Report and Recommendation of the President to the Board of Directors

Project Number: 41902
February 2007

Proposed Guarantee and Loan
Republic of Kazakhstan: JSC Kazkommertsbank

Asian Development Bank

CURRENCY EQUIVALENTS
(as of 16 February 2007)

Currency Unit – tenge (T)

T1.00 = $0.00082
$1.00 = T122.56

ABBREVIATIONS

ABS	–	asset-backed securities
ADB	–	Asian Development Bank
CIS	–	Commonwealth of Independent States
DSCR	–	debt service coverage ratio
DPR	–	diversified payment rights
FMSA	–	Financial Markets Supervisory Agency
GDP	–	gross domestic product
GOK	–	Government of Kazakhstan
JSC	–	joint stock company
IFRS	–	International Financial Reporting Standards
KASE	–	Kazakhstan Stock Exchange
KKB	–	Kazkommertsbank
MT	–	message type
NBK	–	National Bank of Kazakhstan
PSOD	–	Private Sector Operations Department
SMEs	–	small and medium-sized enterprises
SPV	–	special purpose vehicle

NOTE

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

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I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on (i) a proposed credit guarantee (Guarantee) for a principal of up to $100 million and accrued interest of a series of notes to be issued in connection with a deferred payment rights (DPR) securitization by JSC Kazkommertsbank (KKB) of up to $500 million; and (ii) a proposed Tenge denominated senior or subordinated unsecured loan (Tenge Loan) of up to $50 million equivalent.

II. RATIONALE: BACKGROUND, CHALLENGES, AND OPPORTUNITIES

A. Kazakhstan Economy: Overview and Outlook

2. Kazakhstan maintained solid economic growth in 2006 (over 7.4% in the first half of the year), based on foreign direct investments in the energy sector, increased pipeline export capacity, conservative fiscal and monetary policy that balanced the need for public investment with price stability, and strong banking system regulation and supervision. The country has benefited from higher oil prices and greater exports, which have increased foreign currency inflows and assisted debt-servicing. Kazakhstan is rated Baa2 by Moody's, BBB by Standard and Poor's, and BBB by Fitch (all long-term issues default rating). Appendix 1 provides details of the country's macroeconomic outlook.

3. Nevertheless, Kazakhstan's high dependence on oil exports poses a potential threat for the economy given the potential volatility in the international oil market. Small and medium-sized enterprises (SMEs) and other manufacturing and service companies are currently underrepresented in the national economy.[1] Creating conditions for and stimulating the growth of the corporate and SME sector is very important to diversifying the economy.[2]

B. Banking and Capital Markets in Kazakhstan

4. Improvements in the economic and operating environment of Kazakhstan's financial sector have led to rapid growth in the past 5 years and more creditworthy domestic banks. In particular, the Government of Kazakhstan and the National Bank of Kazakhstan (NBK), 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 by robust growth, banks have increased their lending volumes by an average of more than 40% per year (albeit from a very low base), while generally maintaining healthy asset quality and profitability. This is especially true for the top performers in the first two tiers of the banking system. However, the

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[1] The SME sector is estimated to have contributed only 14%–15% of GDP in 2005. Because the sector is relatively labor-intensive, providing approximately 40% of total employment, SME growth is inherently inclusive and pro-poor in nature.

[2] ADB. 2003. *Country Strategy and Program (2004–2006): Kazakhstan.* Manila (p. 17). The Government has a 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) supports 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 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) use state and nonstate resources to support SMEs, (iii) develop SME infrastructure, and (iv) provide advice for SMEs.

strong asset growth over the past five years has put pressure on the adequacy of bank capital, prompting the need for Tier II capital infusions denominated especially in Tenge. Because of the export- driven economy and low interest rates, banks have in the past relied heavily on dollar-denominated funding and lending; however, a changing economy means that banks now need to move more into a tenge-denominated assets and liabilities.

6. One of the key challenges facing the financial sector is the emergence of debt and equity capital markets, especially with respect to the corporate sector. To widen their access to funding, many banks are keen to enter these markets.

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 and Europe. In developed markets, asset securitization serves a number of purposes: (i) supports 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) transfers risk, especially in the context of nonperforming assets and portfolio diversification; and (iv) provides an alternative means of raising finance. In developing Asia, however, securitization is underdeveloped.

2. Future-Flow Securitization and Diversified Payment Rights Securitization

8. Future-flow securitization became popular in emerging markets in the 1990s as a way of reducing sovereign-related risk and providing more attractive access to international capital markets for issuers in the stronger emerging markets. A future-flow transaction is the securitization of a company’s future and existing receivables. In the case of originators in emerging markets, such receivables originate from offshore obligors. Future-flow securitizations mitigate many of the sovereign risks associated with an emerging market borrower by capturing cash flows offshore.

9. Future-flow investments have consistently proven themselves to investors, and over the years they have successfully mitigated a variety of the risks associated with emerging market investments. No future-flow transaction has defaulted so far.

10. In Kazakhstan, future-flow transactions are only beginning to be introduced.

III. THE PROPOSED INVESTMENT

A. Project Conceptualization

1. Background and ADB’s Business History in Kazakhstan

11. ADB took its first steps in Kazakhstan with loans to Bank TuranAlem JSC ($75 million) and Alliance Bank JSC ($50 million).[3] Both loans were disbursed in July 2006. In addition to their direct development impact in terms of SME development, these transactions also

[3] ADB. 2006. *Report and Recommendation of the President to the Board of Directors on Proposed Assistance to Private Banks in Kazakhstan.* Manila.

introduced ADB as a participant in the market. The two loans have been well received, were noted in the market, and have provided a number of follow-up opportunities.

12. In the next phase of financial sector development in Kazakhstan, ADB intends to concentrate on capital markets. ADB's Board of Directors endorsed the first step in this direction by approving in September 2006 ADB's guarantee for the DPR securitization undertaken by Alliance Bank JSC.[4] This transaction reached financial closure in mid-November 2006.

2. ADB Equity Investments

13. ADB is considering taking an equity position in the Kazakh banking market, to further foster the development of this sector and position ADB as serious market participant.

IV. JSC KAZKOMMERTSBANK

A. Overview

14. Established in 1990, KKB is one of the leading banks in Kazakhstan. As of 30 June 2006, it was the market leader as measured by total assets and loans, the third largest in terms of deposits, and the fourth largest in terms of the number of branches. KKB provides a full range of corporate, SME, and retail banking services and insurance, pension, asset management, and other financial services through a network of 22 full branches and 68 outlets. The bank has a well-developed alternative distribution network, including internet banking, 454 ATMs (including 224 added since the beginning of 2004, of which 49 are multi-functional), over 3,200 point-of-sale terminals, and a call center. KKB's main competitors are Bank TuranAlem JSC and Halyk Bank.

15. KKB has a clear expansion strategy to become the leading universal bank in Kazakhstan. As growth through the acquisition of a major player in Kazakh banking is not possible (for anti-monopoly reasons), KKB is growing aggressively in key market areas outside its traditional stronghold of corporate banking (where the growth potential is limited because of strong competition from Bank TuranAlem JSC and Halyk Bank). KKB has managed to build a sizable presence in the retail and SME markets, which are viewed as increasingly attractive. KKB's strong commercial position and good earnings profile mean it is in a good position to prosper from economic growth. The presence of the European Bank for Reconstruction and Development (EBRD) as a shareholder should help with KKB's corporate governance, funding, and capitalization.

16. Currently, KKB is rated by three rating agencies: Moody's, Standard & Poor's (S&P), and Fitch (Table 1).

Table 1: KKB Bank Credit Ratings

Item	Moody's	S&P	Fitch
Long-term	Baa1	BB+	BB+
Outlook	Stable	Stable	Stable
Survivability Assessment	Baa2	BBB	BBB

S&P = Standard & Poor's
Source: Moody's,S&P, Fitch.

[4] ADB. 2006. *Report and Recommendation of the President to the Board of Directors on Proposed Guarantee for the Diversified Payment Rights Securitization by Alliance Bank JSC.* Manila.

B. Business Description

17. **Corporate Banking.** KKB is the largest lender to medium-sized companies and international companies operating in Kazakhstan. KKB's competitive advantages in corporate banking include its ability to provide larger and longer-term facilities than its peers, and its access to cheaper financing. KKB currently provides payroll services to its main corporate clients, which is used for cross-selling into retail products.

18. **Banking for Small and Medium-Sized Enterprises.** KKB is rapidly increasing its banking services for SMEs, a market it regards as underserved and as offering high-yielding lending opportunities.

19. **Retail Banking.** KKB offers its retail customers a comprehensive range of products, including residential mortgages, consumer loans, e-banking, debit and credit cards, and deposit and current accounts. It has one of the top three positions in terms of market share, residential mortgages and retail loans, retail deposits, and credit cards, and ATM services. KKB had about 253,000 retail customers as of 30 June 2006 and plans to increase its retail operations by expanding its branch network to 240 by 2010 and launching an aggressive marketing campaign focused on cross-selling opportunities.

V. THE PROPOSED ASSISTANCE

A. Overview

20. The proposed transaction has two components. (i) a credit guarantee will be issued in favor of investors in notes backed by DPRs originated by KKB. The total amount of the issuance is expected to be up to $500 million, with ADB guaranteeing up to $100 million and MBIA and FGIC guaranteeing the remainder; (ii) the provision of a senior or subordinated, unsecured Tenge denominated loan of up to $50 million equivalent for onlending into the Kazakh SMEs and corporate market. The Guarantee is anchored to the Tenge Loan.

B. Guarantee for DPR Securitization

1. Overview

21. The proposed guarantee will be issued in favor of investors in notes backed by DPRs originated by KKB. The total amount of the issuance is expected to be up to $500 million, with ADB guaranteeing one series of notes with a face value of up to $100 million and interest accrued thereon.

22. This will be the third issuance under KKB's DPR program. The first was in December 2005 by way of a private placement. In June 2006, KKB issued two further series of notes, Series 2006A and 2006B Notes, which redeemed the $50 million floating-rate notes series 2005C in their entirety. The issuance in 2006 had a seven year final maturity.[5] The new 2007 series will increase KKB's maturity profile beyond the 7-year benchmark available in the market, so it can provide longer-term funding for its customers. ADB will assist KKB in this by providing its guarantee for a 10-year maturity.

[5] Both series pay quarterly interest of three-month US dollar LIBOR plus 0.24%. The final expected maturity of both series is in June 2013, with an average life of 5.1 years. The 2006 series notes have an underlying rating of BBB/Baa2 and due to the two guarantees provided by Ambac Insurance Co. and FGIC have a AAA/Aaa rating.

23. This transaction would not only be one of the largest DPR deals ever worldwide, but also the first to reach a 10-year maturity. ADB's decision was used by KKB to convince the two other guarantors to match ADB's maturity.

2. KKB's Diversified Payment Rights

a. Introduction

24. DPRs usually take the form of SWIFT[6] MT102, 103,[7] and 202 payment order messages.[8] These payment orders are generated as part of the international financial operations of KKB. Payment orders are created as a result of KKB's role as a financial intermediary between foreign payors wishing to send funds to Kazakhstan and residents of Kazakhstan receiving these funds. KKB proposes to securitize its MT100 DPRs, denominated in US dollars.

25. KKB generates DPRs by acting as a recipient of payment orders, which arise through a variety of transactions, including from exporters inside Kazakhstan selling goods or services to customers outside Kazakhstan, foreign direct investment, "Kazakhstan flows",[9] overseas transportation, and personal remittances. The payors, who wish to make payments to beneficiaries in Kazakhstan with accounts with KKB Bank, request their banks (payor banks), in the majority of cases located outside Kazakhstan, to initiate transactions for the payment of amounts to beneficiaries in Kazakhstan through KKB, thereby generating payment orders.[10]

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

The BBB underlying rating on the series 2006A and 2006B notes reflects the rating agencies survivability assessment of KKB, i.e., its ability to generate the necessary assets to service the transaction even under a state of selective default or other financial impairment, over the term of the transaction and other structural features that mitigate sovereign interference risk and other credit risks.

6 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.

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

8 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.

9 As a result of current Kazakhstan currency regulation, a Kazakhstan resident cannot make a foreign-currency-denominated payment in favor of another Kazakhstan resident. However, he or she may transfer his or her 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 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.

10 Excluded are payments related to Western Union, credit card payments, and check payments settled through KKB. Appendix 17 provides a detailed description of a MT100 payment flow.

b. Depository Banks

27. Payment orders received by KKB are effected by making a deposit into one of the KKB accounts held with one of its correspondent banks (the depositary banks). These "designated depositary banks" (DDBs) are correspondent banks that KKB has chosen because of their existing relationship with KKB, their credit quality, and their experience with DPRs.

3. Notes Issuance

28. **Issuer.** The special purpose vehicle (SPV), KKB DPR Company, will issue up to three series of notes. The issuance is expected to be listed either in London or Luxembourg. The notes will be distributed under Rule 144A in the United States of America.

29. **Structure of the Issuance.** The issued notes will have a fixed or floating rate. Principal repayment will be amortized. Investors will be entitled to quarterly interest payments and principal payments, in accordance with the transaction's amortization schedule. On each quarterly payment date, the trustee will make the scheduled debt service payments to the investors.

30. **Pricing of the Notes.** The notes issued by the SPV and guaranteed by ADB are not expected to compete directly with any ADB bond issues. Despite both issues having the same ratings (AAA), the spread of the ADB bonds is expected to be tighter, reflecting the risks of ADB as the ultimate borrower. Pricing of the SPV notes will incorporate a prepayment risk, since KKB can choose to buy back the notes from the note holders in the event that it wants to stop paying guarantee fees to ADB and its credit rating improves to a level where reissuing would be less expensive in case of a trigger event. Investors buying the notes are not seeking an ADB bond; they will have to price in the risk of prepayment, other structural features of the notes, and the illiquidity of the paper (essentially buy and hold), all of which will justify a higher yield than for a regular ADB bond.

4. Expected Rating

31. Moody's and Standard & Pors are expected to provide shadow ratings of the notes. The ratings are expected to be up to Baa2 for Moody's and BBB for Standard & Poors. The rating upgrade (as compared to KKB's corporate rating) will be based on (i) the structural enhancements built into the transaction, which will include certain DSCR and rating triggers, and (ii) the respective rating agency's bank survivability assessment of KKB that will mitigate sovereign and certain bank credit risks.[11] The survivability assessment also looks at potential support by the regulator in case of the bank's default or insolvency.[12] Rating agencies generally

[11] 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, which could be rated higher than the company's local currency issuer default rating after considering the company's ability to continue operating beyond a general default and generate receivables for the duration of the deal. The rating agencies generally assume that banks will be able to continue their business, even in case of default, especially with respect to a core business like DPRs. In addition, Government support for the top five banks is expected in Kazakhstan. The going concern assessment (Fitch methodology) and survivability assessment (Moody's) address these issues. Achieving a rating at this level is therefore 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. Both aspects are fulfilled for a Kazakh DPR securitization.

[12] The central bank's support for banking has been mixed. In the first instance, Kramds Bank, at the time the fifth largest bank in terms of assets and a privately owned bank, was liquidated in October 1996 despite its size and apparent importance. The bank was insolvent because of the high level of bad loans. Before the liquidation, the

see the involved volume risk, devaluation exposure, obligor risk, and sovereign redirection risk in a DPR securitization as low compared to corporate transactions.

5. Terms and Conditions of the Guarantee

32. **Guarantee Coverage.** ADB will guarantee timely payment of principal and interest on the notes. ADB's guarantee will be unconditional and irrevocable, and documented in accordance with market standards for this type of transaction and at the same terms and conditions as those for the other two guarantee companies.

33. **Exclusions and Limits on Coverage.** ADB will not guarantee (i) any failure to pay by hedge counterparties, (ii) any "make-whole redemption" premium, (iii) taxes on the Series 2007B Notes, (iv) default or overdue interest, and (v) accelerated principal (whether or not as the result of an early amortization event or a sale recision event). Further, ADB will not guarantee the repayment of the Series 2007B Notes prior to a scheduled quarterly amortization date.

34. **Guarantee Fee.** ADB will receive a guarantee fee, the amount of which will be based on similar DPR securitization structures in Kazakhstan and Turkey. The guarantee fee will be set in accordance with ADB policies by the guarantee committee.

C. Tenge-denominated Unsecured Loan

35. ADB is proposing a senior or subordinated, unsecured loan for up to the equivalent of $50 million, denominated in tenge. The main terms and conditions are (i) a 5-year maturity, (ii) amortization of the loan, with a grace period to determined, (iii) a fixed or floating interest rate to be determined by the ADB interest rate committee, (iv) an underwriting fee of 0.50% to 1.0%, and (v) a commitment fee of up to 0.5%. The loan would be used for SME and corporate onlending. Instead of senior debt the loan may also be structured as subordinated debt, with an indicative maturity of up to 8 years (or the minimum regulatory requirement for Tier II capital).

VI. PROJECT BENEFITS, IMPACTS AND ASSUMPTIONS

A. Justification

1. Investment Objective

36. ADB's objective in the proposed Guarantee and Tenge Loan is to develop Kazakhstan's banking and securitization market in order to (i) diversify funding options, (ii) allow access to longer term funds, (iii) increase onlending to SMEs, and (iii) attract a new set of investors.

37. **Provision of Guarantee.** ADB's proposed Guarantee will increase interest in DPR securitization from Kazakhstan. By further cementing a credit history for KKB, the proposed

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central bank provided Kramds Bank with financial and technical support to try to return the bank to solvency, but problems were irremediable. In 1997, the central bank decided to support Turan Bank and Alem Bank, at that time the fourth and second largest banks. The banks were insolvent because of a very high level of problem loans. The two banks were merged to form Bank TuranAlem in 1997 by setting aside $90 million for the bank's recapitalization. Bank TuranAlem no longer has any significant problems and was privatized in 1998, which restored public confidence. The central bank intervened to support smaller banks affected by the Russian crisis of 1998. In the initial stage of banking restructuring between 1992 and 1995, the central bank's response to the high level of problem loans was to transfer them to state-owned banks and entities. The rating agencies therefore expect Government support in case of a sector crisis.

Project enhances its ability to raise funds in the international capital markets and obtain longer tenor funds than currently possible in the market. KKB's business lines generating DPRs will be under constant scrutiny by rating agencies forcing KKB to adopt and comply with best market practices. The DPR Transaction will boost investor and creditor confidence, both international and domestic, in Kazakhstan's banking system, and increase depositor confidence in the local economy and banking system. The DPR Transaction allows KKB to extend the tenor of its borrowings to up to 10 years, 3 years longer than the maximum tenor it has been able to obtain from the market. In turn KKB will be able to lengthen its tenor for its customers. The DPR Transaction will therefore bridge an unwanted maturity gap and allow KKB to match its assets and liabilities more closely. In addition, the securitization will allow KKB to access lower cost funds, which will make KKB more competitive and allow it to pass savings to its customers.

38. **Tenge Loan.** ADB's second objective is to foster Tenge-denominated corporate and SME financing. ADB is assisting the Government to steer the economy toward more sustainable corporate-led growth and away from dependence on natural resource industries.

39. If the Tenge Loan is structured as subordinated debt (Tier II capital), this will help KKB achieve sustainable growth. Such structure could be replicated by other other Kazahk banks following the KKB Tier II capital management model.

40. In a country with a rapidly developing economy and a fast growing banking sector such as Kazakhstan, there is inevitable pressure on banks' capital adequacy. Access to subordinated debt, which counts as Tier II capital, is key to addressing this issue. ADB would be the first instiution to offer this product denominated in Tenge. With this project, ADB will therefore support the development and growth of a sustainable banking sector.

41. Banks make use of subordinated debt as a capital instrument—i.e., to achieve their regulatory capital requirements. This is a common practice worldwide and prevalent even in relatively unsophisticated markets. The key feature of subordinated debt is that in the case of a liquidation of the bank, subordinated creditors will be paid only after all senior creditors have been repaid in full. Any call or pre-payment of subordinated debt would typically be subject to compliance with minimum capital ratios (after the call) and/or require approval by the regulator.

42. **ADB Bond Issue.** ADB's third objective is to issue its first domestic bond in Kazakhstan and therefore to establish a benchmark for AAA risk in the country and foster the development of the local bond market.

2. Development Outcome

43. **Corporate-led Growth.** The Government is striving to diversify the economy and reduce Kazakhstan's dependence on oil. This entails improving the access of the non-oil sectors to finance and making these sectors more attractive to investors. The DPR Transaction 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.

44. Although the concept of DPR securitization is not entirely new to Kazakhstan, there have been only a few issues, the only ones completed in Asia. They form part of a handful of future-flow transactions executed so far in Asia. An increase in the number of DPR securitizations will improve the understanding of this financing technique. This proposal is expected to facilitate the development of a full-scale securitization market in Kazakhstan, and to have spillover effects elsewhere in the region.

45. The proposed DPR Transaction will allow KKB to service its core businesses and to expand its financing of SMEs and other companies—including those in rural areas—via the existing and growing branch network of KKB, as well as to foster diversification of its loan portfolios.

46. **Increase Access to International Capital Markets.** DPR securitization is designed to mitigate sovereign risk so that non-investment-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 non-investment-grade borrowers in developing countries to obtain financing at significantly lower interest costs and for longer durations. ADB's involvement as guarantor will enhance KKB's credit rating.

47. Securitization of future-flow and existing receivables can provide a way of raising finance for many low-income 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 of raising finance. Future-flow receivables securitization provides a way of securing credit ratings for new issues that reduce sovereign-related risk and thereby of reducing 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 its ability to access capital markets in the future and reduce the costs.

48. From the investors' point of view, the attractiveness of this asset class lies in its good credit rating and its stellar 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.[13]

49. DPR flow securitization has not been available in Central Asia or other parts of Asia, except for Kazakhstan. It would be suitable to such countries as Azerbaijan, Indonesia, Pakistan, and the Philippines. ADB has already been approached by lead managers in other markets and will need to build its reputation and expertise in this field.

50. As local banks realize the funding advantages inherent in packaging securitized DPR flows, they will become more competitive in terms of fees charged for DPRs and remittance transfers. This will encourage both senders and beneficiaries to become bank clients and thereby enter the formal banking system.

51. **Improve Finances of Local Banks.** Tenge-denominated debt and securitization will help improve the asset and liability management of local banks by providing them with access to funding that is free from foreign exchange risk, has a longer term, and is cheaper. Improvements in the banks' finances will in turn improve the stability of the region's banking system.

[13] The asset class withstood the test of the Mexican peso crisis in 1994–1995, the Asian liquidity crisis in 1997–1998, and the Ecuadorian debt default in 1999. A receivable transaction with of PTCL, Pakistan's telephone company, continued to perform even in the face of a selective default on sovereign debt.

3. Value Added of ADB

52. ADB's proposed Guarantee will add value by (i) enabling wider distribution of the Series 2007B Notes, especially to Asian investors; (ii) increasing and diversifying funding sources and investment products; (iii) providing access to longer-term financing for KKB; (iv) helping to develop the securitization market in Kazakhstan; and (v) increasing investor confidence in Kazakhstan's relatively young banking and capital market. ADB's proposed Tenge Loan will provide value by (i) developing the SME market in Kazakhstan, in general; and (ii) assisting KKB in its transition into local currency operations and improving its capital adequacy requirments, in particular.

4. Development Impact Measurement

53. ADB will measure the expected development impact of the Project. Its performance measures will follow the Standards for Evaluation of Private Sector Investment Operations of the Evaluation Cooperation Group of the multilateral development banks. Development impact is measured in three distinct categories: (i) business performance of the project, (ii) economic sustainability, and (iii) private sector development. Appendix 2 shows the development impact framework.

54. ADB will discuss with KKB the inclusion of EBRD's monitoring standards for the usage of its funds under the proposed Tenge Loan.

B. Social and Environmental Safeguard Policies

55. The proposed Tenge Loan has been assigned a Category "FI" environmental classification and is classified as Category "C" with respect to indigenous people and resettlement. KKB will be required to establish an environmental management system and to build capacity for implementing it. At least one KKB officer will attend ADB-sponsored environmental management training. It should be noted however that the social and environmental safeguard policies of the European Bank for Reconstruction and Development are already in place and that the EMS, which is based on EBRD standards, conforms to ADB standards.

56. A desk review of KKB's DPR operations shows that these activities will have no adverse impacts with respect to the environment. Thus, on a stand-alone basis, the proposed Guarantee would be assigned a Category "C" environmental classification.

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

57. KKB 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.[14] KKB 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 insurance and indemnity agreements. Further, KKB will undertake to refrain from engaging in such activities. The documentation between ADB and KKB will allow ADB to investigate any violation or potential violation of these undertakings.

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

VII. ASSURANCES

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

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

VIII. RECOMMENDATION

60. I am satisfied that the proposed guarantee and tenge-denominated loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve (i) the Guarantee of up to $100 million of principal and accrued interest for notes with a maturity of 10 years; (ii) the proposed unsecured Tenge denominated loan of up to $50 million equivalent, both on terms and conditions substantially in accordance with those set forth in this report, and as may be reported to the Board; and (iii) the proposal that ADB's investment through the Guarantee and the Tenge Loan exceed the exposure limit of $75 million in any single investment.

Haruhiko Kuroda
President

28 February 2007

KAZAKHSTAN: MAJOR MACROECONOMIC CONSIDERATIONS

A. Economic Assessment and Outlook

1. High world oil prices, strong domestic consumption, and buoyant investment underlie the continuing economic boom in this oil-rich export economy. Gross domestic product (GDP) growth, led by the oil subsector, averaged 10.4% per annum during 2001–2006. GDP growth reached 10.6% in 2006 and is set to grow annually by an average of 9% during 2007–2009 (increasing from $78 billion in 2006 to $140 billion in 2009). Furthermore, representing 65% of GDP, the private sector is increasingly driving growth in the economy.[1]

2. The fiscal position remained robust in 2006, owing to high world oil prices and improved tax administration. Despite an expansionary fiscal policy, mainly associated with large salary increases, the general government budget still recorded a surplus; though it contracted from 2% of GDP in 2005 to 0.8% of GDP at the end of 2006.

3. High world commodity prices in 2006 helped boost exports by 37.3% to $38.2 billion; oil and metals continued to be major export items, accounting for more than two thirds of the increase. Although imports also increased by almost 37%, the trade surplus expanded by 38% to $12.2 billion. While the deficit on the services, income, and transfers account has widened, the current account recorded a surplus at 0.3% of GDP at the end of the third quarter of 2006.

4. Gross official reserves (including the assets of the National Fund of the Republic of Kazakhstan) doubled, totaling $30 billion in 2006 (equivalent to about 5 months of imports of goods and services); while year-end foreign asset holdings of the National Fund, which saves a part of the Government's oil and mineral revenues for future generations, amounted to $14 billion. Outstanding public external debt fell to $1.7 billion (or 2% of GDP) by the end of 2006. In contrast, the stock of private sector external debt (excluding oil and gas intracompany debt) surged by $16 billion in 2006 to $33 billion (or 42% 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.

5. Led by the strong increase in public wages, buoyant oil revenues, and credit boom, inflation picked up to 8.6%, higher than the Government target of 7.0%. Structural rigidities that limit competition in certain segments of the economy also contributed in part to rising inflation. To subdue inflation, the National Bank of Kazakhstan (NBK) endeavored to reduce excess liquidity in the economy by (i) increasing the refinancing rate from 8% to 9%, (ii) strengthening the minimum bank reserve requirements, (iii) sterilizing extra foreign exchange inflow, and (iv) allowing tenge appreciation. However, despite all these measures, broad money growth rose by 60% in 2006, compared to 29% in 2005.

6. In 2006, the tenge appreciated strongly against the dollar (7.7% on average) as a result of strong export earnings, foreign direct investment, and private external borrowing. Largely because of future substantial oil-related revenues, real appreciation may continue in the medium term.

7. The medium-term outlook for the economy is positive, assuming high world oil prices, buoyant foreign direct investment inflows, strong domestic consumption, continuation of

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

economic diversification, good macroeconomic management, and political stability. In the medium term, GDP is expected to grow at an average of 9%; the Government's target is to double GDP by 2008 in comparison to the 2000 level. Despite the Government's efforts, inflation is expected to rise above the current NBK target (6–7%), mainly because of the excess domestic demand, an expansionary fiscal policy, and buoyant oil-related business incomes. Driven by the hydrocarbons sector, exports are projected to surge by 10% on average per year. This strong growth will be supported by greater oil production and continued high world commodity prices. Imports are also forecast to rise, driven by strong domestic consumption and a boost in investments.

B. Political and Regional Background

8. 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.

9. 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.

10. 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 on 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, the 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, which is being considered by member countries, is the coordination of their fiscal policies, credit and currency policies, and government policies. These efforts will support further economic integration within the Commonwealth of Independent States, one of the aims of which is to assure continued access to export routes.

C. Macroeconomic Considerations and Exchange Rate Policies

11. Since Kazakhstan is heavily dependent on export trade and commodity prices, its economy was severely affected by the Asian financial crisis in July 1997 and by the Russian crisis in 1998, both of which caused world commodity prices to plummet. To protect Kazakhstan's economy from 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.

12. The Government began implementing market-based economic reforms in 1992, including (i) a significant privatization program, (ii) promotion of high levels of foreign direct investment (particularly in the oil and gas sectors), and (iii) introduction of an extensive legal framework. Despite uneven progress, Kazakhstan has experienced extensive economic transformation over the last 12 years. Since mid-1994, the Government has adhered to a macroeconomic stabilization program aimed at curtailing inflation, reducing the fiscal deficit, and boosting international currency reserves. According to figures compiled by Kazakhstan's National Statistical Agency, GDP has continued to grow in real terms following the adoption of a floating exchange rate policy in April 1999. GDP rose by 13.5% in 2001, 9.8% in 2002, 9.2% in 2003, 9.6% in 2004, 9.5% in 2005, and 10.6% in 2006. 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.

13. The tenge is convertible for current account transactions, but it is not a fully convertible currency outside Kazakhstan. Between 1991, when Kazakhstan began its transition to a market-based economy, and April 1999, NBK maintained a managed exchange rate policy, which, although permitting the exchange rate to reflect market conditions, involved official intervention aimed at limiting fluctuations. Depressed export markets in 1998 and early 1999 put considerable pressure on Kazakhstan's managed exchange rate. The 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, 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% in 2003 and 9.9% in 2004. Then during the first 6 months of 2005, it depreciated against the dollar by 4.0%, to T135.26. Since 30 June 2005, the tenge has gradually appreciated against the dollar. On 30 October 2006, NBK reported the official T/$ exchange rate as T127.98/$1.00.

14. 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

15. 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. Broad money supply (M3) rose 49.7% per annum on average during 2000–2005, and was up a further 58% in 2006. Cash in circulation expanded 34% per annum on average during 2000–2004, and increased another 35% in 2005. The big build-up of money in the National Reserve Fund ($14 billion, or 18% of GDP as of the end of 2006), along with selling short-term notes and deposits, has assisted partial sterilization of the domestic liquidity produced by NBK interventions. Nevertheless, the authorities are worried about the rise in monetary pressure on the overall inflation process. With no formal target, the Government aims to keep annual inflation in the 5–7% range during 2006–2008 to ensure a stable macroeconomic environment, while in 2006 the consumer price index increased to 8.6%. 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 on 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 2007–2008 to restrain further price expansion.

E. Regulation of the Banking Industry

16. 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

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

DEVELOPMENT IMPACT FRAMEWORK

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

Impact	Reported Measure
▪ Development of vibrant cross-border securitization market ▪ Development of domestic securitization market ▪ Development of banking sector ▪ Reform and stability of the financial sector	**General** ▪ Evidence of spillover effects and overall development of bond market in Asia, e.g., other Asian countries undertaking DPR securitization transactions within next 36 months **Securitization Market in Kazakhstan** ▪ Spillover effects to other banks in Kazakhstan, i.e., other Kazakh banks doing at least two similar DPR deals within the next 12 months ▪ One more (non DPR related) cross-border transaction (with or without ADB involvement) within next 24 months, e.g., 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 **Banking Sector in Kazakhstan** ▪ Contribution to financial strength of sector, e.g., better match of assets and liabilities ▪ Decrease in the asset/liability maturity gap of the overall banking sector ▪ 5% increase in the share in total financial sector assets of private sector financial institutions ▪ 5% increase in banking sector assets over the next 12 months ▪ 5% increase in SME lending over the next 24 months ▪ 5% increase in provision of tenge loans over the next 24 months

ADB = Asian Development Bank; DPR = diversified payment rights; SME = small and medium-sized enterprise.

[1] ADB will do market research in this respect.

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

Impact	Reported Measure
▪ Overall performance of the financial institution	▪ Return on equity ▪ Return on assets ▪ Net interest margin ▪ Cost/income ratio ▪ Growth in assets ▪ NPL ratio
▪ Flow of DPRs	▪ Total volume of DPRs ▪ Stabilization and/or increase of DPR flows compared to the average between 2003 and 2005

DPR = diversified payment rights; NPL = nonperforming loan.

3. Economic Sustainability (allocation of resources and provision of financial services to viable private enterprises).[1]

Impact	Reported Measure
▪ Contribution to widening the access to finance	▪ Increase in the number of SME borrowers in Kazakhstan and of KKB – 15% more SME customers in next 24 months ▪ Increase in lending to SMEs by KKB (10% in 2007, 15% in 2008), and in Kazakhstan (10% in 2007, 15% in 2008) ▪ Tightening of margins and/or lengthening of maturities for onlending to companies ▪ Disbursements to rural areas – at least 10% to rural areas; 20% outside Almaty by 2008 ▪ Training for staff with respect to (i) credit, and (ii) environment ▪ Credit quality in lending – NPL level not higher than 4% ▪ Average size of loans ▪ No breach of domestic prudential norms (central bank regulations)
▪ Improvements in DPR system	▪ Better technology ▪ Cheaper transfer rates (for SWIFT payments)

DPR = diversified payment rights; KKB = JSC Kazkommertsbank; NPL = nonperforming loan.

[1] ADB will ask KKB for this information, which forms part of its internal reporting requirements.