ADB

Staff Consultant's Report

October 2020

Banking Sector of Kazakhstan under COVID-19 Crisis

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For Asian Development Bank

Asian Development Bank

Acknowledgments

This report was written by Dinara Tazetdinova.

This report was prepared under a staff consultancy engagement with the Asian Development Bank (ADB) related to finance and the economy and an analysis of the socioeconomic impact of the COVID-19 crisis on Kazakhstan’s banking sector. Iskandar Gulamov, ADB Kazakhstan Resident Mission Country Specialist, provided overall guidance and contributed valuable comments. The report benefited from the constructive inputs of Giacomo Giannetto, Principal Financial Sector Specialist at ADB headquarters in Manila.

The report also benefited greatly from recommendations from the Basel Committee on Banking Supervision, the International Accounting Standards Board, and the International Monetary Fund targeted for financial regulators and banks in the light of the global turmoil caused by the COVID-19 outbreak.

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List of Abbreviations

ARDFM	Agency for Regulation and Development of Financial Market
BCBS	Basel Committee on Banking Supervision
CCB	Capital Conservation Buffer
GDP	Gross Domestic Product
FX	Foreign Currency
IAS	International Accounting Standard
IASB	International Accounting Standards Board
LCR	Liquidity Coverage Ratio
LLPs	Loan Loss Provisions
NBK	National Bank of Kazakhstan
NSFR	Net Stable Funding Ratio
NPLs	Non-Performing Loans
SMEs	Small and Medium Enterprises

CURRENCY EQUIVALENTS

As of 1 October 2020

Currency Unit – Kazakhstan Tenge (KAZ)
USD 1.00 = 431.82 Tenge

Executive Summary

This paper examines developments in the banking sector of Kazakhstan under the economic recession triggered by the COVID-19 outbreak and a serious drop in oil prices. In particular, it focuses on the assessment of temporary regulatory relief provided to banks to prevent credit contraction. While certain measures are in line with international practice and the views of the Basel Committee on Banking Supervision, the IMF, and other relevant institutions, some tools should be implemented with caution given the long-standing issue of poor asset quality in the banking sector. The latter refers to the relief on recognition of credit impairment and loosened capital adequacy for certain risk exposures that will impact the resilience of banks.

The paper draws attention to the issue of the increasing role of the state in the economy through numerous business support programs with subsidized interest rate loans. Since March 2020, under the anti-crisis assistance package, the Government of Kazakhstan significantly expanded subsidized financing of small and medium businesses which will further distort the fair value of credit, create the wrong incentives for borrowers, and diminish bank competitiveness. Policy-makers need to focus on tools that reduce borrowers' credit risks without distorting market interest rates and competing with the banks.

Due to the massive clean-up of balance sheets prior to the COVID-19 outbreak, banks seem to be in a better position than in previous crisis episodes, with the exception of a few small failing banks. The key threat for banks is posed by increased credit risks due to tightened financial conditions on borrowers and uncertain perspectives for economic recovery.

A. Background

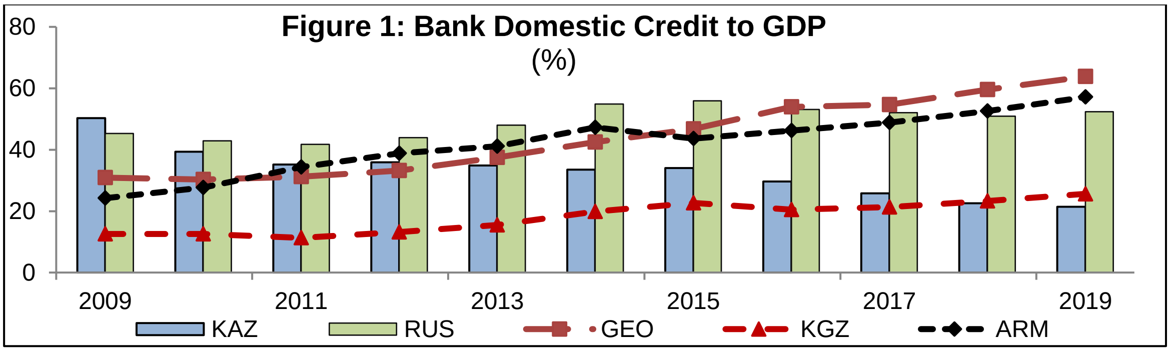
1. Kazakhstan has fallen into a severe recession triggered by the COVID-19 pandemic and the tight containment measures designed to prevent its spread. By October 2020, the country had experienced about 100 days of two strict lockdowns which limited citizens' mobility, suspended business operations, and switched office work and education to the remote mode. As a result of the prolonged business disruption and subdued supply and demand, the gross domestic product (GDP) of the country has contracted by 2.8% with trade and transport sectors being hit the hardest. Another important contributor to the economic downturn is a significant drop in prices for oil which has been the major export revenue source for the country.

2. The Government of Kazakhstan provided a comprehensive anti-crisis assistance package estimated at KAZ 6.15 trillion or 8.8% of GDP to support businesses and the population under lockdowns. About 40% of this amount is targeted at infrastructure development, employment support, and subsidized lending to small and medium enterprises (SMEs) through banks under existing and new state programs. To prevent credit contraction, the financial regulator temporarily relieved banks of certain prudential requirements while banks granted credit holidays to individuals and SMEs at the government's request. However, perspectives regarding economic recovery remain uncertain and depend on how the epidemiological situation evolves and a possible re-introduction of lockdowns in the autumn and winter seasons.

B. Key Developments and Weaknesses in the Banking Sector Preceding COVID-19 Pandemic

3. Prior to the COVID-19 crisis, the banking sector in Kazakhstan was facing a number of persistent institutional and structural shortcomings including weak risk-management that resulted in long-standing unrecognized credit losses and suppressed capital, lack of creditworthy borrowers in the corporate sector, supervisory gaps, the increasing role of the state in offering credit to the economy, a lack of stable long-term funding, and a high level of dollarization. These problems have been impeding effective credit intermediation, with bank domestic credit declining to 21% of GDP by 2020 while a decade ago it accounted for 50% (figure 1). Nevertheless, by the start of the pandemic, noticeable progress had been achieved in resolving certain problems while others remain on the agenda.

Figure 1: Bank Domestic Credit to GDP
(%)



GDP = Gross domestic product
ARM = Armenia, GEO = Georgia, KAZ = Kazakhstan, KGZ = Kyrgyz Republic, RUS = Russian Federation
Source: World Bank Data Catalog

4. In 2017–2020, the banking sector went through a massive clean-up of balances from non-performing loans (NPLs) that had been accumulating since the financial turmoil of 2009.

At some points, sectoral NPLs reached more than 30% of total loans with even higher figures in individual banks. Without going into great detail, the reasons behind this problem pertain to a number of factors including lax accounting practices stemming from the incurred loan-loss model under International Accounting Standard 39 (IAS)[1] that was the sole basis for the loan loss provisions (LLPs) build-up in Kazakhstan before the transition to IAS 9 in 2018.[2] An additional contributing factor was an insufficient supervisory enforcement system that was compliance-based rather than forward-looking and had limited financial regulatory powers as well as poor bank risk-management and corporate governance. Apart from that, regulatory reporting misrepresented the magnitude of NPLs since it did not capture loans transferred off-balance or restructured, practices intensively employed by banks.

5. The clean-up included the bail-out of a systemically important bank and its merger with another large bank, capital injections into five medium-size banks by the National Bank of Kazakhstan (NBK, the monetary authority), and liquidation of small insolvent banks. The total state assistance provided for credit loss recognition during 2017–2019 is estimated at 6% of 2019 GDP (Appendix 1). In 2019, to eliminate concerns regarding the real amount of unrecognized credit losses, the NBK conducted an Asset Quality Review that encompassed 14 banks with 90% of sectoral assets. The exercise unveiled additional cumulative credit losses of KAZ 429 billion with a shortage of capital threatening the financial sustainability of four medium banks.[3] Shareholders of these banks injected capital that covered half the deficit while the remaining portion is to be accumulated by 2025 as agreed with the Agency for Regulation and Development of Financial Market (ARDFM).[4]

6. From 2019, NBK significantly enhanced its powers to eliminate previous supervisory gaps and institutional weaknesses that had led to state support and fiscal losses. The reforms envisage a shift from formalized to risk-based supervision with more space to use regulatory discretion, an expansion of its resolution mandate with a forced bail-in tool, and an improved lender-of-last-resort mechanism that will only be targeted for solvent banks with temporary liquidity shortages. The aim is to enhance the efficiency of the regulator and its ability to rapidly identify threats and to ensure prompt settlement of insolvent banks with minimal fiscal cost. However, more time is required to assess the efficiency of the new regulatory framework.

7. In recent years, the state has increased its role in the economy through programs of business support entailing credit subsidies which distort the fair value of credit and create dis-incentives for borrowers. Large public holding structures such as KazAgro JSC, and Baiterek JSC also provide direct loans to the corporate sector thereby competing with the banks for solvent and quality borrowers. From 2012 to 2019, the cumulative amount of direct lending by quasi-state entities such as the Development Bank of Kazakhstan JSC, KazAgro JSC, and subsidized lending by Damu JSC is estimated at KAZ 7.9 trillion which accounts for 12% of total new loans to the corporate sector through the period (figure 2).[5]

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[1] IAS 39. Financial Instruments: Recognition and measurement employed an incurred loan loss model that was widely criticized for underestimating loan-loss provisions. Financial Stability Forum. 2009. *Report of the Financial Stability Forum on Addressing Procyclicality in the Financial System.*

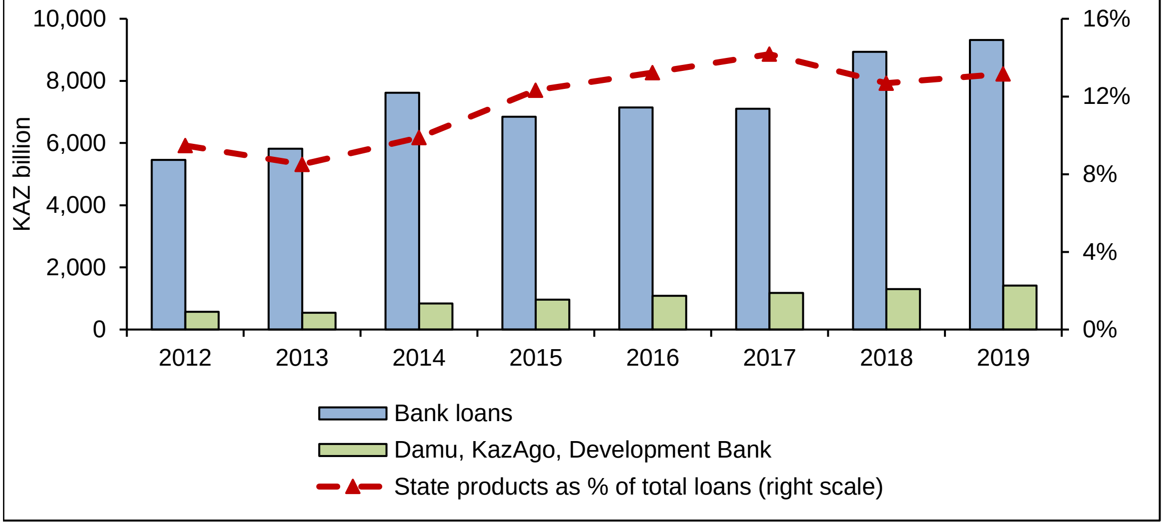
[2] Regulatory loan loss provisions were abolished in 2013.

[3] National Bank of Kazakhstan. 2020. *Final Report on Results of Asset Quality Review of Second Tier Banks of the Republic of Kazakhstan.*

[4] The Agency for Regulation and Development of Financial Market was reestablished in 2020 by a split of the National Bank of Kazakhstan.

[5] This amount accounts only for direct loans by KazAgro to the agricultural sector, direct long-term loans by the Development Bank of Kazakhstan to non-resource corporates, and subsidized loans and funds conditionally allocated in banks by Damu.

Figure 2: New Corporate Loans through Banks and State



State products include subsidized loans, funds conditionally allocated to banks by Damu, direct loans of Kazagro and Development Bank of Kazakhstan

Source: National Bank of Kazakhstan, annual reports of Damu, KazAgro, Development Bank of Kazakhstan

8. Another source of concern prior to the COVID-19 pandemic was related to financial sustainability in the corporate sector since a large number of business entities were burdened with excessive debt. NBK estimates that financially vulnerable enterprises with capital less than 20% of assets and with negative capital accounted for 35% of large, 37% of medium-sized, and 40% of small enterprises at the end of 2018.[6] A shortage of creditworthy borrowers under information asymmetry implies increased credit risk and potential losses to banks and the state.

C. COVID-19 Crisis: Regulatory Relaxations for Banks

9. The first cases of COVID-19 infection were detected in Kazakhstan in March 2020. To prevent contagion, a strict lockdown was introduced from March 16 to May 11 and then repeated from July 5 to August 17 due to the rapid spread of the infection. Under these conditions, most trade, service, and transport facilities ceased operations. About 4.5 million people lost their income during the first lockdown and 2.4 million during the second. The government initiated a number of anti-crisis measures via payments of social allowances to citizens, expansion of subsidized lending programs, and tax and credit holidays.

10. To avoid credit contraction under downside economic risks, ARDFM introduced a number of capital and liquidity relief measures for banks for 6 to 12 months. Some of these tools are considered appropriate given the severity of the current economic downturn and generally correspond to international practices and views of standard-setters such as the Basel Committee on Banking Supervision (BCBS) and the International Accounting Standards Board (IASB, Box 1). However, certain relief measures are not so straightforward and might have adverse implications for the resilience of banks.

11. The government encouraged banks to support social solidarity efforts during this difficult time and to relieve the credit burden on citizens and SMEs affected by lockdowns. In particular, banks arranged credit repayment holidays for these categories of borrowers for a period of 90 days from March 16 to June 15. In total, banks deferred loan payments for 41.5% of SMEs and 34% of individual borrowers as of June 2020 according to ARDFM. This measure was reintroduced for SMEs for an additional 60 days from August 3 to October 1.

[6] National Bank of Kazakhstan. *Financial Stability Report of Kazakhstan, 2018–H1 2019.*

12. Credit repayment holidays were accompanied by regulatory relaxations for banks introduced for a six-month period to 1 October 2020 to avoid credit contraction. Banks were permitted to not recognize impairments on loans restructured under credit holidays or due to deterioration in a borrower's financial health, conditional that loans were properly serviced prior to the lockdown. Without this relief, banks would have had to recognize credit impairment and accrue additional LLPs at the cost of capital.

13. Since a deferral of loan payments would result in an increase in past-due loans, ARDFM also relaxed its quantitative monitoring indicator on past-due loans to the end of March 2021. In particular, prior to the crisis a systematic increase of 90 past-due loans would have qualified as an early signal of rising credit risk with further supervisory corrective actions. Under the relief program, ARDFM temporarily shifted to a 180 past-due loans indicator as an early warning signal without distinction between exposures that were granted credit payment holidays and all other items.

14. Credit holidays and corresponding relief on recognition of credit impairment is a rather common practice employed in a number of jurisdictions due to the pandemic. In this regard, major standard-setters such as BCBS and IASB announced flexibility, acknowledging that the concept of expected credit losses should not be applied mechanistically and payment deferrals should not automatically increase credit risk metrics.[7] BCBS agreed that payment moratorium periods related to the COVID-19 outbreak can be excluded by banks from the counting of 90 days past-due loans for the purpose of capital treatment and the definition of non-performing assets.[8]

15. Although a relief on credit impairment recognition for deferred loans is broadly in line with international practice and guidance from BCBS and IASB, it inevitably increases the unrecognized credit losses on bank balances since a certain portion of borrowers will default eventually. Taking into account the previous long-standing problem with asset quality, this measure will have a negative impact on banks and must be executed with caution. It is also crucial for ARDFM to ensure maximum transparency on restructured exposures through the collection and monitoring of relevant granular data. In this context, IMF recommends that financial market regulators collect data on the number of loan restructurings (both performing and non-performing) taking place due to the COVID-19 crisis as well as monitoring transition matrixes of NPLs and restructured loans.[9]

16. ARDFM also relaxed a number of capital requirements to prevent credit contraction. In particular, a Capital Conservation Buffer (CCB), which is a buffer above the minimum capital requirement, was decreased from 3% to 2% for systemically important banks and from 2% to 1% for other banks for a one-year period to June 2021.[10] CCB is a Basel III macroprudential tool implying accumulation in normal times and depletion in periods of stress. The temporary relaxation of CCB corresponds to its countercyclical nature and to the position of BCBS on the usability of capital buffers for maintenance of credit through economic downturns. However, in line with the Basel III framework, ARDFM as a financial market regulator is expected to disincentivize banks as much as possible to distribute earnings in the form of dividends or any other payouts while the CCB is being drawn down.[11]

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[7] IASB. 2020. *Accounting for expected credit losses applying IFRS 9 financial instruments in the light of current uncertainty resulting from the COVID-19 pandemic.*

[8] Basel Committee on Banking Supervision. 2020. *Measures to reflect the impact of COVID-19.*

[9] IMF. 2020. *The Treatment of Restructured Loans for FSI Compilation*. *Special Series on COVID-19.*

[10] A capital conservation buffer is comprised of Common Equity Tier 1 and distribution constraints are imposed when its value decreases.

[11] IMF. 2020. *Restriction of Banks' Capital Distribution during the COVID-19 Pandemic (Dividends, Share Buybacks, and Bonuses). Special Series on COVID-19.*

For instance, in July 2020 the largest bank Halyk announced a dividend payout on common shares despite a recommendation of ARDFM not to do so.[12]

17. Another relief measure on the part of bank capital was introduced at the end of March 2020 through a decrease of credit risk weights on three loan categories (foreign currency loans, loans to SMEs, and syndicated loans) effective until 1 October 2020.[13] The aim is to reduce pressure on the capital that has to be allocated for these loans and increase the credit capacity of banks. Space for alternation of credit risk weights exists when these parameters are initially set at higher levels than recommended by BCBS. In Kazakhstan, the latter is the case for the credit risk weight on foreign currency (FX) loans, which was tightened to tackle the systemic risk of FX lending to borrowers without FX earnings in 2016. Revised risk weights on other loans fall below industry standards recommended by BCBS, implying that loss absorption capacity of the capital on these risk exposures is reduced.

18. At the end of March 2020, ARDFM temporarily relieved credit ratings to 1 October 2020 on certain exposures one notch downward (correspondent bank accounts, loans, and deposits), resulting in reduced credit risk weights for the purpose of capital adequacy calculation. For instance, loans granted to non-resident organizations with a Standard and Poor's rating of B+ would have previously been assigned a risk weight of 150%, whereas under revisions this credit exposure is risk weighted at 100%. This inflates the capital adequacy ratio and reduces the resilience of banks against risky exposures.

19. Apart from capital tools, ARDFM relaxed the Liquidity Coverage Ratio (LCR), a Basel III buffer of high-quality liquid assets that helps banks withstand short-term liquidity shocks. The required level of LCR was lowered from 80% to 60% for a one-year period to April 2021. This macroprudential instrument is aimed at maintaining lending in periods of stress and its drawdown is anticipated by BCBS under current circumstances.[14] In this regard, the temporary easing of the LCR target for Kazakh banks is grounded on its countercyclical nature with the majority of banks having accumulated this buffer in full by the start of the COVID-19 crisis.

20. Amendments were also made to the calculation methodology of the LCR and another Basel III tool, the Net Stable Funding Ratio (NSFR), with the expansion of eligible high-quality liquid assets and a less conservative assessment of cash outflows and available stable funding on certain positions. Without going into too much detail, these changes deviate from the Basel III framework and will inflate values of the LCR and NSFR, thereby compromising the resilience of banks to manage liquidity and funding risks.

21. While the above-listed relief measures were initiated to avoid deleveraging of the banking sector, ARDFM tightened regulations to prevent speculative deals in the foreign currency (FX) market given a depreciating national currency. Up to the end of 2021, the maximum limit on FX long positions is reduced from 12.5% to 7.5% of capital, and the limit on net FX positions from 25% to 12.5% of capital.

[12] ARDFM issued a letter to banks and insurance organizations recommending they not distribute the accumulated net profit for the payment of dividends in 2020 and not repurchase shares.
[13] Credit risk weight on FX loans granted for a period of up to three years is reduced from 200% to 100%, on loans to SMEs from 75% to 50%, and on syndicated loans from 100% to 50%.
[14] IMF. 2020. *Banking Sector Regulatory and Supervisory Response to Deal with Coronavirus Impact (with Q and A), Special Series on COVID-19.*

Box 1: Brief Overview of Regulatory Relief for Banks Introduced in Different Jurisdictions

Many jurisdictions introduced significant anti-crisis packages in response to the economic turmoil caused by the outbreak of COVID-19. With regard to the banking sector, the most common support measures included temporary deferrals of loan payments for borrowers and certain regulatory relief for banks.

For instance, credit payment holidays were granted on a mandatory or voluntary basis to certain categories of borrowers in the United Kingdom, Europe, Australia, Canada, the Russian Federation, and other countries with a length ranging from three to 18 months.

This measure was followed by guidance on the treatment of COVID-19 payment deferrals under IFRS 9 and capital requirements issued by regulators and standard-setters assuring that it should not result in loan defaults automatically. Thus, the International Accounting Standards Board stated that ‘’the extension of payment holidays to all borrowers, in particular, classes of financial instruments should not automatically result in all those instruments being considered to have suffered a significant increase in credit risk”.[a] Another example of such guidance can be referenced to the Australian Prudential Regulation Authority that allowed banks to reset the arrears count to zero on deferred loans for capital treatment. The Canadian Office of the Superintendent of Financial Institutions outlined how deferred loans will continue to be treated as performing for the purpose of capital requirements for the length of the deferral. At the same time, acknowledging the challenges of credit loss estimation, the IMF and the World Bank strongly discourage authorities to relax regulatory definitions of non-performing loans.[b]

Besides forbearance on the treatment of deferred loans, regulators focused on countercyclical policies to maintain the flow of credit to the economy. These measures broadly include relief of macroprudential capital/liquidity buffers, sectoral tools like Loan-to-Value Ratio, or postponement of earlier planned regulatory tightening. For instance, the European Central Bank allowed banks to operate temporarily below the usual Capital Conservation Buffer and Liquidity Coverage Ratio.[c] The Financial Policy Committee in the UK reduced the rate of its countercyclical capital buffer from 1% to 0%, whereas the Prudential Regulation Authority confirmed that capital and liquidity buffers can be drawn down to support the economy. In the USA. the Federal Reserve System also encouraged banks to use capital and liquidity buffers. However, in all cases, financial regulators explicitly outlined their expectations that banks will suspend dividends and share buybacks as well as cash bonuses to senior staff, which adheres to the position of the MF and other authoritative bodies.

Some countries also used microprudential tools to support sectors affected by the COVID-19 crisis. In particular, Kuwait and the Philippines lowered minimum risk-weight requirements for small and medium enterprises applied in the calculation of capital adequacy to channel more credit to this sector. In general, authoritative bodies do not welcome any reduction of minimum capital standards due to the potential negative implications for the resilience of credit institutions and their capacity to absorb losses.[d]

[a] IASB. 2020. *Accounting for expected credit losses applying IFRS 9 financial instruments in the light of current uncertainty resulting from the COVID-19 pandemic.*
[b] IMF, World Bank. 2020. *COVID-19: The Regulatory and Supervisory Implications for the Banking Sector. A Joint IMF-World Bank Staff Position Note.*
[c] IMF. 2020. *Financial Access COVID-19 Policy Tracker.*
[d] IMF, World Bank. 2020. *COVID-19: The Regulatory and Supervisory Implications for the Banking Sector. A Joint IMF-World Bank Staff Position Note.*
Source: Official websites of financial regulatory authorities, IMF, and IASB.

D. Increase of Credit Subsidy under State Assistance

22. Under the anti-crisis assistance package, the government increased funding of existing business development programs, most of which entail credit subsidies. The budget of the Economy of Simple Things Program was expanded by KAZ 400 billion to KAZ 1 trillion, and the Business Roadmap Program by KAZ 84.5 billion. Both programs envisage a subsidized interest rate of 6%. In March 2020, NBK launched a program of short-term lending to SMEs for working capital replenishment with a subsidized interest rate of 8%. The budget for this program has been recently raised to KAZ 800 billion, which accounts for 20% of the outstanding amount of SME loans in the banking sector. By September 2020, according to state authorities, banks have provided loans in the amount of KAZ 267 billion under the Economy of Simple Things Program and of KAZ 387 billion for replenishment of working capital.

23. Expansion of subsidized lending programs will result in a further increase of the state's presence in the economy, thereby creating demand for cheap funding and substituting bank lending (see para. 7). NBK estimates that while in 2014 only every fifteenth corporate loan was provided under state programs, by 2018 this was true for every eighth loan and every fifth corporate borrower was receiving concessional funds.[15] Another adverse effect of cheap funding is that it might support business entities that otherwise would have become non-viable given a large proportion of corporates with low financial health (see para. 7 and 8).

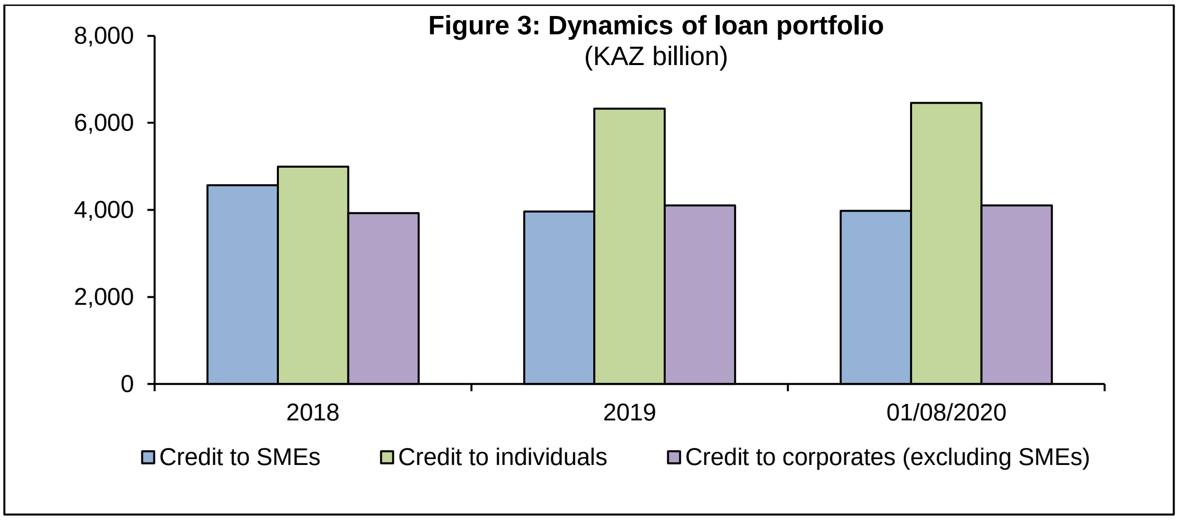
24. Policy-makers should revise the support mechanisms under state programs and focus on tools that reduce credit risks for borrowers without distorting market interest rates and increasing competition with banks. A solution might be found in shifting to state guarantees or insurance of business risks, a common international practice, rather than providing interest rate subsidies. State funding has to be channeled to large-scale infrastructure projects that are too expensive for the private sector to handle.

E. Risk Assessment for the Banking Sector under COVID-19 Crisis

25. The banking sector is better prepared for the current economic downturn due to the massive clean-up of bad assets prior to COVID-19 and enhancement of the regulatory framework implying early risk prevention and orderly resolution of failing banks. The key concern for banks is related to credit risk as an economic recession affects the financial sustainability of borrowers, reducing their cash inflows and income and deteriorating their credit quality. Relief of certain regulatory standards including credit impairment recognition will have an adverse impact on the loss absorption capacity of banks. However, this effect will be more pronounced for a number of medium banks with initially weaker capital positions.

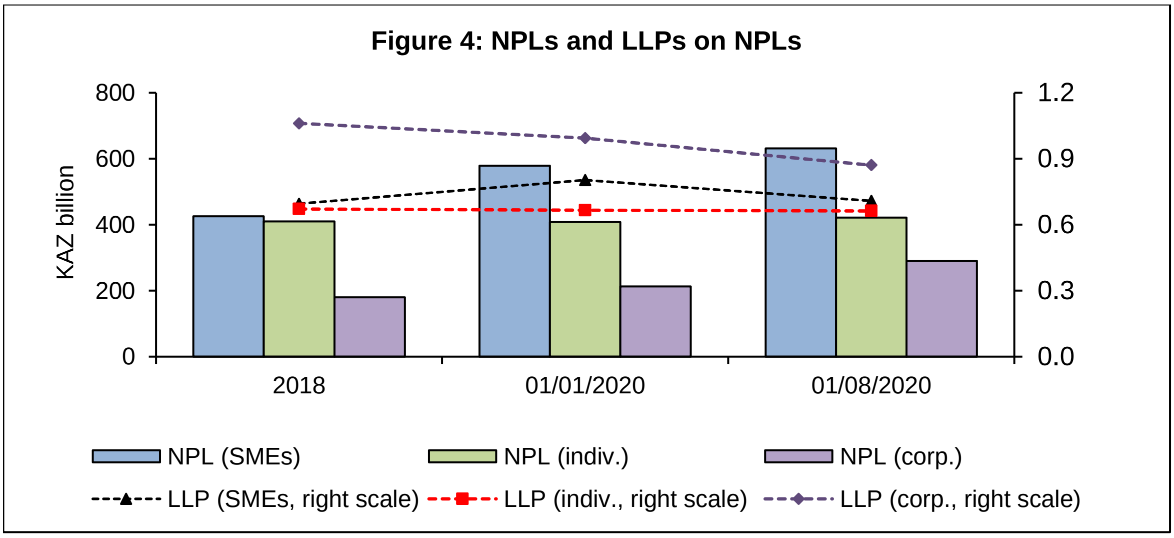
26. Bank credit is subdued under disruption of economic activity and the uncertainty caused by the COVID-19 crisis. From January to July 2020, the outstanding balance of total loans increased by less than 1%, from KAZ 14.4 trillion to KAZ 14.5 trillion due to a 2% growth in loans to individuals.[16] The total amount of loans in the corporate sector and SMEs remained almost unchanged, with a negligible contraction of less than 0.1% in both segments. Credits to individuals grew in the housing loans segment under the state mortgage lending programs 7-20-25, Baspana-Hit, and Nurly-Zher (figure 3).

[15] National Bank of Kazakhstan. *Financial Stability Report of Kazakhstan, 2018–H1 2019.*
[16] The loan portfolio does not account for interbank loans and reverse repo operations.



SMEs = Small and medium enterprises
Source: National Bank of Kazakhstan

27. The quality of the loan portfolio according to official data remains satisfactory, with NPLs accounting for 9% of the total portfolio as of 1 August 2020. From the beginning of 2020, NPLs increased in all segments of the loan portfolio as the economic recession affected the financial sustainability of borrowers (figure 4). Credit holidays for SMEs and individuals introduced under the state of emergency provide only temporary relief for borrowers leading to rising indebtedness.

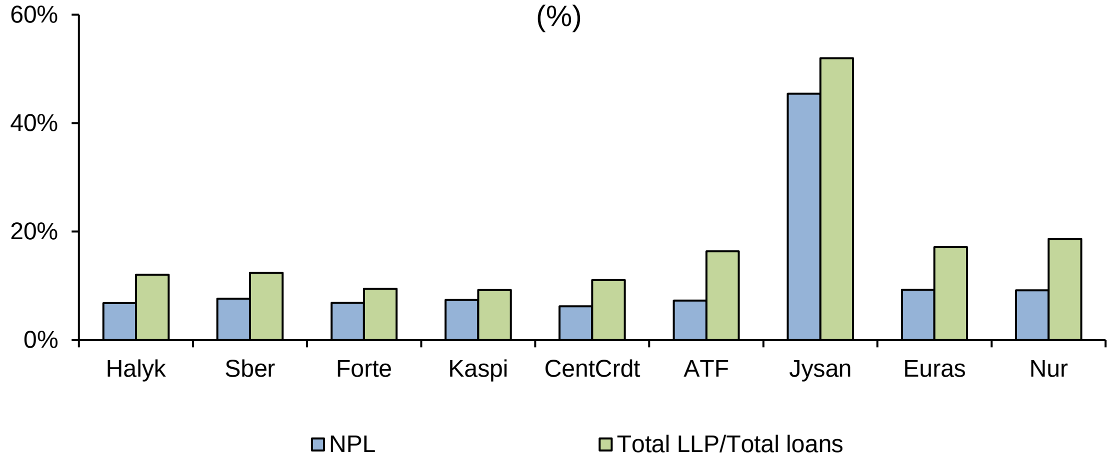


LLP = Loan loss provisions on Non-performing loans, LLP is calculated as a percentage of non-performing loans, NPL = Non-performing loan
Corp = corporate, Indiv = individuals, SMEs = small and medium enterprises
Source: National Bank of Kazakhstan

28. Asset quality is not uniform among banks (figure 5). While the largest banks (Halyk, KASPI, and Sberbank) have relatively strong balances, high provision coverage, and NPLs ranging from 7% to 8%, several small banks and one medium bank (Jysan) face low credit quality. Most concerns are related to the viability of small banks Capital JSC and Asia Credit JSC, with NPLs ranging between 50% to 90% of total loans[17].

[17] In the end of September major shareholder committed to inject capital into these banks by November 2020

Figure 5: NPLs and LLPs in Large and Medium Banks
(%)



LLP = Loan loss provisions, NPL = non performing loans as a percentage of total loans
Source: National Bank of Kazakhstan

29. Banks hold sufficient liquidity with highly liquid assets accounting for 38% of total assets as of 1 July 2020 with the NBK absorbing excess liquidity. Only two small banks with poor loan quality (Capital JSC, Asia Credit JSC) have experienced problems with liquidity breaching prudential requirements. However, when credit risk materializes, it will affect banks capacity to generate cash flow and suppress liquidity.

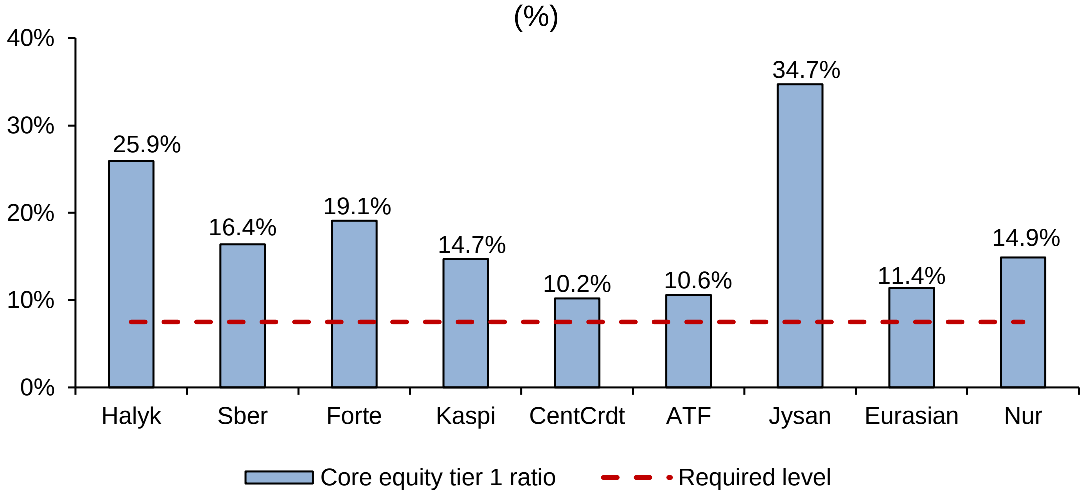
30. The major funding risks for banks are related to persistently high dollarization of customer deposits, risk of early deposit withdrawal, and high concentration of public funds.[18] Deposits remain the major funding source for banks, totaling almost 80% of their liabilities as of 1 August 2020. However, in Kazakhstan most term deposits cannot be qualified as a stable funding source as deposit contracts allow early withdrawal without penalties. This increases liquidity risks for banks and shortens the duration of deposit funding. According to estimates by the NBK, only 2.3% of retail deposits satisfied the criteria for stable funding in 2019. Another structural problem on the liabilities side is related to the concentration of public funds from the state and quasi-state companies that accounted for 27% of total liabilities in the first half of 2019.[18]

31. As of 1 August 2020, FX deposits amounted to 41% of total deposits. High deposit dollarization results in short FX balance sheet positions and forces banks to use off-balance derivatives to hedge against these positions.[18] Periods of exchange rate volatility might force banks to convert tenge liquidity to compensate for short FX positions.

32. Although all large and medium banks have relatively high prudential capital ratios (figure 6), the risk of capital adequacy varies among banks depending on the level of cushion that banks accumulated before the pandemic. An Asset Quality Review revealed insufficient capital in four medium banks, ATF, CenterCredit, Eurasian Bank, and Nurbank (Annex 1). Thus, despite partial capital injections by shareholders in 2019–2020 and state guarantees on the remaining shortages, these banks are in a weaker position in the face of an economic recession. ARDFM might also take appropriate actions required by banking law on small banks with a high level of NPLs and inadequate capital if the latter do not receive capital injections from shareholders. In September ARDFM revoked the license of Tengri Bank, JSC.

[18] National Bank of Kazakhstan. *Financial Stability Report of Kazakhstan.* 2018–H1 2019.

Figure 6: Core Equity Tier 1 Ratio
(%)



Core Equity Tier 1 ratio is a capital adequacy ratio (equity capital divided by risk-weighted assets). Regulatory level is a minimum required level of Core Equity Tier 1 ratio, which is set at 7.5% to 1 June 2021. ARDFM temporarily reduced its level to 6.5%
Source: National Bank of Kazakhstan

33. Another factor that affects capital resilience is related to certain regulatory relaxations employed by the ARDFM to prevent credit contraction. The impact of these measures will be revealed as they phase out and banks start to recognize credit losses.

F. Conclusion and Recommendations

34. The banking sector in Kazakhstan has to withstand a severe economic downturn caused by the COVID-19 pandemic. Although better prepared this time, banks no doubt will be affected through the deteriorating financial health of their borrowers, resulting in rising credit risk and risks for capital adequacy. Thus, it is important for banks to have sound plans for dealing with loans in arrears, in particular those accumulated due to credit holidays since banks will face challenges in drawing a line between viable and non-viable borrowers when payment deferrals phase out.[19] In this context, it is desirable to develop and communicate to banks a clear and consistent exit strategy from relief measures that will provide guidance and ensure confidence in the regulatory regime. The recently enhanced mandate of the ARDFM leaves more space to elaborate specific supervisory approaches and actions for individual banks that might end up in a worse financial condition than their peers.

35. ARDFM should choose and calibrate measures for regulatory alleviation with caution. A run for credit growth might eventually compress credit growth if policy measures are not balanced and provide the wrong incentives to banks. In general, it is a well-grounded practice to relieve macroprudential buffers in stress periods whereas microprudential tools, including credit risk weights, should not be amended. In turn, banks are expected to temporarily suspend earnings and dividend distribution, bonus increases for senior management, and other payouts which correspond to the position of standard setting bodies and regulators globally. Even if its powers are not sufficient to introduce a mandatory ban on earnings distribution, a financial market authority needs to persistently convey to banks the ultimate purpose of capital relief, which is only to credit the economy and not to remunerate stakeholders.

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[19] Bank for International Settlements. 2020. *Payment holidays in the age of COVID: implications for loan valuations, market trust and financial stability.*

36. Since credit holidays were targeted for specific categories of borrowers, namely citizens and SMEs affected by COVID-19 containment measures, ARDFM can clearly distinguish between loans that accumulate the number of days in arrears automatically as a result of payment holidays and all other loans with deteriorating quality. As per BCBS guidance, only the former category can be excluded for a finite period of time from the category of an NPL. Therefore, it is not advised to relax any NPL monitoring tools as that might result in the wrong incentives for bank risk-management systems.

37. It is crucial that the regulatory framework facilitates adequate and timely recognition of credit impairment such that credit risk will not manifest itself in another round of long-standing problems with asset quality. In this regard, it is highly undesirable to introduce new or extend already existing relaxations on recognition of credit impairment. ARDFM also needs to ensure maximum transparency on restructured exposures through the collection and monitoring of relevant granular data. Here, the regulatory authority might employ the experience of loan portfolio analysis gained through the recent Asset Quality Review exercise.

38. Expansion of state subsidy programs with low interest rates under an anti-crisis assistance package will further compress the efficiency and competitiveness of both the economy and the banking sector. Due to information asymmetry, a certain portion of subsidized loans will end up supporting non-viable businesses that will compete with sound firms. Distorted interest rates will squeeze banks out of a level playing field, diminishing their capacity to fully perform functions of financial intermediation. Focus on ensuring sound and efficient rules of the game and a shift to alternative tools for business support such as state guarantees or risk insurance mechanisms will help policy-makers to improve the competitive environment.

Appendix 1: Summary of State Assistance for Clean-up of Bank Balances 2017–2020

Year	Amount of state assistance and brief description of its purpose
2017	*Financial Sustainability Enhancement Program, coordinated by NBK:* KAZ 2,400 trillion: bail-out of systemically important bank (Kazkom) KAZ 654 billion: subordinated loans to medium banks from NBK (Eurasian: KAZ 150 billion, Tsesna: KAZ 100 billion, ATF: KAZ 100 billion, CenterCredit: KAZ 60 billion, RBK: KAZ 244 billion) *KAZ 421 billion: injected by shareholders of medium banks*
2018	KAZ 450 billion: state purchase of NPL from Tsesna KAZ 156 billion: refinancing of FX mortgages issued to 2016 at the favorable exchange rate
2019–2020	KAZ 604 billion: state purchase of NPL from Tsesna *Asset Quality Review:* KAZ 369 billion capital deficit in four banks *(KAZ 180 billion injected by shareholders)* *Remaining capital deficit covered through a state guarantee to 2025* (CenterCredit: KAZ 20.6 billion, ATF: KAZ 33.8 billion, Eurasian: KAZ 41.4 billion, Nurbank: KAZ 41.8 billion)

FX = foreign currency
NBK = National Bank of Kazakhstan
NPL = Non-performing loan
Sources: National Bank of Kazakhstan, Agency for Regulation and Development of Financial Market, and mass-media outlets.