

Special Topics

From Stormy Expansion to Riding out the Storm: Banking Development in Kazakhstan

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Pushed by expanding income (on the back of rising oil prices) and by rapid external debt accumulation, the Kazakh banking sector featured one of the most dynamic credit booms in CESEE until 2007. Following the U.S. subprime crisis, banks' access to external funding plummeted and credit expansion ground to zero. The global financial and economic crisis that broke out in late 2008 forced credit institutions to drive down their external debt. Moreover, the collapse of the oil price in late 2008 and the devaluation of the Kazakh tenge in February 2009 cut domestic demand, liquidity and solvency. The share of nonperforming loans (NPLs) skyrocketed from 7% at end-2008 to 38% a year later. Large losses stemming from real estate exposure (burst of the housing bubble), lending to dubious partners and fraud played a role. Loan loss provisions were sharply ramped up, profitability was all but wiped out in 2008 and hefty losses incurred in 2009 (ROA at end-2009: -24%). Sector capital even turned negative. The authorities' crisis response measures included the nationalization of two of the country's largest banks and the recapitalization of two others (together accounting for two-thirds of banking sector assets). The two nationalized banks then defaulted on their high foreign liabilities and initiated debt restructuring negotiations that are currently in the process of completion, promising steep haircuts for creditors, which should reduce the sector's debt burden and positively impact its capital. Very high credit risk and a weak institutional environment weigh on investor sentiment. But there are also important shock-absorbing factors: the (oil price-driven) recovery of the real economy, depositor confidence, record-level official foreign currency reserves, the record-level oil stabilization fund and modest public debt.

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1 Macroeconomic Background²

Following buoyant economic expansion (by over 10% p.a.) in the period from 2000 to 2007, annual GDP increases decelerated to 3.3% in 2008 and further to 1.2% in 2009. The impressively strong growth until 2007 benefited from economic recovery after a particularly deep transition depression in the 1990s, substantial energy price rises and related terms-of-trade improvements and large inflows of capital – FDI as well as debt-creating inflows. At the same time, the deterioration of the current account balance despite high oil prices signaled economic overheating. Gross external debt swelled to levels of above 90% of GDP in 2006 and 2007,

with banks' external debt growing fastest (table 1). In the period of high oil prices, gross official reserves also increased and the authorities accumulated substantial financial resources in the National Fund of the Republic of Kazakhstan (NFRK), the country's oil stabilization fund.

Kazakhstan's dependence on external financing made itself painfully felt in the second half of 2007, when the U.S. subprime crisis drastically reduced commercial banks' access to external funding. This caused a credit crunch and substantially cut back economic growth. The freezing of global financial markets and the dramatic worsening of the economic crisis in the

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² For additional information, see section 2 in Barisitz (2009).

Table 1

Selected Macroeconomic Indicators

	2005	2006	2007	2008	2009
Real GDP growth (annual change, %)	9.7	10.7	8.9	3.3	1.2
Inflation (end-of period, CPI, annual change, %)	7.5	8.4	18.8	9.5	6.2
Budget balance (general government, % of GDP)	5.8	7.5	-1.7	-2.1	-3.1
Current account balance (% of GDP)	-1.9	-2.5	-7.8	4.8	-3.2
Net FDI inflows (% of GDP)	3.7	8.3	7.5	11.2	8.9
Total gross external debt (% of GDP)	76.5	91.9	91.0	81.7	104.4
Thereof: banking sector gross external debt (% of GDP)	27.0	41.4	43.2	29.7	28.1
Gross international reserves (% of GDP)	12.5	23.7	16.5	15.1	21.7
NFRK ¹ assets (% of GDP)	14.2	17.5	19.7	20.8	22.8

Source: National Bank of Kazakhstan, Thomson Reuters, OeNB calculations, wii w.

¹ National Fund of the Republic of Kazakhstan (oil stabilization fund).

wake of the default of Lehman Brothers in September 2008 further tightened access to foreign finance and contributed to the reversal and sharp decline of oil and raw material prices, thus wiping out previous terms-of-trade gains. The Kazakh economy entered a bout of stagnation.

To cope with the renewed – and more serious – destabilization, the state took over and bailed out some of the country's largest credit institutions. The authorities' entire anti-crisis package³ provides for the allocation of about EUR 10 billion (about 12% of GDP) over 2009 and 2010 to support the banking sector, residential construction, SMEs, agriculture and infrastructure development. Worsening external balances, the strong depreciation of the Russian ruble in late 2008 and early 2009 and mounting losses of currency reserves in defending the Kazakh tenge exchange rate against the U.S. dollar eventually prompted the National Bank of the Republic of Kazakhstan (NBK) to devalue the Kazakh tenge by 20% in one stroke in early February 2009.

Whereas the country's already high external debt remained at around EUR 77 billion to EUR 78 billion during the year 2009, its ratio to GDP sharply increased – to over 100% – largely as a result of the devaluation of the national currency.⁴ Recovery of oil prices and of world economic activity in the second half of 2009 reinvigorated the Kazakh real economy. Meanwhile, as appreciation pressures increased amidst rising commodity prices, the central bank repeatedly intervened on the foreign exchange market to prevent the Kazakh tenge from strengthening too fast. At the same time, foreign currency reserves were replenished (table 1).

2 Banking Developments and Reforms

2.1 Accelerating Credit Boom (up to mid-2007)

Up to 2007, Kazakhstan had witnessed one of the most rapid credit booms of transition history. In 2005 and 2006, annual growth rates of bank loans exceeded 60% in real terms (table 2). The

³ "Joint Action Plan of the Government, National Bank and Financial Supervision Agency for Stabilization of the Economy and Financial Sector for 2009–2010", adopted in late 2008 and later slightly amended.

⁴ As to the structure of the country's external debt, intercompany loans somewhat increased (from 37% of total external debt in 2008 to 44% in 2009), whereas bank external debt declined (from 36% to 27%).

sector was mostly owned by domestic private businessmen and financial-industrial groups (conglomerates), although foreign – including Austrian – participation increased to 16% of total banking assets by end-2007. Important acquisitions by foreign strategic investors include UniCredit Bank Austria's purchase in June 2007 of a 92% stake in ATF Bank, the fifth-largest Kazakh credit institution, for EUR 1.6 billion, and South Korean Kookmin Bank's purchase in March 2008 of a 30% share (later increased to 42%) in Bank CenterCredit (BCC), the sixth-largest, for EUR 400 million.

The credit boom was fueled by expanding deposits and particularly by swelling foreign debt (leverage-led growth model). Relatively cheap syndicated bank loans and eurobond issues contributed to raising the share of non-residents in banks' liabilities from about a quarter early in the decade to over one-half in 2005 and 2006, which even surpassed the share of deposits. Banks' growing external debt (mostly medium- and long-term) was the major force pushing up the country's total foreign debt and in 2006 accounted for almost half of the latter. Mortgage, car and other consumer loans as well as trade and construction loans grew especially swiftly.⁵ Total consumer loans multiplied to reach more than one-third of the credit portfolio. In partly speculative investments, banks also increased their own holdings of real estate, financial assets and investments outside Kazakhstan. Property prices skyrocketed. The share of foreign currency loans in total domestic loans to the private sector remained high, at 48% at end-2006, while in total do-

mestic loans to households it increased markedly to 67% (table 2).

While largely externally financed banking activity constituted a key driver of economic growth and, in fact, macroeconomic overheating, sizeable financial stability risks accumulated: The sheer speed of credit expansion was liable to bear problems for risk management. The substantial share of foreign currency-denominated lending to often unhedged households and firms gave rise to sizeable indirect credit risk. Connected lending is also estimated to have surged. And the degree of dependence attained on cross-border capital inflows exposed banks to considerable refinancing and rollover risks. Moreover, off-balance sheet items⁶ had grown to over three-quarters of the size of balance sheet assets by end-2006. These problems have to be seen against the backdrop of weak corporate governance and banking supervision (see below).

2.2 Strong Impact of U.S. Subprime Crisis

The U.S. subprime crisis of August 2007 immediately heightened international investors' risk aversion and induced large-scale deleveraging, which implied withdrawals from placements in emerging markets. Market perceptions of risk on Kazakh assets rose sharply in August and September 2007, as direct exposure of some systemically important banks to the U.S. subprime market as well as the high degree of dependence on external funding raised analysts' awareness of the built-up debt burden of the Kazakh banking sector. After banks' access to external funding had plummeted, rating agencies down-

⁵ *The oil sector does not rely on domestic banks for financing.*

⁶ *Off-balance sheet items include contingent claims, contingent liabilities, transactions in foreign currencies and precious metals, and derivatives.*

graded some credit institutions and the sovereign in the fall of 2007. Confidence in the banking sector declined and household deposits contracted by about 5% in September and October 2007. Thereupon, credit institutions effectively stopped providing new

loans,⁷ which reined in growth of the nonoil economy and drastically affected mortgage and consumer finance. Property price development reversed and prices declined substantially. The Kazakh housing bubble burst, residential construction virtually stopped. Over

Table 2

Selected Banking Sector Stability Indicators

	2005	2006	2007	2008	2009
Credit risk					
Bank assets (% of GDP)	59.5	86.9	90.9	74.6	72.7
Private sector loans (% of GDP)	34.1	45.9	56.5	46.8	48.1
Real growth of loans to the private sector (annual change in %)	62.5	66.9	30.2	-6.1	-3.5
Real growth of loans to the private sector (exchange rate-adjusted, annual change in %)	61.1	69.4	32.2	-6.2	-13.0
Loans to households (% of loans to the private sector)	25.8	32.7	35.5	31.3	29.1
Nonperforming loans (% of total loans) ¹	3.3	2.4	2.7	7.1	37.8
Market and exchange rate risk					
Foreign currency loans (% of GDP)	17.6	22.2	24.1	20.7	23.3
Foreign currency loans (% of total private sector loans)	51.5	48.4	42.7	44.2	48.4
Foreign currency loans to households (% of GDP)	4.9	6.7	7.4	5.3	5.5
Foreign currency loans to households (in % of loans to households)	63.3	67.0	66.1	57.1	46.3
Foreign currency deposits (% of GDP)	9.1	10.6	9.7	12.0	17.8
Foreign currency deposits (in % of private sector deposits)	41.9	35.2	32.0	35.4	43.7
Lending rate (% p.a.) ²	13.0	12.2	14.8	16.1	14.3
Deposit rate (% p.a.) ³	9.1	9.8	11.5	11.3	10.0
Liquidity risk					
Private sector deposits (% of GDP)	21.8	30.1	30.3	33.9	40.7
Real growth of private sector deposits (annual change in %)	21.1	71.6	6.4	27.0	12.7
Real growth of private sector deposits (exchange rate-adjusted, annual change in %)	19.9	73.6	7.8	27.0	7.6
Loan-to-deposit ratio (%)	156.8	152.5	186.6	137.9	118.1
Loans-minus-deposits gap (funding gap) (% of banks' total liabilities)	23.0	20.2	32.8	19.7	9.3
Liquid assets (% of total assets)	..	16.1	13.9	4.3	19.3 ⁴
Liquid assets (% of short-term liabilities)	..	..	56.3	16.0	51.5 ⁴
Banks' external debt (% of banks' total liabilities)	50.3	52.8	54.1	45.4	35.6
Share of short-term external debt (% of banks' total external debt)	11.4	12.2	12.4	17.5	17.8
Profitability					
Return on assets (ROA, %)	1.8	1.4	2.2	0.2	-24.1
Return on equity (ROE, %)	18.7	14.6	18.4	1.9	-1190.0
Non-interest expenses to gross income (%)	..	76.26	55.08	59.01	96.1 ⁴
Shock-absorbing factors					
Capital adequacy ratio (total banking sector, %)	14.9	14.8	14.2	14.9	-8.0
Capital adequacy ratio (excluding BTA and Alliance bank, %)	..	..	..	..	16.7
Loan-loss provisions (% of total loans)	5.6	5	5.9	11.1	37.7
Memorandum items					
Foreign participation in the authorized capital of financial organizations (%)	10.5	5.6	15.4	17.9	16.7 ⁴
Banks with foreign participation (% of banks' total assets)	7.3	5.9	15.8	15.8	23.8 ⁴
Majority state-owned banks (% of banks' total assets)	..	..	..	..	23.3 ⁵

Source: National Bank of Kazakhstan, Agency on Regulation and Supervision of Financial Markets and Financial Organizations of the Republic of Kazakhstan (FSA), OeNB calculations.

¹ Broad definition of NPLs: loans overdue past 60 days and other qualified loans (FSA categories 5 and loss).

² Refers to weighted average of interest rates on credits extended to legal entities, excluding banks in tenge by maturity.

³ Refers to weighted average of interest rates on time deposits of individuals, in tenge by maturity.

⁴ September 2009.

⁵ Estimate. Source for figures on assets of Kazakhstan's largest banks: ATON.

⁷ Month-on-month credit growth ground to zero.

the year 2007, the credit-to-deposit ratio rose by over 30 percentage points to 187% – among the highest relative to peer countries (table 2).

In response to the liquidity squeeze, the NBK provided large-scale liquidity support to banks through repo agreements, foreign exchange swaps, early redemption of NBK notes and the reduction of reserve requirements. The government established a EUR 800 million (1.1% of GDP) financing facility in the form of earmarked government deposits with banks – to be on-lent to assist construction companies and support SMEs. The NBK also intervened heavily and successfully in the foreign currency market to support the Kazakh tenge. After declining by about 15% in the fall of 2007, official foreign currency assets (comprising NBK reserves and NFRK funds) recovered again and came to EUR 28.4 billion in mid-2008. The (temporary) stabilization of the situation was supported by high and spiking oil prices until the summer of 2008. Meanwhile, banks' external debt climaxed at EUR 31 billion (43% of GDP) at end-2007, and off-balance sheet items reached 90% of the size of the sector's total assets. Notwithstanding progress in strengthening the prudential framework, including the introduction of consolidated supervision, the Financial Supervision Agency (FSA)⁸ remained attached to formalistic compliance-oriented schemes instead of moving toward forward-looking risk-based supervision.

2.3 Repercussions of the Worsening Global Crisis (since late 2008)

The second wave of the U.S. and world financial crisis aggravated the Kazakh banking sector's difficulties. Global deleveraging intensified and forced credit institutions to drive down their external indebtedness. The collapse of oil and commodity prices and the sharp slowdown of growth struck the banking sector by cutting domestic income, demand, liquidity and solvency. Moreover, the devaluation of the Kazakh tenge in early 2009 added to pressures by sharply adjusting debt-servicing burdens of unhedged borrowers. After annual loan growth had more than halved to 30% in 2007 (in real terms), the credit volume shrank by 6% in 2008 and by another 4% in 2009. However, in exchange rate-adjusted terms, shrinkage accelerated in 2009 (–13%). Mainly due to numerical exchange rate effects, the share of foreign currency loans reverted back to 52% in the first half of 2009, before receding to a still high 48% at the end of the year (table 2).

The share of NPLs (broad definition, i.e. loans overdue 60 days) in total loans more than doubled to 7% in 2008 and from there more than quintupled to a disquieting 38% in 2009 (36% at end-March 2010).⁹ The devaluation of the Kazakh tenge in early 2009 certainly contributed to the deterioration. Large losses stemming from real estate exposures, lending to dubious partners, and outright fraud and embezzlement may also have played a role. It is not clear whether a turnaround is imminent, but it is expected to come in

⁸ Agency of the Republic of Kazakhstan on Regulation and Supervision of the Financial Market and Financial Organizations, established in 2004.

⁹ In a narrow definition (i.e. loans overdue 90 days) more consistent with international country comparisons, nonperforming loans rose from 5% of total loans at end-2008 to 21% a year later, which still gives rise to concern. NPLs (of whatever definition) do not include restructured loans, which may account for an additional 20% of the total volume.

2010. A considerable share of banks' external holdings turned out to be of questionable quality. This goes particularly for Bank Turan Alem (BTA), the country's largest credit institution at end-2008, which had invested about half of its assets in Russia, Ukraine and other CIS countries. Many banks have become risk averse and prefer to keep surplus liquidity on accounts with the NBK.

In reaction to the renewed crisis situation, the authorities' anti-crisis plan (see above) has focused its intervention and the largest amount of its assistance on supporting the banking sector. Kazakhstan's legislation was adjusted to enable the state to buy stakes in the country's largest credit institutions. Up to mid-2009, about half of the amount provided for by the anti-crisis plan was disbursed: The three largest and ailing credit institutions were recapitalized: In February 2009 the state holding company Samruk-Kazyna¹⁰ acquired a dominating equity stake of 75% in BTA, a minority stake of 28% in Halyk Bank (a savings bank and the country's second-largest bank), and a minority stake of 18% in Kazkommertsbank (the third-largest bank) for a total of EUR 1.7 billion. Another EUR 150 million was set aside for a majority stake in Alliance bank (the fourth-largest). These four banks together accounted for about two-thirds of the book value of banking sector assets at end-2008; none of them was foreign owned.

Samruk-Kazyna further placed deposits of EUR 1.3 billion (1.6% of

GDP) in the banking sector. Additionally, EUR 1.5 billion was channeled through the sector to support construction projects, mortgage, SME and farm lending. The lion's share of funding for the anti-crisis plan has come from the NFRK. The NBK, in turn, loosened monetary conditions by repeatedly cutting the refinancing rate and by further easing reserve requirements.¹¹ The deposit insurance fund (KDIF, established 1999) was strengthened: The KDIF's capital base was increased fourfold to KZT 100 billion (about 0.6% of GDP) and the deposit ceiling for retail customers was raised from KZT 700,000 per depositor per bank to KZT 5 million (around EUR 22,500).¹² This may have contributed to staving off possible bank runs.

After having slowed down sharply in 2007, total deposits expanded again by over a quarter in 2008 and by 13% in 2009. This was partly due to inflows from public entities (Samruk-Kazyna), and (in 2009) partly due to valuation effects from the devaluation of the national currency. In exchange rate-adjusted terms, deposit expansion in 2009 came to 8%. The loan-to-deposit ratio descended again to 113% at end-February 2010, a level not seen since 2004.

While NPLs have been rising precipitously over the last year, credit institutions have reacted by ramping up loan-loss provisions (and have thus complied with NBK instructions). At end-2009, provisions came to 38% of

¹⁰ Samruk-Kazyna is a public entity created by the end-2008 merger of the state asset holding company Samruk and the sustainable development fund Kazyna. Samruk-Kazyna employs more than 260,000 persons among 404 subsidiaries and associates spread across key sectors of the economy including energy, mining, telecommunication, transportation, finance and banking. Samruk-Kazyna estimates that total deposits by its entities in the top ten Kazakh banks account for more than one-third of the latter's deposit base (IMF 2009, p. 9). According to IMF estimates, by end-2009, Samruk-Kazyna's balance sheet exceeded EUR 35 billion (46% of GDP).

¹¹ Overall, in the assessment of NBK governor Marchenko, the authorities spent about EUR 13 billion in the period from 2008 to 2009 to shore up the banking sector (Euromoney, 2010, p. 32).

¹² However, KDIF reserves are not sufficient to cover deposits at the largest credit institutions. The KDIF has the right to borrow from the NBK (IMF, 2009, p. 11).

total loans (chart 1).¹³ Banks have also shown flexibility by restructuring part of their loan portfolio with the aim of facilitating customers' debt service. However, as a consequence, profitability was all but wiped out in 2008 and hefty losses were incurred in 2009 (ROA end-2009: -24%, table 2).¹⁴

Sector capital adequacy collapsed in the course of 2009 (end-2009: -8%, chart 1). The sector's total debt surpassed its total assets in the second quarter of 2009. Kazakh banking capital thus turned negative.¹⁵ At the end of the third quarter, the gap between banks' assets and liabilities had widened to 6% of GDP. An evaluation of banking sector stability carried out by the FSA at the end of the third quarter of 2009 confirmed a substantial deterioration of stability compared to the situation at the beginning of the year. This deterioration was largely triggered by the erosion of banks' credit portfolio quality and by the increase of provisions. Thus, the FSA assessed the sector as "unstable" at end-September 2009; at the same time, if BTA's and Alliance's

data were excluded, the sector would still be regarded as "stable, with extremely high risk levels".¹⁶ All in all, the above-mentioned "surprises" and deficiencies related to the two defaulted banks (see Box 1) point to persisting serious weaknesses of corporate governance, risk management, prudential regulation and supervision. Kazakh accounting practices do not yet correspond to IFRS.

Due to the frozen international debt market, public assistance and ongoing debt servicing, Kazakh banks reduced their external liabilities over two years by about one-third to EUR 21 billion, which corresponds to 36% of their total liabilities and 28% of the country's GDP at end-2009.¹⁷ Yet banks' total liabilities remained largely stable at around 80% of GDP. The above-mentioned anti-crisis plan thus contributed to effectively replacing banks' declining foreign debt with domestic (state) debt in order to uphold banking resources, activity and the functioning of parts of the economy.

Box 1

Bank Turan-Alem's and Alliance Bank's Default and Restructuring

Soon after BTA and Alliance Bank were nationalized, it turned out that their financial needs were higher than originally assessed: In mid-2009, the two banks' foreign liabilities were estimated to add up to about EUR 12 billion (comprising more than 40% of the banking sector's total external debt or up to 15% of the country's external debt), of which BTA owed almost three-quarters. In April 2009, both banks defaulted on their foreign obligations, which triggered payments on credit default swap (CDS) contracts written on the two banks. The

¹³ Not including Bank Turan-Alem and Alliance, NPLs at end-2009 came to around 18% of the banking sector's loan portfolio, and provisions reached about the same level.

¹⁴ Notwithstanding this dramatic deterioration, many credit institutions have apparently still been reluctant to recognize their losses (NBK-FSA, 2009, p. 51).

¹⁵ The negative equity values of the two large players Bank Turan-Alem and Alliance Bank pushed overall sector capital below zero (NBK-FSA, 2009, p. 58).

¹⁶ NBK-FSA (2009, p. 59); stability evaluation is carried out by calculating the Aggregate Financial Stability Index (AFSI), as described in the NBK-FSA (2008).

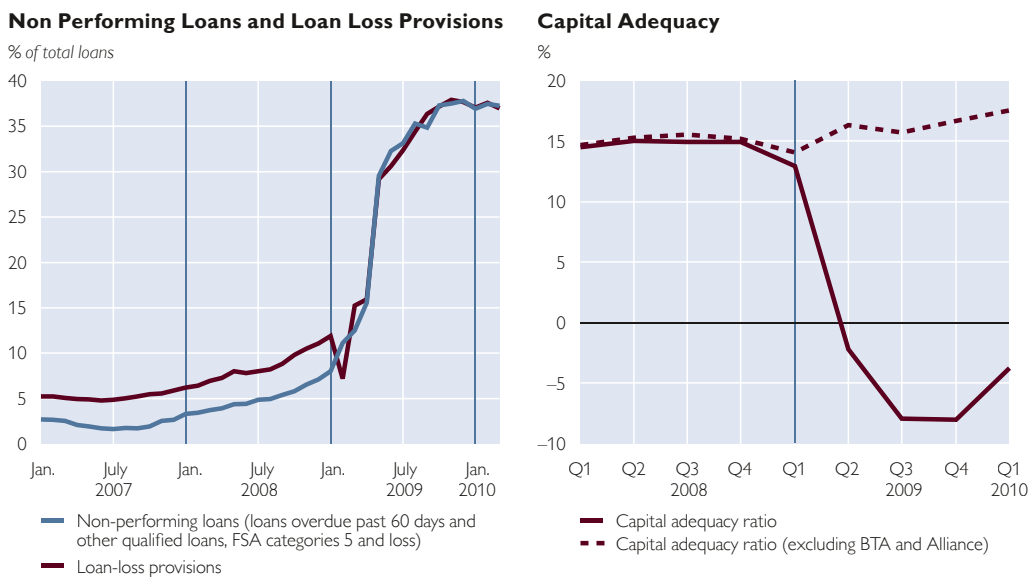
¹⁷ Net external debt of the financial sector was cut much more over this time span: It contracted by three-quarters to EUR 4.9 billion at end-2009 (Standard & Poor's 2010, p. 4). Banks' total external debt reportedly declined further in the first quarter of 2010, to EUR 19 billion. These changes do not yet incorporate any write-offs related to debt restructuring negotiations and/or arrangements with BTA and Alliance.

authorities declared that they do not intend to guarantee the loans of (nationalized) Bank Turan-Alem, Alliance Bank or of any other credit institution. In the summer of 2009, the two insolvent banks signed memoranda of understanding with their foreign creditors in which the latter principally approved to restructure the credit institutions' foreign debt. In November, Temirbank (the eight-largest bank of Kazakhstan), of which BTA – and therefore, the state – is a major shareholder, also declared default on its obligations and launched restructuring negotiations.

In December 2009, BTA as well as Alliance reached preliminary agreements with their creditors in which the latter accepted major haircuts (of 60% and higher). Subsequently, Samruk-Kazyna took over Alliance entirely. Temirbank reportedly reached a preliminary agreement with its creditors at end-March 2010. At around the same time, Alliance is reported to have signed its final agreement, which i.a. provides for the bank's creditors to take a 33% stake in Alliance (besides Samruk-Kazyna's remaining 67% stake) and for the bank's debt to be cut from EUR 3.3 billion to EUR 800 million (i.e. by 76%). BTA's final agreement is expected to be concluded until the summer of 2010. Once the BTA restructuring is wrapped up, Sberbank (of Russia) is widely expected to purchase a majority stake of BTA from Samruk-Kazyna.

Chart 1

Non Performing Loans, Loan Loss Provisions and Capital Adequacy



Source: National Bank of Kazakhstan, Agency on Regulation and Supervision of Financial Markets and Financial Organizations of the Republic of Kazakhstan (FSA).

2.4 Some Signs of Stabilization, Regulatory Reform

While they had dipped in late 2008 and early 2009, combined NFRK funds and NBK reserves subsequently benefited from the brightening external environment and the recovery of commodity prices in the second half of 2009 and expanded to EUR 38.9 billion at end-March 2010 (about 48% of GDP, their

highest-ever combined level). Meanwhile, two new foreign players entered the market in 2009: JSC “Shinkhan Bank” (of South Korea) and Vneshtorgbank (VTB, Russia) opened subsidiaries. Foreign-owned banks' share in total banking sector assets rose to almost one-quarter by end-Sept 2009; foreign-owned banks' share in total deposits also increased. While this partly re-

flects weaknesses of domestically owned banks, it is certainly not a sign of eroding confidence. Credit institutions' overall liquidity situation improved in recent months. Conditions allowing, the state plans to divest its stakes in the banking sector in the coming years.

In a regulatory response to the crisis, the authorities have recently tightened some elements of banking regulation or plan to do so: On October 1, 2009, the FSA raised banks' minimum capital requirements by more than three times to KZT 5.0 billion (approximately EUR 24 million). There are some exceptions for credit institutions that operate outside the two main cities of Almaty and Astana and are not registered there. These banks face minimum capital requirements of KZT 2.0 billion (EUR 10 million). Still, the substantial increase is expected to trigger some mergers and acquisitions in the sector. In early 2010, the FSA decided to curb new domestic foreign currency lending through higher provisioning requirements on loans to borrowers that do not have effective currency hedges (10% from mid-2010, 20% from 2011). The FSA and NBK further aim to limit banks' borrowing in foreign markets to a maximum of 30% of total funding (at end-2009 it stood at 36%), to cap the loan-to-deposit ratio at 150% and to contain the growth of off-balance sheet liabilities potentially through a ban on certain types of transactions (Standard & Poor's 2010, p. 18–19).

3 Conclusion and Assessment of Current Risks

Looking ahead, for the Kazakh banking sector a lot will depend on the further development of the external environment, especially with regard to global demand and the oil price as well as external financing conditions. So far,

signs of recovery of the real economy are not yet accompanied by signals of recovery of banking activity. With an important part of the banking sector still in default, banks are definitely not yet driving the recovery of the national economy; rather, they are preoccupied with overcoming their own serious earnings and capitalization problems. Foreign-owned credit institutions would appear to be in a comparatively good position to fill the gap and contribute to the economic recovery.

3.1 Very High Credit Risk

Very high NPLs reflect pronounced credit risk and are also largely responsible for the continuing credit crunch. This goes particularly for relatively high foreign currency lending – to an important extent to unhedged households. Mounting loan-loss provisions have wiped out profits, generated losses and pushed capital and capital adequacy into negative territory. This happened despite important recapitalization and nationalization measures in the early months of 2009. Obviously, further capitalization and/or restructuring measures appear necessary. Furthermore, despite improvements, Kazakh credit institutions remain exposed to a high share of (domestic and external) foreign currency-denominated debt in total banking debt. However, risks of a further devaluation of the Kazakh tenge are not imminent, as recent appreciation tendencies indicate.

3.2 Risk of Shaking Investor Confidence

The default of two of the largest banks (Bank Turan Alem, Alliance Bank) – after the state had taken over majority stakes in both – already affected investor confidence. Moreover, as a result of restructuring negotiations, foreign creditors are obviously putting up with

sizeable haircuts. Of course, foreign creditors have generally had a lot to cope with in the last two years of global crisis, and the authorities are obviously factoring in investors' usually short memory. In any case, strategic investors' confidence in the Kazakh banking sector has not evaporated, as witnessed by their expanding presence. At the same time, there is an emerging tendency that foreign investors substitute the establishment of subsidiaries (mainly via purchases of existing local banks) for the extension of cross-border loans.

3.3 Uncertainty Triggered by Weak Institutional Environment

Given Kazakhstan's traditional reputation of having the best managed banking sector of the CIS, some observers may not have expected the persistence of institutional shortcomings and flaws with regard to corporate governance, risk management, creditor rights, accounting (including substantial and largely intransparent off-balance sheet items), banking regulation and supervision. Problems with respect to oversight are most visibly reflected by the fact that the above-mentioned two large domestically-owned banks were able to

surprise the authorities – who had even become, or were about to become, their major owners – about their real financial state. Important regulatory and supervisory reforms that have just begun (see section 2.4) will hopefully bring about a qualitative improvement of governance and preclude hazardous faits accomplis of the kind experienced in the spring of 2009.

3.4 Important Shock-Absorbing Factors

Notwithstanding recent upheavals, including the devaluation of the Kazakh tenge, depositors have largely remained confident in the banking sector. Although official foreign exchange assets have been generously used to combat the financial and banking crisis, their combined amount has recently risen to a record level. The state's room for maneuver also stems from its low public debt (about 10% of GDP). Once the restructuring of BTA's and Alliance's external debt has been carried out, the size of the banking sector's foreign liabilities could fall further sharply, which would contribute to restabilizing the sector and may eventually even facilitate banks' re-entry into international debt markets.

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