



Report and Recommendation of the President to the Board of Directors

Project Number: 40941
July 2007

Proposed Credit Guarantee Republic of Kazakhstan: Diversified Payment Rights Securitization by ATF 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 11 May 2007)

Currency Unit	–	tenge (T)
T1.00	=	\$0.007986
\$1.00	=	T125.22

ABBREVIATIONS

ADB	–	Asian Development Bank
ATF	–	ATF Bank JSC
CARG	–	compounded annual growth
CIS	–	Commonwealth of Independent States
DDB	–	designated depositary bank
DPR	–	diversified payment rights
DSCR	–	debt service coverage ratio
FMSA	–	Financial Markets Supervisory Agency
GDP	–	gross domestic product
JSC	–	joint stock company
MT	–	message type
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

NOTE

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

Vice President	L. Jin, Operations 1
Director General	R. Bestani, Private Sector Operations Department (PSOD)
Director	W. Willms, Capital Markets and Financial Sector Operations Division, PSOD
Team leader	W. Willms, Director, PSOD
Team members	D. Wiedmer, Investment Specialist, PSOD V. Armedilla, Senior Investment Officer, PSOD N. Moller, Counsel, OGC

CONTENTS

	Page
I. THE PROPOSAL	1
II. RATIONALE: BACKGROUND, CHALLENGES, AND OPPORTUNITIES	1
A. Kazakhstan Economy: Overview and Outlook	1
B. Banking and Capital Markets in Kazakhstan	1
C. Future Flow Securitization: Overview	2
III. THE PROPOSED INVESTMENT	3
A. Project Conceptualization	3
B. Project Selection and Strategic Approach	4
IV. ATF BANK JSC	5
A. Overview	5
B. The Business	5
V. THE PROPOSED ASSISTANCE	6
A. Overview	6
B. ATF's Diversified Payment Rights	7
C. Guarantee Fee	8
VI. PROJECT BENEFITS, IMPACTS, AND ASSUMPTIONS	8
A. Justification	8
B. Social and Environmental Safeguard Policies	11
C. Anticorruption Policy, and Combating Money Laundering and the Financing of Terrorism	11
VII. ASSURANCES	11
VIII. RECOMMENDATION	11

APPENDICES

1. Kazakhstan: Major Macroeconomic Considerations	12
2. Banking and Capital Markets in Kazakhstan	17
3. Securitization: An Overview	21
4. Benefits of Securitization	24
5. The Mechanics of Future Flow Securitization	26
6. Future Flow Securitization Volumes	29
7. Diversified Payment Rights Securitization	30
8. Policy Project for Development of the Domestic Securitization Market	31
9. Development Impact Framework	36

I. THE PROPOSAL

1. I submit for your approval the following report and recommendation for a proposed credit guarantee (Guarantee) to cover the principal payments of notes for an aggregate amount of up to \$125,000,000 (2007-A Notes) in connection with a diversified payment rights (DPR) securitization by ATF Bank JSC (ATF or the Bank) (the Project).

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 Baa2 by Moody's, BBB by Standard and Poor's, and BBB by Fitch (all long-term issuer default rating). 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 other manufacturing companies are currently underrepresented in the national economy.¹ Creating conditions for growth of the corporate and SME sector is of key importance in striving to diversify the economy.²

B. Banking and Capital Markets in Kazakhstan

4. 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.

5. 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

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

² Asian Development Bank. 2003. *Country Strategy and Program (2004–2006): Kazakhstan*. Manila, 17. The Government has a declared policy of fostering SME development by promulgating SME laws (for instance, the Law on State Support to Development of Small Business in the Republic of Kazakhstan) and establishing organizations to implement this policy. 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.

especially true for the top performers within the first two tiers of the banking system. Appendixes 2 provide a more detailed analysis of the Kazakh banking system.

6. 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, domestically as well as internationally. Securitization in Kazakhstan is currently limited to offshore transactions, due to the lack of respective regulations for domestic issuance.

C. Future Flow Securitization: Overview

1. Securitization Background

7. Securitization has emerged as one of the dominant means of capital formation throughout the world, particularly in the United States (US) and Europe. 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. In developing Asia, however, securitization is still in a nascent stage. Appendix 3 provides a general description of the securitization process and Appendix 4 an overview of the various benefits derived from securitization.

2. Future Flow Securitization and Diversified Payment Rights Securitization

8. 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 offshore receivables. Future flow securitizations mitigate, in this case, many of the sovereign risks associated with an emerging market borrower by capturing cash flows offshore. Appendix 5 gives a more detailed description of the structure of future flow securitization transactions. Of all future flow transactions worldwide, none has so far defaulted.

9. In Kazakhstan, future flow transactions are only beginning to be introduced. Appendix 6 gives details of outstanding future flow asset-backed securities deals, and Appendix 7 provides a brief overview and introduction to DPR securitizations.³

³ In a 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 servicers. 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

III. THE PROPOSED INVESTMENT

A. Project Conceptualization

10. The Asian Development Bank (ADB) took its first steps into the Kazakh market with loans to Bank TuranAlem JSC⁴ (\$75 million) and Alliance Bank JSC (\$50 million).⁵ Both loans were disbursed in July 2006. These transactions, apart from their direct development impacts in terms of SME development, introduced ADB as a participant in the market. These two loans have been well received, were noted in the market, and have provided a number of follow-up opportunities. ADB decided that in a next phase of financial sector development it would concentrate on development of the country's capital markets.

11. The ADB Board of Directors endorsed the first steps in this direction by approving, in September 2006, ADB's guarantee for the DPR securitization undertaken by Alliance Bank JSC and in March 2007 a guarantee for a DPR securitization issued by Kazkommertsbank JSC.⁶ Both transactions have successfully reached financial close. To build a sustainable business model for ADB, replication of certain business ideas is important. In line with this approach, ADB originated a small number of follow-up investment opportunities in Kazakhstan, which meet ADB's development criteria and goals as well as ATF's credit standards.

12. The proposed transaction follows a similar structure as the Alliance Bank JSC and Kazkommertsbank JSC DPR securitizations and was conceptualized in recognition of the need to address the lack of diversity in banking system funding sources, and introduce a new asset class and new investors to Kazakhstan's capital markets.

13. In Kazakhstan, this would be the second DPR securitization of a medium-sized (tier II)⁷ private sector bank. Introduction of this product will facilitate ATF's activities in diversifying its funding sources and provide longer tenor funding to its borrowers.

14. In Kazakhstan, DPR securitization has been introduced, but to fully establish the securitization market and DPR as an established asset class, more securitization deals have to be completed. ATF has previously tried to use this funding technique but was unable to tap the capital markets and ended up leveraging its DPR only in the banking market (via DPR loans). The proposed transaction will give ATF full access to the capital markets. In addition, this transaction is expected to help other banks of similar size and with a similar rating to access this type of funding. The Project has however a two-pronged approach as it also supports the domestic policy dialogue for capital market development.

assigned to the special purpose vehicle. 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.

⁴ ADB. 2006. *Report and Recommendation of the President to the Board of Directors on Proposed Assistance to Private Bank in Kazakhstan* (Bank TuranAlem JSC). Manila.

⁵ ADB. 2006. *Report and Recommendation of the President to the Board of Directors on Proposed Assistance to Private Bank in Kazakhstan* (Alliance Bank JSC). Manila.

⁶ ADB. 2007. *Report and Recommendation of the President to the Board of Directors on a Proposed Guarantee and Loan to the Republic of Kazakhstan for JSC Kazkommertsbank*. Manila.

⁷ Kazkommertsbank JSC, Halyk Bank JSC, and Bank TuranAlem JSC are tier I.

B. Project Selection and Strategic Approach

15. In line with the revised ADB Medium-Term Strategy II,⁸ which identifies the financial sector as the top “Core I” focus, and the 2006 cofinancing strategy paper,⁹ ADB aims to build its cofinancing operations, especially guarantee operations. ADB sees the best strategic fit of this product in applying it to transactions related to capital markets, especially in the form of credit guarantees for securitization transactions. Appendix 8 provides an overview of remittance flows in Central Asia, which form the basis for DPR securitization transactions. ADB is working on a regional study on remittances and poverty in Central Asia and South Caucasus, which is expected to be presented in July 2007.

16. ADB is targeting a total of three to four DPR transactions (with different banks) in Kazakhstan to justify the high opportunity cost of transaction structure development and in an attempt to ensure full development impact. The proposed DPR transaction, however, has the unique feature that ADB is proposing to only provide a partial guarantee (principal only) instead of a full guarantee (principal and interest). This represents a new step in the development of ADB’s efforts. However, due to the structure of this guarantee, it is envisaged that a ‘AAA” rating will still be achieved. This allows the issuer to tap into the very wide investor base that is interested in top grade issues (i.e., AAA rating) combined with exposure to local banks.

17. In parallel, other markets will be developed, so that once ADB exits the Kazakh DPR securitization market a smooth transition is ensured. ADB is concentrating these efforts currently in Azerbaijan, Pakistan, and Philippines. In addition, DPR transactions can be structured as loans at an early stage before the markets are sufficiently developed for the issuance of DPR-backed bonds.

18. In line with this strategy, ADB is also providing (i) hands-on support to the Philippine Government to interpret and apply the newly enacted Securitization Law in connection with DPR (worker remittance) securitization, (ii) technical assistance¹⁰ to the Government of the People’s Republic of China (PRC) for the formulation of a new securitization law, and (iii) support for the Kazakhstan Government in formulating the necessary implementation rules for its newly enacted Securitization Law to allow domestic securitization.

19. This strategy and the proposed transaction are fully in line with ADB’s poverty reduction strategy.¹¹ The strategy states that ADB seeks to promote “sound and efficient banking systems and capital markets,” since these are seen as “indispensable for macroeconomic stability, mobilizing savings, and ensuring availability of long-term financing, an essential requirement for pro-poor growth.” A more effective capital market promotes more efficient channeling of savings to market-based investments that foster more sustainable economic growth. The development of securitization deepens and broadens capital markets, benefiting both issuers and investors.

⁸ ADB. 2006. *Medium-Term Strategy II 2006–2008*. Manila.

⁹ ADB. 2006. *ADB’s Financing Partnership Strategy*. Manila.

¹⁰ ADB. 2005. *Technical Assistance to the People’s Republic of China for Development of the Asset-Backed Securities Market and Restructuring of Asset Management Companies*. Manila.

¹¹ ADB. 1999. *Fighting Poverty in Asia and the Pacific: The Poverty Reduction Strategy*. Manila.

IV. ATF BANK JSC

A. Overview

20. In 2006, ATF was the third largest commercial bank in Kazakhstan. The bank has consistently gained market share, and is now one of the leading banks in the country (11% market share for corporate banking, 13% for SME business, and 13% for mortgage loans as of end-2006). Balance sheet growth in 2006 was primarily driven by expansion in lending activities (retail and SME). ATF operates through 32 full service branches and 62 cash settlement offices in Kazakhstan.

21. Currently, ATF is rated by three rating agencies: Moody's Investor Services Limited; Standard & Poor's Rating Services; and Fitch Ratings, Inc. (Table 2). On 25 June 2007, it was announced that Bank Austria Creditanstalt, responsible within the Italian UniCredito Group for commercial banking activities in the Central and Eastern Europe (CEE) region, has signed a share purchase agreement to acquire a majority shareholding in the Bank. Following this announcement, the rating agencies are expected to upgrade ATF's credit ratings. The rating agencies have already placed ATF on credit watch with positive outlook, reflecting the strong upside potential for ATF's creditworthiness following the change of control. Standard & Poor's expects that ATF will benefit from operational, managerial, and financial support from UniCredito. ATF's long-term rating is expected to benefit from a one-to-three notch uplift from the current stand-alone rating.

Table 2: ATF Bank Credit Ratings

Item	Moody's	S&P	Fitch
Long-Term	Ba1	B+	BB-
Short-Term	NP	B	B
Outlook	Stable	Stable	Stable

Fitch = Fitch Ratings, Inc.; Moody's = Moody's Investor Services Limited; S&P = Standard & Poor's Rating Services.

Source: Source: Fitch, Moody's, S&P.

B. The Business

22. ATF provides a broad range of banking services to large companies and SMEs, and is expanding its retail business focusing on high- and middle-income individuals.

23. Since its inception in 1995, ATF has evolved from an institution primarily focusing on funding its clients' trading activities to a universal bank. This transition has been accelerated by rapidly evolving market conditions, and by the necessity to diversify in order to defend its market position. ATF benefited from the fact that it began its operations as a new entity; it did not have to carry a burden of problems inherited from the past (i.e., bad asset quality as did some of its peers that were founded on the remnants of the banking system of the former Soviet Union).

24. **Corporate Banking.** Corporate banking has historically been ATF's most important business. ATF provides the full spectrum of lending products, i.e., short-, medium-, and long-term financing, trade finance, documentary operations, letters of credit, and guarantees. ATF has long-standing relationships with some of the country's largest corporates, but its customer base is relatively well diversified because ATF is independent from any large industrial group (unlike many of its competitors). ATF's loan concentration has been decreasing since 2003, and in 2006 its top 10 customers represented 20% (28% in 2003) of the portfolio; the top 50

represented 40% (58% in 2003). The corporate loan portfolio has grown from 2003 to 2006, but is projected to grow by only 24% CARG in the next 3 years as ATF increases its focus on the SME and retail segments.

25. **SMEs.** SMEs continue to represent a focus of ATF's business strategy. ATF has a dedicated department for SMEs, and SME business has been growing rapidly (130% CARG from 2003 to 2006). ATF plans to increase the share of SME loans in its total portfolio (currently approximately 20%) as well as its market share in the SME business segment, which is currently estimated at 13%. To cater to the specific needs of its SME customers, ATF launched several strategic initiatives including plans to open 21 dedicated centers providing business services to SMEs. The SME business is intended to be grown rapidly which seems a logical strategic step given ATF's size and its prevailing expertise. At the same time, the SME market segment offers good margins and good potential for sustainable growth in the future.

26. **Retail.** Retail loans accounted for 14% of total loans at the end of 2006. ATF focuses on three main products: mortgages, consumer loans, and car loans. ATF is one of the leading mortgage loan providers in the country with a market share of 13%. The quality of ATF's retail portfolio is good. ATF is expanding its retail distribution network to 150 dedicated retail centers at the end of 2007 and 229 at the end of 2009.

27. ATF is striving to gain market share in the retail business by focusing on the upper and middle classes of the population, hence avoiding the "brick and mortar" style of banking where high overheads are incurred in obtaining many small deposits.

V. THE PROPOSED ASSISTANCE

A. Overview

28. The proposed transaction is a credit guarantee to be issued in favor of investors in notes with a value of up to \$125,000,000 (Series 2007-A Notes) issued by an SPV. The notes are backed by DPR originated by ATF. The credit guarantee will only guarantee the principal of the Series 2007-A Notes. The total amount of the issuance is expected to potentially also include unwrapped notes (Series 2007-B Notes) of an amount to be specified after the due diligence of the rating agency (Moody's).

29. DPR usually take the form of SWIFT,¹² MT102 and 103,¹³ and MT202 payment order messages.¹⁴ These payment orders are generated as part of the international financial operations of ATF. Payment orders are created as a result of ATF's role as a financial intermediary between foreign payors wishing to send funds to Kazakhstan and residents of Kazakhstan receiving these funds, ATF proposes to securitize its MT100 DPR, denominated in dollars (ATF DPR).¹⁵

¹² 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.

¹³ 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.

¹⁴ MT100 (including MT102 and 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. MT200 (including MT202) is the standard message type for payment orders relating to payment from senders to payees that are financial institutions.

¹⁵ ATF's MT200 DPR are miniscule, as well as flows not denominated in dollars (less than 3%).

30. The transaction is part of a securitization program of ATF's existing and future dollar MT100 category DPR. The initial issuance under the program was through a \$100 million loan (Series 2006-A loan). Notes in the capital markets were not issued as this did not seem feasible at the time. The Series 2006-A loan issued on 4 April 2006 has a final maturity of 5 years, a principal repayment grace period of 2 years, with equal quarterly repayments thereafter, resulting in a weighted average life of 3.6 years.

31. The guarantee is anchored in the 2001 technical assistance to Kazakhstan for Preparing the Urban Small Business Development Project.¹⁶ The TA was to promote development of the urban SME sector, review the legal and regulatory framework for SMEs, and foster financial intermediation. This assistance will play a central role in supporting ADB's private sector operations in the financial sector and in strengthening domestic banks.

B. ATF's Diversified Payment Rights

1. Introduction

32. ATF generates DPR by acting as a recipient of payment orders, which arise through a variety of transactions, including from merchants inside Kazakhstan exporting goods or services to their customers outside of Kazakhstan, foreign direct investment, Kazakhstan flows,¹⁷ overseas transportation, and personal remittances. The payors who wish to make payments to beneficiaries in Kazakhstan who have accounts with ATF, request their banks, in the majority of cases located outside Kazakhstan, to initiate transactions for the payment of amounts to beneficiaries in Kazakhstan through ATF, thereby generating payment orders.

33. Processing payment orders is a basic banking business that offers significant benefits such as the ability to (i) strengthen correspondent banking relationships and obtain favorable terms on other banking products and businesses from its correspondent banks, (ii) attract new clients in cases where payment orders are the initial contact the client has with ATF and monitor ATF's borrower's cash flows, (iii) provide high-quality clearing services to its clients in Kazakhstan, (iv) generate foreign currency, (v) expand daily treasury activity, and (vi) improve liquidity.

2. Depository Banks

34. With respect to payment orders received by ATF, these orders are accomplished by making a deposit into one of ATF's accounts held with one of its correspondent banks (the depository banks). ATF receives DPR collections at approximately 44 depository banks in 15 countries, with 19 depository banks located in the US. Currently the designated depository

¹⁶ ADB. 2001. *Technical Assistance to the Republic of Kazakhstan for Preparing the Urban Small Business Development Project*. Manila.

¹⁷ Pursuant to current Kazakhstan currency regulation, a Kazakhstan resident cannot make a foreign currency-denominated payment in favor of another Kazakhstan resident; however, they may transfer their own funds from an account with one Kazakhstan bank in favor of another account held with another Kazakhstan bank. Such a payment order would be settled outside Kazakhstan. Kazakhstan flows are collections that arise when a Kazakhstan bank (whether through a branch, representative office, or other office located inside or outside of Kazakhstan) or a foreign bank's Kazakhstan branch or other office has initiated a payment order. Kazakhstan flows are often the result of Kazakhstan companies moving their own dollar and euro funds.

banks (DDBs)¹⁸ are (i) The Bank of New York (New York); (ii) American Express Bank Ltd. (New York); and (iii) Citibank (New York).¹⁹

3. Historical Flows

35. ATF, a SWIFT member since 1995, has consistently experienced growth in payment orders processed. ATF's DPR business shares a similarity with Kazakhstan's export industry as ATF's DPR include those that relate to exports to various countries, of which the most common have been the US, Netherlands, Great Britain, Russian Federation, PRC, Italy, France, and Switzerland. DPR volumes also tend to reflect Kazakhstan's economic growth patterns.

36. **Seasonality.** ATF's pool of DPR flows as a whole is not subject to any significant seasonality, although year-end volumes do tend to be higher than the yearly average. ATF believes that such increases are a typical year-end phenomenon, as companies attempt to settle their trades before the end of the financial year.

37. **Currency.** The payment orders sold by ATF are denominated in dollars.

C. Guarantee Fee

38. ADB will receive a guarantee fee. The guarantee fee amount and computation will be market driven using similar DPR securitization structures in Kazakhstan and Turkey as a benchmark. The guarantee fee will be set in accordance with ADB policies by the Credit Enhancement and Pricing Committee.

VI. PROJECT BENEFITS, IMPACTS, AND ASSUMPTIONS

A. Justification

1. Investment Objective

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

40. ADB's Guarantee will increase interest in DPR securitization from Kazakhstan. By establishing a credit history for ATF, the Project enhances its ability to raise funds in international capital markets, obtain longer tenor funds than currently possible in the market, and build market confidence in medium-sized banks. ATF's business lines generating DPR will be under constant scrutiny by rating agencies forcing ATF 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

¹⁸ A correspondent bank qualifies as ATF's DDBs if the correspondent bank processes more than 12% of ATF's collection for two consecutive quarters, has good credit quality, and is experienced in handling DPR. ATF signs an account agreement with the qualified correspondent bank to make them a DDB.

¹⁹ Pursuant to certain account agreements, the DDBs are obligated to deposit all funds received (or paid) by them in respect of any DPR into a collection account maintained with each such DDB from where they are transferred by the primary DDBs to the concentration account held by the Bank of New York.

and domestic, in Kazakhstan's banking system, and increase depositor confidence in the local economy and banking system.

41. ADB's second objective is to foster corporate and SME financing. In turn, ADB is assisting 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 ATF 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 ATF will be able to lengthen its tenor for its customers. The transaction will therefore bridge an unwanted maturity gap and allow ATF to match its assets and liabilities more closely. In addition, the securitization will allow ATF to access lower cost funds, which will make ATF more competitive and allow it to pass savings to its customers.

2. Development Outcome

42. The Government is striving to diversify the economy and reduce dependence on the oil subsector. This entails improving access of the nonoil sectors to finance and making investments in these sectors more attractive to investors. The Project seeks to achieve this by helping develop the capital market through diversifying funding sources for borrowers and increasing the availability of investment grade products for investors.

43. Although the concept of DPR securitization is not entirely new to the market, the number of issues in Kazakhstan has been limited. For the emerging market issuers, ADB's guarantee achieves a rating that is higher than the country's foreign currency sovereign rating. The Project will also address the need to educate investors and borrowers on the risks inherent in such a structure by issuing unguaranteed notes. In addition, the Kazakh DPR securitizations are among the very few completed in Asia and form part of a handful of future flow transactions executed so far in Asia. An increased number of DPR securitizations will lead to a better understanding and development of this financing technique. Hence, this proposal is expected to facilitate the development of a full-scale securitization market in Kazakhstan, and have spillover effects for the whole of Asia. ADB will provide for the first time a partial guarantee (instead of a full guarantee) for a future flow securitization, which will further widen the potential investor base and contribute to the diversification of funding sources.

44. Secondly, the proposed transaction will allow ATF to service its core businesses and directly contribute to expanding financial intermediation to SMEs and corporates—including those in rural areas—via ATF's existing and growing branch network, as well as foster diversification of loan portfolios.

45. **Increase Access to International Capital Markets.** DPR securitization is designed to mitigate sovereign risk so that noninvestment grade borrowers can access longer term financing at lower interest rates than they could by borrowing directly. The innovative structuring of these transactions has allowed many noninvestment grade borrowers in developing countries to pierce the sovereign credit ceiling and obtain financing at significantly lower interest costs and for longer duration. ADB's involvement as Guarantor enhances the borrower's credit rating.

46. Securitization of future flow and existing receivables can provide a way of raising development finance for many low- and, in particular, middle-income countries, especially during times of low liquidity and heightened perception of sovereign risk. During a liquidity crisis, developing countries need innovative ways to raise external finance. Future-flow receivable

securitization provides such a means of securing credit ratings for new issues that pierce the sovereign ceiling and thereby reduce the cost of funding. Future flow securitizations also attract a much wider class of investors because of their investment grade rating. Moreover, by establishing a credit history for the borrower, these deals enhance the ability and reduce the costs of accessing capital markets in the future.

47. From the investors' point of view, the attractiveness of this asset class lies in its good credit rating and its good performance in good and bad times. No debt defaults on rated future flow asset-backed securities issued by developing country entities have been recorded despite repeated liquidity and solvency crises.²⁰

48. **Expansion of the Formal Banking System.** As local banks realize the funding advantages inherent in packaging securitized DPR flows, they will become more competitive in terms of fees charged for DPR and remittance transfers, which will encourage both senders and beneficiaries to become bank clients and thereby enter into the formal banking system.

49. **Improve Financial Conditions of Local Banks.** Securitization will help improve the asset/liability management of local banks through access to longer term/lower rate funding sources. For example, banks can replace short-term borrowings in hard currencies with longer term funding through securitizations. Improvements in ATF's financial conditions will in turn lead to more stability of the region's banking system.

50. **Preparing for Domestic Issuance.** Ultimately, these transactions are paving the way for domestic securitization transactions, possibly once ADB has completed its policy project.

3. Value Added of ADB

51. ADB's proposed guarantee will add value by (i) enabling the transaction and a wider distribution of the notes, especially to Asian investors; (ii) increasing and diversifying funding sources and investment products in the market; (iii) providing access to longer term financing for ATF, thus improving ATF's management of its assets and liabilities; (iv) helping develop the securitization and SME market in Kazakhstan by extending a partial guarantee; and (v) increasing investor confidence in Kazakhstan's relatively young capital market by extending a partial guarantee instead of a full guarantee. ADB contributes to the development of the market for this type of transaction and asset class for the second tier banks in Kazakhstan.

4. Development Impact Measurement

52. ADB will measure the expected development impact of the Project. These performance measures follow the multilateral development banks' Evaluation Cooperation Group's Standards for Evaluation of Private Sector Investment Operations. Development impact is measured in three distinct categories: (i) business performance of the Project itself, (ii) economic sustainability, and (iii) private sector development. Appendix 9 shows the development impact framework.

²⁰ The asset class withstood the test of the Mexican peso crisis in 1994/95, the Asian liquidity crisis in 1997/98, and the Ecuadorian debt default in 1999. An interesting example is the receivable deal of PTCL, Pakistan's telephone company, which continued to perform even in the face of selective default on sovereign debt.

B. Social and Environmental Safeguard Policies

53. The Project has been assigned a category C environmental classification and is classified as category C with respect to indigenous people and resettlement. ATF will be required to establish an environmental management system following guidelines and to build capacity for implementing it. At least one ATF officer will attend ADB-sponsored environmental management training. ATF has already established a European Bank for Reconstruction and Development environmental management system.

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

54. ADB undertook due diligence on ATF's procedures in respect of money laundering and financing of terrorism. ATF has been advised of ADB's policy on *Anticorruption* (1998, as amended to date) and policy relating to combating money laundering and the financing of terrorism.²¹ ATF will undertake 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 in the reimbursement and indemnity agreements. Further, ATF will undertake to refrain from engaging in such activities. The documentation between ADB and ATF will allow ADB to investigate any violation or potential violation of these undertakings.

VII. ASSURANCES

55. ADB will enter into an acceptable guarantee agreement and other required legal documents, following approval of the proposed Guarantee by the Board. These agreements will be on terms and conditions satisfactory to ADB.

56. Consistent with the Agreement Establishing the Asian Development Bank, the Government of Kazakhstan will be asked to confirm that it has no objection to the proposed Guarantee. The Guarantee will not become effective until ADB has received such confirmation.

VIII. RECOMMENDATION

57. I am satisfied that the proposed guarantee would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve the credit guarantee to cover the principal payments of notes for an aggregate amount of up to \$125,000,000 in connection with a diversified payment rights securitization by ATF Bank JSC, from ADB's ordinary capital resources, with a maturity of 7 years and conditions substantially in accordance with those set forth in this report, and as may be reported to the Board.

Haruhiko Kuroda
President

11 July 2007

²¹ ADB. 2003. *Enhancing the Asian Development Bank's Role in Combating Money Laundering and the Financing of Terrorism*. Manila.

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, the private sector, representing 65% of GDP, 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 the end of 2005. The Government approved the 2006 state budget 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 the end of 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 30 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).

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

² Asian Development Bank. 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% during 2000–2004 were 6%, 3.2%, and 1.2% (footnote 2, p. 98–99).

8. The hydrocarbons subsector 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. Nonoil output has risen at an average of 7% a year since 2000 and been sustained at 25% of total investment, representing 6.5% of GDP during 2000–2005. Within the nonoil 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 average annual investment rate stood at 3% of GDP during the period, with half of that from the public sector. If the investment rate in the nonoil sector maintains its recent trend, nonoil 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 nonoil and private sectors (footnote 2).

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. Small- and medium-sized enterprise (SME) development is hampered by 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 develop the SME segment, especially manufacturing.

12. 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 minimum⁴ 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

13. 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.

14. 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.

15. 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 economic integration within the Commonwealth of Independent States, one of the aims of which is to assure continued access to export routes.

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 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.

C. Macroeconomic Considerations and Exchange Rate Policies

16. 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 Federation 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.

17. 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 during 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.

18. 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. This policy, 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; as of 11 May 2006, NBK reported the official T/\$ exchange rate as T122.87/\$1.

19. 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

20. 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 increased 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 buildup of money in the National Reserve Fund (\$8.2 billion, or 14.4% of GDP as of the end of 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; 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 price expansion.

E. Regulation of Banking

21. 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.

F. Implementation of Market-Based Economic Reforms

22. 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 telecommunications 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 during 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 for the coming years. 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. 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 34² 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.

¹ Technically, the National Bank of Kazakhstan (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 the National Bank of Kazakhstan, 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.

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. 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 provides 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

6. 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 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. 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

10. Three types of government securities are available: T-bills, T-bonds, and inflation-linked and variable bonds. 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 local pension funds.

11. 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 subsector, only deals of the primary market and purchase-sale deals on the secondary market are considered.

Source: Kazakhstan Stock Exchange.

12. 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.

13. 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.

14. 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. 2004. *Strategy for Kazakhstan*. United Kingdom.

SECURITIZATION: AN OVERVIEW

1. 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.
2. Although securitization has gained wide acceptance in other parts of the world, it is still in its nascent stages in Asia. Issuance of asset-backed securities in the region has been dominated by Australia, Japan, and 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.
3. 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.

A. Background

4. 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.
5. 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.
6. 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.

7. 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

8. At the center of a securitization is an SPV set up by the originator of the financial assets to be securitized. The SPV purchases the financial asset receivables (e.g., mortgages, small- and medium-sized enterprise loans) 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 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, creditworthiness, and size to become liquid secondary instruments through repackaging and cash-flow structuring.

9. 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 was to originate the portfolio, but not have a stake in its eventual performance.

10. 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.

11. 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

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 a bankruptcy remote structure.

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 SECURITIZATION¹

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 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.
- (iv) **Mitigation of event risk.** Unlike similar, high-rated corporate bonds, asset-backed securities are largely immune from event risk. The latter results from

¹ Based on Giddy, Ian H. 2000. *Asset Securitization in Asia*. New York: New York University.

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 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

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 rights (DPR) securitizations.

2. 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, El Salvador, Mexico, Peru and Turkey.¹ 2005 was the highest issuance year with close to \$10 billion in total volume.²

A. Historical Volume Development

3. 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., placing \$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.

4. 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 as strong future flow candidates.

B. Transaction Mechanics

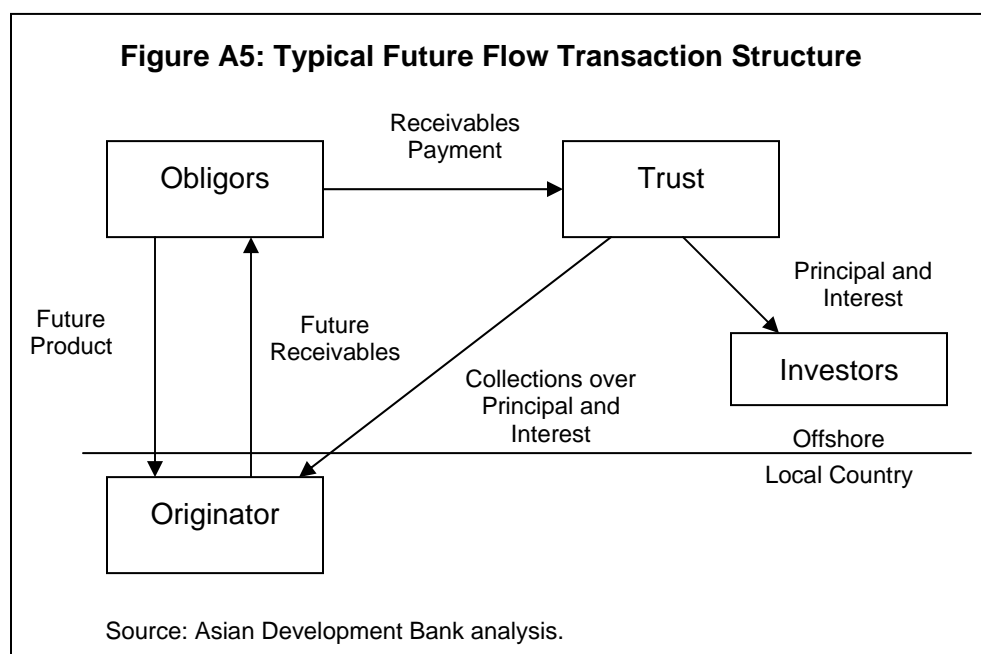
5. A future flow transaction securitizes the cash flow originating from a specific business line of a bank or company that produces goods or services for foreign customers. The structure of the future flow transaction is designed to collect cash flows in a dedicated offshore collection account. The cash 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.

¹ 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.

² Fitch Ratings. Future Flow Securitization Rating Methodology. 15 February 2006.

6. 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.

7. In some cases, a transaction's issuer default rating may be higher than the company's local currency issuer default rating because of 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.



C. Future Flow Asset Classes

8. 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, and electronic (typically SWIFT-related payments,³ including MT100s and MT200s⁴) and paper

³ 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.

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.

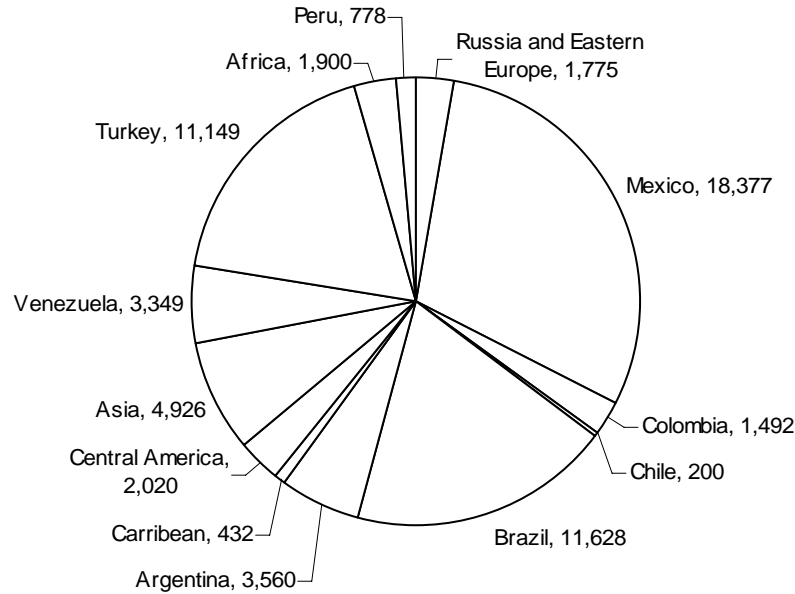
9. A bank or company based in an emerging market securitizes existing and future receivables related to offshore cash flows (usually in a stable foreign currency) and receives the proceeds of the debt issuance denominated in the same currency. The cash flows originate from a specific line of business 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.

10. 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.

⁴ 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. MT200 (including MT202) is the standard message type for payment orders relating to payment from senders to payees that are financial institutions.

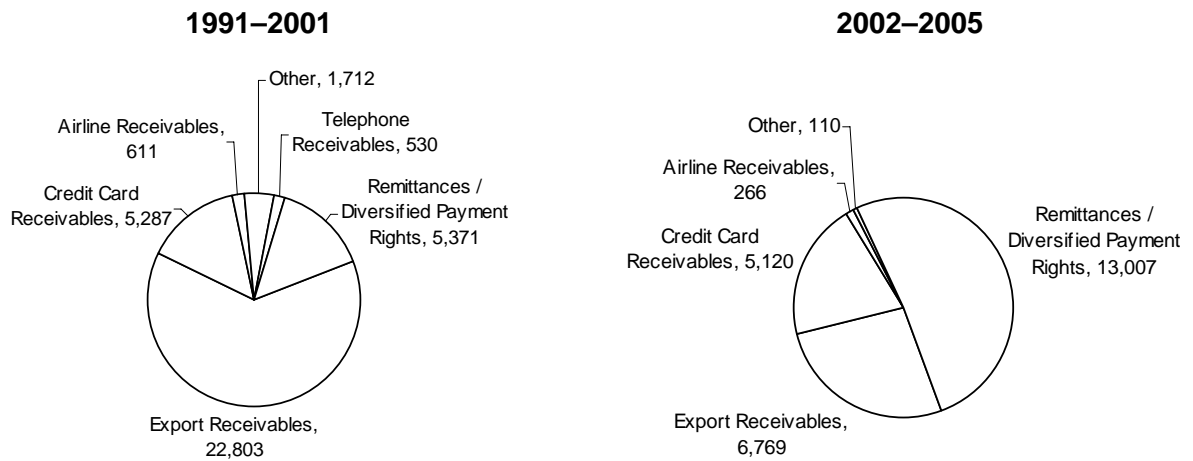
FUTURE FLOW SECURITIZATION VOLUMES

Figure A6.1: Emerging Market Future Flow Issuance by Country/Region



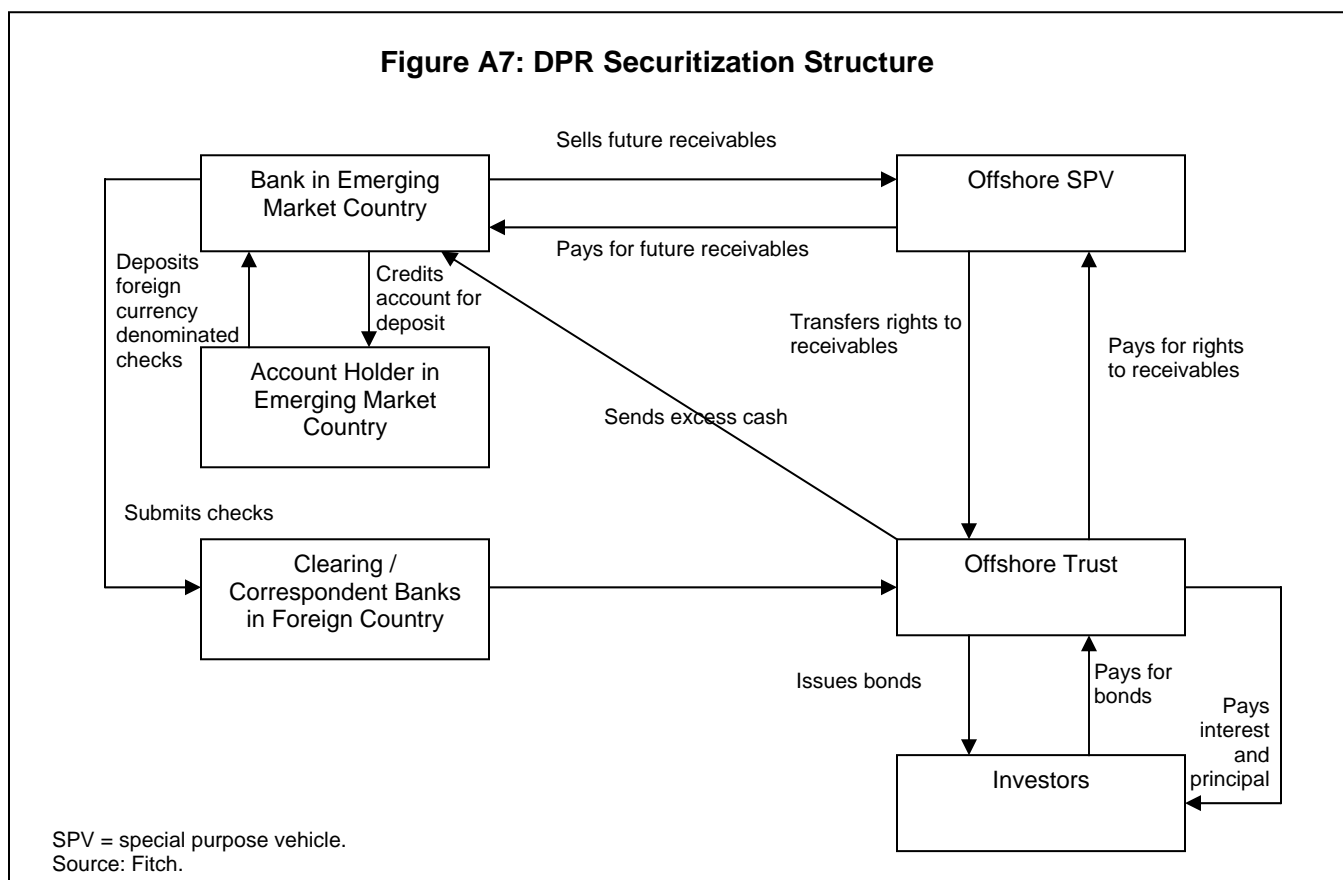
Source: Fitch. Future Flow Securitization Rating methodology, February 2006, p.2.

Figure A6.2: Emerging Market Future Flow Issuance by Asset



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

DIVERSIFIED PAYMENT RIGHTS SECURITIZATION



1. The bank that wishes to raise funds sells its rights to all present and future diversified payment rights (DPR) 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 investors; any excess cash is returned to the originator.

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.

ASIAN DEVELOPMENT BANK'S EFFORTS ON REMITTANCES

1. The director general of the Private Sector Operations Department (PSOD) of the Asian Development Bank (ADB) initiated efforts with regard to remittances in 2004 by hiring a staff consultant to research the topic of remittances and help craft a strategy for ADB's involvement in this arena. Remittance initiatives in 2004 included organizing ADB's cosponsorship of an Asia-Pacific Economic Cooperation conference in Tokyo, and undertaking the first large-scale survey of remittances conducted at ADB. This research effort, which studied the Philippines (one of the world's leading receivers of remittances),¹ was well received. In 2005, ADB participated in a related survey, this time a regional survey of remittances within Asian countries, and organized a major conference on remittances attracting more than 30 speakers and 350 participants. During 2005 and 2006, PSOD represented ADB on a global task force organized by the World Bank and Bank for International Settlements, which developed global principles for remittances that will be finalized in September 2006. This effort indicates that remittances have become a focus of development agencies in general, and ADB participation demonstrates ADB's commitment.

A. Context of Remittances at ADB

2. Remittances—the financial aspect of migration—are a matter of increasing national interest for both developed and developing countries. Global remittances in 2005 are estimated at \$225 billion, and as such represent the second largest flow of external finance after foreign direct investment, and are twice as large as flows of formal development assistance.

3. Remittances have significant importance for development and poverty reduction. In the absence of an efficient domestic labor market and a social insurance system, remittances are a key means for individuals to address poverty. In Tajikistan, for example, the poverty rate declined from 81% to 60% during 2000–2003, largely, according to the International Monetary Fund, as a result of remittance flows. Remittances fuel both consumption and growth; indeed, gross national disposable income was at least 15% higher than gross domestic product per capita in Tajikistan in 2004 with the difference attributed to out-of-country remittances.

4. Remittances also contribute to financing a country's trade deficit and have a positive impact on national current accounts; imports paid for with remittances increase government revenues in customs duties and value-added tax. Remittances are more consistent than other flows and are countercyclical, which helps to balance economic fluctuations caused by changes in exports, imports, or politics; and thus contributes to foreign exchange rate stability. Remittances also help strengthen the banking system and support expanded credit to the private sector by increasing the deposit base to support increased lending.

B. Remittances in Central Asia

1. Overview

5. PSOD's most recent involvement in remittances has been a contribution of \$300,000 to the total project cost of \$1,300,000 for a remittance survey in five Central Asian countries, run by ADB's Central and West Asia Department, which will study both the relationship of remittances to poverty and social conditions, and the relationship between remittances and the financial sector (both formal and informal). The countries covered by the survey will be Armenia,

¹ Estimated at \$12 billion in 2006.

Azerbaijan, Kyrgyz Republic, and Tajikistan (all receiving countries), and Kazakhstan (sending country). Remittances are a major economic factor for receiving countries.²

Table A8: Remittances in Central Asia

Country	Remittance (\$ million)	GDP (\$ billion)	Population (million)
Armenia	1,000	4.8	3.2
Azerbaijan	1,000	12.8	8.3
Kyrgyz Republic	750	2.4	5.1
Tajikistan	1,000	2.3	6.5

GDP = gross domestic product.

Source: Asian Development Bank estimates.

6. Remittances can be considered as particularly important to the health and strength of Central Asian economies. The sudden collapse of the Soviet Union left these countries and governments in economic and social disarray, a condition that persists in many parts of the region. The flow of remittances has significantly contributed to improved conditions in the receiving countries, and supplied necessary labor inputs to migrant recipient economies.

7. Lacking in national advantages such as natural resources and large domestic economies that characterize some of their Asian neighbors, most of the Central Asian republic receiving countries are small and impoverished, and the flow of remittances is particularly critical to their stability and growth. Indeed, with high unemployment rates despite a high degree of literacy and education, many of these receiving countries rely disproportionately on labor as an exportable resource, and on the remittances derived from this resource. Similarly, Kazakhstan and the Russian Federation as migrant destination countries have labor shortages and would not realize their current economic growth without the infusion of migrant labor.

2. Remittances in Kazakhstan

8. In the case of Kazakhstan, workers' remittances and compensation for employees received was \$122 million in 2000, \$148 million in 2003, and \$167 million in 2004.³ Along with the Russian Federation, Kazakhstan has become a major migrant receiving country among the Commonwealth of Independent States (CIS)⁴ in recent years, having lost 20% of its population due to mass emigration of Slavic people, Germans, and Jews in the 1990s. The initial emigration of Kazakhstan nationals to more developed western countries contributes to the country's inward remittances. Every 10th family in Kazakhstan reportedly depends on migration-related earnings and remittances of their relatives.⁵ On the other hand, the entry of other CIS nationals into Kazakhstan resulted in Kazakhstan being identified as one of the sources of remittances among the CIS.

² The total global flows might be up to 50% higher if unrecorded remittances are included; the informal flows to the Commonwealth of Independent States countries are unlikely to be any different, so these numbers probably understate the full picture significantly. Although not covered by this survey, the Russian Federation is the largest source of remittances to the targeted countries, with a total outflow of more than \$5.5 billion compared with inflows of some \$2.7 billion.

³ World Bank.

⁴ The CIS member states are Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyz Republic, Moldova, Russian Federation, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan.

⁵ Global Commission on International Migration.

DEVELOPMENT IMPACT FRAMEWORK

1. Private Sector Development (contribution to the growth of viable financial sector and financial markets development)^a

Impact	Reported Measure
<ul style="list-style-type: none"> ▪ Development of vibrant cross-border securitization market ▪ Development of domestic securitization market ▪ Development of the banking subsector ▪ Reform and stability of the financial sector 	<p>General</p> <ul style="list-style-type: none"> ▪ Evidence of spillover effects and overall development of bond market in Asia; other Asian countries undertaking DPR securitization transactions within next 36 months <p>Securitization Market in Kazakhstan</p> <ul style="list-style-type: none"> ▪ Spillover effects to other banks in Kazakhstan, i.e., other Kazakh banks doing at least two similar DPR deals within next 12 months ▪ One more (non-DPR-related) cross-border transaction (with or without ADB involvement) within next 24 months; for instance, securitization of oil or gas export receivables ▪ Implementation of implementing rules and regulations of the Securitization Law within next 24 months ▪ First domestic securitization transaction within next 24 months; anticipated asset class is SME loans or mortgage loans <p>Banking Subsector in Kazakhstan</p> <ul style="list-style-type: none"> ▪ Contribution to financial strength of subsector (e.g., better match of assets and liabilities); overall banking subsector decrease in asset/liability maturity gap ▪ Share in total financial sector assets of private sector financial institutions; increase by 10% ▪ Increase in banking assets; 5% increase in assets over next 12 months

2. Business Performance (overall profitability and commercial viability of the financial institution)

Impact	Reported Measure
<ul style="list-style-type: none"> ▪ Overall performance of the financial institution ▪ Flow of DPR 	<ul style="list-style-type: none"> ▪ Return on equity ▪ Return on assets ▪ Net interest margin ▪ Cost/income ratio ▪ Growth in assets ▪ Total volume of DPR ▪ Stability/increase of DPR flows compared to average between 2003 to 2006

3. Economic Sustainability (allocation of resources and provision of financial services to viable private enterprises)^b

