



KAZAKHSTAN: MICROFINANCE AND FINANCIAL SECTOR DIAGNOSTIC STUDY

FINAL REPORT



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Table of Contents

Acknowledgments	vii
Abbreviations	viii
Executive Summary.....	xi
Introduction.....	1
Private Sector / MSME	11
Demand for Financial Services.....	14
Financial Sector Overview.....	18
Market Structure.....	30
Performance.....	31
Financial Infrastructure.....	33
Legal, Regulatory, and Policy Framework.....	42
Gap Analysis	45
Selected Bibliography.....	50

Boxes

Box 1. The Recent Financial Crisis	5
Box 2. Government Enterprise Definitions.....	11

Tables

Table 1. Age Structure of Population of Kazakhstan, 2008	2
Table 2. Kazakhstan's Main Economic Indicators, 2003–2007	3
Table 3. Exports and Imports, 2002–2007	9
Table 4. Kazakhstan Country Credit Ratings, 2007 and 2008	9
Table 6. Perceptions of Constraints by Firm Size, 2005.....	13
Table 7. Microcredit Demand in Kazakhstan, 2005.....	15
Table 8. Number of Financial Institutions, 2004–2007	19
Table 9. Financial Sector Depth and Outreach, 2005–2007	19
Table 10. Microfinance Institutions in Kazakhstan, 2006.....	24
Table 11. Commercial Bank Microcredit Portfolio, 2005	26
Table 12. Number of active MLOs by Region of Kazakhstan, January 2008	27
Table 13. AMFOK Member Data, 2006–2008.....	29
Table 14. Overview of Microcredit, Year-end 2007	29

Table 15. Market Size, as of Year-end 2007	30
Table 16. Market Maturities of Banks in Kazakhstan, Year-end 2007	31
Table 17. Classification of Nonstandard Loans by Sector, January 2006–October 2007	32

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Abbreviations

ADB	Asian Development Bank
AKF	Asian Credit Fund (an MFI)
AMFOK	Association of Microfinance Organizations of Kazakhstan
BEEPS	Business Environment and Enterprise Performance Survey (EBRD-World Bank)
BMES	Banking Messages Exchange System
BoP	balance of payments
CAMFA	Central Asia Micro Finance Alliance, USAID program
CIS	Commonwealth of Independent States
CPI	<i>Corruption Perception Index</i> , Transparency International
DBK	Development Bank of Kazakhstan
EBRD	European Bank for Reconstruction and Development
EDF	Entrepreneurship Development Fund, Kazakhstan
FDI	foreign direct investment
FMSA	Financial Markets Supervisory Agency, Kazakhstan
GDP	gross domestic product
IE	individual enterprise
IAS	International Accounting Standards
IFRS	International Financial Reporting Standards
IFC	International Finance Corporation
IFI	international financial institution
IFK	Investment Fund of Kazakhstan
IMF	International Monetary Fund
ISA	International Standards on Auditing
ISMT	Interbank System of Money Transfer
JSC	joint stock company
KAS	Kazakhstan Accounting Standards
KASE	Kazakhstan Stock Exchange
KDIF	Kazakhstan Deposit Insurance Fund
KfW	Kreditanstalt für Wiederaufbau
KISC	Kazakhstan Interbank Settlements Centre
KMF	KazMicroFinance (MFI)
KSBP	Kazakhstan Small Business Program
KZT	Kazakh tenge (currency)
ME	microenterprise
MFI	microfinance institution
MIX	Microfinance Information Exchange
MLO	microlending organization
MSME	micro, small, and medium enterprise
NBFI	nonbanking financial institution
NBK	National Bank of Kazakhstan
NBO	nonbanking organization

NGO	nongovernmental organization
NPL	nonperforming loan
OSCE	Organization for Security and Co-operation in Europe
REPO	repurchase agreement
ROA	return on assets
ROE	return on equity
RTGS	Real Time Gross Settlements System, Kazakhstan
SCPP	State Center of Pension Payments, Kazakhstan
S&P	Standard and Poor's
SME	small and medium enterprise
TACIS	Technical Aid to the Commonwealth of Independent States, European Union
UNDP	United Nations Development Programme
USAID	U.S. Agency for International Development
VAT	value-added tax

All dollar amounts in U.S. dollars unless otherwise noted.

Executive Summary

In recent years Kazakhstan has experienced impressive economic growth, fueled almost entirely by rising natural resource prices. Because of its strong economic performance and financial health, Kazakhstan became the first former Soviet republic to repay all of its debt to the International Monetary Fund, paying back \$385 million in 2000. The average real growth rate of gross domestic product (GDP) over the last four years has been 9.48 percent; average loan growth in the banking sector over the last three years has been 70 percent. Most of this growth has been funded by overseas borrowing which, however, slowed as the effects of the global financial crisis reached Kazakhstan, starting in the second half of 2007.

Concerned by rising inflation rates, a weakening of the Kazakh currency (the tenge, or KZT) against the U.S. dollar, tightening liquidity, refinancing problems, and deteriorating asset quality in the banking sector, the National Bank of Kazakhstan introduced measures to support the banking sector, stabilize the exchange rate, and reduce the inflation rate to below 10 percent by 2009. Government growth projections have since reduced GDP growth to 5 percent in 2008 and 6.3 percent in 2009; average annual bank lending growth over the same time period is now foreseen at less than 18 percent.

By the end of 2007, the financial sector was comprised principally of 35 second-tier commercial banks and was managing a total loan portfolio of KZT 7.3 billion (\$60.4 million).¹ At the time, an estimated 70 percent of loans were directly or indirectly connected to real estate.² The subprime crisis resulted in increasing levels of nonperforming loans—averaging above 14 percent by year-end 2007—due to tightening liquidity, a general slowdown in business activity, and declining real estate values.

Several commercial banks are active in the microfinance sector, but at one-half of one percent of their total loan portfolios, microcredit remains meager and is no more than an adjunct to small business lending. Most banks have received international support for downscaling to set up their small business and/or microcredit loan portfolios. The consultant team for this study estimated that, as of year-end 2007, commercial banks in Kazakhstan had lent a total of \$120 million to about 18,500 borrowers. There is still little interest among commercial banks in providing microcredit services because of the small loan sizes, relatively high administration costs, and difficulties in identifying sound microcredit borrowers. A few banks have been providing wholesale loans to microfinance institutions (MFIs). The liquidity problems of the banking sector, however, have begun to restrain overall liquidity and banks' interest in lending to these institutions.

¹ National Bank of Kazakhstan, 2008, "Statistical Bulletin" (January 1), NBK, Almaty, Kazakhstan. The exchange rate between the Kazakh tenge and the U.S. dollar varied markedly from 2003 through first quarter 2008 (see table 2). Consequently, the report does use a fixed exchange rate. Rather, figures cited in the report reflect the exchange rate provided by the referenced source at the time.

² See Gulnoza Saidazimova, 2007, "Kazakhstan: Global Financial Turmoil Hits Credit Rating," Eurasianet (online publication), October 13, 2007, Central Eurasia Project, Open Society Institute, New York, <http://www.eurasianet.org/departments/business/articles/pp101307a.shtml> (accessed April 2009).

The microfinance sector in Kazakhstan is still underdeveloped, with less than 100 active players, including credit partnerships. Most MFIs are tiny, unsustainable,³ and their financial reporting is not up to international standards, which makes peer analyses difficult (domestically as well as internationally). It appears that the 10 largest MFIs are responsible for more than 80 percent of all microcredit by volume and number of borrowers. The majority of these institutions are concentrated around Almaty City and in South Kazakhstan Oblast. Microfinance institutions in Kazakhstan can be established as microloan organizations (either as for-profit or non-profit organizations), or credit partnerships (which are similar to credit unions). Prior to the enactment of the Micro Loan Organization Law (2003), some MFIs were registered as nonbank financial institutions. None of these organizational forms are permitted to take deposits from the public. The total loan portfolio held by MFIs at the end of 2007 was estimated at \$171 million and represented credit extended to 75,000 borrowers.⁴

The government does not consider MFIs to be part of the formal financial sector and regulatory compliance relates to their status as legal entities rather than financial institutions. Consequently there are informational gaps concerning the financial performance and status of MFIs and their service outreach.

A few larger MFIs have achieved sustainability, such as KazMicroFinance (KMF),⁵ MLO Bereke, and Asian Credit Fund (AKF). As of April 2008, KMF intended to transform into a second-tier bank within the next 12 months. These larger MFIs already cooperate with international investors, such as the European Bank for Reconstruction and Development (EBRD), Deutsche Bank, Blue Orchard, and Hivos-Triodos. Other, smaller institutions receive funding primarily through the state-owned Entrepreneurship Development Fund (EDF) or Frontiers, a leading wholesaler on the microfinance funding market.

This report estimates that the microfinance market could grow considerably over the next five years, requiring approximately \$300–\$350 million to finance the credit demand of 90,000 additional microborrowers. Financing for this growth is currently available from EDF, Frontiers, and large international MFI lenders. One constraint to future growth, however, will be the need for MFIs to source additional equity capital in order to maintain a proper debt-to-equity balance. In the past, grants from donors and retained earnings were adequate to maintain this balance, but more recently, the strong asset growth of MFIs has in many cases outpaced growth in their net worth. These MFIs will either need to look for equity investors or slow down their lending. The financial crisis is unlikely to affect the amount of debt funding available to MFIs, as a key source of financing remains international development-driven organizations, but the crisis could reduce loan portfolio growth and profitability.

³ Less than 30 MFIs are financially and commercially viable.

⁴ This total includes figures provided by the Association of Microfinance Organizations of Kazakhstan (AMFOK) as of January 1, 2008, when the total microfinance loan portfolio held by 32 reporting member MFIs was valued at \$126.5 million and represented loans to 41,700 borrowers.

⁵ KMF is the largest microfinance institution in the country that is registered as a nonbank financial institution.

Introduction

Political Environment

Kazakhstan's secular and democratic political system was established by the country's constitution, which was ratified in 1995 following the country's 1991 declaration of independence. The presidential-based political system has been led by Nursultan Nazarbayev since his victory in the country's first election in 1998 and re-election in 2005, although both these elections failed to meet the standards of the Organization for Security and Co-operation in Europe (OSCE).⁶ None of the 10 existing political parties⁷ provides an effective counterweight to President Nazarbayev's *Nur Otan* ("Fatherland's Ray of Light") party.⁸ Nur Otan has a majority of seats in the bicameral parliament, which consists of the *Majilis* (lower house) and the *Senate* (upper house). To ensure stability among the multiethnic population, a law on political parties prohibits parties based on ethnic origin, religion, or gender, although constitutional amendments passed in 2007 added representatives of ethnic minorities to the *Majilis*.⁹

Significant political reform is necessary. In preparation for its chairmanship of the OSCE in 2010, Kazakhstan must enact a number of political reforms. These reforms include direct elections to at least one house of parliament, loosening political party requirements, providing state financing for opposition parties, granting these parties greater access to the media, and increasing transparency about the inner workings of parliament and executive decision making.¹⁰

Kazakhstan's total population of 15.3 million is comprised of ethnic Kazakhs (53.4 percent), ethnic Russians (30.0 percent), ethnic Ukrainians (3.7 percent), Uzbeks (2.5 percent), Germans (2.4 percent), Tatars (1.7 percent), Uighurs (1.4 percent), and other ethnic groups (4.9 percent).¹¹ The Kazakh language is spoken by 64 percent of the population and has "state" language status, while Russian, which is spoken by almost all residents of Kazakhstan, is the "official" language and is used routinely in business. Forty-three

⁶ See "Kazakh Election Flawed Despite Some Administrative Improvements," December 5, 2005, Office for Democratic Institutions and Human Rights, OSCE, Vienna, <http://www.osce.org/item/17236.html> (accessed April 2009).

⁷ These parties fall into three categories: pro-presidential, "soft" opposition, and "hard" opposition.

⁸ Anthony Clive Bowyer, 2008, *Parliament and Political Parties in Kazakhstan*, Silk Road Paper (Washington, DC: The Central Asia-Caucasus Institute, Paul H. Nitze School of Advanced International Studies).

⁹ *Ibid.*

¹⁰ *Ibid.*

¹¹ ADB, 2007, "Kazakh Country Profile," ADB, Manila, Philippines.

percent of the population lives in rural areas.¹² Annual population growth is relatively strong for the region and is expected to remain at four-tenths of one percent per year, in comparison with Russia's expected growth rate of negative one-half of one percent. Life expectancy in Kazakhstan has declined slightly since independence—current life expectancy is 67.5 years,¹³ compared with 68.1 years in 1991, the first year of independence.¹⁴

The age structure of the population, nearly 70 percent of which is of working age, is shown in table 1.

Table 1. Age Structure of Population of Kazakhstan, 2008

Age	% of total	Male	Female
0–14 years	22.1	1,734,622	1,659,723
15–64 years	69.6	5,219,983	5,463,468
65 years and over	8.2	443,483	819,254

Source: CIA, 2008, *The World Factbook*.

Corruption remains a key problem in Kazakhstan. The country ranked 150th, together with Belarus, Tajikistan, Azerbaijan, and Kyrgyzstan, among the 179 countries in Transparency International's *Corruption Perception Index 2007* (CPI).¹⁵ Of more concern is the trend: Kazakhstan ranked 65th in the 2000 CPI, gradually falling to its current level. Rampant corruption, combined with lack of transparency and public accountability in the extraction and management of the country's rich oil and metallurgical resources has precipitated the decline.

International organizations have cited some improvement in human rights in Kazakhstan, such as limitations on the scope of the death penalty. Yet freedom of religion, freedom of the media, and the treatment of refugees, asylum seekers, and members of political opposition groups are in need of improvement.¹⁶

¹² UNDP, 2007, *UNDP Human Development Report (HDR) 2007/2008* (New York: UNDP), <http://hdrstats.undp.org/indicators/40.html> (accessed April 2009).

¹³ CIA, 2008, *The World Factbook* (updated July 2008), CIA, Langley, Virginia, <https://www.cia.gov/library/publications/the-world-factbook/geos/kz.html> (accessed April 2009).

¹⁴ UNDP, 2005, "The Great Generation of Kazakhstan—Insights into the Future," UNDP, Almaty, Kazakhstan.

¹⁵ Transparency International (TI), 2007, *Corruption Perception Index 2007*, TI, Berlin, Germany, http://www.transparency.org/policy_research/surveys_indices/cpi/2007 (accessed April 2009).

¹⁶ Amnesty International, 2008, "Central Asia: Summary of Human Rights Concerns: March 2007–March 2008," Amnesty International, London, UK, <http://www.amnesty.org/en/library/info/EUR04/001/2008/en> (accessed April 2009); and Human Rights Watch, 2008, "Human Rights in Kazakhstan: The Madrid Promises and Beyond," Human Rights Watch, New York, New York, <http://hrw.org/english/docs/2008/05/29/kazakh19061.htm> (accessed April 2009).

Macroeconomic Context

Kazakhstan has made significant progress in liberalizing its economy since independence, and growth has been supported by strong natural resource prices over the past few years. The global financial crisis, however, reached Kazakhstan in the second half of 2007 and put a damper on growth. Between 1994 and 1996, prices were liberalized, trade distortions reduced, and small and medium enterprises (SMEs) privatized. Beginning in the late 1990s, the financial sector was strengthened (with a third of the weaker banks losing their licenses), rural and urban infrastructure improved, and investment in the private sector encouraged—especially in small businesses.¹⁷ These reforms helped Kazakhstan overcome the difficult transitional years. Reforms and natural resource wealth attracted significant foreign direct investment (FDI) flows, a key driver of strong GDP growth over the last several years, and facilitated full repayment of the country’s debt to the International Monetary Fund (IMF) in 2000, when it paid back \$385 million.¹⁸

Table 2. Kazakhstan’s Main Economic Indicators, 2003–2007

	2003	2004	2005	2006	2007
Nominal GDP (billions KZT)	4,612	5,870	7,591	10,214	12,726
Real GDP growth (%)	9.0%	9.4%	9.9%	10.6%	8.5%
Nominal GDP per capita (US\$)	2,160	3,010	3,758	5,291	6,895
Inflation (%)	6.4	6.9	7.6	8.6	10.8
Exchange rate (KZT / US\$)	143.33	130.00	133.77	127.00	120.30 96
Agriculture as % of GDP	7.9%	7.1%	6.4%	5.3%	5.8%
Industry as % of GDP	35.1%	35.4%	37.6%	39.3%	39.4%
Services as % of GDP	57.1%	57.5%	56.0%	55.4%	54.8%

Source: ADB, 2007, “Kazakh Country Profile;” and National Bank of Kazakhstan, 2008, “Statistical Bulletin.”

Despite this progress, **the global financial crisis hit Kazakhstan’s economy harder than its CIS neighbors** in 2007 due to the banking sector’s high dependency on external borrowing.¹⁹ High commodity prices, expansionary monetary policies, strong capital inflows, rapid credit growth, and rising asset prices fueled domestic demand and led to an overheating of the economy, foremost in the nontradable construction and financial sectors. Inflation, which was

¹⁷ World Bank, 2005, “Republic of Kazakhstan—Country Economic Memorandum,” World Bank, Washington, DC, 2005.

¹⁸ IMF, 2000, “Kazakhstan Repays the IMF Ahead of Schedule,” News Brief, no. 00/35 (June 1, 2000), IMF, Washington, DC.

¹⁹ O. Pindyuk, 2008, “Kazakhstan: After Temporary Slowdown, Growth Accelerates,” Vienna Institute for International Economic Studies, Vienna, Austria.

already on an upward trend, was also fueled by rising food prices and soared to 20 percent in February 2008.²⁰

Yet the crisis is perceived as a temporary slowdown. While banks remain constrained by liquidity, as seen in shrinking loan portfolio growth (from 83.3 percent in June 2007 to 44.4 percent in December 2007), GDP still grew strongly, as shown in table 2. FDI inflows helped support this growth: although declining from a high of \$13.7 billion in 2006 to \$12.6 billion in 2007, the overall level remained strong.²¹

The consequences of the global economic turmoil are expected to fully unroll in 2008 and 2009, slowing GDP growth to 6.3 percent as a result. It is expected that lower GDP growth will reduce both imports of consumer goods and the lending capacity of banks, which will increase the importance of government spending to prop up the economy. This trend, combined with inflation, may pose a threat to economic stability.²² (See box 1 below for details of the crisis.)

According to the national poverty line, 18 percent of population is poor, although this varies greatly from region to region within Kazakhstan.²³ In 2008, Kazakhstan was ranked 73rd out of 177 on the Human Development Index of the UNDP, performing well in terms of literacy and overall employment, but poorly in terms of life expectancy and only average in terms of GDP per capita.²⁴

Kazakhstan's total labor force is approximately 8 million.²⁵ Unemployment is expected to reach a five-year low of 6.6 percent in 2007²⁶ and to remain relatively constant in 2008 and 2009.²⁷

A longer-term macroeconomic challenge for Kazakhstan is diversifying the economy away from a strong concentration in extractive industries, especially attracting FDI to other sectors, and creating a more evenly spread base for GDP growth. In 2007 oil extraction accounted for 48 percent of industrial production. Oil also accounted for 60 percent of merchandise exports,²⁸ and oil

²⁰ World Bank, 2008, World Economic Outlook (online database), April 2008 ed., World Bank, Washington, DC, <http://www.imf.org/external/pubs/ft/weo/2008/01/weodata/index.aspx> (accessed April 2009).

²¹ Pindyuk, 2008, "Kazakhstan."

²² A. Colquhoun, Director of Sovereigns Group, 2008, "Kazakhstan—Short-term Risks, Long-term Strengths," presentation at Fitch Ratings conference, "Kazakhstan in the Context of Global Liquidity Crisis—Risks and Ways For Resistance," February 12, 2008, Almaty, Kazakhstan.

²³ World Bank, 2008, "Kazakhstan Country Brief," World Bank, Washington, DC.

²⁴ UNDP, 2007, *HDR 2007/2008*.

²⁵ The Economist Intelligence Unit, 2007, *Kazakhstan Country Profile* (London: EUI).

²⁶ ADB, 2008, "Kazakhstan 2008 Fact Sheet," ADB, Manila, Philippines.

²⁷ The Economist Intelligence Unit, 2008, *Kazakhstan Country Report* (monthly report), March, EUI, London, UK.

²⁸ Pindyuk, 2008, "Kazakhstan."

production, for about 30 percent of GDP.²⁹ To date, the government has had limited success toward this goal, given such constraints as poor infrastructure, a dearth of long-term, local-currency financing, and institutional weaknesses.³⁰

Box 1. The Recent Financial Crisis

The credit boom in Kazakhstan was fuelled by high levels of foreign currency borrowing by domestic banks until the second half of 2007, when foreign borrowing declined drastically as the global financial crisis reached the country. In third quarter 2007, the net inflow of foreign lending to the financial sector was just \$200 million—a decline of \$8.9 billion compared to the previous six months. This decrease led to a sudden weakening of the national currency (KZT), which fell to 126.25 to the U.S. dollar in August 2007. NBK intervened to stabilize the currency and restore confidence in the banking system by running down its gold and foreign exchange reserves, spending \$6.5 billion over the period August–December 2007. As a result, the KZT strengthened to 120.3 to the dollar.

Another result of decreasing foreign credit was that banks' reserve levels declined drastically. To provide financial institutions with short-term KZT liquidity,^a the National Bank of Kazakhstan (NBK) began in August 2007 to increase volumes of reverse repurchase agreement (REPO) transactions, conduct currency swap operations, and institute a new form of refinancing loans. The latter process involved securing short-term loans against balances in banks' correspondent accounts. A revision of the minimum reserve requirement also enabled banks to free up an estimated KZT 150 billion. About \$4 billion of budget funds were also allocated to Kazakh banks to enable them to complete major construction projects.^b

The NBK's remedial actions have resulted in a significant slowdown in the growth rate of the money supply. According to preliminary data for 2007,^c the money supply increased by 25.5 percent for the year, compared to an increase of 78.1 percent in 2006, while cash in circulation increased by 23.1 percent, compared to 45.9 percent in 2006. On December 1, 2007, the NBK raised the official refinancing rate to 11 percent from its previous rate of 9 percent. Consequently, the average interest rate on bank lending increased to 15.3 percent by March 2008, compared to 13.3 percent at the start of 2007.^d

NBK support is expected to continue throughout 2008. The government, as noted above, has earmarked \$4 billion to support domestic banks, although it may increase spending if growth comes in below expectations. On the positive side, Kazakhstan's relatively low public debt levels and abundance of natural resources provide the country with a buffer against economic downturn.^e

Sources: National Bank of Kazakhstan (NBK); Fitch Ratings Conference, February 2008.

Notes: ^a The NBK has also announced that it is ready to assist banks in meeting their scheduled external debt repayments by providing \$8 billion in liquidity in 2008.

^b NBK, 2008, "Monetary Policy Guidelines," NBK, Almaty, Kazakhstan.

^c NBK, 2007, "Financial Stability Report 2007," NBK, Almaty, Kazakhstan.

^d NBK, 2008, "Monetary Policy Guidelines."

^e Colquhoun, 2008, "Kazakhstan—Short-term Risks, Long-term Strengths."

²⁹ Federation of International Trade Associations, n.d., "Kazakhstan Country Profile," Federation of International Trade Associations, Brooklyn, New York, <http://fita.org/countries/kazak.html> (accessed April 2009).

³⁰ ADB, 2007, "Kazakhstan 2007 Fact Sheet," ADB, Manila, Philippines.

Fiscal Policy

In the aftermath of the financial crisis that began in 2007, the government of Kazakhstan faced politically unfavorable options for its fiscal policy, including cutting government spending and raising taxes to avoid a real appreciation of the tenge (KZT) due to foreign capital inflows.³¹ GDP growth, mostly fueled by rising natural resource prices and the results of earlier tax and financial sector reforms, had improved government finances over the past few years from a budget deficit of 4 percent of GDP in 1995 to a surplus of 0.8 percent in 2006, before eroding to a deficit of 1.7 percent in 2007. At the same time, government revenues increased from 22.5 percent of GDP in 2002 to 28.1 percent in 2006, before slowing to an estimated 22.4 percent in 2007. Government expenditures and net lending grew steadily but moderately from 2002 (21 percent of GDP), then increased sharply in 2007 (to 24.1 percent of GDP).

Spending was focused on social expenditures, housing, agriculture, and energy, before coming to a halt in 2006–2007, when spending was redirected to support the financial sector. This trend is expected to continue in 2008; the government has earmarked a \$4 billion economic stabilization package to deter both a collapse of the real estate market and a hard economic landing. A quarter of this amount was allocated in 2007, with the remaining \$3 billion earmarked for disbursement to domestic banks in 2008. The funds will be used to support small businesses, complete unfinished construction projects, and finance industrial development projects.³²

Kazakhstan adopted a new tax code in 2000. The Law on Changes to the Tax Code was adopted in November 2003, reducing value-added tax (VAT) rates, together with social and personal income tax rates. The impact of tax cuts was partly offset by higher non-tax revenue and one-off receipts. As a result, nonsolid revenues increased broadly in line with estimated non-oil GDP, but declined in relation to overall GDP.³³ Kazakhstan furthered its reforms by adopting a new customs code in April 2003 and a new land code in June of the same year. The government also plans to implement further revisions to the customs code,³⁴ cut payroll taxes, and reduce VAT taxes for SMEs in 2008.³⁵

³¹ J. Wakeman-Linn, 2007, "Capital Inflow: Mixed Blessing?" *IMF Survey Magazine: Countries and Regions* (May 28), IMF, Washington, DC, <http://www.imf.org/external/pubs/ft/survey/so/2007/CAR066B.htm> (accessed April 2009).

³² ADB, 2008, "Asian Development Outlook 2008: Kazakhstan," ADB, Manila, Philippines.

³³ IMF, 2007, "IMF Concludes 2005 Article IV Consultation with the Republic of Kazakhstan," IMF Public Information Notice, July, 1, 2005, available on the Web site of the National Bank of Kazakhstan, http://www.nationalbank.kz/document/?docid=2063#_ftn1 (accessed April 2009).

³⁴ U.S. Department of State, 2008 (July), "Background Note: Kazakhstan," U.S. Department of State, Washington, DC, <http://www.state.gov/r/pa/ei/bgn/5487.htm> (accessed September 2008).

³⁵ John C.K. Daly, 2008, *Kazakhstan's Emerging Middle Class*, Silk Road Paper (Washington, DC: The Central Asia-Caucasus Institute, Paul Nitze School of Advanced International Studies, Johns Hopkins University).

Monetary Policy

Despite seemingly robust economic indicators, the growth of the financial sector in Kazakhstan in recent years has been accompanied by a significant accumulation of risk in the banking system. Appreciation of the KZT, an increase in the sovereign credit rating of the Republic of Kazakhstan and the ratings of domestic banks (until 2007), and the attractiveness of the banking sector for investors facilitated easy access to external capital markets by Kazakh banks. While the growth of external borrowing and large increases in lending volumes were previously supported by a corresponding quality of loan portfolios, domestic banks did not adequately assess the risk of asset quality deterioration.

Robust FDI inflows also led to abundant liquidity, rising inflation, and upward pressure on the KZT, which complicated the conduct of monetary and exchange rate policies. Furthermore, the expansion of bank lending to the construction industry and the real estate market led to further price appreciation in the latter market and increased the banking sector's vulnerability to credit risks.

Thus, **the key policy objectives of the National Bank of Kazakhstan (NBK) have been the maintenance of a stable KZT exchange rate, controlling inflation, and supporting the banking sector following the 2007 crisis.** In 2000, the NBK was forced to abandon the pegged value of the KZT to the USD (85 KZT to \$1), and let the rate float to 142 KZT. As a result of increased oil exports and significant capital inflows, the KZT appreciated considerably against the dollar, with the exchange rate rising from 143.33 KZT in 2003 to 120.3 KZT at the end of 2007. This appreciation placed significant pressure on non-oil exports to remain competitive. Although the KZT is officially a floating currency, the NBK has confirmed that it will keep the KZT-USD exchange rate relatively stable until at least the end of 2008.³⁶ In so doing, the NBK hopes that it can alleviate the foreign currency exposure of the corporate sector and help control inflation.³⁷ Until the situation of the financial markets improves, it is uncertain whether Kazakhstan will return to a more flexible exchange rate policy.

Despite these policy measures, major inflationary factors remain: the strong inflow of foreign currency, a high rate of growth of aggregate demand, an increase in the money supply (a trend that has continued

³⁶ Oksana Reinhardt, 2008, "Kazakh Banks: Outlook for 2008" (February), ING Wholesale Banking Debt Markets Research, ING Bank N.V., Amsterdam, The Netherlands.

³⁷ IMF, 2008, "Republic of Kazakhstan—2008 Article IV Consultation: Preliminary Conclusions of the IMF Mission," IMF, Washington, DC.

over the last three years), low labor productivity, and an insufficient level of competition in certain markets for goods and services. From 2001 to 2007, inflation was below 10 percent, but reached 18.8 percent by the end of 2007, with an average for the year of 10.8 percent.³⁸ Increasing food prices contributed to the spike.

Against this difficult backdrop, the NBK developed monetary policy guidelines, based on scenario analyses, that define inflation targets and monetary policy measures necessary to achieve them. The guidelines target an average inflation rate of 16–19 percent in 2008 and 8.5–10.5 percent in 2009, depending on the scenario. As noted above, the floating exchange rate regime will remain, but sharp short-term fluctuations will not be permitted, depending on the scenario (although no bands or anchors will be introduced³⁹). Additional gold and foreign exchange reserves may be needed as a cushion against the reversal of FDI inflows.⁴⁰

Balance of Payments

The liberalization of exchange arrangements helped regulate the liquidity overhang in foreign currency: effective January 1, 2007, the Republic of Kazakhstan completely eliminated restrictions on capital transactions between residents and nonresidents.

Exports and imports of goods and services continue to grow despite the 2007 crisis (see table 3). According to customs statistical data, exports of goods for the first nine months of 2007 increased by 19 percent (to \$33.8 billion) compared to the same period in 2006. As in previous years, income from current transactions (mostly export income), did not cover import expenditures, including the payment of income to nonresidents for their financial and labor resources. In 2007, these trends intensified and led to a further increase in the current account deficit. The balance of payments (BoP) current account deficit for the first nine months of 2007 amounted to \$5.3 billion and was expected to reach \$7 billion for 2007 as a whole (compared to \$1.8 billion for 2006).⁴¹

³⁸ Ibid.

³⁹ The exchange rate regime in Kazakhstan has been reclassified from a managed float to a conventional peg under the IMF's de facto classification system because of the very limited movement of the tenge against the U.S. dollar since October 2007 (see IMF, 2008, "Republic of Kazakhstan: 2008 Article IV Consultation").

⁴⁰ National Bank of Kazakhstan, 2008, "Monetary Policy Guidelines."

⁴¹ Ibid.

Table 3. Exports and Imports, 2002–2007

	2002	2003	2004	2005	2006	2007
Exports of goods (\$ billions)	7.2	8.0	11.3	15.4	21.0	24.8
Annual growth rate (%)	7.4%	10.4%	41.4%	37.1%	35.8%	18%
Imports of goods (\$ billions)	5.8	5.8	7.6	9.8	13.1	18.5
Annual growth rate (%)	-196.7%	-0.6%	-31.3%	29.9%	33.1%	42%
Exports of services (\$ billions)	1.11	1.0	1.1	1.2	1.5	1.8
Annual growth rate (%)	16.8%	-7.0%	6.6%	10.7%	25.0%	19.0%
Imports of services (\$ billions)	2.5	2.3	2.8	4.1	4.7	5.8
Annual growth rate (%)	-228.4%	-11.3%	23.6%	46.5%	15.4%	23%

Source: Vienna Institute for International Economic Studies, 2008, “Kazakhstan: Selected Economic Indicators” (February), Vienna, Austria.

Note: Figures that are not percentages are rounded.

Rating

In September 2002 Kazakhstan became the first country in the Commonwealth of Independent States (CIS) to receive an investment-grade credit rating from a major international credit rating agency. Kazakhstan’s country ratings have improved over the past few years in tandem with the increase in commodity prices (especially those of oil and gas). However, due to the domestic impacts of the global financial crisis, Standard & Poor’s lowered its rating one notch and Fitch revised its ratings outlook to negative during the last quarter of 2007.⁴² These actions were the result of the increasing reliance of banks on short-term loans from the NBK to support liquidity in the second half of 2007.⁴³

Table 4. Kazakhstan Country Credit Ratings, 2007 and 2008

	Type	Rating	Outlook	Date of update
Standard & Poor’s	LTFC	BBB-	Negative	April 2008
	LTLC	BBB		
Fitch	LTFC	BBB	Negative	December 2007
	LTLC	BBB+		

Source: Web sites of Fitch Ratings, Inc., and Standard & Poor’s.

Notes: LTFC: Long-term foreign currency; LTLC: Long-term local currency.

⁴² Richard Pomfret, 2008, “Kazakhstan’s Banking Problems,” *Central Asia-Caucasus Analyst* (The Central Asia-Caucasus Institute, Johns Hopkins University) 10, no. 4 (February 20): 3–5.

⁴³ Fitch Ratings, Ltd., 2007, “Kazakhstan Ratings Release” (August 10), Fitch Ratings, Ltd., New York and London; and Standard and Poor’s, 2007, “Kazakhstan Ratings Release” (August 10), S&P, New York, New York.

Government Priorities

The government has identified its broad priorities as improving Kazakhstan's competitiveness on world markets, joining the World Trade Organization, and implementing measures to further democratize its society—particularly measures to strengthen the role of both parliament and local representative assemblies in preparation for Kazakhstan's chairmanship of the OSCE in 2010.

The key economic priorities of the government and the NBK include exchange rate stabilization and reducing inflation. These goals are complemented by those of strengthening the financial sector, including building a safety net for banks so that they are not dependent solely on liquidity support in times of crisis, as well as strengthening bank supervision and regulation.

On the development front, notable progress has been made toward the primary education and gender Millennium Development Goals, but according to the UNDP, the 2015 targets for health and the environment might not be reached.⁴⁴ Reducing poverty and the wealth gap between urban and rural populations are also on the government's agenda. In the shorter term, the government faces the difficult tasks of increasing social expenditures and mitigating the negative effects of high food prices, especially for poorer segments of the population. To fight inflation, the government has removed duties on some food imports and has introduced restrictions on the export of certain others.⁴⁵ Measures to reduce poverty include support of SMEs and increased social assistance and accountability at the local government level.

⁴⁴ UNDP, 2005, "Microfinance in Kazakhstan: An Inclusive Sector for All," UNDP, Almaty, Kazakhstan.

⁴⁵ ADB, 2008, "Asian Development Outlook 2008: Kazakhstan."

Private Sector / MSMEs

Overview

Little information about the private sector is available.⁴⁶ Box 2 below provides a breakdown and definitions of micro, small, and medium enterprises (MSMEs) according to the Government of Kazakhstan.

Box 2. Government Enterprise Definitions

Individual enterprises are private individuals engaged in business activities without a legal identity and with no characteristics of a legal entity.

Microenterprises are private individuals or legal entities employing up to 10 people. Microenterprises fall under the category of small enterprise entities.

Small enterprises are private individuals and legal entities employing up to 50 people and owning assets valued up to 60,000 times the monthly calculation index (over \$430,000).

Medium enterprises are private individuals and legal entities employing up to 250 staff and owning assets valued up to 325,000 times the monthly calculation index (approximately \$2.34 million).

Source: Law of the Republic of Kazakhstan No.1543XII, Art. 4, "On Protection and Support to Private Enterprise," July 4, 1992, as cited in UNDP, 2008, "Microfinance in Kazakhstan."

Few consolidated recent statistics are available for the **MSME sector**.

According to the UNDP, as of April 2004, there were about 428,000 **individual enterprises (IE)** in Kazakhstan, of which 350,000 were operational.⁴⁷ The term IE encompasses businesses of various sizes, from micro and small enterprises to large businesses. About 40 percent of operational IEs are involved in trade, another 38 percent are in agriculture, and the remainder are in other services. From a regional standpoint, 21 percent of IEs are located in the South Kazakhstan Oblast, 14 percent in Almaty Oblast, and 11 percent and 7 percent in the East Kazakhstan and Karaganda Oblasts, respectively.

The UNDP estimated the total number of **microenterprises (ME)** at about 82,400 in 2004, or 84 percent of total operational MSMEs. Microenterprises engaged in trade and construction constituted about 61 percent of the total number of microenterprises. These enterprises have limited starting capital or equity.

Data from a 2005 enterprise development sector overview conducted by the U.S. Agency for International Development (USAID) includes the following key figures:

⁴⁶ A complete picture of the private MSME sector is difficult to provide since no accurate, up-to-date statistics are available.

⁴⁷ UNDP, 2005, "Microfinance in Kazakhstan."

- The number of SMEs grew from 138,822 to 221,054 over the years 2003–2005.
- Most SME are active in trade, handicrafts, or small-scale construction.
- SMEs contribute approximately 40 percent of the GDP of Kazakhstan.⁴⁸

According to more recent data from the Statistics Agency of Kazakhstan, 823,156 small businesses were registered as of October 1, 2006, although only **48,739 small businesses are active in Kazakhstan. Small businesses accounted for an estimated 35 percent of GDP in 2006.** Approximately 45 percent of small businesses are concentrated in the trade sector; geographically, there is a high concentration of businesses in the Almaty area (35 percent).⁴⁹

Obstacles to Growth

Two key studies have identified obstacles to SME growth in Kazakhstan. The first, the EBRD-World Bank “Business Environment and Enterprise Performance Survey” (BEEPS),⁵⁰ was carried out in 2005. While the study covers a broad range of business environment issues, as well as all sizes of enterprises, 89 percent of the Kazakhstan survey sample were small enterprises. The study asked businesses to rank their problems in conducting business. The two highest-ranked problems were:

1. the cost and difficulty of accessing finance; and
2. a cumbersome tax administration and high tax rates.

With respect to access to finance, almost 80 percent of the businesses in the sample financed new investments with internal funds and/or retained earnings. **Almost 50 percent of businesses cited the cost of financing as a problem, and close to 30 percent specified that access to finance was a problem. Less than 20 percent of businesses indicated that formal borrowing was used to finance new investments.**

⁴⁸ USAID, 2005, “SME Statistics—Republic of Kazakhstan; Information as of October 1, 2005,” USAID Enterprise Development Project, implemented by The Pragma Corporation, Washington, DC, available on the USAID/EDP Web site, <http://en.casme.net/> (accessed May 2009).

⁴⁹ A.N. Toxanova, 2007, “The Country of Kazakhstan: Barriers of Entrepreneurship and Support for Entrepreneurship,” presentation to the European Economic Commission, Geneva, Switzerland, June 18–19, 2007. Available online on the Web site of the U.N. Economic Commission for Europe, Geneva, Switzerland, http://www.unece.org/ceci/ppt_presentations/2007/eed/tox_e.pdf (accessed April 2009).

⁵⁰ EBRD and World Bank, 2005, “Kazakhstan: BEEPS (Business Environment and Enterprise Performance Survey)-at-a-Glance,” World Bank, Washington, DC, <http://siteresources.worldbank.org/INTECAREGTOPANTCOR/Resources/BAAGREV20060208Kazakhstan.pdf> (accessed April 2009).

Those businesses which did not use formal borrowing (almost 80 percent of the sample) explained their main reasons as the following:

1. not needing a loan (about 65 percent);
2. excessively high interest rates (about 35%); and
3. seeing no chance to obtain credit due to strict collateral requirements (about 28 percent).

The second study, the World Bank's 2005 "Investment Climate Survey,"⁵¹ asked firms to rate their constraints in business. The results are shown in table 6.

Table 6. Perceptions of Constraints by Firm Size, 2005

Firm	Main obstacles to doing business
Small firms (1–49 employees)	Cost of financing (about 21%) Tax rates (about 18%) Tax administration (about 14%)
Medium firms (50–249 employees)	Cost of financing (about 15%) Corruption (about 14%) Tax administration (about 12%)
Large firms (250 employees or more)	Anti-competitive or informal practices (about 15%) Tax administration (about 13%) Economic and regulatory policy uncertainty (about 13%)

Source: World Bank, 2005, "Investment Climate Survey."

Note: Percentages show the number of firms that identified the problem as "major" or "very severe" obstacles.

Both studies described above clearly confirm **that the cost of financing remains a key obstacle for SMEs in Kazakhstan**, along with tax rates and tax administration. Numerous support programs have, however, been initiated for financial institutions to improve their services to SMEs. SMEs have benefited from programs sponsored by the IFC, EBRD, and USAID, among others; these enterprises can also obtain financing from the Entrepreneurship Development Fund (EDF), a government-financed fund established to support SME development. Additionally, commercial bank lending rates to SMEs have declined over the past few years in the country.

Lower interest rates on commercial loans, longer maturities, and a reduction in loan guarantee requirements have eased financing constraints for small businesses. Since the end of 2004, there has been a substantial increase in lending to small businesses. Indeed, small business lending increased from \$2.2 billion at the end of 2004 to \$12.5 billion by the end of 2007: an annual increase of 78 percent. In 2004, small business lending represented 19 percent of total

⁵¹ World Bank, 2005, "Investment Climate Survey: Kazakhstan," World Bank, Washington, DC.

lending by banks; by 2007, this proportion had increased slightly to 20.7 percent.⁵²

These improvements were evidenced in the rating increase that Kazakhstan received in the World Bank “Doing Business in Kazakhstan” report. In this report, Kazakhstan’s rating on “getting credit” moved up 69 points from 117th place in 2005 to 48th place in 2008.⁵³ However, as discussed in the next section, significant demand for finance remains unmet.

Demand for Financial Services

Current Status

During the transition toward a more market-oriented economy, many people turned to microcredit as a way to overcome the economic challenges that they faced.⁵⁴ By 2004, according to the government Agency for Statistics, 50,600 people had received microcredit loans, a 57 percent increase over the 32,300 people that received microcredits in 2003. In 2005, there were an estimated 68,000 active microfinance clients in Kazakhstan.⁵⁵ Support for microcredit is provided by the government, aid agencies (including USAID and UNDP), and international and domestic nongovernmental organizations (NGOs). Today, there is a trend toward greater commercialization of microcredit, meaning strengthened and more appropriate institutional forms and the provision of credit lines rather than grants to microfinance institutions (MFIs). This trend is essential for the industry to maintain steady growth.

Retail Microfinance: Potential Demand and Supply Gap

A general calculation of microfinance demand in Kazakhstan is based on the assumption of a percentage of households using microfinance services. Compared to other similar countries with lower population densities, retail microfinance demand is estimated between 5 and 10 percent of total households. In countries with more members per household, the percentage of households using microfinance services can approach 30 percent.

⁵² National Bank of Kazakhstan, 2008, “Statistical Bulletin.”

⁵³ World Bank, 2008, “Doing Business 2009: Country Profile for Kazakhstan,” World Bank, Washington, DC.

⁵⁴ Inconsistencies in the data set prevent the construction of a complete picture of demand for financial services in Kazakhstan. For example, data regarding obstacles to growth is only available for SMEs, although it is unclear whether microenterprises were included in the samples of the EDRB-World Bank and World Bank “Investment Climate” studies. With regard to demand for financial services, only data on microfinance is available.

⁵⁵ UNDP, 2005, “Microfinance in Kazakhstan.”

The previously cited UNDP report⁵⁶ indicated that more than 200,000 people need access to basic financial services in Kazakhstan. In monetary terms, the report estimated that the market for microfinance services could be as much as \$812 million, as outlined in table 7 below.

Table 7. Microcredit Demand in Kazakhstan, 2005

Microfinance clients	Demand for microfinance services (potential clients)	Average loan size (US\$)	Demand for microfinance services (US\$)
Unemployed people	131,760	1,700	\$224 million
Individual entrepreneurs	70,000	2,500	\$175 million
Microenterprises	16,500	25,000	\$413 million
Total potential clients	218,260		\$812 million

Source: UNDP, 2005, "Microfinance in Kazakhstan."

Based on research for this report, it is estimated that the number of microcredit borrowers in Kazakhstan in 2008 is in the range of 93,000–103,000, or about 2 percent of all households, with much lower penetration in rural areas. According to this research, **it is estimated that the number of microcredit borrowers over the next five years could reach 180,000 borrowers and demand could reach \$590 million in loans outstanding, based on an average loan size of close to \$3,250.** The current average microloan in Kazakhstan could, however, be even higher.

Breaking down the gap between demand and supply, microfinance penetration in rural areas is much lower than the average cited above, given the size of the country and its relatively small population. The poorer western and, paradoxically, oil-producing regions have the highest unemployment levels in the country and the lowest microfinance penetration rates. There is also demand, particularly in rural areas, for attractive microsavings services for poor and low-income households. This potential client segment has been ignored by banks and MFIs are prohibited from accepting deposits. Moreover, commercial banks see microcredit as an adjunct to small business lending, rather than an opportunity in its own right, so there is no interest among banks at present in downscaling their services.

Refinancing: Potential Demand and Supply Gap

The ability to reach potential microentrepreneurs is largely dependent on the access that MFIs have to finance, particularly from international sources. Other potential sources of financing include retained earnings and additional equity subscriptions. Meeting the

⁵⁶ Ibid.

remaining balance of total credit demand (according to table 7) will require other supporting assets. According to research conducted for this report, around \$200 million in debt financing and \$150 million in retained earnings and additional equity will be required by the microfinance sector.

The microfinance market in Kazakhstan is underdeveloped and fragmented. MFIs are generally very small, often regionally focused, and many lack branch networks. Most institutions lack the critical size necessary for direct investment; moreover, for many, financial performance remains weak and the ownership structure, unclear. MFIs are not allowed to operate as joint stock companies (which restricts their ability to bring in additional shareholders), expand their equity base, or diversify ownership away from single owner-operator structures. **Together, small size, unclear or concentrated ownership structures, and poor financial performance make MFIs less attractive to commercial investors, particularly with respect to potential direct investments, although there are exceptions. MFIs are also prohibited from accepting deposits, which prevents them from benefiting from a less expensive and more stable domestic funding source.**

MFIs have traditionally relied primarily on financing from donors or the Entrepreneurship Development Fund (EDF). Relatively few have borrowed from Kazakh banks and when they have; the loan has been secured against a deposit. MFIs in Kazakhstan have, however, increasingly turned to commercial banks for refinancing—some experts have noted that large **commercial banks, prior to the financial crisis, had become the largest source of funding of Kazakh MFIs.** The 2007 financial crisis put a damper on this funding strategy. Commercial banks, which had been charging annual interest rates of 20–22 percent prior to the financial crisis, exercised options in their contracts with MFIs to increase their interest rates, which rose to about 30 percent a year. At the same time, they discontinued any new lending to MFIs.⁵⁷ **As a result, MFIs seeking funding have approached Frontiers (a leading wholesaler on the microfinance market), international MFI lenders, and the government-owned EDF in increasing numbers.**

A number of wholesale funds and structures are currently active in Kazakhstan: Frontiers, Blue Orchard, Planet Finance, ResponsAbility, and EDF are key players in the wholesale market. Additionally, ACIDI-VOCA plans to set up a regional Central Asian private equity fund with its partner MFIs, which would include the Kazakhstan market. In the future, funding may also be provided to

⁵⁷ Information summarized from conversations with local experts in 2008, including Ulugbek Khusanov, CEO, Frontiers.

MFIs outside of the network. **With the exception of Frontiers, the relatively large minimum investment size (about \$1 million) required by wholesale funds precludes them from reaching the many smaller, regionally based MFIs in Kazakhstan’s fragmented market,** whose liquidity demands remain unmet.

Frontiers makes smaller investments and thus reaches down below the top-tier MFIs. Based in Kyrgyzstan, the regional fund currently has five MFIs in its Kazakhstan portfolio. Following the financial crisis of 2007, Frontiers was flooded with funding requests from MFIs in Kazakhstan and is seeking additional funding to support its growth.⁵⁸

The **Entrepreneurship Development Fund (EDF)** provides loans with terms up to 5 years, guarantees, project financing, and leasing products for small enterprises. During the period 2005–2007, 28 start-up MFIs were financed with KZT 94.9 million (\$745,000—an average of \$26,700 per MFI) and 174 existing MFIs received KZT 5.5 billion (\$43 million—an average of \$248,000 per MFI). Some start-up MFIs have since failed.⁵⁹

In 2008, EDF was planning to invest KZT 5 billion (\$41.4 million) in existing MFIs only. Over the next three years, it planned to lend KZT 7 billion (almost \$58 million) annually: a total of KZT 21 billion (\$175 million).⁶⁰ Funding will be provided by the National Oil Fund. While EDF has sufficient liquidity and its loan pricing is lower than that of commercial banks, many smaller MFIs do not meet EDF prequalification criteria, leaving them few funding options other than commercial banks. Additionally, MFIs may prefer other funding options due to potential government influence.

Finally, international financial institutions (IFIs), including the ADB, EBRD, IFC, and KfW, have indicated increasing interest in the sector. (See the last section in this report, “Donor Programs for the Microfinance Sector,” for more details.)

However, according to the research for this report, **it is unlikely that MFIs will be able to source all needed funding from existing sources, given the current tight liquidity of commercial banks, the high minimum investments of wholesale funds, and the limited lending capacity of Frontiers due to its own liquidity constraints.**

⁵⁸ Ibid.

⁵⁹ Information obtained in a meeting with EDF, 2008.

⁶⁰ Ibid.

MFI's can and do accept loans denominated in foreign currency with varying conditions and terms. These loans generally have maturities of one to five years. While the demand for debt is higher in the short term, given the refinancing constraints discussed above, long-term additional equity will also be needed to support growth.

Remittances

Kazakhstan is a check-free economy, therefore the demand for payment services is relatively high. In response, Halyk Bank and the postal service, Kazpochta, offer payment services throughout the country, even in most remote areas. Kazpochta is currently present in 3,401 of Kazakhstan's 7,660 rural locations. Areas without a permanent Kazpochta office are visited on a regular schedule by a Kazpochta delivery service.⁶¹

Financial Sector Overview

Kazakhstan's financial sector is based on a three-tier model, as shown below:

- Level 1: National Bank of Kazakhstan.
- Level 2: Commercial banks. There are 35 commercial banks, although only 26 participate in the interbank clearing system.
- Level 3: Other financial institutions, including insurance firms, pension funds, and other organizations.

Outside of this classification system lie several state-owned financial institutions, which were founded to promote the economy of Kazakhstan (see following section).

⁶¹ Gail Buyske and Mario B. Lamberte, 2006, "Rural Finance in Kazakhstan," in *Beyond Microfinance: Building Inclusive Rural Financial Markets in Central Asia*, ed. Mario Lamberte, Robert C. Vogel, Roger Thomas Moyes, and Nimal A. Fernando (Manila: Asian Development Bank), 125–40.

Table 8. Number of Financial Institutions, 2004–2007

	01.01.04	01.01.05	01.01.06	01.01.07	01.10.07
Second-tier banks	35	35	34	33	34*
Insurance organizations	32	36	37	40	41
Insurance brokers	6	8	12	12	14
Actuaries	28	27	30	33	41
Pension funds	16	16	14	14	14
Pension assets investment management organizations (PAIMO)	10	10	10	13	11
Mortgage companies	2	3	7	10	10
Nonbanking organizations	157	201	270	16	22
Brokers and dealers	52	57	62	69	99
Registrars	19	18	18	16	17
Self-regulated organizations	2	2	2	2	2
Transfer agents	0	0	0	2	2
Investment portfolio managers	10	14	28	37	55

Source: National Bank of Kazakhstan, 2007, “Financial Stability Report 2007.”

Note: *These figures do not include JSC Masterbank, which according to FMSA, received a bank license on October 26, 2007.

Kazakhstan has implemented an impressive range of financial reforms since the mid-1990s, making it the financial center of the CIS. Banking standards and procedures have been mostly brought up to international standards, however certain implementation is still lacking (see section on financial infrastructure below).

Table 9. Financial Sector Depth and Outreach, 2005–2007

	2005	2006	2007
Total loans (\$ billions)	21.9	39.6	61.2
% loan growth	75%	81%	55%
Loans as % of GDP	34%	46%	57%
Total deposits (\$ billions)	26	32.8	34.7
% deposit growth	73%	86	26%
Deposits as % of GDP	21.66%	30.26%	30.48%
Loans as % of deposits	157%	152%	187%
Cash as % of total deposits	47.34%	37.05	28.01%

Source: IMF, 2007, “Republic of Kazakhstan: Staff Report,” IMF Washington, DC.

State-owned Financial Institutions

Several state-owned financial institutions exist, which are all financed by oil revenues. Their main purpose is to promote economic development in Kazakhstan.

The **Exim Bank of Kazakhstan** promotes the exports and imports of Kazakh companies through debt funding and insurance of export-import risks. Founded in 2003, its capital was \$58.2 million in April 2008.

The **Development Bank of Kazakhstan (DBK)**,⁶² founded in 2001, has a capital base of \$607.69 million. The main task of the DBK is to financially support infrastructure initiatives of the private sector and the state by extending long- and short-term, low-interest rate loans, including export credits, as well as by issuing guarantees on loans and credits granted by other credit institutions. Since 2001 DBK has financed 100 investment projects and export transactions, totaling \$1.25 billion. Financing for 49 investment projects and 51 export operations has been approved. As of January 1, 2008, the bank's loan portfolio was valued at \$400 million.

The aim of the **Investment Fund of Kazakhstan (IFK)** is to lend financial support to private sector initiatives in the economy's non-mineral sectors by participating in the authorized capital (i.e., acquiring shares or noncontrolling packages) of enterprises in Kazakhstan. The Fund was formed as a joint stock company with 100 percent government ownership and began its activities in July 2003. Its total capital in April 2008 was \$321.3 million.

The sustainable development fund **Kazyna** was created in April 2006 as an umbrella organization for several state-owned institutions. These institutions include the above-mentioned DBK and IFK, as well as several smaller organizations, such as the National Innovation Fund, or KazInvest, all of which were set up to promote the economic development of the country. The total portfolio of Kazyna was \$4.1 billion in April 2008.

Commercial Banks

Since the mid-1990s banks have had to adopt international banking standards, including the risk-weighted 8 percent capital adequacy ratio set by the Bank for International Settlements. In addition to raising capital requirements, the NBK has relicensed smaller institutions as credit unions or credit partnerships. Mergers have also driven consolidation in the sector. The ongoing remonetization of the economy is allowing banks in the country to become more

⁶² See the English-language version of its Web site at <http://www.kdb.kz/en/> (accessed April 2009).

effective financial intermediaries. At present **35 commercial banks operate in Kazakhstan** (18 domestic and 17 foreign).⁶³

Foreign banks have generally preferred to open representative offices in Kazakhstan, rather than take shares in domestic banks, due to the 25 percent cap on foreign ownership in any single bank. As of April 2008, foreign capital as a percentage of the total authorized banking capital of the sector amounted to 4.5 percent.⁶⁴ Kazakhstan abolished the ban on foreign banks setting up branches in the country in late 2005. The country lifted the ban gradually during a transitional period, when it mapped out certain restrictive rules to ensure that domestic banks could compete fairly with foreign newcomers. The Financial Markets Supervisory Agency (FMSA) requires branches of foreign banks to deposit funds in Kazakhstan's central bank proportional to the total assets that they own. A few major foreign banks have operational branches in Kazakhstan, including ABN AMRO, Citibank, and HSBC. In the year 2007–2008, Italian, Austrian, and South Korean banks initiated steps to purchase equity shares in three Kazakh banks.

Banks with foreign participation are subject to certain restrictions. The total charter capital of these banks must not exceed 50 percent of the aggregate capital of all domestic banks in Kazakhstan. At least one member of the supervisory board of a bank with foreign participation must be a citizen of Kazakhstan with at least three years experience in banking, and not less than 70 percent of all bank employees must be citizens of Kazakhstan.⁶⁵

The ties between politics and business are extremely close in Kazakhstan. This especially holds for the banking sector, as several banks are owned by members of the family of the current president, Nursultan Nazarbayev.⁶⁶

Although banks lend primarily to the oil and gas sector, which carries fewer risks, the rapid growth in credit through mid-2007 raised concerns about a potential deterioration of the quality of loan portfolios, especially since credit analysis remains inadequate in many banks. At end of 2004, lending by commercial banks was \$11.5 million (KZT 1.5 billion). This volume had increased to \$60.4 million

⁶³ World Bank, 2007, "Doing Business 2007."

⁶⁴ National Bank of Kazakhstan, 2007, "Financial Stability Report."

⁶⁵ JSC-Almaty Technology Park, n.d. "Doing Business in Kazakhstan," available online on the Web site of the United Nations Industrial Development Organization (UNIDO), www.unido.org/fileadmin/import/37260_doing_business_in_PK.2.pdf (accessed April 2009).

⁶⁶ "A Steady Hand in a Time of Crisis," *The Banker* (online publication), April 7, 2008, http://www.thebanker.com/news/fullstory.php/aid/5671/A_steady_hand_in_a_time_of_crisis.html (accessed April 2009).

(KZT 7.3 billion) by the end of 2007—an average annual increase of 70 percent.⁶⁷

Commercial bank lending was 25 percent of GDP in 2004 and 57 percent by year-end 2007. Broad money (M3) as a percentage of GDP rose from 21 percent in 2003 to reach 36 percent in 2006, where it remained in 2007. Foreign borrowing in the three years ending in 2007 was equal to 64 percent of the increase in lending by the commercial banks. The low cost of borrowing made this source of funds attractive. The other major source of funding was deposits, which represented 48 percent of additional lending. **As a result of the global financial crisis, capital inflows stagnated in 2007 and domestic banks had to rely on domestic sources of refinancing, such as deposits and liquidity support from the government. To cope with higher refinancing costs, banks increased their interest rates, which peaked at 20 percent in early 2008—double the rate of three years earlier.**⁶⁸

The dominance of foreign borrowing and the very high growth rate in lending meant that the loan-to-deposit ratio of commercial banks declined from 1.57 in 2005 to 1.87 in 2007, even though deposit-taking increased by more than 50 percent each year. Compared to year-end 2007, lending had declined slightly as of March 2008, as had foreign borrowing (by almost \$1.2 billion), while deposits had increased by KZT 228.6 billion (\$1.9 billion). Net open positions in foreign exchange to capital amounted to 0.9 percent in April 2008, compared to a requirement value of 25 percent. This improvement resulted from the decline in foreign exchange liabilities in relation to foreign exchange assets.⁶⁹

Over the period 2005 to 2007, major growth occurred in lending to the construction sector (99.4 percent annually), individuals (90.2 percent annually), and the trade sector (55.7 percent annually). Growth in agricultural lending averaged 26.4 percent in the same period. In the first three months of 2008, lending to the trade, construction, and transport sectors all increased. Lending to agriculture declined on a seasonal basis, while lending to other sectors showed a small decline.⁷⁰

Nonbanking Organizations

As of October 2007, the NBK reported that there were 22 nonbanking organizations (NBOs) in the country. Until the end of 2005, a number of MFIs that were registered as nonbanking financial

⁶⁷ National Bank of Kazakhstan, 2008, “Statistical Bulletin.”

⁶⁸ Pomfret, 2008, “Kazakhstan’s Banking Problems.”

⁶⁹ National Bank of Kazakhstan, 2007, “Financial Stability Report.”

⁷⁰ Ibid.

institutions (NBFIs) were included in these statistics, which showed a total of 270 NBOs as of January 2006. This latter number included 89 credit partnerships and 32 MFIs registered as NBFIs. The Kazakh Development Bank is included as an NBO, as are mortgage companies. The loan portfolios of NBOs are quite sound: 92.5 percent of loans are classified as standard.⁷¹

Pension Funds

Since the pension reform in 1997, pension funds have accumulated \$20 billion in assets (8.9 percent of GDP in 2007). In 2007, there were 14 pension funds with 59 regional branches. As of mid-2008, no fund could invest more than 20 percent of its assets in any one investment. In October 2007, aggregate pension fund investments included securities issued by legal firms (45 percent), government securities (27 percent), commercial bank securities (16 percent) and foreign securities (9 percent); other investments, including gold and financial derivatives, made up the balance.⁷²

Insurance Companies

The insurance sector has developed quickly as firms devise new instruments to attract more customers. The overall amount of insurance premiums written rose from \$178.6 million in 2003 to \$981.23 million in 2007.⁷³ There has been a large increase in housing and property insurance, concomitant with increased lending for housing. Most insurance written, however, is for industrial, oil, and aviation risks. The government has implemented changes to make this sector more efficient. The most important change is a ceiling that limits the placement of insurance companies' assets in bank deposits: this ceiling is currently 15 percent of a company's assets. This change forces insurance companies to invest in other market areas, such as:

- foreign government securities with a rating at least BBB;
- foreign mutual funds with ratings above A (10 percent of a company's assets can be invested in A-rated funds and 30 percent, in AAA-rated funds); and
- gold and other valuable metals (up to 5 percent of assets).

Leasing Companies

Leasing services are currently provided by 14 leasing companies. The total lease portfolio for 2005 was \$100 million, 50–70 percent of which was for SMEs, depending on how a leasing company defines SME. An IFC assessment of the potential market demand for leasing is \$500 million to \$550 million. In 2003, leasing represented only 0.68 percent of fixed capital investments in Kazakhstan, compared to 4 percent in Russia and approximately 15–20 percent in industrialized

⁷¹ National Bank of Kazakhstan, 2007, "Annual Report," NBK, Almaty, Kazakhstan.

⁷² Ibid.

⁷³ National Bank of Kazakhstan, 2007, "Financial Stability Report 2007."

countries. If leasing were to grow to 4 percent—which would be a realistic goal over the next five years—leasing finance would increase to \$533 million.⁷⁴ The reasons for slow growth include issues with leasing legislation and limited capital resources for leasing operations. It is expected that with changes in both the Law on Financial Leasing and the Tax Code, leasing will develop rapidly in Kazakhstan.

Commercial banks have established 9 of the 14 existing leasing companies, and have headquartered these companies mainly in Almaty and Astana. Other leasing companies have been set up by federal and municipal governments to support the agricultural sector. The majority of deal sizes range from \$40,000–\$350,000; however, there are several companies that finance deals up to \$2–\$4 million. Interest rates on lease rentals range from 18–22 percent a year (net); but agricultural companies receive government-funded lease financing at significantly lower rates to support growth in the sector. The majority of leases are for transportation, construction, mining, agricultural, agricultural processing, and oil processing equipment.

Microfinance

Microfinance in Kazakhstan is still underdeveloped, although a variety of institutions provide microfinance services (as shown in table 10). Among these are commercial banks, nonbank financial institutions, credit partnerships (cooperatives), microlending organizations, and NGOs. While accurate information is unavailable, it is estimated that these institutions had an outstanding loan portfolio of \$290 million, representing loans to approximately 93,200 borrowers, as of December 2007.⁷⁵

Table 10. Microfinance Institutions in Kazakhstan, 2006

Level	Actors	Number
I	Second-tier banks (including EBRD downscaling program)	8
II	Nonbanking financial institutions	26
	Credit partnerships	193
III	Microcredit organizations	296
Total	Microfinance institutions	523

Source: Microfinance Information Exchange, 2006 and 2008, “Central Asia Benchmarking Report,” MIX, Washington, DC.

According to the Statistics Agency of the Republic of Kazakhstan, 1,086 microcredit organizations were registered in the Republic as of January 1, 2008, among which only about 500 seemed to be active.

⁷⁴ “Kazakhstan Leasing Development Project 2003-2005,” IFC Web site, IFC, Washington, DC, http://www.ifc.org/ifcext/eca.nsf/Content/kazakhstan_advisoryprojects_completed (accessed April 2009).

⁷⁵ Data provided by the Association of Microfinance Organizations of Kazakhstan (“AMFOK”), February 2008.

The Government of Kazakhstan has established the basic preconditions necessary to develop the microfinance sector: a stable macroeconomic environment and an enabling legal framework for MFIs. This intent was also evidenced in the Law on Microlending Organizations (2003), which allows commercial and noncommercial organizations to register as microlending organizations (MLOs) and provide basic microcredit services.⁷⁶ The legal form for for-profit institutions is an economic partnership, and for non-profit institutions, a public fund.

Major stakeholders in the microfinance sector are listed below.

1. Commercial banks

Commercial banks started to provide microcredit services in the 1990s, supported by various international donor programs (i.e., downscaling programs). It appears that commercial banks do not maintain accurate separate data on their microcredit lending businesses. The most relevant data available are for small enterprise lending, usually comprising loans up to \$100,000. These data also include microcredit loans, which are commonly designated as having values of less than \$10,000. According to AMFOK data in February 2008, there were about 18,500 microcredit borrowers, with total borrowing of \$120 million, yielding an average loan size of about \$6,500 at the end of 2007.

Eight commercial banks were using credit lines from the EBRD for microfinance lending. Kazkommertsbank obtained a credit line from the German development bank KfW for lending to SMEs.⁷⁷ In addition to these lenders, Bank Caspian and ATF Bank have also received support from the EBRD.

⁷⁶ Janice K. Stallard, 2005, "Kazakhstan's Microfinance Law: Opportunities and Future Challenges," *Essays on Regulation and Supervision*, no. 13 (June), IRIS Center, University of Maryland, College Park, MD, http://www.mfc.org.pl/doc/Kazakhstan_s_Microfinance_Law.pdf (accessed May 2009).

⁷⁷ According to the "Central Asia Benchmarking Report" (February 2008) prepared by the Microfinance Information Exchange (MIX), as of December 31, 2006, there were about 50,045 active microcredit borrowers with a total outstanding portfolio of \$619.0 million. This data contradicts AMFOK statistics, however, the portfolio figure includes SMEs (which probably account for the majority of loans in the portfolio). The assumption that SME loans account for the majority of the loan portfolio is backed by the fact that the 10 biggest MFIs in Kazakhstan currently have an accumulated outstanding loan portfolio of not more than \$113 million (see Mix Market on the Web site of the Microfinance Information Exchange, Washington, DC, <http://www.mixmarket.org/en/demand/demand.global.results.aspx?pxy=622068223311200844284679QEHL7930C47M4YY5&pxy=1571326246&sc=totalloans&so=descending> (accessed April 2008)). Therefore the \$290 million figure for the outstanding loan portfolio provided by AMFOK appears quite accurate.

Table 11. Commercial Bank Microcredit Portfolio, 2005 (includes SME lending, US\$)

	Active number of credit accounts	Total credit amount	Average loan size
ATF Bank	3,126	\$6,433,245	\$2,058
Bank Centre Credit	3,408	\$5,639,366	\$1,655
Kazkommertsbank	5,448	\$10,102,944	\$1,854
Halyk Bank	7,226	\$13,709,060	\$1,896
Temir Bank	1,809	\$3,486,194	\$1,927
TuranAlem Bank	7,188	\$12,465,034	\$1,734
Tsesna Bank	237	\$567,804	\$2,396
Total	28,442	\$52,397,647	\$1,842

Source: UNDP, 2005, "Microfinance in Kazakhstan." More recent statistics are not available.

An April 2008 review of six commercial banks for this report indicated that microcredit comprised, on average, 0.2 percent of commercial banks' loan portfolios. It appears that commercial banks have found it difficult to track the status of microenterprises and their loans and have become less interested in microcredit. The conditions of these banks' microenterprise loan programs are as follows:

- nominal interest rates between 25 and 30 percent;
- a fee of between approximately 2 and 5 percent of the credit amount; and
- required collateral in the form of vehicles, stock, personal property, purchased goods, or real estate. Loans without collateral have to be secured by a third-party guarantee.

2. Microlending organizations (MLOs)

Under the current regulatory framework MLOs are not supervised by the central bank, but rather, the government Statistics Agency. MLO operational requirements include:

- microlending should be the main business activity of the organization, with loan sizes not exceeding KZT 8.7 million (\$72,500) and not comprising more than 25 percent of total capital;
- minimum paid-up capital of \$5,300 for for-profit organizations; and
- a prohibition on collecting savings.

Most MLOs in the country are located in the South-Kazakhstan Oblast (15 percent), Almaty (14 percent), and the Karaganda Oblast (11 percent), according to table 12.

Table 12. Number of Active MLOs by Region of Kazakhstan, January 2008

Region	Total active MLOs	% of total number
Akmolinskaya	24	5%
Aktyubinskaya	19	4%
Almatinskaya	30	6%
Atyrauskaya	7	1%
East Kazakhstan	23	5%
Zhambylskaya	29	6%
West Kazakhstan	24	5%
Karagandinskaya	56	11%
Kostanayskaya	22	4%
Kyzylordinskaya	47	9%
Mangistauskaya	16	3%
Pavlodarskaya	13	3%
North Kazakhstan	21	4%
South Kazakhstan	74	15%
Astana City	20	4%
Almaty City	72	14%
Republic of Kazakhstan	497	100%

Source: Statistics Agency of the Republic of Kazakhstan, January 2008.

Cultural, economic, and geographic factors explain the distribution of MLOs. South Kazakhstan is both one of the most densely populated and one of the poorest oblasts in the country. On the other hand, Almaty is Kazakhstan's financial center, where some of the first MFIs were established and where entrepreneurial spirit is strong.

Among the institutions shows in table 12, few have significant size or market share. According to the data of the MIX Market and AMFOK, the 62 members of AMFOK (reporting and nonreporting) have a loan portfolio of \$170 million and 74,000 borrowers. KMF alone accounts for 31.5 percent of total borrowers and loan volume. **The 10 largest MFIs (including Tat Senim, Valyut-Transit, ORDA Credit, Almaty Credit, Bereke, ACF, Arnur Credit and A-Invest) account for 67.6 percent of microfinance borrowers and loan volume.** Very few institutions have more than 10,000 clients. The larger MFIs are also those with the highest loan portfolio growth rates—estimated at around 40 percent in early 2008.⁷⁸

The UNDP and AMFOK conducted a survey in 2005 to assess the characteristics of MFIs in Kazakhstan. Although the data is old, the

⁷⁸ Estimate based on research conducted for this paper.

analysis still provides some useful insight into microfinance services in the country:

- **Loan portfolio:** the average loan size varied greatly, ranging from \$275 to \$212,000. NGO-MFIs had smaller average loan sizes, with MFIs that mostly employed group loans having the smallest average size. The largest loan sizes were found among credit partnerships.⁷⁹
- **Size:** with few exceptions, MFIs are small in Kazakhstan. They often have only one office or branch and cover only one oblast. The number of loan officers employed confirms their relatively small size. As noted earlier, outreach is limited, but the size of an MFI's portfolio is not always linked to the number of clients due to the existence of different kinds of borrowers. Therefore, MFIs that show better results in terms of clients are not necessarily those with the biggest loan portfolios.
- **Clients:** two kinds of borrowers use MFIs: small traders, farmers, and entrepreneurs, on one hand, and SMEs, on the other.
- **Loan products:** MFIs in Kazakhstan offer only microcredit services, but have developed different products, such as solidarity group loans, individual business loans, agriculture loans, vehicle loans, and housing loans. Most loans, though, are for trading activities. In general, loans that are not solidarity group loans and those that exceed \$500 require collateral. The majority of loans have terms of less than 12 months and in the case of agriculture, are seasonal. In most MFIs the majority of borrowers are women, reflecting the predominance of loans for trading purposes and the poverty orientation of some MFIs.
- **Deposit services:** no deposit services are provided either in the form of compulsory or voluntary savings, as these services are not allowed under current legislation. Neither has there been any attempt to develop and deliver other financial services, such as health or life insurance, by having MFIs act as agents for specialized institutions.
- **Self-sustainability:** almost all MFIs that responded to the survey conducted by the UNDP and AMFOK in 2005 were nearly or fully financially self-sustainable. This was largely due to good loan performance, but also due to the fact that many institutions had access to grant funding and low-cost concessional financing.

⁷⁹ Members of credit partnerships must make a minimal capital contribution of \$700, which excludes smaller clients.

- Sources of funding:** It is difficult to draw a map of funding sources. However, it seems that very few MFIs received money from the government. Otherwise, there are good indicators of private sector involvement. MFIs that received donor grants tended to have better performance overall. Most larger successful MFIs have at least partly been refinanced directly or indirectly by commercial sources. They have thus been affected by the liquidity shortage in the banking sector and, as of April 2008, were experiencing problems in obtaining refinancing.

An update of AMFOK member data is shown in table 13.

Table 13. AMFOK Member Data, 2006–2008

	Jan 2006	Jan 2007	Jan 2008
AMFOK members (no.)	35	45	62
Reporting members (no.)	27	26	32
Outstanding loans (\$ millions)	\$47.1	\$72.3	\$126.5
Active borrowers (no.)	34,915	37,450	41,653
Avg loan size (\$)	\$1,349	\$1,930	\$3,036

Source: AMFOK, January 2008.

In summary, table 14 shows the estimated microcredit loan portfolio at year-end 2007.

Table 14. Overview of Microcredit, Year-end 2007

Source of microcredit	Loans outstanding (\$ millions)	No. of borrowers
Commercial banks	120.0	18,500
AMFOK reportees	126.5	41,700
Non-Reporting MFIs	44.5	33,000
Total Microcredit	291.0	93,200

Source: AMFOK, January 2008.

Average loan sizes more than doubled from 2006 to 2008, while the outstanding portfolio increased by 170 percent. Both figures are signs that **MFIs are reaching a broader range of clients, including not only microenterprises, but also small enterprises.**

Market Structure

Asset and Liabilities of the Financial Sector

The financial sector is dominated by banks, which as of year-end 2007 comprised 81.9 percent of financial sector assets, followed by pension funds (7.9 percent) and insurance companies (1.3 percent), as shown in table 15 below. Bank assets increased by 77 percent in 2005 due to the high level of credit activity by second-tier banks. For example, 40 percent of corporate bond issues were provided by the second-tier banks.

The financial sector of Kazakhstan is highly concentrated. As of October 1, 2007, the largest five banks comprised 78 percent of the market; these banks plus pension funds comprised 80 percent.⁸⁰ A mere four banks (Kazkommertsbank, BTA Bank, Halyk Bank, and Alliance Bank) accounted for 70 percent of banking sector assets.⁸¹

Table 15. Market Size, as of Year-end 2007

Type of organization	No. of institutions	Assets (\$millions)	% of financial sector assets
Second-tier banks	35	76.6	81.9
Pension funds	14	7.4	7.9
Nonbanking organizations	22	4.6	4.9
Securities dealers	99	2.4	2.6
Insurance firms	41	1.2	1.3
Mortgage companies	10	1.2	1.3
Total	221	93.4	100

Source: FMSA, December 2007, "Statistics," FMSA, Almaty, Kazakhstan.

Note: Asset figures are rounded.

Major commercial banks have been expanding operations to neighboring CIS countries in recent years. For example, more than 70 percent of assets of banks in the Kyrgyz Republic are Kazakh-owned.⁸² From 2002 to 2006, the asset growth rate for commercial banks rose from 40 to 96 percent. However, growth stagnated in 2007 due to the financial crisis, resulting in asset growth year on year from 2006 to 2007 of 32 percent.⁸³

⁸⁰ National Bank of Kazakhstan, 2007, "Financial Stability Report."

⁸¹ National Bank of Kazakhstan, 2007, "Annual Report."

⁸² Pomfret, 2008, "Kazakhstan's Banking Problems."

⁸³ Ibid.

On the liability side, the external funding of commercial banks peaked at 50 percent before the financial crisis.⁸⁴ Banks profited from low international interest rates compared to double-digit domestic rates, and thus relied heavily on international refinancing. This trend resulted in a liquidity shortage once international banks reduced their lending to banks in Kazakhstan. Moreover, the maturity of international loans has been considerably shorter than the terms of domestic on-lending, increasing pressure on banks' liquidity. As shown in table 16 below, banks have considerably more long-term assets than liabilities, which puts pressure on their short-term liquidity.

Table 16. Market Maturities of Banks in Kazakhstan, Year-end 2007

Assets and liabilities by maturity bucket (KZT billion)					
Maturity bucket	Assets	Liabilities	A – B	Contingent liabilities	A/(B + D)
	(A)	(B)	(C)	(D)	(E)
On demand	1, 655.0	1, 272.8	382.2	74.7	1.2
Up to 30 days	2, 461.9	2, 072.3	389.5	1,347.5	72.0
Up to 3 months	3, 024.0	3, 132.5	-108.6	2,014.8	59.0
Up to 6 months	3, 603.8	3, 951.6	-347.8	2, 937.5	52.0
Up to 1 year	4, 548.1	5, 151.3	-603.3	3,768.4	51.0
Above 1 year	6, 582.7	4, 942.7	1, 640.0	5,862.2	61.0
Total:	11,130.8	10, 094.1	1, 036.7	9,630.5	56.0

Source: FMSA, December 2007, "Statistics," FMSA, Almaty, Kazakhstan.

Performance

The financial crisis, in conjunction with an over-heated economy and rising inflation, exposed deficiencies in the banking sector. In summary, these were: (i) an excessive reliance on foreign borrowing as a source of funds; (ii) an unsustainable rate of lending growth; (iii) excessive loan exposure in sectors such as construction and real estate; and (iv) deteriorating loan portfolio performance. The decline in real estate values further weakened the security of bank lending. Over the six years ending in September 2007, housing prices in Kazakhstan grew at an annual average rate of 38 percent.⁸⁵ Return on assets (ROA) and return on equity (ROE) remained relatively constant, with a slight improvement in ROA, at 1.6 percent.

⁸⁴ André Küüsvek, 2007, "Kazakhstan—EBRD View," EBRD, Astana, Kazakhstan, <http://www.ebrd.com/country/country/kaza/ebdview.pdf> (accessed May 2009).

⁸⁵ National Bank of Kazakhstan, 2007, "Financial Stability Report."

Table 17 shows a classification of nonstandard loans by sector over the period January 1, 2006 through October 1, 2007. As of January 2006, 41.8 percent of all lending was classified as less than standard; this volume fell in the following year to 20.6 percent in January 2007. However, there was a general deterioration in 2007—the Financial Markets Supervisory Agency (FMSA) announced that as of October 1, 2007, 60.9 percent of lending was less than standard.

Table 17. Classification of Nonstandard Loans by Sector, January 2006–October 2007 (%)

	2006	2006	2007	2007
Lending by Sector	January 1	October 1	January 1	October 1
Industry	39.1%	42.2%	22.6%	45.7%
Agriculture	61.5%	50.0%	47.4%	66.7%
Construction	61.9%	56.7%	24.9%	73.1%
Transport	42.2%	39.6%	18.2%	46.9%
Communications	17.1%	30.1%	13.9%	49.4%
Trade	45.7%	39.6%	16.8%	63.0%
Other (individuals/consumption)	34.3%	38.1%	13.3%	54.3%
Total (all sectors)	41.8%	40.8%	20.6%	60.9%

Source: National Bank of Kazakhstan, 2007, “Financial Stability Report.”

It is expected that the slowdown in lending will expose a greater volume of under-performing loans. A report by Fitch Ratings indicated that nonperforming loans (NPLs) to individuals had increased from 3.3 percent in August 2007 to 8.8 percent by the end of February 2008.⁸⁶ Sectors of major concern were construction, trade, and individual lending: these sectors represented 86 percent of total lending that was classified as less than standard. As a result of the crisis, bond yields of second-tier banks had risen from a range of 6.04–7.9 percent at the start of 2007 to a range of 6.95–14.6 percent by the end of the year. Banks perceived to be at risk, such as Alliance, were paying the higher rate.⁸⁷

In general, commercial banks have so far been in a sound position to absorb loan losses. The average capital adequacy ratio (CAR) for all commercial banks was 14 percent in October 2007, with regulatory capital of KZT 1,685.6 billion, or 19 percent of loans outstanding. It is estimated that one of the worst-hit banks (Alliance) could write off 12.2 percent of its gross loans before its regulatory capital fell below 12 percent.⁸⁸ An assessment of excess risks, such as illiquidity, interest rate changes, and currency depreciation, put three banks on watch. The remaining banks are considered sound.

⁸⁶ As cited by UniCredit Group, 2008, “Kazakhstan Quarterly Outlook, 02/2008,” UniCredit Group, Milan, Italy.

⁸⁷ National Bank of Kazakhstan, 2007, “Stability Report.”

⁸⁸ Fitch Rating, February 2008.

The near-term performance of the financial sector is closely linked to Kazakhstan's overall economic performance and the price of oil. If this price stays high, the money inflow will finance the vast amount of real estate projects in which domestic banks have invested. But if the real economy and the price of oil go down, loans will go into default and solvency problems will occur on top of decreased liquidity.⁸⁹

According to the IMF, banks will still face liquidity challenges, since NPLs are expected to continue to worsen in 2008 and most banks will have to make external debt repayments.⁹⁰ The financial soundness of domestic commercial banks in the future remains uncertain and risk management steps need be taken to mitigate risks, including, for example, conservative collateral evaluations (in view of falling property prices).

Microfinance Sector

The financial crisis in the banking sector will have an impact on the performance of MFI loan portfolios. However, no data are available regarding the performance of the aggregate microfinance loan portfolio in 2008 as compared to 2007. It is expected that NPL ratios might go up, to a lower extent than in the banking sector since MFI loans are mostly short-term and based mainly on trading activities that frequently close positions within one or a few days. The exposure to risk is thus limited to a few days. Furthermore, most borrowers do not themselves provide trade credit, and this has also reduced their risk exposure. There has been an increase in NPLs among some MFIs visited for this report; this trend appears to be due to lax management or longer-term and larger business loans, or both.

Financial Infrastructure

Capital Market

The national currency, the KZT, was introduced November 15, 1993, shortly before the Kazakh Interbank Currency Exchange was established as a closed joint stock company by the NBK and 23 leading commercial banks.

Stock Market. The Kazakhstan Stock Exchange (KASE) has been in operation since 1993 and works both with primary and secondary markets; it is the only financial exchange in the country. With 103 members, KASE enables trades in shares, corporate securities,

⁸⁹ Pomfret, 2008, "Kazakhstan's Banking Problem."

⁹⁰ IMF, 2008, "Republic of Kazakhstan—2008 Article IV Consultation."

government securities, REPO instruments, and foreign currency and futures contracts, generally through open trading. It has issued 450 shares with an equity of KZT 1,131,566,000 (\$9.4 million) as of January 1, 2008. Turnover in 2007 was \$322.5 billion. Strategically, KASE plans to launch a currency swap market, as well as a derivatives market based on a KASE Shares Index, before 2010.⁹¹

Bond Market. The government was initially the only bond issuer, but recent changes have enabled large companies to issue bonds with maturities of up to nine years. In 1998, the government securities market was stimulated by the entrance of a new group of securities market participants—pension asset management companies. By law these companies are forced to operate only in an institutionalized stock market. In the same year, with the help of the National Securities Commission of Kazakhstan, a secondary market for sovereign eurobonds of Kazakhstan was formed. The first trades in these eurobonds were conducted on the stock exchange in late 1998. The involvement of the stock exchange in corporate bonds started in 1999. In 2006, KASE managed the first trade with foreign corporate bonds (in association with JP Morgan and Merrill Lynch). Most bonds are issued by second-tier banks, which over the last three years have been responsible for 78–86 percent of the total volume of bonds, followed by the energy sector (2–5 percent).

Fiscal surpluses have also had a positive impact on the development of private savings and the bond market. The growing demand of pension funds for quality investment outlets triggered the rapid development of the debt securities market. Pension fund capital is invested almost exclusively in corporate and government bonds, including Government of Kazakhstan eurobonds, which has positively impacted the development of the corporate bond market.

Payment System

Interbank System of Money Transfer (ISMT). The ISMT performs payments in the national currency with settlement guaranteed in one operational day—the international standard for interbank money transfers. Settlements are performed through the use of money in the accounts of ISMT participants at the National Bank of Kazakhstan. Kazakhstan operates a Real Time Gross Settlements System (RTGS)—a “push payment” system in which the transaction is initiated by the paying bank. Transfers are done on a continuous, transaction-by-transaction basis throughout the day in electronic form. The system has been in use since August 1996 under the Kazakhstan Interbank Settlements Centre (KISC).

⁹¹ National Bank of Kazakhstan, 2007, “Financial Stability Report 2007.”

There are 54 direct participants in the system, including the NBK, the Treasury of the Ministry of Finance, the State Center of Pension Payments (SCPP), commercial banks, KASE, and the Securities Central Depository. On average, 33,000 transactions are channeled per day through the system.

All Kazakh banks or financial institutions that carry out limited types of banking operations (the SCPP, Treasury, and bank branches) can be members of the clearing system. The maximum payment amount must not, however, exceed KZT 3 million (about \$24,857 as of April 1, 2008).⁹²

Banking Messages Exchange System. KISC also implements a Banking Messages Exchange System (BMES), in which banks and others can use cryptographic facilities to identify clients of the payment system, encrypt and protect transmitted information, and check electronic digital signatures.

Deposit Insurance

In 1999, NBK introduced deposit insurance to strengthen the banking sector, protect depositors, and reduce the risk of bank insolvency. The deposit insurance system is managed by the closed joint stock company Kazakhstan Deposit Insurance Fund (KDIF). The NBK is the founder of the KDIF and invested KZT 1 billion (\$8.4 million) in its authorized capital. KDIF will pay off insured deposits to depositors of a bank that is forced to liquidate. The system is mandatory and had 32 bank members as of September 1, 2007. In its original form, the system required a flat premium of 0.25 percent of total insured deposits for the first 2 years, and 0.16 percent thereafter.

A new law on deposit insurance came into force in January 2007. This law allows for the set-up of a differential premium system for banks, based on risk classification. According to the KDIF, the new approach enables full coverage of 98 percent of all individuals' deposits in Kazakhstan, exceeding by over 7 times the average individual deposit amount (KZT 96,300). All deposits are insured with the following exceptions: (i) time deposits greater than KZT 7 million (\$58,000 as of April 1, 2008); (ii) deposits held by the CEO of a failed bank; and (iii) deposits of shareholders (and close relatives) who hold more than 5 percent of the stock of the failed bank. Accrued interest is also excluded.⁹³

⁹² Kazakhstan Interbank Settlement Centre (KISC), National Bank of Kazakhstan, n.d., "Clearing: Information on Clearing," KISC English-language Web site, Almaty, Kazakhstan, http://www.kisc.kz/english/pay_systems/srp.htm (accessed May 2009).

⁹³ National Bank of Kazakhstan, 2007, "Annual Report."

Kazakhstan has experienced a few cases of bank bankruptcies. The two most recent are Valut-Transit Bank (one of the largest regional banks), whose bank license was revoked at the end of 2006, and Nauryz Bank, which was closed at the end of 2005. In both cases, the deposit insurance system repaid all depositors, although in the case of Nauryz, procedures had yet to be finalized as of mid-August 2007. For Valut-Transit Bank, the KDIF claims to have repaid 94 percent of its total liabilities as of August 2007.

Accounting Standards

In 1995, national accounting standards (Kazakhstan Accounting Standards, or KAS) were developed, based on International Accounting Standards (IAS). In 2002, the country decided to fully adopt International Financial Reporting Standards (IFRS). These changes were implemented in a step-by-step approach, starting with financial institutions (2003), followed by joint-stock companies (2005), and then all other entities (2006). In a recent amendment of the Law on Accounting and Financial Reporting in early 2007, a three-tiered reporting structure was set up: microenterprises apply simplified tax-based rules, SMEs apply national accounting standards, and larger companies and public interest entities, including banks, are obliged to use IFRS.

According to a gap analysis conducted by the World Bank in 2007,⁹⁴ **there are larger differences between IFRS and KAS than originally planned.** The main points of difference include overstated valuations of property, plant, and equipment; overstatements of interest-free loans in the balance sheet of the lender; and open questions concerning the approach to measuring the costs of agricultural products and livestock. There is a shortage of professional accountants in the country and while audited IFRS financial statements on a general level are in compliance (although further work is still needed), the quality of KAS-based financial statements tends to be very low. The gap analysis notes that in many cases, deficiencies are so severe that an informed decision about a company is not possible based on its financial statements.

Only a few firms follow the legal requirement to make their financial statements available to the public. Most larger banks publish their financial statements on their Web sites. However, several smaller banks do not publish such statements in a proper and timely manner. MFIs are advised, but not legally required, to follow KAS. As seen in the Microfinance Information Exchange reports and AMFOK statistics, **more than half of MFIs are behind in completing and presenting their financial statements.**

⁹⁴ World Bank, 2007, “Kazakhstan—Report on the Observance of Standards and Codes (ROSC),” report no. 40942 (May), World Bank, Washington, DC.

Audit Standards

While the Law on Banks requires these institutions to publish an annual report, there is no requirement for them to make consolidated financial statements publicly available (as mentioned above, the requirement is only for the financial statements of legal entities). The required annual report must include a balance sheet and an income statement after an audit has been carried out and the financial statements are approved by a general shareholders' meeting. Banks with subsidiaries are obliged to prepare consolidated financial reports in the same format, which are submitted to the owners and the FSA.

However, the standard formats used for financial statements have only limited value for users and cannot be considered consolidated financial statements. This approach differs from the spirit of the Core Principles for Effective Banking Supervision issued by the Basel Committee on Banking Supervision. As a consequence, **depositors and other creditors may face considerable difficulty in obtaining sufficient information about the financial condition of banking groups.**

Positive changes in the regulatory framework have recently been enacted. Recent amendments to the Accounting Law, in 2007, allow the government to set up a depository where all joint-stock companies must file their financial statements, which would improve available information. The Law on Audit Activity, adopted in May 2006, stipulates the use of International Standards on Auditing (ISA) in the conduct of audits in Kazakhstan as of November 2006. The Audit Law also introduced a number of other significant changes, generally for the better, to the statutory framework for auditing. These include:

- mandatory membership of all auditors in a professional association (the law envisages more than one professional association);
- a requirement that audit firms have at least three auditors and a system of internal quality control, and that the auditors own a majority of the shares of the audit firm;
- a requirement that individual auditors be members of only one audit firm at a time (sole practice is no longer permitted);
- a requirement that professional associations become responsible for oversight of their members under the supervision of the Ministry of Finance; and
- a requirement that professional associations appoint representatives to the Qualification Commission, which will be a separate legal entity.

Rating and Credit Information

As with accounting, there is a general lack of good audit professionals in Kazakhstan, as well as training opportunities in the country. A system of professional quality control does exist in which all auditors are tested once every three years by the professional association to which they belong. Procedures for quality control, however, are set up by the respective associations and the results of the controls are not required to be made public. There are presently two professional associations in Kazakhstan: the Chamber of Auditors and the Collegium of Auditors.

“The big four” accounting firms—Pricewaterhouse Coopers, Ernst & Young, Deloitte, and KPMG—are all present in Kazakhstan, which is a positive sign for future development. There is no requirement yet for banks to rotate audit firms, although a suggestion for an audit rotation every three years is under discussion.

Rating. The three large rating firms (Standard & Poor's, Fitch Ratings, and Moody's) are all active in Kazakhstan and conduct ratings at both the country and institutional level (the latter relates to ratings of corporate and financial institutions). The Development Bank of Kazakhstan as well as the ten biggest commercial banks have been rated.

In the microfinance sector, the larger microfinance rating agencies are to some extent active in the country. ACCION has completed a CAMEL Rating for both Asian Credit Fund and Bereke; M-CRIL rated KMF in 2002, while Mikrofinanza rated the small microfinance institution A-Invest in late 2006.

Credit Information. A private credit bureau was founded in July 2004 by seven top banks (Alliance Bank, ATF Bank, Bank TuranAlem, Bank CenterCredit, Kazkommertsbank, Halyk Bank of Kazakhstan, and Tsesnabank) and the Financial Institutions' Association of Kazakhstan. The credit bureau was formed as part of the Financial Sector Initiative of the Pragma Corporation/USAID. The bureau, named First Credit Bureau, is a limited liability partnership and started commercial operations in early 2006 under the framework of the law “On Credit Bureaus and Formation of Credit Histories.” The bureau provides reports on legal entities as well as physical persons. As of April 2008, it worked with over 70 clients, including all commercial banks and several microcredit organizations, such as Almaty-Finance LLP, TAT SENIM, Astana-Finance, Credit Land KKO, and KazMicroFinance LLC.⁹⁵

⁹⁵ First Credit Bureau Web site, Almaty, Kazakhstan, <http://www.1cb.kz/> (accessed April 2009).

According to the World Bank's "Doing Business 2007" report, private credit bureau coverage, that is, the number of individuals and firms covered by a private credit bureau as a percentage of the adult population, increased from 5.5 percent in 2006 to 13.7 percent in 2007.⁹⁶

Apex Banks and Funds

It was observed that commercial banks have, in the past, made medium- to long-term loans to MFIs to allow these institutions to increase their lending. Alliance Bank, for example, made loans in the range of KZT 100–400 million for five-year terms at an interest rate of 11 percent (now 15 percent) a year. Such terms were attractive to MFIs. Today, however, the liquidity crisis has restrained commercial bank lending to the microfinance sector.

The Entrepreneurship Development Fund (EDF) started operations in 1997, initially under the name of the Small Entrepreneurship Development Fund. EDF is completely government-owned and funds small- and medium-sized business loans through banks, leasing services, and MFIs. It also provides advisory services to entrepreneurs. (See "Demand and Supply for Refinancing" section for more details.)

The National Oil Fund was established to ensure the economy's stability against swings in the price of natural resources. The assets of the National Fund, which amounted to \$21.6 billion at year-end 2007, are monitored by the National Bank of the Republic of Kazakhstan. The Fund is managed by the Management Council of the National Fund of the Republic of Kazakhstan, which was formed by the President of Kazakhstan and is comprised of high-level political officials. The National Oil Fund has provided financial assistance to banks for lending to the construction sector and to EDF for on-lending to MFIs. Over the period April 2007 to April 2008, the assets of the Fund grew by \$6.86 billion. Proceeds have been partially used to finance several MFIs (approximately 28 MFIs in Almaty have been supported by the Fund).

The Development Bank of Kazakhstan (KDB) was set up in 2001 by the government as a specialized financial institution to provide non-extracting economic sectors and infrastructure projects long-term financing and technical assistance. KDB has financed more than 100 investments totaling \$1.3 billion. Its outstanding loan portfolio at the end of 2006 was \$400 million. To date, KDB has not been active in microfinance development.

⁹⁶ World Bank, 2008, "Doing Business 2007."

Frontiers is a wholesale microlending company based in Kyrgyzstan that was established in 2003 by the American nonprofit organization ACIDI/VOCA. Intending to fill the gap in financial systems in the region, Frontiers provides loans to regional MFIs, including wholesale loans, mortgage loans, and technical assistance loans. The organization often lends to MFIs that have yet to establish a borrowing history. Frontiers currently finances five MFIs in Kazakhstan, with investments ranging from \$500,000 to \$2.5 million.⁹⁷

There are a number of other wholesale funds active in the region, including Blue Orchard, Planet Finance, and responAbility. Additionally, ACIDI-VOCA is considering setting up a Central Asia fund, which would include the Kazakhstan market (see “Demand and Supply for Refinancing” section for more details.)

Industry Associations

There are a number of financial sector industry associations in Kazakhstan.

The **Kazakhstan Bank Association**, with 10 members, pursues the following activities:

- represents the interests of the banking sector before the government, the central bank, and other governmental bodies;
- serves as a support and commenting body for the development and adjustment of the legal framework for the banking sector;
- organizes training for bank employees;
- organizes and participates in discussions, conferences, and meetings on financial and business matters;
- sets up and organizes interbank cooperation;
- organizes the Deposit Insurance Fund for commercial banks; and
- provides consultancy services to commercial banks.

The Financial Institutions Association of Kazakhstan, founded by five second-tier banks and one insurer, is responsible for:

- participating in the financial market and tax regulation development;
- promoting financial services market development;

⁹⁷ Phone conversation with Frontiers office staff member, Urmat Sarpekov [sp?], August 1, 2008.

- participating in the development, support, and protection of local entrepreneurs;
- compiling, analyzing, and summarizing member's proposals on the resolution of financial sector issues;
- establishing work groups according to priorities identified by members; and
- providing information assistance to members.

The **Association of Microfinance Organizations of Kazakhstan (AMFOK)** was the umbrella organization for 68 MFIs as of year-end 2007. As such, AMFOK coordinates technical support for MFIs by providing training courses and acts as an advocate to influence government policy. Its areas of focus include research and development, policy advocacy, knowledge management, and governance. The aggregate loan portfolio of 32 AMFOK members at year-end 2007 was KZT 15.2 billion (\$126 million), representing loans to 41,653 active borrowers. No information was available concerning loan classification. Approximately 70 percent of the borrowers of these 32 members are women. AMFOK stated that as of year-end 2007, it had 15 member MFIs with loan portfolios in excess of \$1 million.

The **Eurasian Bankers' Club**, consisting of 7 commercial banks, is active in:

- the integration of financial and banking structures;
- holding discussions on acceptable procedures of state bodies and the harmonization of regulations, and
- harmonizing financial legislation.

Training for the Financial Sector

A number of local institutions provide training to the banking sector, as described below.

The Almaty Bank Training Center was established in 1994 as part of the European Union program Technical Aid to the Commonwealth of Independent States (TACIS) and offered bank training to commercial banks on a range of topics. Recently, however, interest in ABC's training has declined and some courses have been taken over by the NBK as part of its own in-house training.

Bang College of Business is a private not-for-profit organization within the Kazakhstan Institute of Management, Economics, and Strategic Research. The college offers a Master's Degree in Finance,

Accounting, and Management and is a member of the American Association of Collegiate Schools of Business. It has 4,800 students.

Education centers within commercial banks. Some commercial banks, such as TuranAlem Bank and Temir Bank, have their own training centers to provide staff educational programs, which are delivered by both local and foreign trainers.

Training and consulting for microfinance organizations. AMFOK acts as a promoter and coordinator of training courses for MFI staff, identifying the needs of its members and then arranging for training to be provided by selected trainers, usually with donor financial assistance. The larger MFIs in the country have participated in training sessions organized and delivered by the MicroFinance Center (Warsaw and Almaty), as well as a range of international training courses and seminars in the USA, Europe, and Mongolia.

Technology

There is limited information available on the level of technology of banks in Kazakhstan. Annual reports of some of the banks mention growth in the issuance of cards and the development of Internet banking.

Of specific interest to the microfinance sector is the continuing development of mobile banking to reach remote clients. Since 2005 Halyk Bank has worked on a pilot project with VISA called “Mobile Bank—Verified by Visa.” By the end of 2007, Halyk Bank had registered 200,000 mobile banking clients and as of April 2008, was working on further service developments to enable money transfers.

Legal, Regulatory, and Policy Framework

The **National Bank of Kazakhstan** has delegated the regulation and supervision of the financial sector to the **Financial Markets Supervisory Agency** (FMSA, the formal name of which is the Agency for Regulation and Supervision of Financial Markets and Institutions). FMSA is responsible for, among other things, the acquisition of banks, external borrowing for domestic banks, and the capital adequacy rate. The “Concept of Finance Sector Development in Kazakhstan” was adopted by the government in mid-2003 to further streamline the development of Kazakhstan’s financial sector. The legal framework identifies three kinds of institutions:

- commercial banks;
- nonbanking financial institutions, credit partnerships, and pawnshops; and
- microcredit organizations.

Subsequently, MFIs (in the forms of NBFIs, MLOs, and credit partnerships) were taken out of the formal financial sector and were no longer supervised by FMSA.

Three main laws regulate Kazakhstan's financial sector. An overall framework is provided by the "Law on Banks and Banking Activity," ratified on August 31, 1995. This law provides the legal framework for banking activities both for banks and organizations carrying out banking operations. It establishes registration procedures, organizational and legal structures, amounts of chartered capital, and operational and reporting requirements. It also defines the responsibilities of banks in:

- (i) disclosing their terms of operation;
- (ii) granting special terms for individuals with whom banks have special relationships;
- (iii) regulating bank operations; and
- (iv) protecting the interests of depositors.

The law also specifies the supervisory authority under which banks and nonbank financial institutions operate. Two other laws, on microfinance and credit partnerships, respectively, enacted in 2003, provide specific regulations for MFIs.

The **Law on Microlending Organizations** governs the provision of microcredit and provides specific requirements regarding the establishment, legal status, operations, re-organization, and liquidation of microcredit organizations. Apart from financial institutions, **microlending organizations are not allowed to collect savings.**

The **Law on Credit Partnerships** establishes a special regime for mutual credit, which gives small enterprises access to credit. In addition, the law provides simplified procedures for private individuals and legal entities to set up and withdraw from credit partnerships, specifies the terms of participation in such partnerships, and defines simplified procedures for their licensing and supervision.

In a review of the problems of the financial sector in 2007, the government outlined its objectives as: finding and maintaining a proper balance between reaching a soft landing in the banking sector and not impairing the credit rating of the country, while avoiding the creation of moral hazard through the careful use of reserves and the assets of the National Oil Fund.

The government's plan includes improving the governance and transparency of the banking system to allow more effective market discipline, as well as strengthening bank supervision by FMSA. The latter goal will entail curtailing related-party lending, enhancing the technical capabilities of the FMSA and increasing its staff, and improving the collection of market data critical for timely decision making. The FMSA will actively encourage banks to review and revise their risk management practices and conduct stress testing of their portfolios. The NBK and the FMSA both plan to carefully track changes in world financial markets, conduct cogent analysis, and prepare policy recommendations for the government.

Apart from obtaining a business license and undergoing an annual external audit, there are no regulatory requirements of MFIs, nor are they supervised. Lenders to larger MFIs conclude contracts that require financial reporting, which partially offset the lack of general supervision. **Among AMFOK member MFIs, almost 50 percent had not released their 2007 reports by April 2008. The percent of reporting MFIs has, moreover, declined each year.** Among Kazakhstani MFIs listed on the MIX Market, over half have not provided full reports in the last year.

Concerns remain regarding the advantages and privileges that banks have vis-à-vis MFIs, such as different definitions of pre-tax expenses (specifically, loan loss provisions are tax deductible for banks).

Requirements to transform into banks are rather strict. According to the research conducted for this report, no MFI has yet received a banking license, although KMF and ORDA Credit have initiated transformation processes and applied for licenses. Most MFIs do not have the technical or financial base to transform themselves into banks and are obliged to operate as microlending organizations instead. AMFOK has accordingly made recommendations to the government to amend and improve legislation affecting MFIs. The major recommendations are to:

- (i) remove the statutory limit on loan size to borrowers;
- (ii) allow an MFI to become a joint stock company;
- (iii) allow MFIs, as joint stock companies (JSCs), to issue bonds; and
- (iv) enact legislation permitting the existence of credit unions.

These AMFOK proposals require further discussion between practitioners and the government. Greater credit risk stemming from excessively large loans must be taken into account. Moreover, only larger, professional MLOs should be allowed to issue bonds so as to ensure a level of investment safety for the public. Allowing MFIs to

become JSCs has merits in that it would simplify the process of mergers among MFIs and encourage a much-needed diversification of ownership. Legislation allowing MFIs to collect savings is also under discussion.

Gap Analysis

Summary of Gaps

Information and Reporting. Whether referring to banks, microfinance institutions, or individual enterprises, there is a clear dearth of information in Kazakhstan, particularly regarding MFIs, since they are not regulated and financial reporting is not mandatory for them. In general, data is often unavailable, outdated, incomplete, or unreliable, creating a large hurdle to forming a clear picture of demand for microfinance services in Kazakhstan. Significant differences in local versus IFRS accounting standards present another hurdle for institutions, such as banks, which are required to report.

Supervision. There is an urgent need for a responsible authority to, at a minimum, establish and implement an enforceable system of off-site supervision of MFIs. Several key deficiencies exist:

- (i) **Loan classification and loss provisioning:** standards have been set by the NBK, but there is no monitoring or enforcement of these standards.
- (ii) **Exposure:** there is no regulation concerning restrictions on lending to sectors, on related group lending, or on lending to staff or owners.
- (iii) **Qualifications of senior management:** no standards regarding years of experience or education exist.
- (iv) **Internal audit:** no requirement exists.
- (v) **External audit:** MFIs are required to submit annual audited financial statements to the FMSA, but there is no portfolio at risk analysis and reports are often late.
- (vi) **Loan loss provisions:** these provisions are not tax deductible. Only declared loan losses can be deducted against income tax.
- (vii) **Ownership structure:** many MFIs are single-founder limited liability companies. As of April 2008, MFIs cannot be joint stock companies. This means that it is impossible for an MFI to diversify its ownership structure unless it becomes a bank; this option is beyond the financial capacity of most MFIs.

- (viii) **Accounting standards:** the financial reports of many MFIs that were visited for this report lacked adequate information disclosure. Many did not show (a) loan loss provisions, (b) a proper classification of the loan portfolio, or (c) adequate descriptions of all assets and liabilities. In all MFI financial reports, there were significant annual variations in the amounts of expenses, assets, and liabilities that were not adequately explained. Without such explanations, these statements would prevent MFIs from obtaining financing.

Demand for Microfinance Services. Despite the lack of complete and reliable information, it is clear that demand for microcredit in Kazakhstan outstrips supply. The gap is estimated at 125,000 borrowers, which will require an additional \$300 million in credit. The demand and need for attractive and accessible microsavings services, especially in rural areas and among poor and low-income households, has been ignored by the banking sector. At present, MFIs are prohibited from offering such services. Commercial banks, moreover, see microcredit as an adjunct to small business lending, rather than an opportunity in its own right, and are not at present interested in downscaling their services.

Demand for Refinancing. Although estimates are difficult to generate in light of the lack of data, research for this report suggests that \$200 million in debt financing and \$150 million in retained earnings and additional equity will be required by the microfinance sector. It is unlikely that current funding sources will be able to fully satisfy demand for refinancing. Direct investments in MFIs are challenging, given their small average size and unclear or concentrated ownership structures, although there are exceptions. While a number of wholesale funds are present in the region, many have relatively large minimum investment sizes. Additionally, as discussed earlier, MFIs may prefer funding sources other than EDF. Finally, Frontiers requires additional liquidity to support its growth.

Legal and Regulatory. There are a number of gaps in the legal and regulatory framework governing MFIs. Most importantly, there is an urgent need to establish and implement an enforceable off-site system of supervision for MFIs, as discussed above. Other key gaps include inadequate monitoring, tax disadvantages relative to banks, restrictions on legal form (JSCs are not permitted), ineffective industry self-regulation, and poor accounting standards, among others. These are serious deficiencies that need to be addressed by the government if the microfinance sector is to flourish.

Ownership and Capital. MFIs are not allowed to operate as joint stock companies, which restricts their ability to bring in additional

Donor Programs for the Micro- finance Sector

shareholders and expand their equity base, diversify ownership, and move away from being single owner-operator institutions. The restriction on their legal form also makes MFIs less attractive as commercial borrowers and restricts their choice of debt financing instruments.

Organization. Most MFIs lack a proper organizational structure and are reliant on a single key manager, limiting their growth and development.

Transformation. A few MFIs have developed a proper organizational structure and a branch network that allows greater outreach of services at relatively low cost. These networks also provide a base for expanding these institutions' range of services and products. There is, however, insufficient legislative and regulatory support to encourage more efficient MFIs to transform into more advanced financial institutions. There are two abrupt hurdles: converting to a joint stock company (and identifying appropriate shareholders) and finding and attracting the large amount of equity required to become a second-tier bank.

Several larger donors support the development of the microfinance sector.

The **International Finance Corporation (IFC)** began its advisory program in Kazakhstan in 1995, when it helped privatize the East Kazakhstan Polymetallic Mines. Since then, advisory work has continued in the fields of steel production, oil services, and banking for small and medium enterprises. In recent years, the IFC has been concentrating its efforts on creating favorable conditions for the growth of the leasing industry and housing finance. In addition, IFC's regional advisory programs, which support MFI growth and transformation strategies, as well as good governance, benefit the entire microfinance industry.

The **European Bank for Reconstruction and Development (EBRD)** is active in improving the transparency of ownership and integrity in the banking sector. Recent financing included a €15 million equity investment for 20 percent of Kazinvestbank; investments in two funds, Centras Private Equity (€8 million) and Barings Vostok Fund (€6 million); and a mortgage finance facility for €3 million. The EBRD also extended a €219 million syndicated A-B loan to Kazkommertsbank, with EBRD financing comprising one-third of the loan. In addition, the EBRD took an 8 percent shareholding in the bank. As of early 2008, the EBRD also appeared to be in discussion with EDF to take over 25 percent of its shares.

The EBRD has also provided several technical assistance programs to the banking sector, including the multidonor program “Kazakhstan Small Business Program” (KSBP), that promotes small business lending by participating commercial banks. This project was also partly financed by the World Bank under its Second Agriculture Post-Privatization Project. In 1998, the EBRD provided \$77 million in loans and \$4.4 million in technical assistance to KSBP I for lending to microenterprises and small businesses. This investment was followed in 2002 by KSBP II, in which the EBRD invested \$100 million and in 2005 by KSBP III, in which it invested \$100 million of senior debt and \$60 million in cofinancing and syndicated loans. Very little of this lending has, however, gone to microenterprises. Under KSBP III, there is a provision to provide financing to KazMicroFinance (KMF). At the time of this writing, KMF indicated that it had made a financing request of \$6.8 million.

The **Asian Development Bank** (ADB) launched a program to support financial sector governance in 2004. Recently, ADB also launched a technical assistance program to strengthen FMSA’s supervisory function. In addition, it has provided five-year loans totaling \$125 million to two Kazakh commercial banks.

In 2002, the **U.S. Agency for International Development** (USAID) contracted ACIDI-VOCA to carry out the four-year, \$4.7 million “Central Asia Micro Finance Alliance (CAMFA)” program, covering Kazakhstan, Kyrgyzstan, Tajikistan, and Uzbekistan. CAMFA supported the development of Frontiers and AMFOK, as well as provided technical support to KMF, AKF, Bereke, and other smaller MFIs. Support comprised technical assistance (in the form of training) for institutional strengthening and product development.

The **World Bank’s** Second Agricultural Post-Privatization Project, approved in December 2004, had a rural microfinance component that funded \$5.4 million to enhance MFI operational and managerial performance and facilitate product innovation and MFI access to commercial funds. The project cooperated closely with AMFOK in identifying MFIs interested in rural and agricultural lending and providing training to staff of these institutions.

The **United Nations Development Programme** (UNDP) supported the transformation of the NGO Atyrau into an MFI (1998–2005), as well as that of Bereke in the Semipalatinsk region (2002–2006). Bereke has since become a financially sustainable MFI. No information has been available on Atyrau since the end of 2006, but at that time the institution was quite small, with a total loan portfolio of about \$170,000 and 42 borrowers. Both MFIs are AMFOK members.

Larger MFIs received international support during their start-up phases and are developing linkages with a broader range of donors. USAID, through ACDI/VOCA, supported KMF and AMFOK. The U.S. Department of Agriculture and USAID, through Mercy Corps, supported the development of ACF. USAID/Winrock supported KFOND, and the UNDP supported the development of Bereke. A total of 199 MFIs have received financial support totaling KZT 5.6 billion (more than \$43 million) from the government-funded Small Entrepreneurship Development Fund (now EDF). An increasing number of international financiers are now interested in financing the better-performing MFIs, including Oiko Credit, Deutsche Bank, Morgan Stanley, CitiBank, Symbiotics, Blue Orchard, PlaNet, Hivos-Triodos, Incofin, MicroVest, and the regionally located Frontiers. These international funders are generally focusing on the three to five largest MFIs, including KMF, ACF, and Almaty Finance.

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