ADB

Report and Recommendation of the President to the Board of Directors

Project Number: 40937

Proposed Guarantee for the Diversified Payment Rights Securitization by Alliance Bank JSC

In accordance with ADB's public communications policy (PCP, 2005), this abbreviated version of the RRP excludes confidential information and ADB's assessment of project or transaction risk as well as other information referred to in paragraph 126 of the PCP.

Asian Development Bank

CURRENCY EQUIVALENTS
(as of 9 August 2006)

Currency Unit – tenge (T)

T1.00	=	$0.0082
$1.00	=	T122.56

ABBREVIATIONS

ADB	–	Asian Development Bank
ALB	–	Alliance Bank JSC
CIS	–	Commonwealth of Independent States
DDB	–	designated depository bank
DPR	–	diversified payment rights
DSCR	–	debt service coverage ratio
GDP	–	gross domestic product
JSC	–	joint stock company
KfW	–	Kreditanstalt für Wiederaufbau
NBK	–	National Bank of Kazakhstan
PRC	–	People’s Republic of China
PSOD	–	Private Sector Operations Department
SMEs	–	small- and medium-sized enterprises
SPV	–	special purpose vehicle
SWIFT	–	Society for Worldwide Interbank Financial Telecommunications
US	–	United States

NOTE

In this report, "$" refers to US dollars.

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APPENDICES

I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed credit guarantee (Guarantee) for principal of $100 million and accrued interest in connection with diversified payment rights securitization by Alliance Bank JSC (ALB) of up to $200 million in total.

II. RATIONALE: BACKGROUND, CHALLENGES, AND OPPORTUNITIES

A. Kazakhstan Economy: Overview and Outlook

2. Kazakhstan maintained its solid economic growth in 2006 (in excess of 7.4% during January–June 2006) based on foreign direct investments in the energy sector, increased pipeline export capacity, conservative fiscal and monetary policy balancing increased public programs with price stability, and strong banking system regulation and supervision. The country has benefited recently from higher oil prices and greater exports, both of which have increased foreign currency inflow and assisted debt-servicing efforts. For these economic strengths, Kazakhstan is rated Baa1 by Moody's and BBB by Standard and Poor's, with a positive/stable outlook. Appendix 1 provides details on the country's macroeconomic outlook.

3. Nevertheless, Kazakhstan's high dependence on oil exports poses a potential threat for the economy given potential volatility in the international oil market. Small- and medium-sized enterprises (SMEs) and manufacturing are currently underrepresented in the national economy.[1] Because, the SME sector is relatively more labor-intensive, providing approximately 40% of total employment, SME growth is significantly more inclusive and pro-poor in nature. Therefore creating conditions for growth of the SME sector is of key importance. In striving to diversify the economy, especially by developing the SME sector,[2] the Government has a declared policy of fostering SME development by promulgating SME laws[3] and establishing organizations to implement this policy.[4]

4. SME development is hampered by the difficulty in accessing capital, especially debt financing, at sustainable market rates; and the lack of confidence of SME entrepreneurs in the banking subsector, which is still burdened with an image created during the Soviet time. In an economy where access to capital is constrained and banks have a legacy problem of attracting customers, as they are not seen as reliable funding sources, serious negative consequences can arise. These hurdles must be overcome if Kazakhstan wants to move out of its heavy dependence on oil exports and to develop the SME segment, especially manufacturing.

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[1] The SME sector is estimated to have contributed only 14%–15% of GDP in 2005.

[2] ADB. 2003. *Country Strategy and Program (2004–2006): Kazakhstan.* Manila, 17.

[3] Law on State Support to Development of Small Business in the Republic of Kazakhstan.

[4] The policy includes various support measures, provision of services via business development centers, and small business loans. An exhibition and information center (a wholly state-owned joint-stock company) works in accordance with the Government's program to support SMEs. In addition, the Government set up the SME Support Fund in 1997 as a nonbanking financial institution. The fund's main objective is to effectively use financial resources allocated within the framework of state and regional programs for projects and activities aimed at supporting SMEs. The fund is tasked to (i) broaden access to finance for SMEs, (ii) effectively use state and nonstate resources aimed at SME support, (iii) develop SME infrastructure, and (iv) provide consultations for SMEs.

B. Banking and Capital Markets in Kazakhstan

5. Improvements in the economic and operating environment of Kazakhstan's financial sector have resulted in rapid growth during the past 5 years, leading to enhanced creditworthiness and commercial profiles for domestic banking. In particular, the Government and National Bank of Kazakhstan, the central bank, have undertaken structural reforms to promote consolidation and improve the overall viability of the banking system.

6. Encouraged by this improving macroeconomic environment and robust growth, Kazakh banks have increased lending volumes by an average of more than 40% per year (albeit from a very low base), while generally maintaining healthy asset quality and profitability. This is especially true for the top performers within the first two tiers of the banking system. Market observers expect this pace of growth to be sustained throughout 2006. Appendices 2 and 3 provide a more detailed analysis of the Kazakh banking system.

7. One of the key challenges facing the financial sector is the development of the nascent (debt and equity) capital markets, especially with respect to the corporate sector (Appendix 2). To widen their access to funding, many banks are keen to enter the securitization markets.

C. Securitization: Overview

1. The Global Scenario

8. Securitization has emerged as one of the dominant means of capital formation throughout the world, particularly in the United States (US) and Europe. Each year trillions of dollars of securitization transactions are structured by a wide range of entities such as financial institutions, automobile financiers, leasing companies, credit card issuers, infrastructure and insurance companies, governments, and local authorities.

9. Asset-backed securitization is a highly structured financing technique that provides an entity with an economical means of financing without the added burden of increasing debt and/or equity. In its simplest form, securitization is a process whereby the revenue stream of a segregated pool of receivables or other income-producing (mostly financial) assets owned by an original lender or commercial enterprise (originator) is repackaged into tradable securities issued to investors. The receivables are sold by the originator to a specially incorporated, off-balance sheet company or trust, known as a special purpose vehicle (SPV). In return, the SPV will generally pay a purchase amount equal to the (par or net present) value of the receivables, with limited recourse or no recourse against the originator for nonperformance of the underlying debtors. Appendix 4 provides a general description of the securitization process.

10. In developed markets, asset securitization serves a number of purposes: (i) supporting public policy objectives such as broad home ownership and development of financial markets (especially capital, retail, and mortgage markets); (ii) addressing regulatory requirements for financial institutions, especially capital adequacy and lending limit requirements applicable to banks; (iii) transferring risk, especially in the context of nonperforming assets and portfolio diversification; and (iv) providing an alternative means of raising finance.

2. Securitization in Asia

11. Although securitization has gained wide acceptance in other parts of the world, it is still in its nascent stages in Asia. In the Republic of Korea, banks turned to securitization following a

stringent period of bank restructuring, adding an extra measure of liquidity. Elsewhere in Asia, securitization is still not being regularly accessed. Issuance of asset-backed securities in the region has been dominated by Australia, Japan, and the Republic of Korea, which account for around two thirds of overall issuance, followed by Hong Kong, China; Malaysia; Singapore; and Taipei,China. A strong argument can be made favoring the growth of asset securitization in countries with developing capital markets. Many Asian countries are uniquely positioned to gain from the evolution of securitization in the region.

12. For Asian corporations, asset securitization provides a new and potentially cheaper form of financing. For loan originators such as banks, securitization is a means of removing assets from the balance sheet, while retaining most of the economic benefits associated with the assets and of freeing up capital to support further loan underwriting, while better matching assets and liabilities. For investors in Asia, including banks, unit trusts, and pension funds, the securities issued offer yields exceeding those on comparable corporate bonds, while providing an opportunity to diversify a fixed-income portfolio by adding another class of securities.

13. Securitization is already proving to be an important option for governments seeking to promote private-sector growth and employment, and to access funding for infrastructure development. In addition, and because asset-backed deals are usually large and have high credit ratings, the securities tend to be liquid and may be actively traded in secondary markets. This promotes capital market development and enhances the competitiveness of regional financial centers. Appendix 5 provides a more detailed overview of the various benefits derived from securitization.

D. Future Flow and Diversified Payment Rights Securitization

1. Future Flow Securitization

14. Future flow securitization became popular in emerging markets in the 1990s as a mechanism to reduce sovereign-related risk and provide more attractive access to international capital markets for the stronger emerging market issuers. A future flow transaction is a securitization of a company's future and existing receivables that are due from offshore obligors. Future flow securitizations mitigate many of the sovereign risks associated with an emerging market borrower by capturing cash flows offshore. Appendix 6 gives a more detailed description of the structure of future flow securitization transactions.

15. This securitization technique has grown in the emerging markets over the past 15 years, primarily in response to the search for lower cost funding by companies that generate hard currency flows. While many of these issuers historically relied upon bank debt and straight capital-market bond debt, the volatility and risk perception within emerging markets pushed these entities toward future flow securitizations. Future flow investments have consistently proven themselves to investors, and over the years they have successfully mitigated a variety of the risks associated with emerging market investments. Of all future flow transactions worldwide, none has so far defaulted. Appendix 7 gives details of outstanding future flow asset-backed securities deals.

2. Diversified Payment Rights Securitization

16. In a diversified payment rights (DPR) securitization, the future cash flows result from payment orders or electronic messages requested by offshore obligors instructing a bank to make a payment to a beneficiary other than the bank. This may take the form of payments to

local exporters, foreign direct investments, tourism-related payments to travel agencies, personal wire transfers or workers' remittances, and payments to local service providers.[5] Appendix 8 provides a brief overview and introduction to DPR securitizations.

17. The first major securitization deal involving migrant remittances occurred in 1994 in Mexico. During 2000–2004, a total of $10.4 billion was raised through DPR securitization by Brazil, Turkey, El Salvador, Mexico, and Peru.[6] 2005 was the highest issuance year with close to $10 billion in total volume.[7]

18. In Kazakhstan, future flow DPR transactions are only beginning to be introduced. Transactions completed since 2001 are listed in Table 1.

Table 1: Future Flow Transactions from 2001 to 2005

Originator	Product	Class	Standard and Poor's Rating	Closing Date	Amount ($ million)
Halyk Savings Bank	Future flows	—	—	Oct 2003	100
JSC Kazkommertsbank	Future flows	2005A	AAA[a]	Dec 2005	200

— = not available.
[a] With credit enhancement. Two more series issued without a guarantee.
Note: JSC Kazkommertbank's foreign currency rating is BB+ and the Republic of Kazakhstan's foreign currency rating is BBB–.
Source: Standard and Poor's.

III. THE PROPOSED INVESTMENT

A. Background

19. ADB has been active in promoting the Asian Bond Market Initiative,[8] which was proposed by the Government of Japan in December 2002 and under which various efforts to develop bond markets have been under way within the framework of ASEAN+3 (Japan, the PRC, and the Republic of Korea). ADB promotes the Asian Bond Market Initiative inter alia through the use of its guarantee products.

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[5] Payments to banks relating to such payment orders are owned by the bank and not the named beneficiary. In other words, the receiving bank does not act as a trustee of these funds but the bank is performing a service for the sending bank, gets paid for doing so by the sending bank (and thus becomes the owner of these flows) and incurs a matching obligation to the beneficiary. In this regard such payments are similar to deposits made into a deposit account. While the bank will have an obligation to pay the local beneficiary (recipient) an equivalent amount of money (in the stipulated currency), the bank does not have the obligation to deliver the exact same funds received from the sender (money is fungible). In other words, during the period from the receipt of the funds from the sender by the bank (from its foreign branch or correspondent bank) up to the stipulated delivery for the funds by the bank to the local beneficiary, the bank has effective title to these funds (similar to the 2-day float after a check is deposited). On a continuing basis, the average daily float can be calculated and made the basis of the amount of foreign currency received and then assigned to the SPV. From this perspective, what the bank is assigning is its expected float and not the remittances themselves that it expects to transact from foreign senders.

[6] Dilip Ratha (Senior Economist and Lead Author of Global Economic Prospects 2006: Economic Implications of Remittances and Migration, World Bank, Washington D.C. 18 November 2005.

[7] Fitch Ratings. Future Flow Securitization Rating Methodology. 15 February 2006.

[8] The Asian Bond Market Initiative was launched as a measure to prevent the recurrence of the Asian currency crisis by channeling funds in the Asian region, which is characterized by a high savings rate, to investments within the region. Currently, discussions are under way among the governments of ASEAN+3 countries on ways to develop and invigorate bond markets in Asian countries.

B. Fit to Country Strategy

20. In view of the Government's medium-term targets for 2010, the development of a vibrant and competitive private sector is vital to ensure economic diversification as well as balanced and inclusive development. The Government has a particular focus on SME development, and on deepening and developing the financial sector. The ADB program, as set out in the private sector development section of the 2006–2008 country strategy and program update,[9] seeks to complement the Government's efforts by increasing activities in private sector operations.[10] Private sector operations will focus on the financial sector and capital markets.[11] As a result, the country strategy and program update (i) emphasizes the Government's policy on SME development to create jobs and recommends ADB assistance by providing credit to SMEs via domestic banks and (ii) identifies the need to deepen capital markets.

21. The proposed Guarantee directly responds to this country strategy by (i) providing a new structure of funding, and in the process, deepening the securitization market specifically for medium-sized financial institutions; and (ii) fostering financial intermediation for SMEs. Indirectly, the assistance also supports rural area development, as ALB is providing loans to SMEs in these areas.

22. Moreover, ADB's private sector initiatives are part of a wider effort to improve the efficiency of the financial sector, as these are accompanied by policy dialogue with the Government to enable both a strong financial sector and reform in SME finance. ADB has undertaken various projects to increase private sector development in Kazakhstan.[12]

IV. THE PROJECT SPONSORS

A. Alliance Bank JSC

1. Overview and History

23. ALB was incorporated in 1993 as an open joint stock company under the name IrtyshBusinessBank JSC. It merged with Semipalatinsk City Bank in 1999. The combined bank primarily served large industrial enterprises in the Eastern Kazakhstan and Pavlodar regions. In 2001, a consortium of domestic companies acquired a 37% interest in the bank, which in 2002 changed its name to Alliance Bank and relocated its headquarters to Almaty, Kazakhstan's financial center. In 2004, ALB was reregistered as the joint stock company Alliance Bank JSC.

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[9] ADB. 2005. *Country Strategy and Program Update (2006–2008): Kazakhstan.* Manila.

[10] In October 2004, the Government signed the framework agreement signaling the start of ADB private sector operations in Kazakhstan.

[11] ADB. 2003. *Country Strategy and Program (2004–2006): Kazakhstan.* Manila, p. 20.

[12] For instance, the objectives of the Urban Small Business Development technical assistance were to promote development of the urban SME sector, review the legal and regulatory framework for SMEs, and foster financial intermediation (ADB. 2001. *Technical Assistance to the Republic of Kazakhstan for Preparing the Urban Small Business Development Project.* Manila). Most recently, the Financial Sector Governance Phase II technical assistance seeks to foster a sound, efficient, and broad financial system by strengthening the supervision of banks, accumulation of pension funds, and operations of asset management companies (ADB. 2005. *Technical Assistance to the Republic of Kazakhstan for Financial Sector Governance Phase II.* Manila). This assistance will play a central role in supporting ADB's private sector operations in the financial sector and in strengthening domestic banks.

24. As of 30 June 2006, ALB was the fourth largest commercial bank in Kazakhstan by reference to its assets of $4.4 billion, the fourth largest as measured by shareholders' equity of $282 million, and the fourth largest in terms of total time deposits (including retail deposits) of $1.05 billion.

2. The Business

25. ALB is authorized to act as a commercial bank and to offer a wide range of traditional banking services, including deposit taking, lending, issuing letters of credit and guarantees, and others. ALB's primary business consists of retail and corporate banking. Its retail banking activities include lending and deposit taking as well as providing payment cards. Its corporate banking division provides a broad range of banking products to a diversified group of domestic customers, with particular focus on SMEs.

3. Credit Ratings

26. Currently, ALB is rated by two rating agencies: Fitch IBCA (Fitch) and Moody's Investors Service (Moody's) (Table 2).

Table 2: Alliance Bank Credit Ratings

Fitch		Moody's	
Long-term	BB-	Long-term	Ba2
Outlook	Stable	Outlook	Positive

Source: Alliance Bank JSC.

B. Merrill Lynch

27. Merrill Lynch was selected as Lead Manager for the proposed DPR securitization. Merrill Lynch is one of the world's leading wealth management, capital markets, and advisory companies, with offices in 36 countries and territories and total client assets of approximately $1.8 trillion at the end of second quarter 2006. The Global Markets & Investment Banking Group is one of the world's top global investment banks, providing institutional sales and trading, investment banking advisory and capital raising services to corporations, governments, and institutions worldwide; and is one of the leaders in securitization, especially with respect to DPR securitization.

V. THE PROPOSED ASSISTANCE

A. Overview

28. The proposed transaction is a credit guarantee to be issued in favor of investors in notes with total issuance size of up to $100 million backed by DPRs originated by ALB. The entire issuance will consist of two series of notes, $100 million guaranteed by ADB (Series A) and up to $100 million unguaranteed notes (Series B). The placement of the Series B notes will be dependent on market demand.

29. DPRs usually take the form of SWIFT[13] MT102, 103,[14] and 202 payment order messages.[15] These payment orders are generated as part of the international financial operations of ALB. Payment orders are created as a result of ALB's role as a financial intermediary between foreign payors wishing to send funds to Kazakhstan and residents of Kazakhstan receiving these funds. ALB proposes to securitize its MT100 and MT200 DPRs, denominated in US dollars, euros, and (potentially) Russian rubles (ALB DPRs).

30. Similar to the role of a traditional monoline insurer, ADB will provide credit enhancement to the investors in the notes in the form of a credit guarantee. ADB's Guarantee will cover timely payment of principal and interest of the guaranteed notes. ADB will syndicate part of this exposure.

31. The recently disbursed $50 million loan to ALB will be used as the anchor investment of the proposed Guarantee.

VI. PROJECT BENEFITS, IMPACTS, ASSUMPTIONS AND RISKS

A. Justification

32. ADB's objective in the proposed transaction is (i) to develop Kazakhstan's securitization market to (a) diversify funding options; (b) procure access to longer term funds, specifically for medium-sized private sector banks; and (c) attract a new set of investors; and (ii) to foster SME financing in Kazakhstan.

33. ADB's proposed Guarantee will increase interest in DPR securitization from Kazakhstan. By establishing a credit history for ALB, the proposed Project enhances its ability to raise funds in international capital markets, obtain longer tenor funds as currently possible in the market, and build market confidence in medium-sized banks. ALB's business lines generating DPRs will be under constant scrutiny by rating agencies forcing ALB to adopt and comply with best market practices. For the investor, the proposed transaction will provide access to a new market; diversify its portfolio; and presumably receive higher returns than government, bank, and corporate bonds. The transaction will boost investor and creditor confidence, both international and domestic, in Kazakhstan's banking system, and increase depositor confidence in the local economy and banking system.

34. ADB's second objective to foster SME financing, involves helping ALB to increase its SME loan portfolio by providing part of the needed debt funding, and in turn, helping the Government in its efforts to steer the Kazakh economy toward more sustainable SME-led growth while diversifying away from the dominance and dependence on natural resources industries. The Project allows ALB to extend the tenor of its borrowings to up to 7 years, 2 years longer than the maximum tenor it has been able to obtain from the market. In turn ALB will be

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[13] Society for Worldwide Interbank Financial Telecommunications (SWIFT) is an international messaging system owned and maintained by the member banks (payment order only, no settlement). MT103/103+ are sent by the ordering customer's bank to the beneficiary's bank and are used to convey a funds transfer instruction.

[14] MT102 is principally a set of bulked customer transfers that meet certain criteria (e.g., common correspondent banks, common currency or common value date). MT103 is a customer transfer wherein either the sending party or the payer or both is not a financial institution. MT103 is a more structured version. MT202 relates to payment orders from senders to payees that are financial institutions.

[15] MT100 (including MT102, 103) is the standard message type for payment orders relating to payment from senders to payees who are individuals, companies (other than financial institutions), or governments through banks. MT 200 (including MT202) is the standard message type for payment orders relating to payment from senders to payees that are financial institutions.

able to lengthen its tenor for its customers. The transaction will therefore bridge an unwanted maturity gap and allow ALB to match its assets and liabilities more closely. In addition, the securitization will allow ALB to access lower cost funds, which will make ALB more competitive and allow it to pass savings to its customers.

B. Social and Environmental Safeguard Policies

35. The proposed transaction has been assigned a "C" environmental classification and a "C" with respect to indigenous people and resettlement. A desk review and onsite visit of ALB's DPR operations shows that these business activities have no anticipated adverse impact on the environment.

C. Anticorruption Policy, and Combating Money Laundering and the Financing of Terrorism

36. ALB has been advised of ADB's anticorruption policy[16] and policy relating to combating money laundering and the financing of terrorism.[17] In connection with ADB's recent loan to ALB, ALB has undertaken to institute, maintain, and comply with internal procedures and controls following international best practice standards for preventing corruption, money laundering activities, and the financing of terrorism. Further, ALB has undertaken to refrain from engaging in such activities. The loan documentation between ADB and ALB allows ADB to investigate any violation or potential violation of these undertakings. ALB is expected to give a similar covenant under the insurance and indemnity agreement.

37. ALB will not be allowed to use the proceeds of the proposed transaction in any country identified under (i) The Trading with the Enemy Act of 1917, 50 U.S.C.A. of the United States of America; (ii) the International Emergency Economic Powers Act, 50 U.S.C.A. of the United States of America; (iii) the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (*USA PATRIOT Act*), Pub. L. No. 107-56, 115 Stat. 272, of the United States of America; and (iv) any similar acts, executive orders, or similar government actions of the United States or Kazakhstan, including regulations issued.

D. Transaction Risks

38. ADB conducted comprehensive due diligence to determine the viability of the proposed guarantee. Overall, the risks can be regarded as acceptable for a transaction of this kind.

VII. ASSURANCES

39. ADB will enter into a guarantee agreement and other required investment documents, following approval of the proposed Guarantee by ADB's Board of Directors. These agreements will be on terms and conditions satisfactory to ADB.

40. A framework agreement relating to ADB's status, privileges, and immunities with respect to its lending and guarantee operations in the private sector is in effect between Kazakhstan and ADB. Consistent with the Agreement Establishing the Asian Development Bank, the Government will be requested to confirm that it has no objection to the proposed ADB Guarantee. The Guarantee will not be made effective until ADB receives such confirmation.

[16] ADB. 1998. *Anticorruption.* Manila.
[17] ADB. 2003. *Enhancing the Asian Development Bank's Role in Combating Money Laundering and the Financing of Terrorism.* Manila.

VIII. RECOMMENDATION

41. I am satisfied that the proposed Guarantee would comply with the Articles of Agreement of ADB and acting in the absence of the President, under the provisions of Article 35.1 of the Articles of Agreement of ADB, I recommend that the Board approve

(i) the Guarantee covering a principal amount of $100 million together with accrued interest thereon in favor of the holders of notes with a maturity of 7 years backed by DPRs of ALB, on terms and conditions substantially in accordance with those set forth in this report, and as may be reported to the Board; and

(ii) the proposal that ADB's assistance for the Project exceed the single project exposure limit.

Liqun Jin
Vice President, Operations 1

15 September 2006

KAZAKHSTAN: MAJOR MACROECONOMIC CONSIDERATIONS

A. Economic Outlook

1. High oil prices, foreign investment, and good macroeconomic management underlie the continuing economic boom in this oil-rich export economy. Gross domestic product (GDP) growth, led by the oil subsector, averaged 10.3% per annum during 2001–2005. GDP growth reached 9.4% in 2005 and is set to grow to $65.3 billion in 2006 and $84.8 billion in 2008. Furthermore, representing 65% of GDP, the private sector is increasingly driving growth in the economy.[1]

2. These factors helped lift 2005 general budget revenues by 4.7 percentage points to 28.2% of GDP. This large gain was somewhat offset by the increase in budgetary spending before the December presidential election. The general government budget recorded a surplus of 0.6% of GDP, from a slight deficit of 0.3% in 2004. In view of its strong financial position, the Government made early repayments totaling $850 million on its external public debt, reducing the total to about 4% of GDP at end-2005. The 2006 state budget was approved in November 2005. It raised revenues by 2% of the previous year's GDP, reflecting government projections for greater receipts from oil. The increase is earmarked for public investment and social programs.[2]

3. High world commodity prices helped boost exports by 40.0% to $28.7 billion; oil and metals accounted for more than two thirds of the increase. Imports also increased by 37%, driven largely by machinery, equipment, and nonprecious metals. The trade surplus improved by about 45% to $9.8 billion, but the deficit on the services, income, and transfers account worsened sharply. The latter stemmed from greater payments for construction, freight, insurance, and information technology services, as well as a near doubling of income payments to foreign direct investors, nearly all associated with oil sector development. Consequently, the current account surplus in 2005 improved only marginally from a year earlier to $750 million (about 1.3% of GDP). For the first time in 5 years, official reserves at the National Bank of Kazakhstan (NBK) declined, although they recovered substantially in the first 2 months of 2006 (footnote 2).

4. Gross official reserves stood at $7.1 billion at end-2005 (equivalent to 37 months of imports of goods and services); while year-end foreign asset holdings of the National Fund of the Republic of Kazakhstan, which saves a part of the Government's oil and mineral revenues for future generations, amounted to $8.0 billion. During the year, the total of official reserves and fund assets strengthened by about $684 million (about 1.2% of GDP) to $15.1 billion. Outstanding public external debt was reduced by about $1.0 billion to $2.4 billion (about 4.2% of GDP) in the 9 months to end-September 2005. During this period, private sector external debt (excluding oil and gas intracompany debt) increased sharply by $4.6 billion to $16.6 billion (about 33% of GDP). The upsurge in private debt in recent years—mainly local bank borrowing for onlending—was largely a response to the differential between available foreign borrowing rates and domestic lending rates of about 15% for tenge loans and 11% for loans denominated in foreign currency (footnote 2).

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[1] European Bank for Reconstruction and Development and Merrill Lynch estimate. This is up from 55% of GDP in 1998.

[2] ADB. 2006. *Asian Development Bank Outlook 2006*. Manila.

5. The tenge continued to appreciate against the dollar (2.9%) on an average annual basis, reflecting export earnings, foreign direct investment, and private external borrowing. However, tighter market conditions in the final months of 2005 resulted in a 2.2% depreciation on an end-of-year basis. As in the previous year, the real effective exchange rate rose by about 6% year-on-year, due to inflation differentials. Largely because of future substantial oil-related revenues, real appreciation may continue in 2006 (footnote 2).

6. The medium-term outlook is positive, assuming buoyant oil prices, foreign direct investment inflows, continuation of economic diversification, good macroeconomic management, and political stability. In 2006, GDP growth is expected to be sustained at 8.5%. Moreover, macroeconomic stabilization should continue, with inflation estimated at about 6.5% in 2006. Despite recent substantial increases in wages and social spending, the Government has maintained sustainable fiscal and monetary policies, which have limited budget deficits and inflation. General government debt will continue to decrease in the next few years by about 1.0%–1.5% of GDP annually. Additionally, with the National Reserve Fund for excess oil earnings and tax revenues expected to reach about $7.4 billion by year-end 2005, a substantial fiscal buffer has been created.[3] Despite increased external borrowing by commercial banks, the overall external position remains strong.

7. Overall growth during 2000–2004 was led by strong contributions from capital and total factor productivity. The contribution of labor accumulation declined continuously, suggesting that the economy is likely approaching full employment. According to government data, the contributions of capital accumulation, total factor productivity, and labor growth to the average GDP rate of expansion of 10.4% in 2000–2004 were 6%, 3.2%, and 1.2% (footnote 2, 98–99).

8. The hydrocarbons sector has grown at an average of 16% a year since 2000, and will remain the engine of growth in the medium term. Its share in GDP, including production and related services, jumped from 11% in 2000 to almost 25% in 2005, and is expected to continue rising as production capacity increases. Sector growth has been fueled by large capital investments; oil and gas have received 60% of total investment, equivalent to 15% of GDP during 2000–2005. Two thirds of the oil and gas investment came from the private sector. The share of hydrocarbons in GDP will increase over the medium term as large projects come onstream, although investment in the sector is expected to taper off as a share of total fixed investment (footnote 2).

9. Non-oil output has risen at an average of 7% a year since 2000 and been sustained at the rate of 25% of total investment, representing 6.5% of GDP during 2000–2005. Within the non-oil sector, construction and services have been the most dynamic. Their combined share in GDP and total employment has increased to 65% and 60% (footnote 2).

10. In contrast, the share of manufacturing and agriculture in GDP has declined, reflecting low capital investment. The investment rate stood at 3% of GDP a year on average during the period, with half of that from the public sector. If the investment rate in the non-oil sector keeps to its recent trend, non-oil growth could remain at 7%–8% a year in the medium term—and even higher if the Government manages to diversify the economy and stimulate the private sector. Removing impediments to regional trade and accession to the World Trade Organization would advance development of both the non-oil and private sectors (footnote 2).

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[3] The National Fund of Kazakhstan was created in 2001 to accumulate a part of the Government's oil and mineral revenues for stabilization purposes and to save for future generations.

11. Continuing growth, job creation in the private sector, and pro-poor growth have raised living standards. In 2004, real per capita incomes rose by 13%. The percentage of people living below the subsistence minimum[4] fell from 19.8% in 2003 to 15.0% in 2004. Unemployment declined from 8.8% in 2003 to 8.4% in 2004.

B. Political and Regional Background

12. Kazakhstan became an independent sovereign state in 1991 as a result of the dissolution of the former Soviet Union. Since then, Kazakhstan has experienced significant change as it emerged from a single party political system and a centrally controlled command economy to a market-oriented, democratic model. The transition was initially marked by political uncertainty and tension, a recessionary economy marked by high inflation and instability of the local currency, and rapid but incomplete changes in the legal environment.

13. Since 1992, Kazakhstan has actively pursued a program of economic reform designed to establish a free-market economy through privatization of state enterprises and deregulation; it is more advanced in this respect than some other countries of the Commonwealth of Independent States. However, as with any transition economy, no assurance can be given that such reforms and other reforms described elsewhere in this proposal will continue or that such reforms will achieve all or any of their intended aims.

14. Kazakhstan depends on neighboring states to access world markets for a number of its major exports, including oil, steel, copper, ferro-alloys, iron ore, aluminum, coal, lead, zinc, and wheat. Kazakhstan is thus dependent upon good relations with its neighbors to ensure its ability to export. In addition to taking various steps to promote regional economic integration among neighboring countries, Kazakhstan signed an agreement in September 2003 with Belarus, Russian Federation, and Ukraine to create a single economic zone, which is expected to result in common economic policies, harmonization of legislation implementing such policies, and creation of a single commission on trade and tariffs. The aim of the single economic zone is to create a free customs area within which member countries would enjoy free movement of goods, services, capital, and labor. Another step toward integration is that the member countries also intend to look at ways to coordinate their fiscal policies, credit and currency policies, and government policies. These efforts will support further economic integration within the Commonwealth of Independent States, one of the aims of which is to assure continued access to export routes.

C. Macroeconomic Considerations and Exchange Rate Policies

15. Since Kazakhstan is heavily dependent upon export trade and commodity prices, it was particularly affected by the Asian financial crisis in early 1998 and by the Russian crisis later that year, both of which exacerbated the problems associated with falling commodity prices. Because Kazakhstan's economy is negatively affected by low commodity prices and economic instability elsewhere in the world, the Government has promoted economic reform, inward foreign investment, and diversification of the economy. Notwithstanding these efforts, low commodity prices and weak demand in its export markets may adversely affect Kazakhstan's economy in the future.

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[4] The subsistence minimum is a measure of poverty. Calculated by the State Statistics Agency, it comprises the cost of a basket of 70% food items and 30% goods and services. The poverty line is established as a fixed percentage of the subsistence minimum, and it is used for determining households' social assistance allowances and eligibility for such assistance. In 2004, the subsistence minimum was T5,427 or equivalent to $40 a month.

16. The Government began implementing market-based economic reforms in 1992, including a significant privatization program, promotion of high levels of foreign direct investment (particularly in the oil and gas sectors), and introduction of an extensive legal framework. Despite uneven progress, Kazakhstan has experienced extensive economic transformation over the last 12 years. Since mid-1994, the Government has adhered to a macroeconomic stabilization program aimed at curtailing inflation, reducing the fiscal deficit, and boosting international currency reserves. According to figures compiled by Kazakhstan’s National Statistical Agency, GDP has continued to grow in real terms following the adoption of a floating exchange rate policy in April 1999. It rose by 13.5% in 2001, 9.8% in 2002, 9.2% in 2003, and 9.4% in 2004. However, no assurance can be given that GDP will continue to grow, and any decrease in GDP or in the rate of GDP growth in subsequent years could adversely affect Kazakhstan’s development.

17. The tenge is convertible for current account transactions, although it is not a fully convertible currency outside Kazakhstan. Between 1991, when Kazakhstan began its transition to a market-based economy, and April 1999, NBK maintained a managed exchange rate policy, which, although permitting the general trend in the exchange rate to reflect market conditions, involved official intervention aimed at limiting fluctuations. Depressed export markets in 1998 and early 1999 caused considerable pressure on Kazakhstan’s managed exchange rate, and resulting official intervention in the foreign exchange markets led to losses on foreign currency reserves. In response to these pressures, the authorities instituted a number of expenditure cuts, took revenue-increasing measures, and in April 1999, NBK floated the tenge. The tenge fell by 64.6% against the dollar as of 31 December 1999, compared to a depreciation of 10.7% as of 31 December 1998. Following the adoption of a floating exchange rate policy in 1999, the tenge continued to depreciate against the dollar, although at a much slower rate. It depreciated by 4.6% in 2000, 3.8% in 2001, and 3.3% in 2002. The tenge subsequently appreciated against the dollar by 7.3% during 2003 and 9.9% during 2004. Then during the first 6 months of 2005, it depreciated against the dollar by 4.0%, to T135.26 as of 30 June 2005. Since then the tenge has gradually appreciated against the dollar and as of 11 May 2006, NBK reported the official T/$ exchange rate as T122.87/$1.

18. While NBK has stated that it has no plans to resume a managed exchange rate policy, any subsequent decision to support the exchange rate could have an adverse impact on Kazakhstan’s public finances and economy.

D. Monetary Policy

19. NBK maintains a managed floating currency regime and does not set any official targets for the tenge exchange rate. It uses interventions on the foreign exchange market as one of the tools to manage systemic liquidity. Monetary policy implementation is complicated by strong private capital inflows, rising oil earnings, and buoyant domestic demand. M3 rose 49.2% per annum on average during 2000–2004, and was up a further 50.2% in 2005. Cash in circulation expanded 34% per annum on average during 2000–2004, and increased another 35% in 2005. The big build-up of money in the National Reserve Fund ($8.2 billion, or 14.4% of GDP as of end-February 2006), along with selling short-term notes and deposits, has assisted partial sterilization of the domestic liquidity produced by NBK interventions. Nevertheless, the authorities are worried about the rise in monetary pressure on the overall inflation process. With no formal target, the Government aims to keep annual inflation in the 5%–7% range during 2006–2008 to ensure a stable macroeconomic environment, while in February 2006 the consumer price index increased to 8.7%. During the next 2 years, stronger social spending

along with further tax cuts will continue to put upward pressure on disposable income growth and consequently prices. Market observers therefore expect that with some easing of the tight fiscal stance, greater exchange rate flexibility will be allowed to keep inflation in check. NBK might allow the tenge to appreciate in 2006-07 to restrain further price expansion.

E. Regulation of the Banking Industry

20. In September 1995, NBK introduced strict prudential requirements for the operation and capital adequacy of banks. In addition, an institutional development plan was prepared for leading Kazakhstan banks. According to the plan, banks are required to prepare their accounts in accordance with International Financial Reporting Standards and to apply the Basel Committee norms within the period determined by NBK on a case-to-case basis. Further, Kazakhstan banks are required to join a bank-funded deposit insurance scheme and be audited annually by a public accountancy firm approved by NBK, which is likely to be one of the leading international firms. Following legislative changes in July 2003, the Financial Markets Supervisory Agency was formed, and as of 1 January 2004, it took responsibility for most of the supervisory and regulatory functions in the financial sector, which had previously been performed by NBK. The agency's main task is to regulate and supervise the financial markets and financial institutions in Kazakhstan.

E. Implementation of Market-Based Economic Reforms

21. The need for substantial investment in many enterprises has driven the Government's privatization program. The program has excluded certain enterprises deemed strategically significant by the Government, although major privatizations in key sectors have taken place, such as full or partial sales of certain large oil and gas producers, mining companies, and the national telecommunication company. However, a need remains for substantial investment in many sectors of the Kazakhstan economy and in some areas economic performance in the private sector is still constrained by inadequate business infrastructure. Furthermore, the extent of noncash transactions in the economy and the size of the shadow economy adversely affect implementation of reforms and hamper the efficient collection of taxes. The Government has stated that it intends to address these problems by improving bankruptcy procedures, business infrastructure, and tax administration; as well as by continuing the privatization process. Implementation of these measures in the short term has produced few positive results, and improved results may not materialize until the medium term, if at all.

BANKING AND CAPITAL MARKETS IN KAZAKHSTAN

1. Encouraged by the improving macroeconomic environment and robust growth, Kazakh banks have increased lending volumes by an average of more than 40% per year in the last 5 years (albeit from a very low base), while generally maintaining healthy asset quality and profitability. This is especially true for the top performers within the first two tiers of the banking system. Market observers expect this pace of growth to be sustained throughout 2006. While focusing mainly on the domestic market, some Kazakh banks are increasingly expanding their operations in other regional Commonwealth of Independent States countries, including Kyrgyz Republic, Russian Federation, and Ukraine, in order to expand and diversify their businesses and market exposure.

A. Overview of the Kazakh Banking Market

2. The commercial banks in Kazakhstan can be divided into four groups: (i) large local banks (tier I banks), [1] such as Bank TuranAlem JSC and its principal competitors, Kazkommertsbank and Halyk Bank; (ii) banks under foreign ownership, such as ABN AMRO Bank Kazakhstan, HSBC Bank Kazakhstan, and Citibank Kazakhstan; (iii) second tier (tier II banks) medium-sized banks with regional operations; and (iv) smaller local banks. The decrease in the number of banks from 184 in 1996 to the current 34[2] is primarily attributable to the ongoing sector reform undertaken by the National Bank of Kazakhstan (NBK).

3. Three dominant banks—Bank TuranAlem, Halyk Bank, and Kazkommertsbank—collectively represented 55.8% of total system assets and 50.7% of capital, as of 30 June 2006. Established in 1990, Kazkommertsbank is the country's largest bank in terms of assets and second largest as measured by shareholders' equity. It had total assets of $9.85 billion and capital of $734.8 million as of 30 June 2006. Bank TuranAlem is the second largest bank in terms of assets ($9.68 billion) and the leading bank in terms of capital ($1.03 billion). Halyk Bank is the third largest bank in terms of assets—approximately $6.44 billion. In the past few years, however, the tier II banks have been increasingly taking more market share from the tier I banks. In particular, the big three banks' collective market share declined from 62.3% in 2003 to 55.8% as of 30 June 2006. This trend is expected to continue into the coming years.

4. Banking reform began in 1996 with the introduction of international prudential standards, including requirements on capital adequacy, liquidity ratios, transparency as to the auditing of banks by local and international auditors, harmonization of local accounting practices to International Financial Reporting Standards, and personnel training programs. In addition, NBK required commercial banks to adopt recapitalization and corporate enhancement plans with the aim of boosting their abilities to attract long-term, private investors. In 2000, guidelines were established for bank inspections and for periodic reporting by commercial banks to NBK (and now also to the Financial Markets Supervisory Agency, which currently is the banking supervision body in Kazakhstan). In 2003, all banks were requested to develop and install internal risk management systems.

5. According to published financial statements, the total assets of the banking system increased by 60% in 2004 and 68% in 2005, and as of 30 June 2006 amounted to $46.52 billion.

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[1] Technically, NBK would be the first tier. The terminology used here therefore only refers to commercial banks below NBK.

[2] As of August 2005, 34 banks were operating in Kazakhstan, excluding NBK, including two fully state-owned special-purpose banks and 14 banks under foreign ownership. As of mid-2004, 27 foreign banks had representative offices in the country.

During the same period, the total capital of the banking system increased by 46% in 2004 and 63% in 2005, and as of 30 June 2006 amounted to approximately $4.6 billion (Table A2.1 and Appendix 3 provide details).

Table A2.1: Structure of Banking Aggregate Liabilities
(as of 1 January 2006)

Liability	**Amount** (T billion)	**% of Total**
Client deposits	2,533	62.2
Interbank deposits	185	4.5
Loans from the Government	3	0.1
Loan from international financial organizations	27	0.7
Loans from other banks and organizations performing certain types of banking operations	577	14.2
REPO transactions with securities	164	4.0
Subordinated debt	185	4.5
Outstanding securities	273	6.7
Other creditors	128	3.1
Total	**4,073**	**100.0**

REPO = repossessed.
Source: Agency of the Republic of Kazakhstan on Regulation and Supervision of Financial Market and Financial Organizations.

B. Credit Standing of Commercial Banks

11. The financial standings of Kazakhstan's banks vary. As of 30 September 2005, 18 of the 34 commercial banks had registered capital of over T2 billion, 15 banks had registered capital of over T2 billion, 15 banks had share capital of T1 billion to T2 billion, and one bank had registered capital of T500 million to T1 billion. No banks have registered capital of less than T500 million, and any bank whose capital falls below this level is required to submit an application for voluntary reorganization into an entity performing only limited banking operations to the Financial Markets Supervisory Agency. As of 30 September 2005, aggregate provisions of Kazakh banks on overdue receivables were T52.5 billion.

7. As of 31 December 2005, all of the commercial banks licensed in Kazakhstan were in compliance with prudential regulatory requirements on capital adequacy, single borrower limits, liquidity ratios, foreign currency limits, and reserve requirements. As of 31 December 2004, two commercial banks had failed to comply with seven prudential regulatory requirements, compared to one noncompliant bank as of 31 December 2003 and one as of 31 December 2002 (Alliance Bank was not among these banks). The noncompliant banks did not meet any of the current liquidity ratios, own capital ratios, single borrower exposure ratio, open currency position ratio, and maximum asset investment ratio. Provisions for bad debts of all banks operating in the Kazakhstan banking subsector as of 31 August 2005 totaled T52.5 billion.

C. Access to Funds

8. Total liabilities of the banking system increased by 68.4% to T4,073 billion as of 1 January 2006 (Table A2.1). The most significant impact was on client deposits, which increased by 56.5% to T2,533 billion and accounted for 62.2% of aggregate banking system liabilities. The increase was attributed to a combination of economic growth and rise in population income.

9. The lack of a well-functioning domestic interbank market continues to hamper the liquidity management of banks. Interbank deposits only account for 4.5% of the aggregate banking system's liabilities. The banks are therefore turning to the international debt capital markets for funding enabled by the improving country rating. Access to the international loan markets by medium-sized banks has also improved. Several banks were able to raise financing from the international loan market.

D. Overview of Kazakh Capital Markets

9. Three types of government securities are available: T-bills, T-bonds, and inflation-linked bonds and variable bonds. Currently, only one T-bill is outstanding; it will mature on 30 March 2006. Nineteen T-bonds are outstanding; they are typically 3–5 year debt, with the longest fixed-rate bond maturing in May 2010. The amount outstanding currently stands at T56 billion, or $430 million; the coupons are paid semiannually. The five consumer price index-linked bonds are valued at T 15 billion ($115 million). The latest consumer price index-linked bond was issued in April 2005, has the largest outstanding amount (T14 billion, or $110 million), and matures in 2015. Due to the high oil revenues and a cautious fiscal stance, the Government does not need to borrow in the local debt market. Due to the growth of the pension fund system in Kazakhstan, the country has a serious shortage of good domestic long-term investment assets for these funds. The country's bond market is therefore very illiquid, as most of the outstanding issues are held by the local pension funds.

7. Turnover at the Kazakhstan Stock Exchange increased by 37% in 2005 (Table A2.2). However, exchange turnover growth has been concentrated on repurchase transactions, primarily on government securities. Turnover of the corporate sector only accounted for around 3.4% of total turnover in 2005. The most active participants in the exchange (i.e. buying and selling securities) are the banks, such as Bank TuranAlem, Kazkommertsbank, ATF Bank, Eurasian Bank, and Alliance Bank.

Table A2.2: Comparative Data on Kazakhstan Stock Exchange Turnover
($ million)

Market Sector	2004 Volume	2004 % of Total	2005 Volume	2005 % of Total	YTD June 2006	June 2006 % of Total
Foreign Exchange	9,449	16.1	12,044	15.0	12,687	22.1
Government Securities	5,558	9.4	4,754	5.9	2,189	3.8
Corporate Shares	977	1.7	1,040	1.3	800	1.4
Corporate Bonds	853	1.4	1,715	2.1	1,800	3.1
Repurchase[a]	42,012	71.4	60,848	75.7	39,854	69.5
Total	**58,850**	**100.0**	**80,403**	**100.0**	**57,331**	**100.0**

YTD = year-to-date.
[a] Corporate and government securities.
Note: Only deals of the primary market and purchase-sale deals on the secondary market, including state blocks of shares are considered in the sector of equities and corporate bonds. In the government securities sector, only deals of the primary market and purchase-sale deals on the secondary market are considered.
Source: Kazakhstan Stock Exchange.

8. Market capitalization of the stock market increased from $3.94 billion in 2004 to $10.52 billion in 2005, and was $30.56 billion as of June 2006. The increase in market capitalization was partly explained by the growth in the number of listed companies from 84 at year-end 2005 to 107 in June 2006. Liquidity, however, remains a concern where corporate share turnover only

accounted for 1.3% of total exchange turnover in 2005 (Table A2.2). Domestic companies still fear the loss of control that would result from having institutional minority shareholders, while the institutional investors are concerned about insufficient protection of their minority interests. This accounted for the underdeveloped status of the stock market.

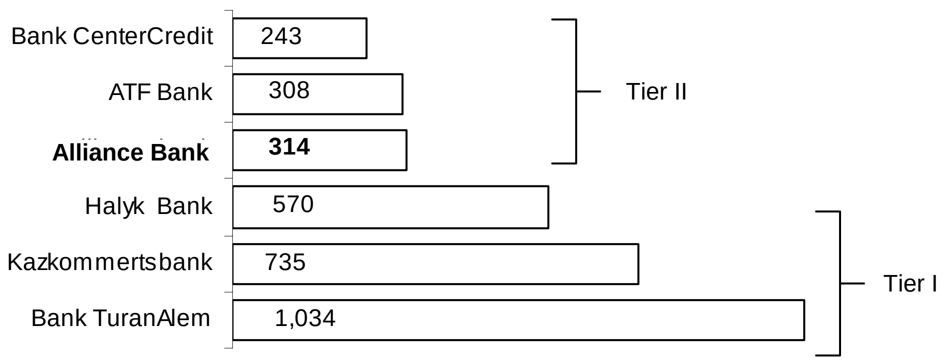
9. The corporate debt securities market of the Kazakhstan Stock Exchange is represented by 176 bond issues including 2 issues by nonresidents (JP Morgan, Merrill Lynch) as of June 2006. The financial sector remains the leader in terms of debt issuance. The debt securities market capitalization is estimated at $10.4 billion, which is 63% higher than in 2005. It is characterized by a large volume of consumer price index-linked bonds due to increasing inflation and an overall yield increase due to the rise in inflation and instruments supply.

10. Domestic pension funds have increasingly emerged as important investors in the local bond market since the launch of pension reform in 1998. The steadily accumulating pension funds provide a supply of long-term funds that is lacking in most emerging markets, including many other former Central Asian and Commonwealth of Independent States countries. In the case of pension fund assets, these are heavily concentrated from a portfolio management perspective. NBK bills and corporate bonds account for 34% and 26% of total assets, Government bonds, including municipal bonds, account for 19% and are declining as the Government seeks to reduce its domestic burden. Investments into domestic equity are less than 5% of total assets.[3]

[3] European Bank for Reconstruction and Development. Nov 2004. Strategy for Kazakhstan.

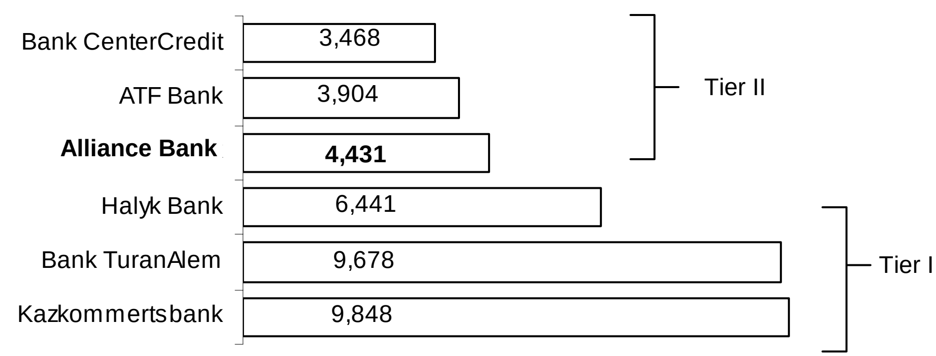
OVERVIEW OF KAZAKH BANKING SYSTEM

Figure A3.1: Capital Base of the Banking System
(as of 30 June 2006, $ million)



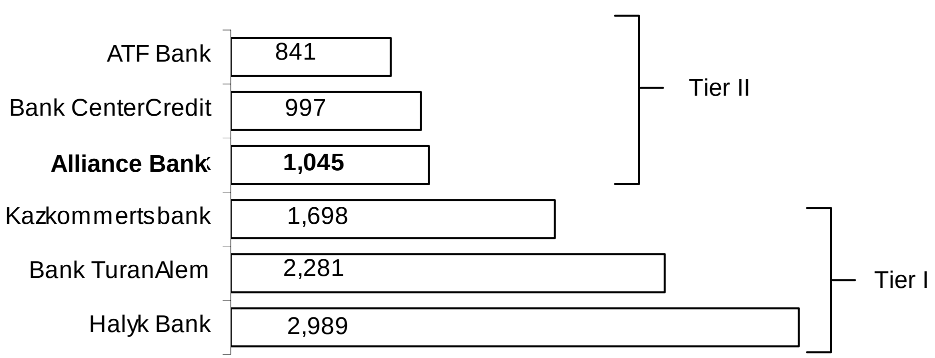
Source: Unaudited, according to Kazakhstan Accounting Standards

Figure A3.2: Assets of the Banking System
(as of 30 June 2006, $ million)



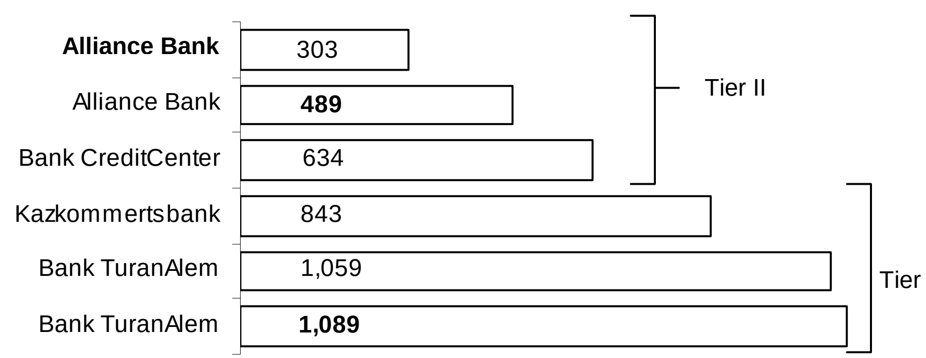
Source: Unaudited, according to Kazakhstan Accounting Standards.

Figure A3.3: Time Deposits
(as of 30 June 2006, $ million)



Source: Unaudited, according to Kazakhstan Accounting Standards..

Figure A3.4: Retail Time Deposits
(as of 30 June 2006, $ million)



Source: Unaudited, according to Kazakhstan Accounting Standards.

SECURITIZATION: AN OVERVIEW

A. Background

1. Securitization is a form of financing that involves the pooling of financial assets and the issuance of securities that are repaid from the cash flows generated by these assets. This is generally accomplished by a true sale of the assets to a bankruptcy remote vehicle, which finances the purchase through the issuance of bonds backed by the future cash flows of the asset pool. This achieves the outcome of creating a class of securities for which the underlying risk is independent from that of the originating institution, and generally of a higher credit quality.

2. Securitization gained popularity as an asset class in the mid-1980s. By late 2004, it had grown to represent 31% of the $23 trillion United States bond market, with home mortgages representing the majority of the securitized assets. Although securitization in Europe took longer to establish, securitization issuance increased from $50 billion to $500 billion between 1998 and 2003.

3. In the emerging markets, securitization has been growing quickly. Initially, most transactions involved the securitization of future offshore cash flows derived from exports and remittances. Such structures, generally referred to as future flow transactions, are driven by the need for borrowers to raise relatively cheap cross-border financing. This is achieved by mitigating the currency transfer risk that would otherwise be present in their corporate borrowings. More recently, as many developing countries have begun adopting the legal and regulatory reforms necessary for the domestic issuance of securitization, the bulk of activity has shifted to local markets. Although future flow transactions do play a role in local markets, the securitization of existing assets has seen the largest growth.

4. Securitization is most appropriate for a company that is seeking balance sheet management, or a company with a specific pool of assets that is better than its overall credit quality. In principle, any assets pool with predictable cash flows can be securitized, even those that are nonperforming, as long as the timing and amount of recovery is predictable. The most common assets for securitization include mortgages, credit cards, auto and consumer loans, corporate debt, export receivables, and offshore remittances.

B. Structure

5. At the center of a securitization is a special purpose vehicle (SPV) set up by the originator of the financial assets to be securitized. The SPV is purchasing the financial asset receivables (mortgages, SME loans, etc.) from the originator. The SPV will be structured to control its income and expenses so that it will be "bankruptcy remote."[1] The SPV will fund the purchase of the receivables through the issue of debt securities to investors, which will be secured on the receivables by virtue of a security interest granted to a security trustee acting for the investors and other creditors. The originator (or an associated company) may continue to act as the servicer in collecting and administering the receivables as an agent of the SPV, which in turn will apply the income from the receivables to make payment of principal and interest

[1] A key concern in securitization transactions is to ensure that the transfer of assets of the originator to the SPV is not affected by bankruptcy or distress of the originator. This necessitates certain legal precautions in structuring the assignment of receivables, and also constituting the SPV that it can neither be taken to liquidation by the shareholders of the originator, nor by those of the SPV itself. Further, the structure should also ensure that the SPV would not be treated as the subset of the originator by substantive consolidation. Such a structure is called bankruptcy remote structure.

under the debt securities as well as transaction expenses. A standby servicer may also be arranged in case the originator fails to perform its servicing obligations. Funds received by the SPV in excess of those required to pay investors are generally channeled back to the originator. Thus, securitization enables nontradable assets that range in marketability, credit-worthiness, and size to become liquid secondary instruments through repackaging and cash-flow structuring.

6. To obtain the lowest all-in cost of financing for the asset originator, the risk inherent in the asset pool is often structured to create two or more layers of risk. These layers are often referred to as tranches. Typically, the expected loss on the portfolio is identified and placed in a junior (also referred to as equity) tranche that is retained by the originator. Requiring the originator to fully absorb the initial losses helps to mitigate the moral hazard that would otherwise be present if one entity were to originate the portfolio, but not have a stake in its eventual performance.

7. The next tranche of risk is often referred to as mezzanine, which is generally structured to absorb losses that are not necessarily expected, but that may reasonably occur if performance of the portfolio is much worse than anticipated. With the proper amount of subordination, derived from the junior and mezzanine tranches, a highly rated senior tranche can then be structured that is generally deemed to comprise relatively little risk. If adequately structured, this senior tranche achieves a risk-reward combination sufficient to attract institutional investors.

8. Various forms of credit and liquidity enhancement will be used and structured into the transaction cash flow to ensure that payments on the debt securities issued to the investors are made in full and on a timely basis. Consequently, the recourse of the investors is usually limited to (i) receivables, (ii) transaction cash flow, and (iii) credit enhancement incorporated in the securitization structure. A high credit rating (usually higher than that of the originator) on the debt securities and therefore cheaper funding can be obtained by reason of the quality of the receivables, the isolation of the receivables from the other risks of the originator's business (by arranging a "true" sale of the receivables from the originator to the SPV) and the arrangements for credit enhancement and liquidity support.

BENEFITS OF SECURITIZATION[1]

A. How Originators Benefit

1. Originators (the selling bank) gain from securitization by obtaining many of the benefits of high-credit quality financing without retaining the debt on their books and without forgoing profitable aspects of the assets, including origination, servicing, expansion of business, and retention of excess spread. The technique for determining the price paid can be complex and may require a significant initial investment of managerial and financial resources. Some relevant advantages include the following:

(i) **Assets removed from the balance sheet**. If structured as a true sale, securitization can allow the originator to reduce its assets and debt, thereby increasing its scope for borrowing. Securitization allows a bank or business to achieve greater leverage.

(ii) **Lower financing costs**. Well-regarded pools of assets owned by a company or bank can be used to structure a security of higher credit quality, and therefore, of lower market cost than the corporate entity could issue itself.

(iii) **Reduction in required capital**. For a bank or finance company that faces regulatory capital requirements, a securitization transaction that qualifies as a sale of assets for bank regulatory purposes reduces the need for equity financing. The latter may be costly and hard to obtain, and may dilute control.

(iv) **Recognition of gains (or losses).** Depending on accounting rules, a securitization structured as a sale of assets may allow a seller to recognize an accounting gain (or loss) equal in the aggregate to the present value of any expected future cash flows payable to the seller that will be derived from the assets.

(v) **Access to an alternative source of finance and class of investors**.

B. How Investors Benefit

2. Asset-backed securities are not suitable for all investors: they are more complex, and they may be less liquid than other debt securities. Nevertheless, many investors find that asset-backed securities open up attractive new investment opportunities for the following reasons:

(i) **Superior return.** The main benefit from the investor's viewpoint is a higher return or spread than is generally available on corporate or sovereign debt of a similar rating.

(ii) **Liquidity.** The securitization structure offers far greater liquidity than the individual loans backing the transaction.

(iii) **Diversification.** Investors gain an opportunity to diversify their portfolios by participating in a different class of assets.

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[1] Based on Giddy, Ian H. 2000. *Asset Securitization In Asia.* New York University

(iv) **Mitigation of event risk.** Unlike similar, high-rated corporate bonds, asset-backed securities are largely immune from event risk. The latter results from takeovers, restructurings, and other events that effectively alter the credit status of senior unsecured corporate obligations.

(v) **Coping with constraints**. Many institutional investors are constrained to purchase only investment grade securities, and some are limited to triple-A paper. Both requirements can be met in the securitization market.

C. How the National Economy Benefits

3. The effect of securitization on the economies of different countries is still difficult to assess because the technique is in its infancy in many parts of the world. Nevertheless, in countries such as Australia, Canada, United Kingdom, and the United States, where a high proportion of residential mortgages and other claims have been securitized, the gains to the national economy can be measured in the billions of dollars. In the United States alone, for example, at least $1,600 billion of mortgage- and asset-backed securities are outstanding. According to a conservative estimate, securitization in the United States reduces the annual cost ($1,600 billion) of financing for homeowners and others by 0.5%, freeing up $8 billion of resources each year.

4. But the case for securitization is actually even stronger than this. Asset securitization, if introduced in a transparent and orderly fashion, offers Asian countries additional gains from

(i) capital market development, as more high-quality securities are added to the fixed-income market;

(ii) a source of funds for rapidly growing, capital-constrained banks, finance companies, and industrial companies whose expansion depends on the extension of credit to their customers;

(iii) an expanded source of financing for residential home ownership and other asset classes; and

(iv) the potential for financing infrastructure projects and other assets that produce reliable revenue streams capable of being contractually assigned to a separate legal entity.

THE MECHANICS OF FUTURE FLOW SECURITIZATION

A. Introduction

1. The types of assets securitized by future flow securitizations have varied over the years. The most common flow being securitized previously stemmed from export receivables. Over the past 15 years and through 2005, approximately $54.2 billion in future flow export receivables transactions have occurred. Since 2002, financial remittances have become the most popular future flow asset class, with $13.2 billion of remittances/diversified payment right (DPR) securitizations.

B. Historical Volume Development

2. Latin America has traditionally been the strongest originator of future flow receivables. Issuers such as Mexico's Petróleos Mexicanos (Pemex), which in 1996 placed $6.0 billion, and Venezuela's PDVSA Finance Ltd placement of $3.4 billion have enhanced Latin America's volume over the years. Until 2001, Mexico had always been the dominating country for future flow issuance. Prior to the upsurge in volume in Turkey in 2005, Brazil had taken over as the primary source for future flow paper. This is mainly due to the countries' sovereign ratings. Mexican issuers, because they are domiciled in an investment-grade country, are less in need of the structural protections provided by future flow. Brazil (and Turkey in 2005) on the other hand, which has been rated between B and BB since 2001, is a market where future flow is useful in mitigating sovereign-related risks and opens access to international capital markets for strong companies.

3. While Mexico, Brazil, and Turkey could be considered the historical leaders, other countries have also had significant amounts of issuance. Argentina has produced more than $3.5 billion, although amounts have been limited since the 2001 financial crisis. Top banks from various Central American countries issued financial remittance future flows. Recently, Indonesia returned to the future flow market with $600 million securitization of coal exports. Finally, Eastern Europe and the Russian Federation have shown significant potential for strong future flow candidates.

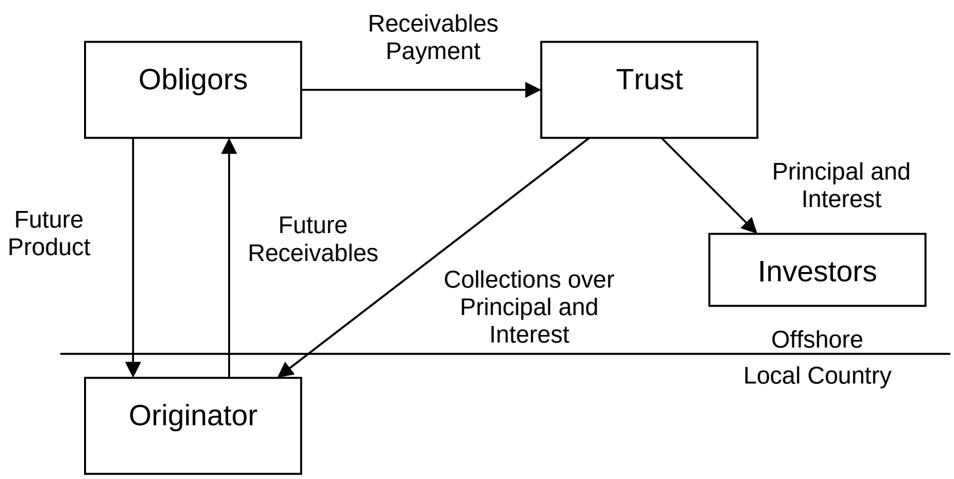
C. Transaction Mechanics

4. A future flow transaction securitizes the cash flow originating from a specific business line of a bank or company that produces goods or services for foreign customers. The structure of the future flow transaction is designed to collect cash flows in a dedicated offshore collection account. The cash flows come from a variety of sources, including foreign importers making payments on receivables, international credit card companies making settlement payments to local banks, and international banks making remittance transfers to local banks. All cash flows pass through the offshore collection account, and the excess flows are returned to the originating entity only after periodic debt-service payments are made.

5. The transaction's structure mitigates many sovereign risks by keeping the cash flow offshore until the investors are paid. If certain events occur (trigger events), the structures typically trap all cash flows going through the collection account to accelerate amortization of the notes. In some cases, only a portion of excess flows are captured during early amortization events in order to avert a liquidity crisis for an issuer. Ratings of future flow transactions are tied to the credit quality of the originator, which is typically measured by its local currency issuer default rating.

6. In some cases, a transaction's issuer default rating may be higher than the company's local currency issuer default rating thanks to the company's ability to continue operating beyond a general default and generate receivables for the duration of the deal. The going concern assessment (Fitch methodology) and survivability assessment (Moody's) address these issues. Achieving a rating at this level is a twofold concept. The company must not only continue to generate these receivables by producing and delivering the product, but the collections from the receivables must also be legally protected through a true sale structure. In some cases, transactions are rated above the issuing company's local currency issuer default rating but below the going concern/survivability level.

Figure A6: Typical Future Flow Transaction Structure



Source: Asian Development Bank analysis.

D. Future Flow Asset Classes

7. The two general types of future flow securitizations are (i) financial future flows backed by banks' generation of hard currency flows, and (ii) corporate-related transactions typically involving export receipts of some description. Financial flows include credit card vouchers, electronic (typically SWIFT-related payments,[1] including MT100s and MT200s[2]) and paper remittances. Corporate-related transactions typically involve airline ticket receivables; telephone net settlements; and the most prevalent, export receivables transactions, which are backed by products such as oil, gas, steel, iron ore, soybean, paper and pulp, aluminum, coffee, and chemicals.

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[1] Society for Worldwide Interbank Financial Telecommunications (SWIFT) is an international messaging system owned and maintained by the member banks (payment order only, no settlement). MT103/103+ are sent by the ordering customer's bank to the beneficiary's bank and are used to convey a funds transfer instruction.

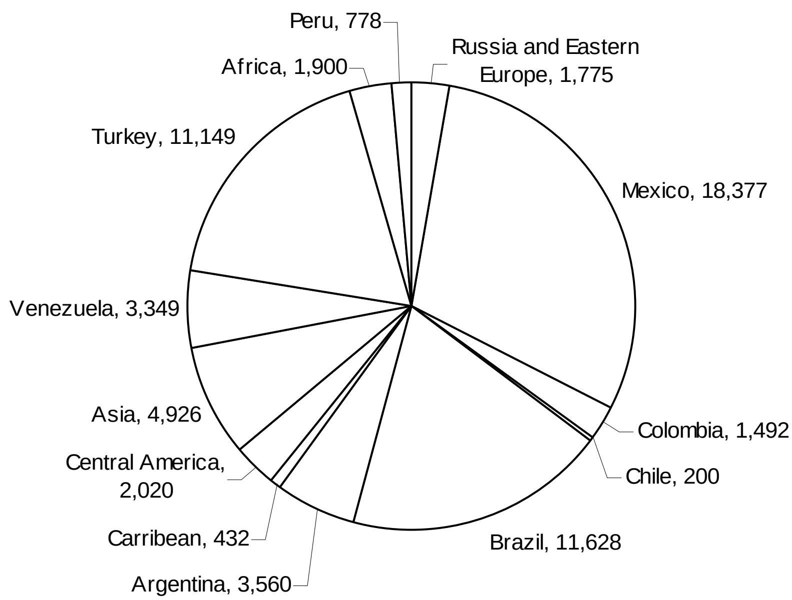
[2] MT100 (including MT102, 103) is the standard message type for payment orders relating to payment from senders to payees who are individuals, companies (other than financial institutions), or governments through banks. MT 200 (including MT202) is the standard message type for payment orders relating to payment from senders to payees that are financial institutions.

8. A bank or company based in an emerging market securitizes existing and future receivables related to offshore cash flows (usually in a stable foreign currency) and receives the proceeds of the debt issuance denominated in the same currency. The cash flows originate from a specific line of business in which the bank/company has demonstrated consistent strong performance and is expected to continue for the foreseeable future, or at least for the life of the structured deal. In the majority of structures, the bank/company sells its rights to the future flow to an offshore special purpose vehicle, which transfers its rights to an offshore trust. The trust issues debt securities backed by future cash flows, and remits the sale proceeds to the special purpose vehicle, which in turn passes them back to the originating bank/company.

9. Because note holders have access to payments on the receivables before they return to the country in which the issuer is located, they are not believed to be directly subject to convertibility and transfer risks. Thus, the ratings of these transactions are not strictly constrained by the foreign currency rating of the host country (the sovereign ceiling). However, all sovereign risks are not mitigated by the structure, and transaction ratings are still constrained by certain inherent political and economic risks of an emerging-market country. These risks can arise from such events as government instability, civil unrest, or natural disaster.

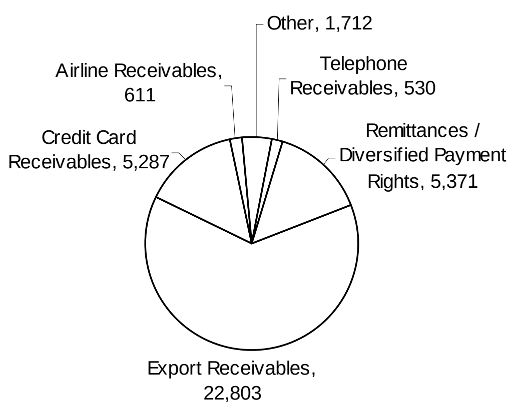
FUTURE FLOW SECURITIZATION VOLUMES

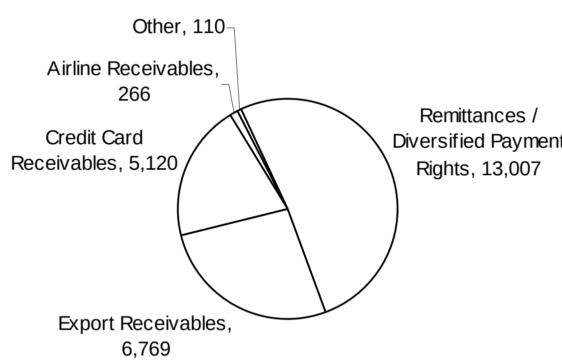
Figure A7.1: Emerging Market Future Flow Issuance by Country/Region



Source: Fitch. Future Flow Securitization Rating methodology, February 2006, p.2.

Figure A7.2: Emerging Market Future Flow Issuance by Asset

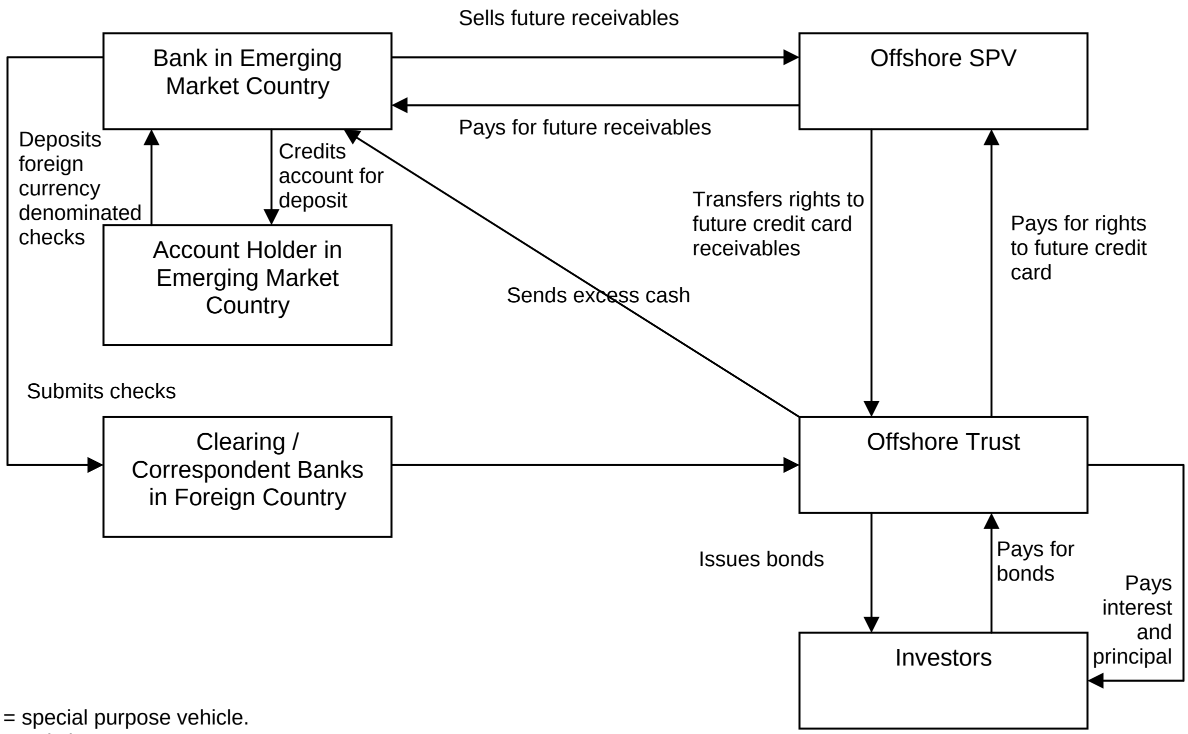




Source: Fitch. Future Flow Securitization Rating methodology, February 2006, p.2.

DIVERSIFIED PAYMENT RIGHTS SECURITIZATION

Figure A8: DPR Securitization Structure



SPV = special purpose vehicle.
Source: Fitch.

1. The bank that wishes to raise funds sells its rights to all present and future diversified payment rights (DPRs) to an offshore special purpose vehicle (SPV). The SPV transfers its rights to the cash flows to an offshore trust, and then issues debt securities (notes) backed by the future cash flows. The sale proceeds from the notes are then transferred from the SPV to the originating bank.

2. The cash flows sold are typically only those payments received from correspondent banks located in highly rated countries such as Europe and the United States. The correspondent banks sign a notice and acknowledgment that commits them to sending all future receivables to a trust account held by the SPV. This cash flow is then used to make scheduled principal and interest payments to the notes investors; any excess cash is returned to the originator. Appendix 8 provides a graphic illustration of a DPR securitization.

3. DPR securitization is recognized as an alternative source of long-term capital for banks. The cost of funds is attractive compared to unsecured bonds. The notes usually receive a rating higher than the host country's foreign currency sovereign rating since (i) the future receivables are due from offshore obligors, and (ii) the repayment is made directly by the SPV, which again is located offshore, to the investor. The investment grade rating makes these transactions attractive to a wider range of investors such as insurance companies that face limitations on buying subinvestment grade. The sold receivables also form part of the assets of the SPV and therefore, are not subject to claim of any other creditor in the event of bankruptcy.