turn it increases the exposure to losses related to the exchange rates fluctuations and particularly to the exceptional depreciation of the national currency exchange rate. At the same time the risk related to the US dollar exchange rate fluctuations prevails that is characterized by the ratio of this currency position to equity capital.

Sharp increase in liabilities of investment portfolio management companies since the beginning of 2005 caused the growth of a gap between assets and liabilities in foreign currency, and increase in the ratio of short currency net-position to equity capital accordingly. Despite the fact that the currency net-position is covered by equity capital, the level of the currency risk of investment portfolio management companies is the highest among other financial market segments.

Table 3.4.3

Currency net-position to equity capital (in %)				
	as of 01.01.2004	as of 01.01.2005	as of 01.01.2006	as of 01.10.2006
Insurance companies	-12.1	-1.5	1	6.6
Non-bank institutions	-	-	-3.11	-23.53
Investment portfolio managers	99.4	4.9	-53.8	-56.8
Broker-dealer	52.5	12.7	24.5	29.9
Registrars	2.66	0.38	0.33	0.04

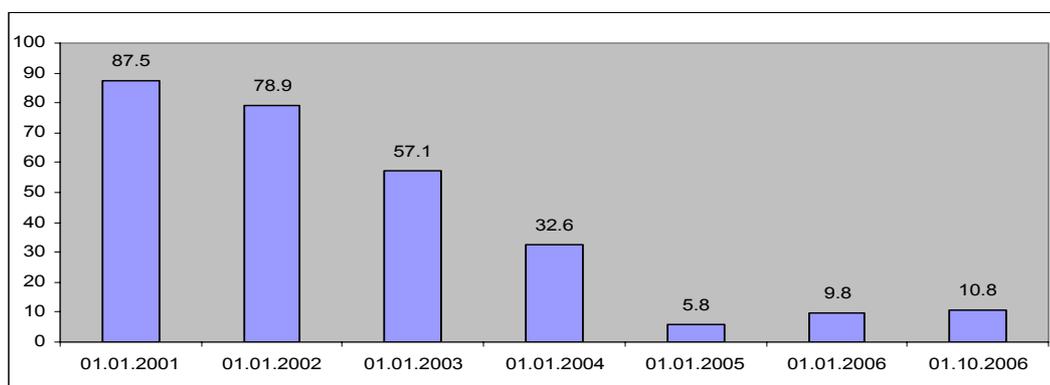
Source: FSA

The currency risk decrease for retirement savings funds is determined by the reduction of the share of foreign currency securities in the aggregate investment portfolio.

The first stage of accumulative pension system development is characterized by significant presence of nominated in foreign currency funds in the aggregate investment portfolio that was caused by deficiency in high-liquid and long-term tools on the stock market. Later on the weight of financial instruments in foreign currency in pension funds portfolio significantly reduced, because of national currency exchange rate strengthening tendencies and positive dynamics on internal stock market (Figure 3.4.5). Thus, dynamics of indicators characterizes the reduction of investment portfolio sensitivity to sudden exchange rate fluctuations and accordingly reduces the level of currency risk and its influence on portfolio profitability indicators. But since the beginning of 2005 the increasing tendency of foreign currency stocks in investment portfolios is observed due to growing yield of some financial instruments on international markets.

Figure 3.4.5

Level of the currency risk exposure of pension funds (in %)*



* Share of financial instruments in foreign currency in investment portfolio of pension funds

Source: FSA

IV. Financial market infrastructure

4.1. Payment systems

Payment systems are the biggest channel by mean of which the different shocks can spread over all financial system and markets. For this reason providing stable and effective functioning of payment systems is one of the key conditions for supporting and strengthening financial stability in the country.

Two types of risks can be defined within operating of payment systems. They are systemic and technical risks²⁹, which have an influence on functioning of payment systems and financial stability in the country. Therefore, the risk analysis approach is very essential.

4.1.1. Systemic risk analysis

The main reason of systemic risk in payment systems is a lack of liquidity in the system. For this reason let's analyze the dynamics of liquidity indices for the period of 2001-2006 and their adequacy for effective operating of payment systems in order to determine the probability of systemic risk appearance.

Interbank money transfer system (hereinafter - IMTS) (Tables 4.1.1.1 and 4.1.1.3)

IMTS is a system of gross payment in real-time for making the largest and high-priority payments in the country, characterized by the principle of individual payment and minimization of financial risks.

Since the beginning of 2001 the total payments volume in system and their average day indices have a tendency of growing. So, the growth of the both indices was 5.2 times in 2005 in comparison with 2001. For 9 months of 2006 the total payments volume in system and their average day turnovers increased comparing with the same period of 2005 for 80.1 and 71.6 % accordingly.

The sum of users' equity, transferred in the beginning of system operation day for realizing the payments and money transfers (users' equities) has also grown. If in 2005 comparing with 2001 their growth was 3.2 times, than in January - September 2006 users' equities increased in 2.6 times.

Thus since 2006 in IMTS has been the tendency of high users' equities comparing with their total turnovers in system that contribute to increase in part of the users' payment by equities. So, during 9 months of 2006 the sum of users' equities in their total volume of payments was 93.9 %, i.e. only 6.1 % of users' payments were realized by incoming cash flows from other users while the remainder (93.9 %) was realized by equities. Over a period of 2002 to 2005 users' equities in total volume of payments also remained significant and their part was about 76 % on average.

The share of users' payments realized by their equities positively characterizes the development of system because of low probability of system risk in IMTS.

The favorable situation with liquidity in IMTS is also approved by the fact of unexecuted payments reduction because of lack of liquidity.

So, the number of unexecuted payments in IMTS reduced in 2005 comparing with 2002: from 215 to 20 units (for information, in 2005 the total number of refined payments in system was 7.9 million transactions). The volume of unexecuted payments in system during this period reduced from 3907.1 to 329.8 million tenge or in 11.8 times while the total volume of payments increased in 3.4 times.

The number of days in year with during which the unexecuted payments because of lack of liquidity also reduced from 35 to 4 days³⁰

²⁹ System risk is a financial risk during which non-fulfillment of one or few users liability because of the lack of liquidity leads to becoming non-fulfillment of other users liability.

Technical risk is a risk related to the probability of failure and mistakes of hardware and software components and telecommunications resources.

Concerning the dependence of system operating on its big users which is also the factor determining the probability of system risk appearance in case of big users liquidity problems appearance than the situations looks like the following (Table 4.1.1.3).

By the results of 9 months of 2006 the share of 5 (five) first-rate banks - system users from the total amount and volumes of payments in IMTS was 32 % and 32.3 % accordingly. At the same time since 2002 during all the analyzed period the part of five big users has been changing insignificantly and was about 30 % of total amount and volumes of payments. This ratio is not insignificant and not bringing additional risks to the system with high system dependence on its big users' operation.

At the same time risk management methods used today let system users attract subsidiary liquidity to the system in cases of their shortage for realizing the payments and money transfers.

Generally today in IMTS observes favorable situation with liquidity volumes adequacy for its regular functioning. At the same time there is almost no probability of system risk appearance because of lack of liquidity. And it is so by taking into consideration high system turnover (generally 7-8 transactions in 1 second) and current users owned funds part in the aggregate payments volume (more than 90 %) it may be noticed that

Interbank clearing (then - clearing) (Tables 4.1.1.2 and 4.1.1.3)

In clearing the payments are realized at the net basis. The main line of clearing is to conduct a great amount of retail payments on driblets.

The probability of system risk appearance in clearing appears in the case of money shortage at the users' accounts in IMTS for calculation of their net debit position sum in clearing.

The total volume of payments in clearing and their average day indicators have also had a tendency of systematic growth. So, in 2005 comparing with 2001 total volume of payments in system and their average day volumes increased in 2.6 times accordingly. By the results of 9 months of 2006 the volume of payments growth in system was 35.2 % and their average day indexes increased on 26.8 %.

In payment systems there were augmentation of average sum of net debit position of users in clearing in terms of volume of payments increase. In 2005 comparing with 2001 the average sum of net debit position increased 79.7 % up to 1.24 billion tenge. In January - September 2006 comparing with the same period of 2005 the average sum of net position increased to 31.7 % and was 1.6 million tenge.

Because of significant excess of liquidity volume in IMTS over the clearing (more than 45 times) the part of users clean position sum in clearing towards the sum of users' average day turnover in IMTS³¹ is insignificant. At the same time in the terms of more high annual payments volume in IMTS increase rates a constant reduce of corresponding part is observed.

So, if in 2001 this ratio was 1.8 % then by the results of 9 months of 2006 it was 0.5 %. Insignificant part of this ratio positively characterizes system operating and shows practically zero risk of system risk appearance because of potential money lack of users in IMTS for calculating their net debit position in clearing.

This circumstance confirmed by reduction facts of cancelled paying documents in clearing because of lack of liquidity. In 2005 comparing with 2001 the amount and the sum of cancelled paying documents reduced on 74.7% and 70.5 % accordingly to 141 units and 44.9 million tenge. The amount of days in a year with facts of cancelled payments documents was reduced from 32 days to 4 days. 21 July 2006 there was only one fact of cancelled payments in the system because of lack of liquidity, most of which belong to "Kazpost" JSC - 156 payments to the sum of 83.9 million tenge. Later all of these payments were calculated over IMTS.

³⁰ Substantial increase of the number of unexecuted payments till 2160 units in 2004 was triggered by single factors of unexecuted payments by Treasury Committee of Ministry of finance RK (11 and 30 of June) – on 2133 units and to the amount of 4539 million tenge.

³¹ The average amount of the net debit position of users is correlated to the annual average amount of users turnover in IMTS as the calculation of the net positions of clearing users is carried out at the expense of available funds of IMTS users

During January - September 2006 the amount of payments part of 5 (five) largest clearing users in the total volume of payments in system was 34.6 % by the amount and 41.4 % by volume of payments (Table 4.1.1.3). During 2001-2005 the part of heavy users by payments amount was about 30-35 % whereas part of users by the volume of payments was about 40 %. This ratio is insignificant and doesn't bring additional risks to the system such as in IMTS.

One of the clearing features is that in system all payments are calculated by money in IMTS. Because of this in the terms of significant liquidity volume in IMTS excess comparing with clearing the probability of system risk appearance in clearing is insignificant. Active risk management methods fully satisfy system demand and provide its uninterrupted and effective work.

4.1.2. Technical risk analysis

The probability of appearance of technical risk in payment systems occurs in case of failure in operating of the payments systems hardware and telecommunication facilities.

For the purpose of technical risk minimization in payment systems of Kazakhstan the main center of the Kazakhstan payment systems is supported by the stable Reserve center situated in remote locality. Moreover, for the purpose of timely and effective solving of technical problems in operating of the payment systems servers the Kazakhstan Interbank Payments Center RSE (hereinafter - KIPC) has entered into a contract with an outside organization providing technical maintenance of equipment and its round-the-clock monitoring.

In the area of payment systems there are the international standards called the Key Principles for the System-Significant Payment Systems developed by the Committee on Payment and Settlement Systems of the Bank for International Settlements which assess the level of payment systems development relating the provision of safe and effective interbank payments conducting within the country.

The results of the Kazakhstan payment systems assessment on conformity to these Key Principles show that all measures and terms required to predict the technical risk occurrence have already been foreseen (Box 4).

Table 4.1.1.1

Indicators of liquidity in IMTS

	2001	2002	2003	2004	2005	9 months of 06
Users turnover in the system, billion Tenge	9 708.6	14 786.2	21 595.2	29 101.2	50 257.6	64 660.3
<i>Increment for the period, in %</i>		52.3%	46.1%	34.8%	72.7%	80.1%
Average daily users turnover, billion Tenge	38.5	58.7	86.0	115.5	201.0	345.8
<i>Increment for the period, in %</i>		51.3%	45.8%	33.7%	74.8%	71.6%
Users' owned funds (remain on average per a day) , billion Tenge	44.9	49.0	67.0	83.4	143.0	324.2
<i>Increment for the period, in %</i>		8.9%	36.7%	23.9%	72.3%	126.6%
<i>Share of remain amount to the system turnover, on average per a day, in %</i>	115.4%	83.1%	77.9%	72.2%	71.1%	93.9%
Average amount of 1 (one) payment in the system, million Tenge	2.6	4.6	5.9	4.7	6.3	10.6
Outstanding payments on liquidity shortage, including						
Quantity, units	no data available	215	123	2 160	20	8
Amount, million Tenge	no data available	3 907.1	7 364.5	4 645.9	329.8	1 183.5
Number of days in a year during which the facts of outstanding payments were observed	no data available	35	15	13	4	5

Table 4.1.1.2

Indicators of liquidity in clearing

	2001	2002	2003	2004	2005	9 months 06
Users turnover in the system, billion Tenge	564.0	675.9	816.7	942.8	1448.1	1374.0
<i>Increment for the period, in %</i>	н/д	19.9%	20.9%	15.4%	53.6%	35.2%
Average daily users turnover, billion Tenge	2.2	2.7	3.3	3.7	5.8	7.3
<i>Increment for the period, in %</i>		19.8%	21.8%	14.5%	54.8%	26.8%
Average amount of the users' net position (AUNP), billion Tenge	0.69	0.77	0.91	0.98	1.24	1.64
<i>Increment for the period, in %</i>	н/д	11.6%	18.2%	7.7%	26.5%	32.3%
<i>AUNP share to the amount of average daily turnover in IMTS, in %</i>	1.8%	1.3%	1.1%	0.8%	0.6%	0.5%
Cancelled payments in the system, including						
Quantity, units	558	392	515	164	141	156
Amount, million Tenge	152.2	57.9	107.4	27.8	44.9	83.9
Number of days in a year during which the facts of payment cancellation were observed	32	16	10	5	4	1

Table 4.1.1.3

Payments share of five large users⁶³ in the aggregate volume and amount of payment in IMTS and clearing

	2001	2002	2003	2004	2005	9 months 06
Interbank Money Transfer System, including						
Quantity, in %	40.6%	33.3%	28.2%	28.6%	31.7%	32.0%
Amount, in %	33.3%	32.5%	29.7%	31.3%	29.0%	32.3%
Interbank Clearing, including						
Quantity, in %	33.2%	30.8%	27.5%	33.8%	30.1%	34.6%
Amount, in %	42.4%	38.9%	38.8%	40.8%	38.6%	41.4%

Source: NBRK

⁶³ Five large banks – users of IMTS and clearing whose share was the biggest in the year according to payments volume.

Detailed assessment of observance by the Kazakhstan payment systems of Key Principles of the Paying and Accounting Committee of the International Payment Bank (hereinafter - KP)

<i>KP I - The system shall have strong legal basis in all corresponding jurisdictions</i>	
DESCRIPTION	Payment systems are based on a strong legal basis represented by the Laws of the Republic of Kazakhstan "On the National Bank of the Republic of Kazakhstan", "On banks and bank activity in the Republic of Kazakhstan" and "On payments and money transfers". Besides there are special rules precisely determining the order of payment systems organization and operating, responsibility and functions of the National Bank, RSE KCIA system operators and system users: the Rules of Money Transfer to IMTS and the Rules of transactions conducting in KCIA clearing system
<i>KP II - The rules and procedures of the system shall let the participants have clear conception of the system's influence on each type of financial risk, which they assume due to participation in the system.</i>	
DESCRIPTION	The rules and procedures regulating the systems operating precisely determine the responsibility of all participants of the systems and financial risks they incur due to participation in the system. The rules and procedures also exactly determine the financial risks management methods including the sources of additional liquidity attraction and the methods of payments in queue management.
<i>KP III - There should be exactly determined procedures of credit risk and liquidity risk management in the system, they should describe corresponding responsibilities of the system operator and its participants as well as appropriate stimuli for this type of risk management and their restriction.</i>	
<i>Description</i>	The National Bank performs the monitoring of credit risk and liquidity risk on a real-time basis. In case of liquidity shortage there is an opportunity to obtain credit from the National Bank within the limits established or on security of the government securities. At that the liquidity available for the system is currently sufficient that is approved by rare facts of default in payments in the systems. There are also additional sources of liquidity replenishment: money transfer from correspondent account to the National Bank (liquidity bridge) and interbank money markets. Methods of delayed payments in queue management are used: message priority change and message from queue cancellation which help to solve the problems with payments queue without additional liquidity attraction. In clearing risk management method - queue promotion - is additionally used.
<i>KP IV - The system shall provide operational final settlement at the value date; preferably such settlement shall be performed during the day or at the end of the day.</i>	
<i>Description</i>	<u>The Interbank Money Transfer System</u> provides settlement on a real time basis. <u>Clearing</u> makes payments once per day at the end of banking day after calculation of the net positions of the system participants.
<i>KP V - The system, in which multilateral nettings are conducted, shall be able, as minimum, to provide timely day payments completion in case of one participant with the highest individual value of the final payment obligation is unable to provide its settlement.</i>	
<i>Description</i>	In <u>the Interbank Money Transfer System</u> multilateral nettings are not used. In <u>clearing</u> all settlements are carried out at the expense of money on accounts opened in the Interbank Money Transfer System. The liquidity volume that is available in the Interbank Money Transfer System is sufficient to provide all settlements on payments in clearing (in average, the funds volume in the Interbank Money Transfer System exceeds the clearing liquidity more than 45 times. Therefore, in case if a large-scale clearing user has any problems with liquidity the existing liquidity of other users of the Interbank Money Transfer System would be sufficient to complete clearing settlements at the end of the banking day.
<i>KP VI - The assets used for settlement should be the requirements to the central bank; in the case of other assets use they shall have small or zero credit risk and small or zero liquidity risk.</i>	
<i>Description</i>	Settlement in payment systems is carried out at the expense of money on the Interbank Money Transfer System account opened in the National Bank. Therefore, the assets participating in settlements in payment systems are the requirements to the National Bank and accordingly bear zero credit risk.
<i>KP VII - The system shall provide the high level of security and operational reliability and also shall have the mechanisms that allow to complete the day handling of payments in time in case of emergency.</i>	
	In accordance with the contract entered into between KCIA and the company providing technical maintenance of equipment the round-the-clock monitoring of equipment and payment systems databases state is realized during 7 days a week. In emergency case and main payment system center operating break the Reserve payment system center begins to operate. This center fully duplicates the functions of main center until technical problems of main payment systems center are resolved. In the case of power distribution break the uninterruptible power source is turned on; it will operate until total repair of main power source.

KP VIII - The system must serve as mechanism of payments conducting which is suitable for users and effective for economics	
	Payment systems are fully automatized electronic system providing its participators safe and in-time payment messages exchange during operational day. Payment systems are effective systems because the execute their destination: <u>IMTS</u> - in conducting the most big and prior payments in the country in real-time mode and <u>clearing</u> in conducting the big amount of non-urgent payments to small sums.
KP IX – The system must have objective and published criteria for participating which provide fair and public access to the system	
	The IMTS and clearing users may be financial institutions possessing correspondent account in National Bank. Criteria of entering and leaving the participators are determined in the rules and procedural regulations and all system participators can easily get acquainted with them. The main information about the system and the copy of its operating rules are published in public form at National Bank and KCIA web-sites.
KP X - System management mechanisms must be effective and provide control and transparency	
	The rights and responsibilities of system participators are exactly formulated and summarized in different rules and procedural regulations. Payment systems are effective system because they provide the probability of electronic communication with all second-level banks via safe and reliable paying network meeting the users requirements. Important decisions are taken after consulting with all interested parties. Each system participator is fully informed about his role and responsibility. The operator of payment systems is KCIA whose single founder and stockholder is National Bank.

4.2. Financial system regulation

The amendments to standards and minimum reserve requirements system

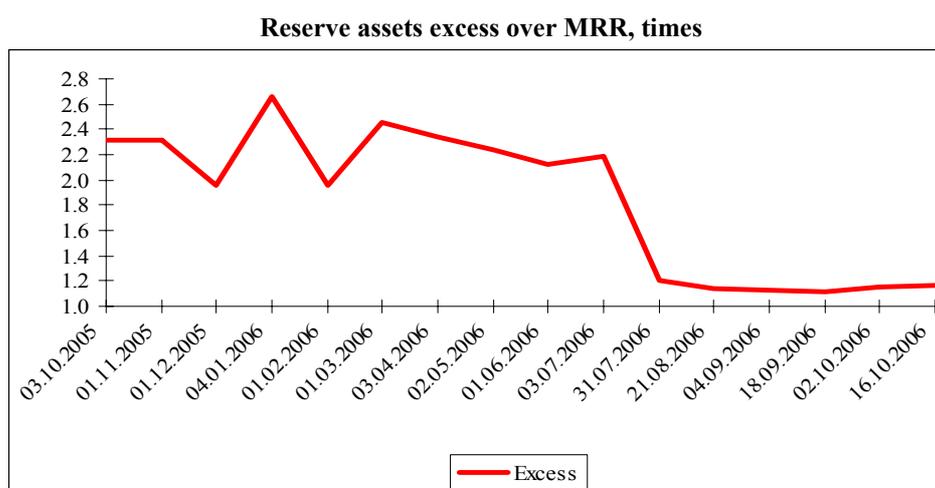
In order to reduce the banking sector liquidity, banks' crediting activity and, consequently, inflationary pressure the National Bank has toughened minimum reserve requirements (hereinafter - MRR) since 12 July 2006.

Main amendments to minimum reserve requirements concerned liability base widening, reserve assets, mechanism of MRR requirements execution and reporting order.

The standards were established at the level of 6 % for internal liabilities and 8 % for other liabilities in accordance with National Bank amendments.

The liquidity of the banking system decreased by the middle of October of the current year compared to July. At the same time MRR sum increased 4.5 times, which ends up in normal operation of the banking sector, having the acceptable level of liquidity.

Figure 4.2.1



Source: NBRK

The need of obligatory reserves increase will influence the cash level in banks that in part can lead to sufficient fall in profitability. This, in turn, resulted in adequate response from banks. They solved this problem by toughening loan terms and conditions for their clients. So, average weighted fee rate for credits in national currency increased from 15.3 % to 15.9 % in August 2006

compared to July 2006 (when new MRR came into effect) and from 14.2 % to 15.9 % compared to December 2005.

The main amendments in regulations concerning containment and minimization of risks in second-tier banks activity

To provide effective and efficient consolidated supervision of financial groups particularly possibilities of centralized operative control of all financial institutes, taking coordinated decisions for crisis situations prevention, complex investors rights protection 1 January 2004 the Agency of the Republic of Kazakhstan of Regulation and Supervision of Financial Market and Financial Organizations (hereinafter - Agency).

The International financial institutions provide good assessment to the level of financial sector regulation. The joint mission of the International Currency Fund and the World Bank over the Programs of financial sector assessment and struggle with money-laundering and counteraction to financial terrorism realized in 2004 significant progress in regulation and supervision not only of banking sector but financial sector in general comparing with mission assessment in 2000 is noticed.

At the same time by the Directive of Agency Executive Committee #397 of 27 December 2004. The scheme of operative actions during system risks on financial markets increase (hereinafter - Scheme) was accepted.

The Scheme is oriented on crisis phenomenon revelation and system risks regulation and foresees stability indexes of each financial market sectors (banking, insurance, and pension and stocks market) and also the complex of operative (emergency) measures which may be taken by regulation and supervision agency when system risks increase.

According to the Scheme financial system's constant diagnostics, monitoring and assessment of financial organizations financial and economical state within supervision are conducted. When problem situation is revealed its character and risk degree of system crisis appearance are determined. The ways to solve the problem using sanitary actions with private sector or state participating are overviewed.

There are certain problems in different financial market segments which can negatively influence on financial system stability and it is necessary to take additional regulation and supervision measures to remove them. Because of this one of the main measures of further financial system stability improvement was the perfection of requirements to risk management systems in financial organizations which foresee the division into basically and additional of requirements criteria for presence in the banks of risk management systems and internal control. The conformity to the basically requirements criteria the banks must provide by 1 January 2006, to the additional criteria - by 1 January 2007.

Providing Kazakhstan financial system stability is also realized by perfection of consolidated supervision as the main purpose of consolidated supervision is banking conglomerate risks analysis, i.e. financial state assessment not only of the bank itself but also with considering financial state of banking conglomerate participators and their affiliated persons.

In 2005 changes to series of legislative acts were made concerning:

- 1) protection of depositors rights, banks activity transparency increase, banks non-specialized activity control;
- 2) financial organizations licensing system optimization in the part of branches and representative offices creating procedures and also financial organization without system risk supervision liberalization;
- 3) access of foreign financial institutes to Kazakhstan financial market.

Implementation of the Law «On Consolidated Supervision» will provide:
perfection of financial organizations consolidated supervision to provide Kazakhstan financial system stability;

applying to banking conglomerates the measures of prudential regulation overseeing organizations in banking conglomerate and its affiliated persons financial state assessment;

getting more full information about financial organizations affiliated persons and probability of taking correcting measures to remove significant risks of financial organizations and financial groups;

strengthening responsibility of organizations and their affiliated persons included into banking conglomerate for revelation the information about their activity, financial state, organizational structure and property structure, general group policy of risk management and internal control mechanism and also for revelation the information about persons controlling the group.

Banks activation at external markets strengthened banking sector susceptibility to country risk. That's why in 2005 changes and add-ins to prudential standards for second-level banks foreseeing owned capital adequacy calculating method including country risk were made.

To save temporary competitive advantages of Kazakh banks concerning foreign markets particularly CIS countries and Russia in November 2005 limits of credits granted by head bank to its daughter non-resident banks were rather reduced, i.e. risk level reduced from 150 % to 100 % by assets placed in daughter non-resident of RK banks. It is caused by presence of supervision for daughter banks activity from the direction of regulation agencies and also higher daughter banks awareness of corresponding markets state and risks.

To protect banking activity from other than financial risks susceptibility additional limits of banks investment activity are foreseen. Full list of permitted bank participating in legal entities types is established; this requirement applies to organizations in banking conglomerate composition. Limits of bank risks consequent to participating in financial and non-financial organizations authorized capital stock are established.

Also to stimulate stocks market and to diversify the second-tier banks investment portfolio is extended the list of permitted for them operations (deals) with financial instruments particularly with foreign eminent bonds possessing minimal required rating, with shares of stocks investment funds of certain investment - residents of the Republic of Kazakhstan and derivative stocks the list and acquisition order of which is determined by the Agency.

To manage the process of banks external borrowing increase and currency risks decrease within prudential regulation limits of currency position established for second-level banks are reduced, prudential standards of currency liquidity limits are established to provide the monitoring of conformity by assets and banks liabilities maturity date by each foreign currency the liability volume of which must be not less than 1 % of bank liabilities volume.

Further, the practice of attracting the loans with short repayment term by the banks for following long-term projects financing may negatively influence on banking sector liquidity. That's why the maximum limit of short-term liabilities (with start repayment term up to one year inclusive, and also urgent liabilities to the Republic of Kazakhstan non-residents with absolute creditor's right for demand of prescheduled liabilities repayment excluding urgent and conditional deposits of individuals and legal entities (excluding banks)) of the Republic of Kazakhstan non-residents at the rate of bank owned capital which must be observed by banks from 1 July 2006 was established.

Because of the second-tier banks' credit risks increase with respect to the real estate operations the requirements of capital adequacy are strengthened concerning mortgages including those which provide:

- applying 50 % risk to mortgage loans granted to individuals which collateral is not more than 7000 month calculation indexes;

- applying 75 % risk to mortgage loans granted to individuals which collateral is more than 7000 month calculation indexes.

Besides, there is a maximum risk calculation on one borrower for participators of real estate building including customers, share holders and guarantors of share holders as "one borrower" and also unified definition of mortgage loan and its minimum requirements in accordance with international practice are applied.

To increase adequate to market and operational risks the second-tier banks capitalization the method of calculating prudential standards for the second-tier banks has been modified and the following changes and add-ins were made:

A) approach to market risk assessment on basis of bank supervision international practice recommended by bank supervision Basel committee (Amendment to the capital accord to incorporate market risks (January 1996, updated to April 1998) and also in accordance with the European Union Directives;

B) including capitalization requirements to capital adequacy calculation by operational risk according to the new Basel capital agreement (Basel II - International Convergence of Capital Measurement and Capital Standards: A Revised Framework, June 2004);

C) including term less financial instruments meeting the certain requirements in accordance to Basel capital agreement to banks owned capital calculation (news release of Basel committee of 27 October 1998 «Instruments eligible for inclusion in Tier 1 capital»).

At the same time based on inadmissibility of legal entities with instable financial condition and doubtful business reputation capital penetration to Kazakhstan banking sector including the Republic of Kazakhstan non-residents capital the system of capital permit to native banking services market was improved.

Because of banks informational transparency special role Memorandum about partnership and interaction at the problems of activity transparency increase is signed up with 16 banks.

Introduction of banking secrecy institute, deposits insurance system favored the increase of population trust to banking system. To perfect the mechanism of deposit payments depositors of bank forcibly to be dissolved since 1 January 2007 the aggregate guaranteed compensation over assured deposit is increased up to seven hundred thousand Tenge.

Main changes in regulatory procedure directed to control and minimization of risks in the activity of insurance companies

The insurance activities regulation in Kazakhstan is based on principles and standards of the International Association of Insurance Supervisions (IAIS).

During 2005 the Agency took some steps on insurance legislation harmonization with the European Union Directives and IAIS principles.

The classification of insurance risks was in accordance with the international practice. The new classification makes it possible to apply the instruments of regulation and supervision in more flexible manner taking into consideration special features of specific insurance classes and to distinguish more clearly the spheres of insurance companies' activity in the life insurance branch and general insurance branch.

New requirements for formation and operation of insurance brokers and insurance agents have been introduced and some restriction related to non-residents of the Republic of Kazakhstan have been cancelled including the limit on participation in insurance (reinsurance) organization establishment, prohibition on insurance (reinsurance) organization setting up by non-insurance person and others.

The Insurance Compensation Guarantee Fund operates in Kazakhstan; when the insurance event occurs this Fund will make guarantee payments to persons entered into the insurance contract with an insurance company which is subject to liquidation afterwards.

The Kazakhstan Mortgage Credits Guarantee Fund is an important financial institution. The main goal of its establishment is the further development of the mortgage lending system in the country by means of reduction of creditors' financial risks at the expense of their insurance in case of non-performance of liabilities under the mortgage agreement by the borrower, prolongation of

terms under mortgage credits, reduction in interest rates on such credits, increase in the amount of credits and reduction of the initial installment amount in mortgage credits.

Creation of database on insurance events and insurance compensation is one of the most important tasks at this stage. This database will let maintain a full insurance statistics and will also let insurance companies carry out an adequate pricing policy. At present the project on legal environment formation is carried out for such database creation and operation.

Main changes in regulatory procedure directed to control and minimization of risks in the activity of non-bank institutions

Financial services market in Kazakhstan is characterized by the high level of competition at the city level exclusively. In countryside along with credit society and micro credit organizations the National post operator is one of the participants of the financial services market, which doesn't carry out credit transactions.

Such a situation along with the existence of some objective factors (lack of sources of financing including foreign, intension of population to work with banks, etc.) is partly may be explained by the existence of a rather strict system of non-bank institutions regulation.

The existence of such system of non-bank institutions regulation was justified during the period of the Republic of Kazakhstan banking system formation. Actually the legislation regulated the activity of non-bank institutions at all stages of the activity.

According to the international practice the majority of countries direct their main efforts to the depositary institutions supervision.

In this respect the Conception of the further regulation of non-bank institutions based on principles of practicality and rationality was proposed in 2005.

Since 2006 the terms of license obtaining by non-bank institutions have been changed, the list of bank and other transactions has been optimized with account of economic expediency of their licensing, liberalization of procedures and/or cancellation of non-bank institutions licensing have been performed.

Legislative acts regulating the activity of lombards, credit societies and institutions carrying out individual types of bank transactions provide the probability for such organizations to carry out specific transactions without licensing. The list of bank transactions subjected to licensing has been substantially reduced.

Taking into consideration the significant growth of mortgage lending, the existence of sizable risks related to the procedure of mortgage lending, the state funds involved in carrying-out of the Conception of long-term financing of building construction and mortgage lending development in the Republic of Kazakhstan, the mortgage institutions licensing and regulation have been preserved.

The definition of "mortgage institution", its status and permissible types of activity as well as the prudential supervision of such activity were determined at the legislative level. Besides, the regulatory requirements for the minimum dimension of authorized capital and equity capital, equity capital adequacy, magnitude of the credit risk per borrower, liquidity and amount of investments to the capital assets and other non-financial assets as well as limits of the open foreign exchange position were determined.

Introduction of prudential standards for mortgage institutions will make the strengthening of reliability and stability of the financial system possible. Moreover, it will stimulate the spreading of the more reliable practice for risk management in the system of mortgage lending, in particular, the risks related to insolvency of a borrower, potential collapse of prices for real estate, change in market interest rate and liquidity of credit institutions.

The prudential supervision related to the National post operator has also been retained as it is the only non-bank institution which has the right to attract deposits of individuals on the basis of the Law of the Republic of Kazakhstan "On Post".

Besides aforesaid the requirements on minimum dimension of authorized capital and financial reporting have been set for licensable non-bank institutions.

Liberalization of financial institutions regulation will let increase the scope of lending of people at large (especially rural sector), attract more small enterprises to this sector, withdraw money from the shadow turnover, increase the level of competition level at the credit market.

These actions also correspond to the international rules of regulation of the non-bank market of financial services according to which the institutions performing deposit transactions are only subjected to supervision. The state supervision resources shall be directed to regulation of the financial institutions with the high level of capital concentration and systemic financial risks.