RECOMMENDATIONS

FOR THE

STATE ANNUITY COMPANY

AND THE

KAZAKHSTAN LIFE INSURANCE AND ANNUITY MARKET

November 2005
Almaty Kazakhstan

Table of Contents

I. INTRODUCTION

Recent amendments and additions to Kazakhstan's workers' compensation and pension laws have created demand for products that market forces in the country's insurance industry will find difficult to provide.[1] The products that the law now mandates and the market cannot provide are annuities—both whole life (pension) annuities and so-called disability (workers' compensation) annuities. In response to this problem, the Ministry of Labor recently established and capitalized the State Annuity Company, a wholly government-owned insurance company. Its charter is to provide both pension and disability annuities as required by law.

Reconciling the law to prevailing market forces is a difficult business. In essence, existing insurance companies have not developed annuity products that comply with the law's requirements for three reasons.[2]

1. The annuitant pools of both pensioners and disabled workers are too small, at least initially, to be considered statistically valid samples. This means that the actual mortality of these pools will not necessarily comport with statistically calculated mortality rates, and life insurance companies writing annuities will run longevity risks that are, quite literally, incalculable. Annuitant mortality is the main factor in the insurance industry's pricing of annuities; random mortality could easily make writing annuities too risky at the present time.

2. Existing legislation does not properly acknowledge life insurance and annuity operations. The insurance company law does not allow insurance companies to expense annuity-related costs (e.g., sales commissions, administration, the transaction costs of investment) against annuity-generated income. This means that annuity-related expenses must be subsidized by income from other insurance company products. Existing tax legislation also taxes insurance company investment income, unlike the income of pension funds, which is tax free.

3. Kazakhstan's current risk-free (government) yield curve is neither long enough nor liquid enough to adequately support annuity product development. The short yield curve and illiquidity will raise investment transaction costs and reinvestment risk in insurance companies' annuity investment schemes. Stable investment income is the key component of annuity pricing.

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[1] *"On the Program for Further Development for Social Reforms in the Republic of Kazakhstan,"* Directive No. 1241 of November 2004, mandates that retirees with sufficient-sized pension fund balances purchase lifetime annuities from licensed life insurance companies. *The Employers Obligatory Insurance Law of* 2004 mandates that employers purchase disability or survivor annuities (wage replacement income) for workers permanently disabled or deceased as a result of workplace accidents.

[2] Valyut Transit Life Insurance Company has to -date written twelve annuities, but they are neither guaranteed whole -life nor disability.

Annuity pricing is especially critical in Kazakhstan because pension accumulations are still very small—on average, about 90,000 KZT. The average accumulation of those nearing retirement is higher, but not necessarily very much higher, as nearly every age group with accumulations has been accumulating over a similar length of time and all but a modest new labor force cohort was working when pension reform occurred (although most accumulations are not sufficient to provide a living wage during retirement). At current accumulation levels, proper pricing can help to moderate old age poverty. At the same time, it can make the difference between a robust life insurance industry and one on the verge of bankruptcy. Annuity pricing is not only a financial issue, but also a social one.

Realizing the importance of the issue, the Financial Supervisory Agency (FSA), which is charged with regulating the State Annuity Company (SAC), requested that USAID's Financial Sector Initiative (FSI) provide recommendations on the structure and function of SAC and the development of its mandatory annuity products. Further, inasmuch as SAC risks becoming a state-owned monopoly, FSA also requested that FSI suggest viable alternatives to SAC that might stimulate the private life insurance industry and invigorate the country's annuities market.

In response to FSA's request, FSI has prepared the present report, based on the investigations, interviews, and research of four short-term consultants and Pragma Corporation resident staff during the period August–October 2005. The report is divided into four sections:

Section I: Pension Annuities Overview of the pension system and retirement income

Section II: State Annuity Company and possible alternatives reviews annuity product development, operations and organization functions, financial viability, future financial performance and makes recommendations on the alternatives to the State Annuity Company.

Section III: Summary of Recommendations proposes changes that need to be implemented to improve the life insurance and annuity market in which the State Annuity Company and other life insurance companies will operate.

Section IV: Annexes contains the Projections of the Annuity Market, the State Annuity Company Financial Projections and the Legal Environment and Financial Sector Laws.

SECTION I: PENSION ANNUITIES: OVERVIEW OF PENSION SYSTEM AND RETIREMENT INCOME

Solidarity Pension System

Kazakhstan's pension system currently consists of three pillars: (1) a state-administered solidarity (pay-as-you-go or PAYGO) system, (2) the private accumulation pension fund system and (3) from 1 July 2005, a demogrant—a payment directly from the government to all those reaching retirement age, regardless of time of service in the solidarity system or pension accumulations and without any form of means testing.

Table 1 **PAYGO Pension Calculations**

Males.
2.4% times minimum years of service (*lesser* of 25 or retiree's actual years of service prior to 1/1/1998) plus 1% times the lesser of 15 or excess years of service (number of retiree's actual years of service prior to 1/1/1998 minus 25) times reported wages for retiree's average 3 final years of service, not to exceed 75% of 15 base numerates.

Females.
3% times minimum years of service (*lesser* of 20 or retiree's actual years of service prior to 1/1/1998) plus 1% times the lesser of 15 or excess years of service (number of retiree's actual years of service prior to 1/1/1998 minus 20) times reported wages for retiree's average 3 final years of service, not to exceed 75% of 15 base numerates.

The pay-as-you-go system currently accounts for the bulk of all pension payments and will continue as the primary "pillar" for the next several years, until pension fund payouts become the primary source of retirement income. By 2025, no new retirees will collect benefits from the PAYGO system, although pensioners who retired prior to 2025 will continue to receive benefits until death. It is estimated that the PAYGO system will continue to pay benefits until about 2043. (Table 1 provides the formula for calculating PAYGO pensions.)

Some 1.59 million pensioners currently receive retirement benefits in Kazakhstan. For 2005, the average monthly pension payment is estimated at KZT 9,200—a 9.5 percent increase over 2004 (KZT 8,408). KZT 9,200 also happens to be the minimum monthly wage for 2005; the minimum monthly pension is KZT 6,696.

Pension Fund Accumulations

Currently there are fourteen accumulation pension funds, including the State Accumulation Pension Fund. Ten asset management companies (KUPA), of which three are pension funds, manage pension fund assets. At the end of August 2005, pension fund accumulations totaled KZT 583.7billion (US$ 4.32 billion).

TABLE 2 **KAZAKHSTAN ACCUMULATION PENSION FUNDS**
ASSETS AND CONTRIBUTIONS IN MILLION KZT

	Assets *(million KZT)*	New Contributions *(million KZT)*	Change in asset value *(million KZT)*	Pension Accounts
2005 Aug	583.7	79.7	20.10	7,299,393
2004	483.9	95.3	20.20	6,974,437
2003	368.4	83.0	15.70	6,164,316
2002	269.7	65.3	22.00	5,399,313
2001	182.4	43.7		4,630,205

Source: National Bank of Kazakhstan website: www.nationalbank.kz
All data as of 31 Aug 2005.

Since inception, pension funds have paid out a total of KZT 32,738 million to some 710,597 participants; of that total, scheduled payments to retirees amount to KZT 12,415 million to an average of 45,650 participants a year. However, more than half (51.8 percent) of all scheduled payments have been made since 1 January 2004. Since inception, pension funds have paid out a total of KZT 32,738 million to some 710,597 participants; of that total, scheduled payments to retirees amount to KZT 12,415 million to an average of 45,650 participants a year. However, more than half (51.8 percent) of all scheduled payments have been made since January 1, 2004. As of August 2005, pension funds had made scheduled payments of KZT 3,465 million to 52,799 participants or, on average, KZT 65,626 per participant.—that is, KZT 8,203 per month for the eight months of the current year.

Demogrant

Effective, July 1, 2005, the government installed a demogrant—a direct payment from the government to all who attain retirement age. Currently set at KZT 3,000 per month, the demogrant is in addition to and independent of benefits for time of service under the solidarity system or scheduled payments from pension accumulations. The demogrant benefit is paid for life; it will be recalculated every year, gradually rising to the official subsistence level (currently, KZT 5,994). Once solidarity benefits cease sometime in the 2040s, the two pillars of the pension system will be private pension fund accumulations and the demogrant.

Total Retirement Income

IN 2005 the mean income for pensioners with pension fund scheduled payments is KZT 20,400 (US$ 152.24), or approximately 58.0 percent of the current average wage (KZT 35,142). The components of pensioner mean income are:

PAYGO Benefit	9,200	45%
Scheduled Payout	8,200	40%
Demogrant	3,000	15%
Total	20,400	

The reader is cautioned that KZT 20,400 is not the average pension; it is the mean income of

pensioners receiving the average PAYGO benefit and the average pension fund scheduled payment *in the current year 2005*. Pensioners receiving scheduled withdrawals represent only 3.3 percent of the total pensioner population.[3] However, included in that group are pensioners with accumulations greater than KZT 100,000 who have elected to receive the maximum annual payment allowed by law (KZT 100,000, or KZT 8,333 per month) as scheduled payments every year *for as long as they last.* And they do not last long. Given the current structure of accumulations, in the current year no more than 30 percent of resulting scheduled payouts will last longer than ten years. The remaining 70 percent will, on average, last only about four years—a small percentage will last as short as a year and a half, a slightly larger percentage as long as seven years. (See Table 3) In fact, fewer than two hundred current pensioners had sufficient accumulations at retirement (about KZT 1,500,000) to receive an average KZT 8,200 scheduled payment for an extended period of time—fifteen years or more. When pension accumulations run out, pensioners' incomes drop abruptly—in 2005, by 40 percent from KZT 20,400 to 12,200. KZT 12,200 is about 35 percent of the current average wage but still more than two times the official subsistence level.

Outliving Scheduled Withdrawals

Clearly, the situation is far from ideal: pensioners are outliving a significant portion of their pension income. And, in theory, the portion of income they are outliving is set to increase as a percentage of total retirement income. PAYGO benefits are scheduled to decrease by about one percent for each successive annual cohort of retirees; incremental increases in the demogrant to subsistence level (which itself will probably be increased) will offset decreases in PAYGO benefits, as will periodic cost-of-living adjustments to the PAYGO benefit itself. Nevertheless, pension fund accumulations will at some point in the future become the primary "pillar" of the pension system.

		Table 3. **Accumulations KZT**						**Total**
		≤100,000	**100,001 - 250,000**	**250,001 - 500,000**	**500,001 - 1,000,000**	**1,000,001 - 1,500,000**	**over 1,500,000**	
Male	number	1 262 316	275 617	153 572	48 211	7 062	4 871	**1 751 649**
	%	*72,1%*	*15,7%*	*8,8%*	*2,8%*	*0,4%*	*0,3%*	*100,0%*
	Average account balance	24 717	162 858	346 901	661 745	1 193 335	2 501 531	**103 832**
Female	number	1 101 525	295 381	78 838	16 082	2 567	1 825	**1 496 218**
	%	*73,6%*	*19,7%*	*5,3%*	*1,1%*	*0,2%*	*0,1%*	*100,0%*
	Average account balance	26 505	159 117	330 184	661 604	1 200 690	2 402 978	**80 426**

The fact that pensioners are outliving scheduled payouts from pension accumulations is mainly due to the fact that the system is still young. There is, however, a specific technical

[3] All other pensioners (or their survivors) , if they had any accumulations, have received one-time lump sum payments, meaning their accumulations totaled less than KZT 100,000 or they emigrated abroad. In the current year, for example, pension funds have made KZT 2,791 million in one-time lump sum payments (43.8 percent of total payments so far this year) to 30,448 to new retirees, their survivors or emigrating citizens—the largest group being emigrants.

explanation as well. The coefficients used to determine the amount of a given accumulation to be paid out in a given year are calculated as an ascending payment (non-level) twenty-five year annuity; ascending payment means that the payment in the current year is less than the payout in the following year.[4] The first year payout coefficient of this annuity is 0.06016 (age 58); this means that the first year payout of any accumulation less than KZT 1,665,000—that is, almost all accumulations in the system—will be less than KZT 100,000, or the maximum annual payment allowable under current rules. Clearly, pensioners will elect to receive the annual maximum. When they do, of course, they accelerate the depletion of their total accumulations and shorten the period of scheduled payouts. And the depletion factor will increase when the minimum monthly pension is raised to more than KZT 8,333, effectively increasing the annual maximum withdrawal to more than KZT 100,000. This could happen as early as 2006.

However, there is another noteworthy aspect of this phenomenon: in the main, it is women who are outliving their scheduled payouts. In 2004, life expectancy at retirement age was 60.62 years for males and 72.0 years for females. Some 30 percent of the population dies before the age of 60—mostly men. It is not surprising then that 69.15 percent of the pension population is made up of women.

Uncertain Mortality

Ministry of Labor Decree 1241 requires new retirees to purchase guaranteed lifetime annuities with their pension accumulations beginning in 2006. The same decree, however, establishes a grace period only before the end of which the annuities must be purchased. The grace period for females is nine years until age 67; for males, seven years until age 70.

Table 4. **Retirees with Accumulations more than 1.5 million KZT**

Year of retirement	Projected numbers of pension fund contributors with accumulations over 1,500,000 KZT by year of retirement			Total number of pension fund contributors by year of retirement	Potential annuitants as % of all retirees by year of retirement
	Male	Female	Total		
2005	54	45	99	55 311	0,2%
2006	129	145	274	61 092	0,4%
2007	148	173	321	66 662	0,5%
2008	349	415	764	70 928	1,1%
2009	899	793	1 692	82 505	2,1%
2010	1 930	984	2 914	97 265	3,0%
2011	1 959	909	2 867	97 468	2,9%
2012	2 279	1 568	3 847	104 429	3,7%
2013	3 895	2 777	6 672	107 127	6,2%
2014	5 598	4 096	9 694	108 905	8,9%
2015	7 487	4 953	12 440	111 183	11,2%
2016	7 500	4 929	12 429	112 093	11,1%
2017	7 995	5 139	13 134	115 383	11,4%
2018	7 985	9 198	17 182	118 252	14,5%
2019	10 787	13 223	24 010	116 297	20,6%

[4] The ascending payout annuity was probably intended to prevent the payout from eroding due to inflation. However, since the outstanding balance of accumulations earns interest, this feature is somewhat redundant. In any event, a level payout annuity would provide greater benefits in the early years of the twenty-five year annuity. Scheduled payouts are still not guaranteed for life.

2020	14 024	16 985	31 009	114 894	27,0%

Table 5. Payout Option (KZT)	Male	Female
Annuity certain to age 84 (21 years for males and 26 years for females)	120 289	108 827
Standard Life Annuity	147 738	116 298
Life Annuity with 50% of Present Value of Future Annuity Payments Inherited upon Death	129 714	108 929

Delaying the compulsory purchase of annuities is perfectly understandable. Indeed, both FSA Decree 729 and this study identify impediments to annuity issuance that cannot be remedied administratively as, for example, problems with the tax code can be. Specifically, as Table 1 demonstrates, only after year 2019 will both male and female annuitant pools become statistically valid samples and more probably conform to the rates calculated in Kazakhstan's annuitant mortality tables. The reader is reminded that Kazakhstan's annuitant mortality tables are untested regardless sample size

Unfunded Longevity

Mortality rates play a key role in determining the annual benefit of a whole-life annuity. In calculating a whole-life annuity, the annual mortality benefit that theoretically inures to the insurance company is, in fact, factored back into each year-end outstanding balance, thereby increasing the annual annuitant benefit. Simply put, as a result of the mortality calculation, whole-life annuities pay out more than period certain annuities with the same premium and the same theoretical duration. *(See Table 5)* Another way to understand the effect of the mortality calculation is to see it as shortening the term-basis of the equivalent period certain annuity; in *Table 5,* for example, the Male Period Certain annuity would pay about the same as the Male Standard Life annuity if its term-basis were reduced from 21 to 15 years. The result, of course, would be that the six years of longevity from the end of year 15 to the end of year 21 is unfunded.

Actual mortality in Kazakhstan is extremely uncertain, and will continue to be to at least until 2019. Even if one has a sample large enough to determine 2019 mortality risk, it will take another 5-10 years to determine trends. There is a significant risk that the higher payouts of whole-life annuities are not properly funded on a year-by-year basis. If annuitant mortality tables overestimate mortality in the early years of an annuity, the mortality calculation based on those tables under funds longevity in the ensuring years. Longevity that is under-funded or even unfunded by actual mortality eventually has to be funded by the insurance company at the expense of profit. It should be noted that Russian Federation data could be helpful and there should be a more collaborative data sharing between Kazakhstan and Russian Federation actuaries and insurance companies.

It merits mentioning here that it is highly unlikely current annuitant mortality tables overestimate mortality; they were developed with a conservative bias using demographic techniques widely tested on western populations. It is much more likely that random variability arising from small samples sizes will cause real mortality to vary, sometimes significantly, from the rates in the tables. The variation can, of course, be in favor of the insurance company—that is, higher mortality than calculated; the fact is, however, small

sample sizes simply render mortality unpredictable. As a result, there is a high risk of insurance company losses from under-funded or unfunded longevity. If retirement age life expectancy used in calculations proves too high, then standard life annuitants are hurt.

Faced with that risk, there will be a strong temptation for insurance companies to abandon whole-life annuities with mortality calculations in favor of longer term period certain annuities. This clearly reduces risk to the insurance company, but it does so at the expense of the annuitant whose annual benefit will be lower and whose longevity beyond the term of the annuity is entirely unfunded. Selling a period certain annuity as a whole-life annuity is fraud; if the insurance company explicitly guarantees whole-life on the basis of a period certain annuity, it should be made abundantly clear to the annuitant that any longevity beyond the term of the annuity will be funded by insurance company profits, which are notoriously volatile and may not be available when needed. It will be the role of State Annuity Company to insure that retirees can purchase whole-life annuities if that is in fact the product they want. For reasons discussed later, whole-life annuities may not be what consumers want.[5]

Potential Market Size

While the "extremely low payments" problem clearly prevents annuitizing the accumulations of all contributors scheduled to retire in a given year, it does not preclude annuitizing that portion of retiree accumulations above a certain, relatively high threshold. Table 4, indicates that, in the 40 to 57 (62) age group, there are currently has some 6,696 pension fund contributors (4,871 males, 1,825 females) with accumulations over KZT 1,500,000. The average accumulation within this group is about KZT 2,500,000.

While there are a number of compelling arguments against making annuities compulsory immediately, there is also a strong argument in its favor of making them compulsory, if one accepts that accumulated assets are not contributors' unrestricted property. Compulsory annuities would allow insurance companies to begin developing annuity products and building their customer support and administrative capabilities on smaller annuitant pools. Due to the uncertainties surrounding mortality, immediate annuitization of pension accumulations would no doubt prove costly to insurance companies in the short term; however, having the annuity infrastructure in place to handle the much larger annuitant pools of the future might, in the long run, save money.

In any event, assuming average accumulations of KZT 1,500,000 and using the projected size of retiring annual cohorts in Table 4, above, the table below estimates the minimum size of the potential pension annuity market each year through 2020. The cumulative total through year 2010 is KZT 9,096 million and through year 2015, KZT 62,738 million.

	Potential Premium Income

[5] In the current year, seven individuals used pension fund accumulations to purchase KZT 10,269,000 of annuities from life insurance companies; the average premium for these annuities was KZT 1,467,000. The terms and conditions of the annuities is not public information. Seven individuals is only 0.2 percent of the retiring cohort of 55,311, and about 7 percent of retirees with accumulations over KZT 1,500,000.

	Male	Female	Total
2005	81,00	67,50	148,50
2006	194,17	217,56	411,73
2007	221,85	259,31	481,16
2008	523,74	622,51	1 146,26
2009	1 348,49	1 189,10	2 537,59
2010	2 894,81	1 476,55	4 371,36
2011	2 937,90	1 363,31	4 301,21
2012	3 419,24	2 351,47	5 770,71
2013	5 843,00	4 165,55	10 008,55
2014	8 397,22	6 144,37	14 541,59
2015	11 230,18	7 429,64	18 659,83
2016	11 249,47	7 393,95	18 643,43
2017	11 992,04	7 708,56	19 700,60
2018	11 977,11	13 796,57	25 773,68
2019	16 181,06	19 834,10	36 015,15
2020	21 036,58	25 477,09	46 513,68
Total	**109 527,86**	**99 497,15**	**209 025,02**

The most striking feature in the table 6 is the rapid growth of potential premium income from annuitants with accumulations greater than KZT 1,500,000. The major factor at work in the table is the retirement of Kazakhstan's "baby boomers," which begins in earnest for women in 2005 and for men in 2010. Rapid economic growth and sustained increases in wages and salaries also play a role, as does the maturity of the accumulation pension system. According to the table, over the next fifteen years, annual potential annuity premium income will increase 313.22% percent. The reader is reminded that calculations in the table are based on wages and salaries also, of course, play a role, as does the maturity of the accumulation pension system. According to the table, over the next fifteen years, annual potential annuity premium income will increase 313.22% percent. And the reader is reminded that calculations in the table are based on the minimum. Based on the current average of accumulations over KZT 1,500,000, the total market over the next fifteen years could be as large as KZT 350 billion—not an insignificant sum, and one which Kazakhstan's three life insurance companies are undoubtedly eyeing with mounting anticipation. We would also suggest that annuities not be mandatory for those who are seriously ill. People should have the option to put some or all of those savings into medical accounts. A retiree who has accumulated a decent amount should be able to spend it on a pacemaker, a kidney transplant, or a hip replacement.

Longevity vs. Survivorship

As stated above, scheduled withdrawals from pension fund accumulations are, in fact, period certain annuities. The periods range from less than a year for the 72 percent of current contributors with accumulations of less than KZT 100,000 to periods of more than 25 years for the 0.4 percent of contributors with accumulations over KZT 2,500,000. When a pensioner dies before depleting his accumulations, by law, the heirs or assigns have the right to receive any remaining accumulations.

The survivorship, or inheritance, feature of pension fund withdrawals may represent an obstacle to selling whole-life annuities; retirees may prefer leaving a legacy to funding their own longevity. The notion that the insurance company keeps money that rightfully belongs to a deceased annuitant's heirs is compounded by the natural cultural bias against insurance companies generally which, for years after economic reforms began, routinely defrauded

clients or refused to pay claims. It does not help that over the past five years some 35 insurance companies have gone into receivership. In any event, the inclination to prefer legacy over longevity will no doubt reduce the number of retirees interested in whole-life annuities. It will also introduce selectivity bias due to **adverse selection** that is those interested in whole-life annuities will be in better health than those who are not.

The inclination will probably be strongest among retirees with mid-level accumulations—between, say, one million and two million KZT. Retirees with higher accumulations at retirement probably have real property or other tangibles to bequeath to their heirs and are more likely to understand the mortality calculation in whole-life annuities; that is, the insurance company does not really keep the money, mortality does fund longevity, and it is better not to make one's old age a burden on one's survivors.

In any event, there should be a strong public relations campaign informing future retirees of the true benefit of whole-life over period certain annuities and disabusing them of the notion that insurance companies keep money rightfully due the deceased's heirs.

Annuities with partial (twenty-five or fifty percent) survivorship will typically pay more than long-term period-certain annuities. (See the example in Table 5) A partial survivorship product should be developed to meet local needs.

Lastly, the State Annuity Company should keep in mind that pension funds have a vested interest in convincing clients to accept scheduled withdrawals at retirement: pension funds earn 15 percent of all investment income plus a small percentage on the total of funds under management. Average investment income of, say, six percent per annum equates to a spread of 90 basis points between actual income earned and income paid out. Scheduled withdrawals are extremely profitable for pension funds, and they will understandably do everything in their power to dissuade clients from purchasing annuities from unaffiliated insurance companies.

Pricing Annuity Products

Whole-life annuity pricing has three components: annuitant mortality rates, the spread on investment income retained by the insurance company, and allowable expenses

Annuitant Mortality

Annuitant mortality in general and Kazakhstan's annuitant mortality in particular, were discussed at some length earlier. It bears repeating, however, that the sample size of retirees with annuitizable accumulations (KZT 1,500,000 in the current year) will remain statistically invalid until at least 2019. That has two implications. First, it will not be possible to begin testing the mortality tables against actual annuitant mortality until at least 2019; comparing mortality rates of statistically invalid samples does not constitute a test. Moreover, if relatively high rates of annual inflation in Kazakhstan persist, it might be necessary to raise the minimum annuitizable amount from KZT 1,500,000 to some higher amount in the future. Doing so may mean maintaining, or even further reducing, sample sizes into the post-baby boom retirement period, when demographically Kazakhstan's annual cohort of retirees might naturally begin to get smaller.

Second, small sample sizes invite random variation in actual mortality which in turn increases the risk of under funded longevity and insurance company losses. We suggest that GoKaz, through FSA or SAC, offer free or subsidized insurance to insurers against losses caused by errors in official life tables used in calculating annuities to encourage the growth of the

annuity market.

Small sample sizes of the annual cohorts of retirees remains the one of many strong arguments against annuitizing pension fund accumulations in the immediate future.

Investment Income

From the point of view of investments, a whole-life annuity is considered a low-maintenance product; the investment manager simply buys a long term government or AAA-rated bond in the amount of the annuity and holds it to maturity twenty or thirty years hence. In Kazakhstan, there are no thirty-year government bonds, nor is there any AAA-rated paper of any maturity. The longest maturity issued to date in Kazakhstan is fifteen years, and there is not enough of it to cover a meaningful number of annuities. The lack of long term investment vehicles in Kazakhstan means, at the very least, that investment transaction costs in life insurance companies will be high as will be losses to reinvestment risk that is, losses arising from the inability to invest at the yield implicitly guaranteed to annuitants. The set of permissible instruments also seems to preclude effective currency hedging if key assets are priced in dollars – or even if investments go into sectors in which the price of outputs is dollar denominated. Further, due to relatively high rates of annual inflation, for the foreseeable future yields guaranteed to annuitants will almost invariably be net negative (less than the rate of inflation) just as pension fund yields have been since 2003. That means the fixed annual annuity benefit will lessen in value every year.

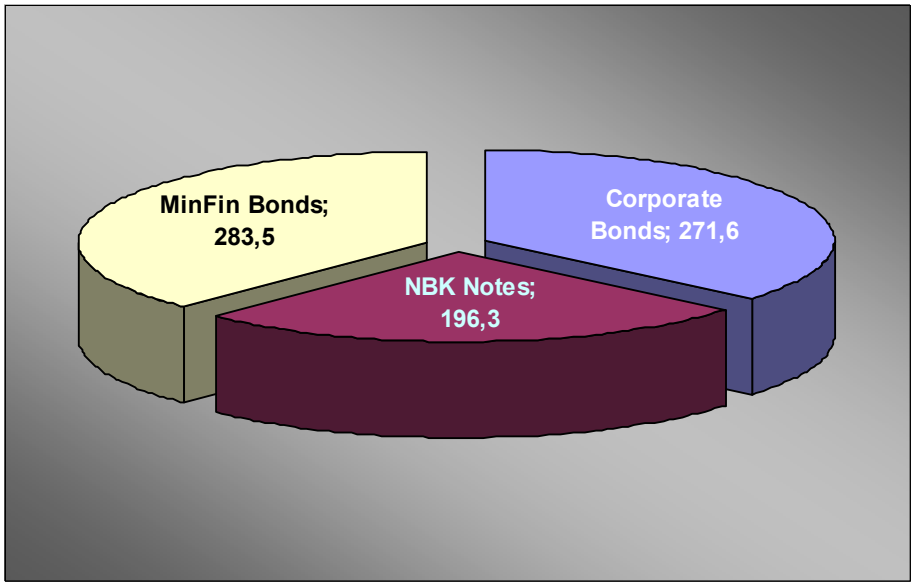
The shortage of investment opportunity for insurance companies in Kazakhstan is made worse by the rules governing insurance company investment and by separate taxation of insurance company investment income. Rules governing annuity investments should be liberalized to approximate those of pension funds, which include foreign investment. The yields on long term (twenty-year) AAA-rated corporate bonds have higher yields then most of the short term notes of the National Bank and Ministry of Finance which life insurance companies are forced to invest in.

Taxing investment income in life insurance company annuity accounts is double taxation. The annuitant is obliged to pay income tax on the annual annuity benefit, which has already been reduced by a tax on the investment income that helps fund the annuity. And the reduction is significant. At current nominal yields (about six percent), the fifteen percent tax represents ninety points basis of yield annuitants do not receive. Such double taxation does not exist for pension funds.

Still another aspect of taxing investment income in annuity accounts bears discussion. Life insurance companies make money on annuities not from the accrual of mortality benefits, which, as already discussed, are reincorporated into the annual annuity benefit, but from the investment income spread—that is, the difference between the yield the company earns on investments and the yield it guarantees to annuitants. If a company writing annuities gets the mortality calculation exactly right (which is rarely the case), it will make a profit on annuities written; if actual mortality doesn't conform exactly to the company's calculated mortality, the company's investment income spread funds unanticipated annuitant longevity; that is, investment income increases if life expectancies fall short of predicted durations. Independently taxing investment income in annuity accounts reduces insurance companies' ability to fund unanticipated annuitant longevity, which puts both annuitants and insurance companies in jeopardy.

Total Domestic Debt Outstanding: KZT 751.4 Billion
(In Billions of KZT as of 1 November 2005)

Figure 1



Source: KASE, NBK, Pragma Corporation

Allowable Operating Expenses

The issue of allowable expenses—that is, operating expenses insurance companies are allowed to charge against either premium income or annual benefit—has been thoroughly discussed in a paper authored by Dina Urzhumova on behalf of the Society of Actuaries of Kazakhstan. The issue is, therefore, well known and of critical importance to the fair pricing of virtually all types of annuities except variable annuities.

In Kazakhstan, the fairness of annuities to both annuitants and life insurance companies is a regulatory issue because annuities are mandated. It will be up to the regulators to establish pricing that pays the annuitant a fair benefit and at the same time allows life insurance companies to earn a fair profit. International practice makes it abundantly clear that life insurance companies cannot earn a profit on annuities at all without some allowable expenses.

In that regard, the regulators should be aware that life insurance companies writing annuities in Kazakhstan are operating under two distinct disadvantages. First, all companies currently licensed to write annuities, including the State Annuity Company, are “start ups.” Because the present number of annuitants is so few, the start-up expenses associated with annuities (product development, sales agent training, etc.) will be extremely high on an amortized basis. Therefore the allocation of allowable expenses will require frequent review and adjustment.

Second, (and this is simply beyond the control of the regulators) licensed life insurance companies are also writing very few life insurance policies. As a result, the standard product

mix over which insurance companies typically amortize both risk and expenses is absent. Annuities and life insurance are complementary products: life insurance requires long term investments to fund mortality benefits, while with annuities, mortality will fund longevity benefits. It is difficult to predict the long term effects of writing a disproportionate amount of one product relative to the other. Sales of a mandated annuity product would, of course, rapidly overtake sales of a voluntary life insurance product. Currently, there are some 110 life insurance policies in force with a value of KZT 2,136 million. *(See Table 7)*

Table 7 **FSA INSURANCE DEPARTMENT** ASSETS AND LIABILITIES IN MILLIONS KZT	
No of Licensed Insurance Companies	36
Life Insurance Companies	3
Property & Casualty Companies	33
P&C Companies licensed for Employers Obligatory Insurance Law	19
P& C Companies in bankruptcy	9
Total Assets	60,445
Life Insurance Assets	2,136
P&C Assets	58,309
Total Liabilities	22,153
Life Insurance Liabilities	938
P&C Liabilities	21,215
Total Policies in Force	129,446
Life Insurance Policies	110
P&C Policies	129,328
Annuity Policies	8
Owners Equity (%)	*0.604*

Disability Annuities for Worker Compensation Insurance System

Legal Basis

Kazakhstan's social security system—charged with the protection, care, and rehabilitation of invalids and the disabled—is based on three laws: the laws "On the Social Protection of Invalids," "On Mandatory Social Insurance," and "On Mandatory Employer Insurance." The last, which became effective in July 2005, is the most recent; it requires all nongovernmental employers to purchase worker compensation insurance from specially licensed non-life insurance companies. To date, some nineteen such companies have been licensed.

The purpose of the insurance is to provide for the medical care of workers injured on the job and, depending on the degree of resulting disability, compensate them for loss of income from the time of the accident until retirement age. The face value of the policy cannot be less than the employer's entire annual payroll. The policy premium is based on the company's total work force divided into some 22 employment categories; minimum and maximum tariffs per category are established in the law. While there is a clear correlation between disability rates by employment categories in various industries and the tariffs, the disability data themselves, having been skewed by abuse of the disability system during the early years of reform, are somewhat questionable. Note that, for certain industries, there is no correlation at all between the size of a company's annual payroll and the all-in costs—medical expenses and annual annuity benefits—of a given disability insurance event. Where it is determined that the face value of the employer's insurance policy is insufficient to cover the eventual all-

in costs of a disability event, it falls to the employer to make up the difference.

The non-life insurance company reimburses all medical expenses resulting from the disability event until disability annuity benefits begin. Thereafter, any medical expenses are covered by the disabled worker out of the monthly annuity benefit.

Period-certain Disability Annuities

The amount of the monthly annuity benefit is determined by the severity of the disability. There are three classes of disability—severe, moderate, and minor; for each class, the percentage of wage replacement is stipulated in the law. Once the class of disability has been certified by a medical examination board, the life insurance company computes the annuity premium to be paid by the non-life company. Under current circumstances, the resulting annuity should be period certain—that is, it will not employ mortality calculations—meaning annuity premiums paid by non-life companies on average will be at least thirty percent higher than they might otherwise be.

Survivorship

In the case of immediate death as a result of a work-related accident, the law stipulates that the deceased's survivors shall receive benefits as set forth in the Civil Code. In the case of disability, the Civil Code further stipulates that, once any form of wage replacement (annuity or other) has begun, should the disabled die, the deceased's qualifying survivors shall receive continuing benefits at rates and for terms that depend on the survivors' age and ability to work. This, in turn, means in many cases that the resulting annuities will be period certain with survivors receiving at least fifty percent of the original annuity.

In a few cases, however, to comply with Article 940 Paragraph 3 of the Civil Code, annuities may have to be calculated with lifetime benefits for the survivor. These cases will be rare, but they will also be extremely costly to the annuity company that fails to identify them when calculating the annuity premium.

Disability Mortality

There are as yet no disability mortality tables for Kazakhstan. Generally speaking, however, disabled mortality is higher than population mortality. It is estimated that, in Kazakhstan, mortality for disabled with Class I (severe) disability is on the order of four to five times the mortality of the general population; mortality for those with Class II disability is two to three times population mortality; and for those with Class III disability, it is one-and-a-half to two times.

Issuing disability annuities with mortality calculations would significantly decrease the annuity premiums the non-life companies would have to pay. However, the problem of small sample sizes of disabled gives rise to random mortality and, unlike the case of retiree cohorts, there is little likelihood that sample sizes in any disability class will ever become statistically valid.

Table 8 **Disabled by Age Group and Gender, 1997–2004**

	1997	1998	1999	2000	2001	2002	2003	2004
DISABLED								
Total New Disabled	**55 509**	**55 145**	**49 683**	**46 133**	**40 820**	**38 993**	**37 577**	**35 808**
of which:								
Female	22 607	22 504	20 515	18 892	17 020	16 266	15 709	14 798
Male	32 902	32 641	29 168	27 241	23 800	22 727	21 868	21 010
Employed New Disabled	**17 885**	**14 752**	**10 930**	**8 979**	**8 675**	**8 885**	**9 201**	**9 475**
Able-bodied, male & female	17 301	14 216	10 515	8 787	8 539	8 717	9 007	9 320
Age 16 to 39	4 819	3 777	2 789	2 219	1 932	1 891	1 872	1 964
Age 40 to retirement	12 482	10 439	7 726	6 568	6 607	6 826	7 135	7 356
Retirement and older	**584**	**536**	**415**	**192**	**136**	**168**	**194**	**155**
Female	220	188	132	51	64	60	65	48
Male	364	348	283	141	72	108	129	107

SECTION II: THE STATE ANNUITY COMPANY

Objectives

The Ministry of Labor's objectives in establishing the State Annuity Company are twofold:

- to create a reliable insurer to provide pension and disability annuities in compliance with the law; and
- to spur private life insurance companies to expand into the annuity market in the way the State Accumulation Pension Fund prompted private pension fund participation in the accumulation pension system.

Establishing a state annuity company will not alone encourage private insurance companies to enter the annuity market. Developing a robust annuity market in Kazakhstan will require substantive changes to the tax code and perhaps the law on pension. Operations of the State Annuity Company will, however, clarify precisely what changes are needed to the tax code and other legislation and uncover other annuity-related complications that might not yet be foreseen.

Structure

Regardless of whether private or public, life insurance companies writing pension and disability annuities should have a structure that supports the essential activities of the business. Essential activities may be broken down into the following six technical categories

Policy Underwriting. The ability to develop mortality risk models of an annuitant or insured life is key in calculating the risk and cost for an insurance company. In conjunction with the insurance industry, the State Annuity Company's actuaries need to develop and refine mortality data to assist in decisions to underwrite policies and set the price for annuities. One suggestion for speeding up the development of risk mortality tables is for SAC to absorb the Kazakhstan Actuarial Center.

Product Development and Sales. The SAC staff needs to have the ability to create a series of annuity products and to continually revise and refine products to meet the needs of the buying public. The staff needs the ability to identify prospective annuity buyers and to customize products to their needs. Staff members must have the ability to communicate and educate the public on purchasing annuities. The staff of the SAC needs ability to contract with or directly hire and manage a sale force and to structure their compensation levels to meet the State Annuity Company's sales goals and to adhere to regulatory and disclosure requirements.

Operations, Administration, and Customer Service. SAC needs to maintain the appropriate data files for all policyholders, create billing and benefit payment systems, conduct financial review, provide good customer service, generate accounting statements for each policyholder, and communicate with existing clients.

Financial Management. The staff of the SAC needs the ability to create and manage sustainable cash flow models to ensure its continued financially sound existence. The staff needs the ability to comply with regulatory financial filings and financial reports to the Board of the State Annuity Company.

Asset Management. SAC should consider outsourcing all or some aspects of its investment needs. Areas that need attention include investment policies and objectives, investment research, matching assets to short and long-term liabilities, managing the international investment trading component and relationships with brokers, custodial activities, and calculating internal returns and net asset values.

Information Technology (IT). All successful financial institutions today depend on the expertise of a fully integrated financial IT system. From the tracking of sales and prospects to answering customers questions, from managing account records and investments to completing timely regulatory reporting – modern financial institutions rely on IT to process, back up, and retrieve large amounts of data in a useful management system.

The current management of the State Annuity Company has not previously created or managed life insurance products and currently lacks experience in all aspects of running a life insurance company except for actuarial. The lack of experience can be mitigated by instituting staff training and by the addition of experienced life insurance company executives to assist in SAC's management. Organizations that might help in the area of training for the SAC are:

- LIMRA www.limra.com,
- the International Insurance Society (IIS) www.iisonline.org, and
- the Chartered Insurance Institute (CII) www.cii.co.uk.

The six technical categories listed above support two broad categories of product: pension annuities and disability annuities. Each is discussed separately below.

Financial Viability of the State Annuity Company

The State Annuity Company's initial capital was 500 million KZT and later increased to 1 billion KZT. The company plans to start selling life insurance and annuities to the public October 2005.

Pragma/FSI analyzed several financial projections based on assumptions of sales of life insurance products and annuities. *Scenario 1*, summarized in Table 9, reflects some life insurance sales and some disability annuity sales, but no pension annuity sales. Pragma/FSI does not project a significant level of pension annuity sales for the State Annuity Company until the annuitization of accumulation pension funds becomes compulsory for all new retirees. Full financial projections that include *Proforma* Income Statement and Balance Sheet are also included in the Annex.

For these scenarios, current market conditions are assumed, except that the 15% tax on investment income from non-government bonds is removed, as is the prohibition against including cost of expenditures to recover some administrative expenses in connection with the sale of pension annuities.

Table 9 **STATE ANNUITY COMPANY**

Scenario 1: Annuity Sales. Some Disability, No Pension

(KZT millions)

	Year 1	Year 2	Year 3	Year 4	Year 5
Income	361	459	626	742	860
Expenses	387	467	642	765	890
Net Gain (Loss)	**-26**	**-8**	**-16**	**-23**	**-30**
End-year Assets	1,225	1,520	1,914	2,359	2,856
End-year Liabilities	251	555	965	1,433	1,960
End-year Capital	974	965	949	926	896
Liabilities and Capital	**1,225**	**1,520**	**1,914**	**2,359**	**2,856**

Scenarios II and III are included in the Annex and assume pension annuity sales and as a result show smaller losses by year five. Making the annuitization of accumulation pension fund balances compulsory earlier would enhance the financial viability of the State Annuity Company. This recommendation is included in Section III. The State Annuity Company, if well managed, could grow to a reasonable size over the next ten years, serving the needs arising out of the potential compulsory purchase of pension life annuities by new retirees and from the new Employers Obligatory Insurance system, providing annuities for disabled workers.

In all probability, the State Annuity Company will continue to lose money through its first five to ten years, although, with good financial management, the losses will not be crippling. Please note that for start-up life insurance companies in other countries it is not uncommon for financial projections to similarly reflect annual losses for periods up to ten years.

The State Annuity Company could, after it reaches assets of 5 billion KZT, reduce its annual loss to zero and eventually make a profit if it is able to achieve “reasonable investment” returns. To achieve a “reasonable investment” return, the scenario projections assume very little, if any, excess of actual investment earnings over the interest assumptions used in the annuity pricing. If the actual investment returns are greater, providing better interest margins, the timing of "making a small profit" would occur earlier.

The three scenarios show different financial projections. Under Scenario 1, with disability annuity sales and no pension annuity sales, it would take to the end of year 9 to reach assets of 5 billion KZT. Under Scenario 2, with disability annuity sales and some pension annuity sales, it would take to the end of year 7 to reach assets of 5 billion KZT. Under Scenario 3, with more disability annuity sales and some pension sales, it would take 6.5 years to reach assets of 5 billion KZT. Under none of the scenarios would SAC show profits as it reaches assets of 5 billion KZT, whether in 9, 7, or 6.5 years.

Alternatives to the State Annuity Company

Are there better alternatives for using the 1 billion KZT allocated to the State Annuity Company? Generally, countries that have undertaken multi-pillar pension reforms, or introduced obligatory disability insurance underwritten by private insurance companies, have not successfully made the transition from government guarantees to private sector guarantees.

In analyzing the best practices to guarantee the lifetime income of mandated annuity purchases, the following items were considered in developing the institutional environment in which the life insurance companies would be operating: (1) the ability of the FSA’s insurance department to enforce regulations aimed at ensuring the solvency of life insurers, (2) the general transparency of the use of different guarantee mechanisms, and (3) concern over the public’s inclination to rely on the State Annuity Company, creating a *de facto* adverse selection problem. The outcome of this review is not a recommendation of one alternative over another but a discussion of potential advantages and disadvantages of three options:

- the creation of a separate guarantee fund,
- the State Annuity Company as the guarantor of mandated lifetime benefits, and
- partnership between the State Annuity Company and the State Accumulation Pension Fund.

Separate Guarantee Fund

An alternative use of the 1 billion KZT that was invested to create the State Annuity Company would be the establishment of a Life Insurance Company Guarantee Fund. Such a fund would require participating interest by new or existing life insurance companies. One reason cited by the Vice Chairman of the FSA to create the State Annuity Company was the lack of willingness of life insurance companies to enter the market. Pragma/FSI specifically inquired as to the interest level in a guaranteed fund by the two existing life insurance companies and the two other financial organizations that have made application to be granted life insurance licenses. There was no interest nor did any of the four firms consider the lack of a guarantee fund to be an objection needing to be overcome to sell pension or disability annuities in Kazakhstan. While the response from the private sector is not reason enough to reject the creation of a guaranteed fund, other problems with guaranteed funds were also identified.

One option considered was a guarantee fund[6] similar to that of the current State Obligatory Insurance Guarantee Fund, which acts as a guarantor to policy holders of obligatory insurance purchased under the third party auto liabilities law. The arrangement requires that all auto owners purchase a compulsory automobile insurance policy from a general insurance company, also called a Property and Casualty company. The P&C company in turn pays a portion of premiums collected into the Guarantee Fund. All P&C companies pay the same premium regardless of financial stability. In case of a default by the insured's original carrier, the new replacement P&C insurance company will pay benefits on claims arising on the old policy.

Impact of Alternative: The main theoretical argument against guarantee schemes is "moral hazard." This is a classic problem with any type of insurance, where the buyer or issuer of the insurance product adopts riskier models of behavior as an undesirable response to the financial protection provided by the guarantee fund. If insurance companies, regulators, and the general public believe that a guarantee fund will pay in the event of bankruptcy, there is no incentive to properly structure and adequately manage an insurance company, indirectly encouraging looser oversight, mismanagement, and unnecessary risk taking in investments. There is no incentive for the general public to scrutinize one insurance company over another. The basic incentive for doing business with a financially strong, well-run firm is removed if all insurers pay similar premiums to a guarantee fund, regardless of how well or poorly the firm is managed, and there is no opportunity for market forces to influence the decision to **purchase** insurance. Risked-based premiums, audited by the FSA's insurance department, could alleviate some problems by creating a healthy link between the protection a guarantee fund offers and the moral hazard it aims to prevent. This system could specify that a given firm's contributions would be adjusted up or down in recognition of the level of past claims, thereby reducing moral hazard.

Recommendation: The use of the guaranteed fund is possibly an option in a fully private sector market, but it is not recommended for Kazakhstan.

State Annuity Company as Guarantor

The second option considered is directly positioning the State Annuity Company to guarantee lifetime annuity benefits in the event that one of the life companies paying pension or disability annuities goes into bankruptcy.

Impact of Alternative: Again, moral hazard is an issue with respect to whether the insurance company management, the regulators, and the buying public would rely on the implicit guarantee of the State and not apply high levels of scrutiny over the life insurance companies with which they do business with. A further concern with this option is whether retirees and disabled workers receiving annuity payments would consider the State Annuity Company were the safer option, given that it is the guarantor behind any bankrupt life insurance company, and therefore select only the State Annuity Company as their insurer.

Recommendation: It is believed that retirees and disabled annuitants will gravitate toward the State Annuity Company out of continued concern for safety, resulting in no real market selection taking place. The use of the State Annuity Company as a guarantor is an option in a fully private sector market, but would weaken the private insurance sector in Kazakhstan. This option is therefore not recommended

[6] There are presently thirteen guarantee and reinsurance funds operating in Kazakhstan today covering a wide range of insurance coverage.

Partnership between the State Annuity Company and the State Accumulation Pension Fund

The third option considered was for the State Annuity Company to create a partnership with the State Accumulation Pension Fund.

Impact of Alternative: The benefits to partnering with the State Accumulation Pension Fund are great as it could leverage their relationships with new retirees each year to consider the purchase of pension annuities form the SAC. In general retirees and disabled workers receiving annuity payments would consider that the State Annuity Company/State Accumulation Pension Fund the safest option.

Recommendation: We believe that the partnership would be detrimental to the development of the private sector insurance industry as retires might conclude that the company had an implied government guarantee. It is also believed that do to the independent nature of each organization, it is unlikely that a sharing of information such as pension annuity sales leads would take place and thus reduce the economies of scale that could be achieved. Also complicating this option is the State Accumulation Pension Fund is in the process of concluding an investment from the European Bank for Reconstruction and Development (EBRD). A company created between the State Annuity Company and the State Accumulation Pension Fund would certainly crowd out the private sector.

SECTION III: SUMMARY OF RECOMMENDATIONS

Set out below are a number of recommendations that, if adopted, would greatly improve the environment in Kazakhstan for the successful operations of life insurance companies, including the State Annuity Company, selling pension and disability annuities.

Compulsory Annuities for Accumulations over 1.5 million KZT

Problem: Ministry of Labor Decree 1241 mandates that, beginning in 2006, new retirees purchase a guaranteed lifetime annuity at retirement (men age 63, women age 58); however, the same mandate establishes a grace period—seven years for men, nine years for women—before the end of which new retirees must purchase annuities. Another problem is that women, who have the longest retirement lives, are forced to retire five years earlier. Equalizing retirement ages for men and women should be considered**.**

Impact of Problem: Beginning in 2006, new retirees whose pension accumulations might be sufficient to purchase an annuity (approximately 1.5 million KZT and higher in the current year) will most likely choose to delay purchase for the full term of the grace period, by which time they will no longer have funds sufficient to purchase an annuity.

There are two reasons for this. First, even the best educated retirees will not know what annuities are or how they work, and are likely to be suspicious of the new product as well as the State Annuity Company.

Second, scheduled payouts from pension funds—the only alternative to annuities for retirees with accumulations of 1.5 million KZT or more—are guaranteed by the government and, in the case of death of the retiree, are automatically paid out to the deceased's surviving spouse or rightful heirs.

Scheduled payouts, however, are not whole life annuities; there is a risk, albeit small, that retirees will outlive their scheduled payouts. Further, since pension funds continue to earn

commissions and fees on scheduled payout accounts, *a standard annuity could actually pay the retiree as much as 22.0 percent more than do scheduled payouts* as currently calculated over the course of a twenty-year retirement. (See Table 5.)

Recommendations

1. The inadequacy of investment opportunity in Kazakhstan coupled with the high probability of random variability in mortality rates a result of small annuitant pools argues strongly against making pension annuities compulsory before the grace period dates currently established in Decree 1241, regardless of levels of accumulations. Authorities must understand that, if SAC begins writing annuities under current circumstances, losses due to random volatility of mortality rates and inadequate investment opportunity will (1) be unpredictable and (2) amount to a state subsidy of unknowable size that may be required for many years. Rather than accelerating private life insurance company growth, the subsidy could actually retard it.

2. FSA and SAC should be aware that certain life insurance companies have begun selling pension annuities to retirees with accumulations of approximately 1.5 million KZT. These sales demonstrate that (1) there is already interest, albeit extremely limited, in whole life annuities among current retirees and (2) there are companies willing to take on inordinate risks in order to do the business. Should this trend accelerate sharply, SAC may find it necessary to offer competing annuity products in order to assume some of the inordinate risks private companies appear prepared to run. The action on the part of SAC would be purely prophylactic, intended to prevent onerous risks from accumulating in private life insurance companies.

   In the event SAC were required to take such measures, it should be prepared to offer at least two products:

   a. A whole-life annuity with no survivorship provisions

   b. In appropriate cases, a *joint and survivor annuity with a 10-year period certain*. This annuity offers the following features:

      - a guaranteed lifetime income to the annuitant
      - upon death of the annuitant, guaranteed lifetime income to the surviving spouse
      - in the event of the deaths of both the annuitant and spouse prior to year 10,. remaining benefits through year 10 paid to heirs or assigns

3. If the government takes the decision to make annuities compulsory for retirees with accumulations above a certain amount, the nominal amount itself should not be codified in the law; it should rather be defined in terms of overall replacement rates or expressed as a ratio, or coefficient, of identifiable retirement income components. For example, if the demogrant plus the average PAYGO monthly pension equals *X* (KZT 11,000 today), and if the average retirement life expectancy is *Em* for men and *Ef* for women, then, ignoring further earnings, the threshold could be defined as *k* times *X* times *Em* or *Ef.*

4. Extremely ill retirees should not be forced to purchase annuities, provisions should be

made to allow such retirees to apply for and be granted Scheduled withdrawals in lieu of annuitization because of the low life expectancy of such extremely ill people. Annuities should not be mandatory for those who are seriously ill as people should have the option to put some or all of those savings into medical accounts. A retiree who has accumulated a decent amount be able to spend it on itema such as a pacemaker, kidney transplant or hip replacement to extend their lives.

5. If the government makes annuities compulsory for retirees with accumulations greater than a certain amount, the State Annuity Company should be the default selection option as provider of the annuity: that is, if a retiree fails to purchase an annuity from another licensed insurance company within 120 days of notice from his accumulation pension fund, his pension accumulations will be automatically transferred to the State Annuity Company for purchase of the appropriate annuity.

Equalizing Retirement Ages for Men and Women

Problem: For the foreseeable future, the vast majority of current retirees, the majority of which are women, will outlive scheduled withdrawals from the pension system.

Recommendation:

6. Due to the low level of average accumulations in the pension system, making annuities compulsory for accumulation above a certain level would not significantly reduce the number of retirees currently outliving their pension withdrawals. Further, since the vast majority of retirees are women, it follows that the majority of retirees outliving scheduled withdrawals are also women. Currently, the only way to effectively reduce the number of retirees outliving scheduled withdrawals is to increase the retirement age for women.

Expense Recovery

Problem: Current regulations do not permit life insurance companies to recover pension annuity related expenses (e.g., general and administrative, investment transaction costs, sales commissions, et al.) from premium income or benefit payments.

Impact of Problem: Life insurance companies will be hard pressed to break even in selling pension annuities if, in pricing, they are unable to recover their costs of operation.

Recommendation:

7. Amend Regulation 249 to permit life insurance companies to recover expenditures for pension annuities: up to 3% of acquired premiums and 4% of benefit payments. This recommendation is currently before the FSA Board. It is strongley recommended that the change be made, but limits of 5% of acquired premiums and 5% of benefit payments would be much more realistic.

Prohibit Transfers

Problem: Pension fund contributors are allowed to transfer their accumulations to another fund up to twice annually free of charge. This rule extends to an annuitant who transfers his pension accumulations to an insurance company to purchase an annuity, allowing a retiree to transfer from his present insurer to an annuity at another life insurance company, even after payments have commenced under the original pension annuity.

Impact of this problem: An annuity is a life insurance company's promise to pay an amount over a specified period, e.g., lifetime or period certain. An annuity is not the pay-down of an account balance. It is not feasible to allow such transfers after mortality pooling has begun, i.e., after benefit payments.

Recommendation:

8. Amend the law "On Provision of Pension" to eliminate the annuitant's right to transfer from one pension annuity provider to another or to an accumulation pension fund after annuity payments have commenced.

Guarantee Annuity Payments

Problem: The law "On Provision of Pension," Article 6, Paragraph 1 states that the government guarantees the security of contributors' pension accumulations during accumulation and payout stages. The law sets forth no comparable government guarantee of pension annuity payments made by a life insurance company after the pension accumulation is paid to the life insurance company.

Impact of this problem: Retirees will not consider pension annuity payments from life insurance companies as having the same government guarantee as that of schedule pension payouts from accumulation pension funds.

Recommendation:

9. Amending the law "On Provision of Pension," Article 6, Paragraph 1 to extend the government's guarantee of security to pension annuity payments will effectively guarantee annuities. However, it will also introduce moral hazard on the part of life insurance companies, which creates long term systemic risks in the life insurance industry.

Emerging Mortality Experience

Problem: Regulations do not permit life insurance companies to revise the payment levels of outstanding annuities based on emerging mortality experience.

Impact of this problem: As stated earlier, annuitant mortality plays a significant role in pricing annuities. Kazakhstan's first annuitant mortality tables were only developed this year and rely heavily on non-Kazakhstani annuitant mortality experience. The tables have not yet been tested against actual Kazakhstani annuitant mortality, and effective testing will require several years of growing annuitant pools in ever older age groups in order to establish the accuracy and reliability of the tables. Mortality rates in various age groups will no doubt change somewhat from the current rates.

In the absence of "seasoned" mortality tables, since allowable expenses will be fixed percentages of premium and benefit payments, life insurance companies will understandably adopt conservative pricing strategies; that is, they will widen the spread between investment income earned and investment income paid to annuitants, and they will tend to overestimate annuitant longevity. These strategies will result in lower benefit payments to annuitants.

Low benefit payments are not inevitable, however. Knowing that they can from time to time adapt benefit payments to emerging mortality experience, life insurance companies will be less inclined to establish conservative pricing strategies initially or to correct overly conservative initial estimates. Less rigid regulation will also automatically create a funded constituency for more accurate and reliable annuitant mortality tables. And more flexible

regulation encourages greater competition among life insurance companies which should in the long run result in a bias toward higher benefit payments.

Recommendation:

10. Amend Regulation 374 to allow life insurance companies to periodically revise the payment levels of new annuities based on emerging mortality experience. The revisions must be closely regulated, since the annuity is mandated by law.

Improve Investment Environment for Life Insurance Companies

Problem: The market of allowable investments for insurance companies is small and illiquid; there is an absence of financial instruments with maturities long enough to match minimum whole life annuity requirements. The government yield curve is currently net negative; that is, the yields of virtually all government securities are below the current rate of inflation.

Impact of problem: Annuitants would be subjected to higher costs resulting in lower annuity benefit payments. When an insurance market lacks an adequate supply of suitable investments, life insurance companies are often forced to project higher costs to compensate for projected lack of investment income.

Recommendation:

11. Extend the investment policy of the accumulation pension funds to the life insurance companies, and allow life insurance companies access to currency hedging tools and 15-year government bonds. Also the government of Kazakhstan should introduce a 20-year government bond.

Parity between Pension Funds and Life Insurance Companies

Problem: The investment income of accumulation pension funds invested in non-government bonds is not taxed while the investment income of identical investments of life insurance companies is taxed at the rate of 15%.

Impact of this problem: The result is double taxation. Two entities are taxed on the same income: the pension annuitant is taxed when the pension annuity benefits are paid and the State Annuity Company insurance company is taxed the year in which the income is earned. Annuitants would be subjected to higher costs resulting in lower annuity benefit payments.

Recommendation:

12. Eliminate the 15% tax on bond investment income of life insurance companies and create parity between the taxation of investment income of a pension fund and a life insurance company. This recommendation is before the FSA Board for correction. Pragma/FSI supports this change.

Improve Education and Understanding of Annuities in Kazakhstan

<u>Government</u>

Problem: There is a lack of technical understanding of life insurance and annuity products among lawmakers, regulators, supervisory authorities and other governmental agencies, e.g., Ministry Labor and Social Security (MOLSS) and the tax authorities.

Problem: Lack of English fluency is one of the largest obstacles to FSA management accessing international training and researching and staying current with information from English language technical insurance websites.

Impact of Problems: The FSA's Insurance Department, which should be at the forefront of protecting consumers and their retirement benefits, will lose pace with quickly changing technical requirements and understanding.

Recommendations:

13. In order for a system to be in place that guarantees lifetime retirement income, the capacity of the system must be enhanced and the capacity of the regulators to oversee the industry must similarly be strengthened.

Allocate sufficient funds, require annual training and develop training programs for lawmakers, FSA, MOLSS and tax authorities in international insurance practices, trends and developments. The FSA should require that all management and department heads be trained in and achieve fluency in English to allow them free access to the information online and to participate in a greater number of training programs organized by groups such as the International Association of Insurance Supervisors (IAIS), of which the Kazakhstan FSA is a member.

Finally, the FSA should consider internship exchange programs for department heads to cross-train at insurance regulatory commissions in other countries to accelerate the training of key personnel. The IAIS could be a resource for such cross-country internship programs. In addition, Russian data exchanges would be very valuable.

Insurance Industry

Problem: The insurance industry also lacks technical product knowledge which is complicated by lack of credibility with the public. Life insurance companies lack experience in developing, introducing and pricing new insurance products and selling pension and disability annuities.

Impact of problem: The life insurance industry is at risk of losing the opportunities for growth of the annuity market created through a series of mandated Decrees in 2004 because of lack of credibility by the public.

Recommendation:

14. The insurance industry should create training and testing program and require that executives, management and technical staff participate in continuing education programs. Many insurance companies communicated to Pragma/FSI plans to partner with international insurance companies. Such partnerships would open the opportunity for utilizing international training programs already in place in such partner's country of origin and should be utilized.

General Public

Problem: Demand for annuities is extremely small due to lack of familiarity with annuities, a general distrust of the financial sector, and misgivings about insurance companies driven in part by the news that one-quarter of insurance companies are failing. The public's lack of confidence is reinforced by news of financial institution insolvencies.

Impact of Problem: Despite new decrees mandating the purchase of lifetime guaranteed

annuity products, the general public may not understand annuities and the advantages of more complex features such as joint and survivor benefits, period-certain options, and benefit payments indexed to inflation.

Recommendation:

15. The government and the insurance industry should work together to develop and implement a long-term plan to communicate the benefits of annuities. A working group consisting of the insurance industry, communication specialists, and government agencies should draft goals and develop a timed plan to introduce the benefits of annuities. Development of simple online programs where investors can examine different investment strategies and annuity options would be helpful.

Improve Annuity Products: Disability Annuities

Link Employer Premiums to Disability Annuity Benefits

Problem: Under the Employers Obligatory Insurance Law, an employer is required to pay premiums (tariffs) to a general insurance company, also called a P&C company. These premiums are based on a table of risk ranges by worker classification. If a worker suffers a workplace injury, the P&C company is required to pay to the employer a benefit equal to the assessed claim. This amount is governed by the decision of the Health Commission certificate. Payment is also subject to a legal maximum related to the total payroll of the employer. The employer is then required to purchase an annuity for the disabled worker. If the cost of the annuity is greater than the claim payment paid by the P&C company, the employer is required to fund the shortfall. [The MOLSS has been requested to clarify the methodology used to develop the range of tariffs.]

Impact of Problem: For an employer with a small total payroll, or even a large employer with several accidents, there may be a shortfall between the amount paid by the P&C company and the amount required to fund the disabled worker's annuity. If there is a shortfall, the employer must make up the difference, which could result in the employer's bankruptcy. The disabled worker would be required to seek his annuity benefit through the courts (an injured worker's claim for disability income is second in the list of creditors).

Recommendation:

16. Revise the Employers Obligatory Insurance Law to more properly align the calculation of the employer's premium with the benefits paid from a disability annuity. Further, require that the mandated coverage (one times employer's annual payroll) be adjusted to link employer's premiums to annuity benefits.

Lack of Reliable Mortality Data for Disabled Lives

Problem: There is a lack of reliable disability mortality data for use by life insurance companies in calculating disability benefits.

*Impact of Problem: A*nnuitants would be subjected to higher costs resulting in lower annuity benefit payments. The lack of reliable data will put the estimates of the insurers at risk of underestimating costs of paying benefits, a concern also echoed by the State Annuity Company and each of the life insurance companies and the insurance and labor regulators. This could result in insurance reserves being too high (resulting ultimately in lower benefit payments to retirees or disabled workers) or too low (resulting in solvency risk of the insurance company).

Recommendation:

17. There are two recommendations, the first is the long-term resolution to the problem and the second is the interim solution. (1) To create reliable mortality data accessible by the MOLSS, FSA and members of the insurance industry, and other stakeholders will require a complex multi-project process to identify all sources of data inputs and commence collection, analysis, and creation of a proper mortality database. (2) Until that process is undertaken and initial mortality data are generated, the use of an alternative data source is recommended. In the absence of other reliable statistics on insurance companies and the MOLSS, members of the staff of Pragma/FSI are preparing recommendations on a valid substitute source of disability data.

Realign the Laws and Regulations

Problem: In general, the laws involved in the annuities market, the Pension Law, the Insurance Law, and the Employers Obligatory Insurance Law lack the specificity and detail to meet international standards.

Recommendation:

18. The laws, particularly the Pension Law, need to be reviewed. There are many inconsistencies and ambiguities therein.

There is an inherent problem in the Kazakhstan approach to law making that, while it may not be an impediment to the domestic market, may become an impediment to the international market. Kazakhstan is a Civil Code nation, as opposed to a Common Law country. Code laws are drafted differently from Common laws. In Code countries, each law relies on and derives its authority from the Civil Code. If a topic is covered in the Civil Code, it is not repeated in the specific law. If something appears in one law, it is not repeated in another. While this system works well for lawyers who are trained in Civil Code law, it does not travel across to Common Law systems. European countries using the Civil Code law system have made adjustments to the international market in drafting their laws in a way that Kazakhstan has not yet considered. In general, the international reader is used to more specificity and detail than currently exists in the laws affecting annuities in Kazakhstan. If the government of Kazakhstan is interested in attracting international companies into the annuities market and/or interested in joining the European Market, it may be necessary to begin drafting or redrafting laws with international assistance and with the intent of being easily understood by the international reader. Examples of these differences include:

The Insurance Law has one definition for insurance organization (insurer). The text of the law then goes on to describe that this organization may perform either general activities or life and annuity insurance activities. A separate license is required for each. When using the term “insurance organization” in the body of the law there is no distinction between a general or life insurance company. The reader must “deduce” which is meant by the subject of the text.

The Pension Law uses the terms “affiliated person” and “custodian bank.” While there are partial definitions for these terms in this law, the reader is supposed to know that the full, accurate, and official definition for “affiliated persons” is in the Joint Stock Company Law and that for “custodian bank” one is supposed to refer to the Securities Market Law. The Russian lawyer would say that one law never repeats definitions that are included in another law. The international lawyer would expect to find all terms fully defined within the law in which it is used regardless whether it appears in another law.

SECTION IV: ANNEXES

Financial Analysis of the State Annuity Company

Assumptions

The following describes the assumptions used to prepare the Financial Projections for the State Annuity Company (SAC) described as Scenarios 1. 2. and 3.

Life and Accident and Sickness Insurance
In Year 1 (2006) in all three Scenarios SAC writes a small amount of non-endowment life insurance and a small amount of Accident and Sickness Insurance Detailed premium figures are shown on the projected Income Statements that follow in this Annex
The volume of this business grows from 50million KZT of annual premium per year in Year 1 to 205 million KZT in Year 5 (2010).

Disability Annuities and Pension Annuities

In the following financial projections for Scenarios 1. 2. and 3. varying amounts of Disability Annuities and Pension Annuities are assumed to be written as described below under the headings for each of the three Scenarios.

Basic Assumptions Involved in all three scenarios
Gross Investment Earnings are assumed to be received tax-free at an average nominal rate of 5% per annum
Corporate Tax rates on premiums are assumed to be 4% on Accident and Sickness and non-endowment life insurance, 1% on Disability Annuities and Pension Annuities.
Commission rates paid on premiums received are assumed to be:
2% for Pension Annuities

- 5% for Disability Annuities
- 15% for Accident and Sickness Insurance
- 25% for Other Life Insurance

Reserve assumptions are reasonably conservative, assuming mortality and Investment returns close to the assumptions used in pricing.
Pricing for Pension Annuities contains very small margins.

Scenario 1: No Pension Annuity Sales

Disability Annuities
In Year 1 (2006) SAC writes 56 Disability Annuity policies as a result of the introduction of Employers Obligatory Insurance Law.

56 cases constitute approximately 14 % of the estimated 400 Certified Workplace Disabilities per year. Average single premium 4.5 million KZT per case the volume of business grows each year to reach 116 cases in Year 5 (2010)

Pension Annuities
In this Scenario 1, it is assumed that the purchase of Pension Annuities from life insurance companies *is not made compulsory* for those retiring with 1.5 mln KZT in obligatory Pension Accumulation Fund accounts and as a result SAC sells no Pension Annuities and it is

assumed that SAC concentrates on selling Disability Annuities.

Scenario 2: Growing Pension Annuity Sales

Disability Annuities
The same volumes of Disability Annuities as in Scenario 1 are assumed to be sold in Scenario 2.

Pension Annuities
In Scenario 2 it is assumed that the purchase of Pension Annuities from life insurance companies *is made compulsory* for those retiring with 1.5 million KZT or more in obligatory Pension Accumulation Fund accounts.

In Year 1 (2006) it is assumed that SAC writes 25 Pension Annuities; this is approximately 9 % of the estimated 274 citizens of Kazakhstan reaching retirement age in 2006 (63 years male, 58 years female) with more than 1.5 mln KZT in obligatory Pension Accumulation Fund accounts. Average single premium 1.8 mln KZT

The volume of such Pension Annuity sales grows each year to 125 in 2010, which will be just under 5% of the estimated 2,914 citizens reaching retirement age then with more than 1.5MLN KZT in obligatory Pension Accumulation Fund accounts.

Scenario 3: Stronger Disability Annuity Sales

Disability Annuities

In Scenario 3 the volume of Disability Annuities sold in response to the new Employers Obligatory Insurance Law is assumed to be as follows:
In Year 1 (2006) SAC writes 89 Disability Annuity policies as a result of the introduction of Employers Obligatory Insurance Law. The 89 cases constitute approximately 22% of the estimated 400 Certified Workplace Disabilities per year. Average single premium 4.5 mln KZT per case The volume of business grows each year to reach 139 cases in Year 5 which is 2010.

Pension Annuities
In Scenario 3 the Pension Annuity sales are assumed to be at the same level as in Scenario 2.

STATE ANNUITY COMPANY					
Scenario 1: Annuity Sales. Some Disability, No Pension					
(KZT millions)					
	Year 1	Year 2	Year 3	Year 4	Year 5
Income	361	459	626	742	860
Expenses	387	467	642	765	890
Net Gain (Loss)	-26	-8	-16	-23	-30
End-year Assets	1,225	1,520	1,914	2,359	2,856
End-year Liabilities	251	555	965	1,433	1,960
End-year Capital	974	965	949	926	896
Liabilities and Capital	1,225	1,520	1,914	2,359	2,856

STATE ANNUITY COMPANY					
Scenario 2: Annuity Sales. Some Disability, Some Pension					
(KZT millions)					
	Year 1	Year 2	Year 3	Year 4	Year 5
Income	407	553	770	938	1,111
Expenses	431	562	785	959	1,138
Net Gain (Loss)	-24	-9	-15	-21	-27
End-year Assets	1,268	1,645	2,162	2,773	3,475
End-year Liabilities	292	679	1,211	1,843	2,572
End-year Capital	976	966	951	930	903
Liabilities and Capital	1,268	1,645	2,162	2,773	3,475

STATE ANNUITY COMPANY					
Scenario 3: Annuity Sales. More Disability, Some Pension					
(KZT millions)					
	Year 1	Year 2	Year 3	Year 4	Year 5
Income	554	706	883	1,055	1,231
Expenses	601	737	915	1,093	1,275
Net Gain (Loss)	-47	-31	-32	-38	-44
End-year Assets	1,379	1,866	2,456	3,138	3,910
End-year Liabilities	426	944	1,566	2,286	3,102
End-year Capital	953	922	890	852	808
Liabilities and Capital	1,379	1,866	2,456	3,138	3,910

Income Statements

Scenario 1 No Pension Annuity Sales					
State Annuity Company					
Proforma Income Statement					
	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**
Income					
Premiums					
Accident and sickness	20,000	35,000	50,000	65,000	80,000
Life insurance	30,000	45,000	75,000	100,000	125,000
Disability annuity	255,000	310,000	415,000	470,000	525,000
Pension annuity	0	0	0	0	0
Total Premiums	***305,000***	***390,000***	***540,000***	***635,000***	***730,000***
Investment Income	55,618	68,614	85,842	106,833	130,391
Total Income	**360,618**	**458,614**	**625,842**	**741,833**	**860,391**
Expenses					
Claims					
Accident and sickness	15,000	26,250	37,500	48,750	60,000
Life insurance	15,000	22,500	37,500	50,000	62,500
Disability annuity	13,464	29,832	51,744	76,560	104,280
Pension annuity	0	0	0	0	0
Total Claims	***43,464***	***78,582***	***126,744***	***175,310***	***226,780***
Reserve Increase					
Life insurance and Accident and sickness	17,376	20,800	32,500	42,900	53,300
Disability annuity	233,750	283,100	377,545	425,475	473,409
Pension annuity	0	0	0	0	0

Total Reserve Increase	***251,126***	***303,900***	***410,045***	***468,375***	***526,709***
Commissions					
Life insurance and Accident and sickness	10,500	16,500	26,250	34,750	43,250
Disability annuity	11,650	15,500	20,750	23,500	26,250
Pension annuity	0	0	0	0	0
Total Commissions	***22,150***	***32,000***	***47,000***	***58,250***	***69,500***
Administration Expenses					
Start up	18,348				
Normal	44,391	46,611	48,925	51,371	53,940
Total Administration Expenses	***62,739***	***46,611***	***48,925***	***51,371***	***53,940***
Corporate Taxes	***7,550***	***6,300***	***9,150***	***11,300***	***13,450***
Total Expenses	**387,029**	**467,393**	**641,864**	**764,606**	**890,379**
Net Income (Loss)	**-26,411**	**-8,779**	**-16,022**	**-22,773**	**-29,988**
	-$195.64	**-$65.03**	**-$118.68**	**-$168.69**	**-$222.13**

Scenario 2 Growing Pension Annuity Sales

State Annuity Company

Proforma Income Statement

	Year 1	Year 2	Year 3	Year 4	Year 5
Income					
Premiums					
Accident and sickness	20,000	35,000	50,000	65,000	80,000
Life insurance	30,000	45,000	75,000	100,000	125,000
Disability annuity	255,000	310,000	415,000	470,000	525,000
Pension annuity	45,000	90,000	135,000	180,000	225,000
Total Premiums	***350,000***	***480,000***	***675,000***	***815,000***	***955,000***

Investment Income	56,693	72,812	95,175	123,369	156,183
Total Income	**406,693**	**552,812**	**770,175**	**938,369**	**1,111,183**
Expenses					
Claims					
Accident and sickness	15,000	26,250	37,500	48,750	60,000
Life insurance	15,000	22,500	37,500	50,000	62,500
Disability annuity	13,464	29,832	51,744	76,560	104,280
Pension annuity	2,376	7,128	14,256	23,760	35,640
Total Claims	***45,840***	***85,710***	***141,000***	***199,070***	***262,420***
Reserve Increase					
Life insurance and Accident and sickness	17,376	20,800	32,500	42,900	53,300
Disability annuity	233,750	283,100	377,545	425,475	473,409
Pension annuity	41,250	82,190	122,816	162,948	202,889
Total Reserve Increase	***292,376***	***386,090***	***532,861***	***631,323***	***729,598***
Commissions					
Life insurance and Accident and sickness	10,500	16,500	26,250	34,750	43,250
Disability annuity	11,650	15,500	20,750	23,500	26,250
Pension annuity	900	1,800	2,700	3,600	4,500
Total Commissions	***23,050***	***33,800***	***49,700***	***61,850***	***74,000***
Administration Expenses					
Start up	18,348				
Normal	46,728	49,065	51,500	54,075	56,779
Total Administration Expenses	***65,076***	***49,065***	***51,500***	***54,075***	***56,779***
Corporate Taxes	***5,000***	***7,200***	***10,500***	***13,100***	***15,700***
Total Expenses	**431,342**	**561,865**	**785,561**	**959,418**	**1,138,497**
Net Income (Loss)	**-24,649**	**-9,053**	**-15,386**	**-21,049**	**-27,314**

	-$182.58	**-$67.06**	**-$113.97**	**-$155.92**	**-$202.33**

Scenario 3 Stronger Disability, Annuity Sales at 5%, Investment Income					
State Annuity Company					
Proforma Income Statement					
	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**
Income					
Premiums					
Accident and sickness	20,000	35,000	50,000	65,000	80,000
Life insurance	30,000	45,000	75,000	100,000	125,000
Disability annuity	400,000	455,000	515,000	570,000	625,000
Pension annuity	45,000	90,000	135,000	180,000	225,000
Total Premiums	***495,000***	***625,000***	***775,000***	***915,000***	***1,055,000***
Investment Income	59,469	81,114	108,052	139,853	176,188
Total Income	**554,469**	**706,114**	**883,052**	**1,054,853**	**1,231,188**
Expenses					
Claims					
Accident and sickness	15,000	26,250	37,500	48,750	60,000
Life insurance	15,000	22,500	37,500	50,000	62,500
Disability annuity	21,120	45,144	72,336	102,432	135,432
Pension annuity	2,376	7,128	14,256	23,760	35,640
Total Claims	***53,496***	***101,022***	***161,592***	***224,942***	***293,572***
Reserve Increase					
Life insurance and Accident and sickness	17,376	20,800	32,500	42,900	53,300
Disability annuity	367,380	415,144	466,984	513,656	559,807
Pension annuity	41,250	82,190	122,816	162,948	202,889
Total Reserve Increase	***426,006***	***518,134***	***622,300***	***719,504***	***815,996***

Commissions					
Life insurance and Accident and sickness	10,500	16,500	26,250	34,750	43,250
Disability annuity	20,000	22,750	25,750	28,500	31,250
Pension annuity	900	1,800	2,700	3,600	4,500
Total Commissions	***31,400***	***41,050***	***54,700***	***66,850***	***79,000***
Administration Expenses					
Start up	18,348				
Normal	66,013	68,350	64,800	67,375	70,079
Total Administration Expenses	***84,361***	***68,350***	***64,800***	***67,375***	***70,079***
Corporate Taxes	***6,450***	***8,650***	***11,500***	***14,100***	***16,700***
Total Expenses	**601,713**	**737,206**	**914,892**	**1,092,771**	**1,275,347**
Net Income (Loss)	**-47,244**	**-31,092**	**-31,840**	**-37,918**	**-44,159**
	-$349.96	**-$230.31**	**-$235.85**	**-$280.88**	**-$327.10**

Balance Sheets

Scenario 1 No pension annuity sales					
State Annuity Company					
Balance Sheet					
	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**
Total Assets	**1,224,715**	**1,519,836**	**1,913,859**	**2,359,461**	**2,856,182**
Liabilities					
Life insurance and Accident and sickness	17,376	38,176	70,676	113,576	166,876
Disability annuity	233,750	516,850	894,395	1,319,870	1,793,279
Pension annuity	0	0	0	0	0
Total Liabilities	**251,126**	**555,026**	**965,071**	**1,433,446**	**1,960,155**
Owners Equity					
Charter Fund	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
Retained Earnings (Losses)	-26,411	-35,190	-51,212	-73,985	-103,973

Net Equity	**973,589**	**964,810**	**948,788**	**926,015**	**896,027**
Total Liabilities and Equity	**1,224,715**	**1,519,836**	**1,913,859**	**2,359,461**	**2,856,182**

Scenario 2					
Growing Pension Annuity Sales					
Balance Sheet					
	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**
Total Assets	**1,267,727**	**1,644,764**	**2,162,240**	**2,772,513**	**3,474,797**
Liabilities					
Life insurance and Accident and sickness	17,376	38,176	70,676	113,576	166,876
Disability annuity	233,750	516,850	894,395	1,319,870	1,793,279
Pension annuity	41,250	123,440	246,256	409,204	612,093
Total Liabilities	**292,376**	**678,466**	**1,211,327**	**1,842,650**	**2,572,248**
Owners Equity					
Charter Fund	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
Retained Earnings (Losses)	-24,649	-33,702	-49,087	-70,137	-97,451
Net Equity	**975,351**	**966,298**	**950,913**	**929,863**	**902,549**
Total Liabilities and Equity	**1,267,727**	**1,644,764**	**2,162,240**	**2,772,513**	**3,474,797**

Scenario 3 Stronger Disability Annuity sales					
5% of investment income					
	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**
Total Assets	**1,378,762**	**1,865,804**	**2,456,264**	**3,137,850**	**3,909,687**
Liabilities					
Life insurance and Accident and sickness	17,376	38,176	70,676	113,576	166,876
Disability annuity	367,380	782,524	1,249,508	1,763,164	2,322,971
Pension annuity	41,250	123,440	246,256	409,204	612,093
Total Liabilities	**426,006**	**944,140**	**1,566,440**	**2,285,944**	**3,101,940**
Owners Equity					
Charter Fund	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
Retained Earnings (Losses)	-47,244	-78,336	-110,176	-148,094	-192,253
Net Equity	**952,756**	**921,664**	**889,824**	**851,906**	**807,747**
Total Liabilities and Equity	**1,378,762**	**1,865,804**	**2,456,264**	**3,137,850**	**3,909,687**

Legal Appendices by Law

Note: The international reader is accustomed to reading laws and regulations that are drafted with more specificity and clarity than is currently available in the laws governing annuities in Kazakhstan. Even the native Russian language reader finds these laws vague, incomplete and open to wide interpretation. In our experience this lack of specificity has led to confusion, conflicting interpretations or simply no answer at all. The Pension Law is the best example of these problems and the one in most need of assistance. However, the Employers Obligatory Insurance Law also has several areas that need improving, not the least of which are gaps between itself and the Civil Code that can only be filled by additional legislation

Pension Law

Law No. 136 of 20th June 1997 of the Republic of Kazakhstan Concerning Pension Support in the Republic of Kazakhstan (Pension Law)

Comments to this Law are restricted to those that fall within the scope of the project; namely, to propose recommendations designed to create and grow a thriving annuity market.

To the English language reader: If the English seems awkward at times, it is because it is constructed to aid in the translation into Russian.

Primary Recommendations:

1. Modify the Pension Law to require the purchase of a pension annuity at retirement with the obligatory pension accumulations balance for those retirees whose account balances are in excess of 1.5 million KZT.

Add new Article 23, paragraph 3, to read:

"The purchase of an annuity for pension payments from accumulation pension funds at the expense of obligatory pension contributions shall be mandatory for accumulation pension funds that have a balance of 1.5 million KZT or more. Accumulation pension funds accounts having less than 1.5 million KZT may be withdrawn in either a lump sum or a series of equal or substantially equal payments over a period of time mutually agreed to by the pension fund and the person who has a right to pension payments from an accumulation pension fund.

2. Require that the mandatory form of annuity at retirement, purchased with obligatory pension accumulations balances, be in the form of a joint and survivor life annuity with a 10 year period certain and remove the required minimum monthly payment.

Amend Article 31-1, paragraph 1 to read:

"1. The persons mentioned in (*paragraphs 1-3 of Article 9 and*) subparagraph 3) of paragraph 1 of Article 23 *(*added by 16) of this Law shall have the right to conclude a pension annuity contract with an insurance organisation for the performance of insurance payments for life with the use of the pension savings formed at the expense of obligatory pension contributions. In this case the monthly insurance payment from the insurance organisation may not be less than the amount of the minimum pension established by the law concerning the republic's budget for the relevant financial year as on the date of conclusion of the pension annuity agreement."

(delete the language in (*italics)* from the existing language.)

Add a new Article 31-1, paragraph 1, subparagraph 1-1, to read:

"1-1. The persons mentioned in paragraphs 1-3 of Article 9 of this Law shall conclude a pension annuity contract with an insurance organisation for the performance of insurance payments in the form of a Joint and Survivor life annuity with a ten (10) year period certain with the use of the pension savings formed at the expense of obligatory pension contributions."

5. Eliminate from the Pension Law the retiree's right to transfer between pension annuity providers.

Delete definition 7

Amend Article 6, paragraph 13, to read:

"13) granting to the (*receiver*) **depositor** of opportunities to transfer their pension (*receipts)* **amounts of their individual pension account** from one accumulation pension fund to another, but not less (sic: the Russian text reads "more" which is correct) frequent than twice a year."

(add language in **bold** to existing language and delete the language in (*italics)* from the existing language.)

Amend Article 25, paragraph 2-1, subparagraph 3 to read:

"transfer of pension savings into another accumulation pension fund in accordance with legislation *(or to an insurance organization, under the pension annuity contract*, in accordance with the procedure provided for by the legislation) of the Republic of Kazakhstan."

(delete the language in (*italics)* from the existing language.)

Delete Article 31-2, paragraph 6

Delete Article 31-3, paragraph 2, subparagraph 2

Delete Article 31-3, paragraph 4, subparagraph 3

II Legal Recommendations: References are to the Pension Law

Article 1 Definitions

14) Individual pension account

The definition of this account includes all contributions, other receipts and the Russian word "penu," which is translated into English as "penalties." FSI has been told that this word in Russian usually means a deduction and is probably the wrong Russian word because here it is intended to mean an addition to the account.

It appears that any errors made in operating the account (credits, investments, transfers, etc) result in a penalty to the offending institution. That penalty, minus charges for collecting it, is then deposited into the affected account. Should the amount of the penalty, minus the collection costs, fall short of the actual loss in the account, the individual has a right to go to court to recover the short fall from the offending institution. Should the amount of the penalty, minus collection costs, exceed the actual loss to the individual account, the account keeps the excess.

This practice does not meet international standards and should be changed.

International practice regarding errors made to an account requires that the individual account is made whole as of the day the transaction was suppose to have take place. The account does not profit from the mistakes or gains, it does not suffer losses and it most certainly is not required to go to court to recover any losses.

This definition should include the deduction of fees and expenses.

Amend Article 1, definition 14 to read:

"individual pension account- a personal nominal account of a depositor (recipient) at an accumulation pension fund in which one keeps records of his obligatory or voluntary pension contribution, or voluntary vocational pension contributions, **plus (minus) investment income, gains (losses), minus fees and expenses,** *(investment gain, penalties and other receipts in accordance with the legislation of the Republic of Kazakhstan)* and from which pension payments are effected."

(add language in **bold** to the existing language and delete language in (*italics)* from the existing language.)

III Additional Recommendations

Pension Law

This law should be translated into English again by another source, at a minimum, and preferably should be redrafted.

The English translation of this law is very poor. Not only is it confusing and vague, it contains inaccuracies. One example: Article 6, paragraph 13 provides for transfers of individual pension accounts from one pension fund to another. The English translation goes on to read "…but not less frequent than twice a year…" Clearly, this should read not "**more**" frequently than twice a year, as it appears in the original Russian.

In fairness to the translation, however, the original law, with all its subsequent amendments, has produced a result that is so poorly drafted as to be continuously confusing to the reader, even a native Russian language reader. It is disorganized and frequently unclear as to whether it is referring to mandatory, voluntary, voluntary vocational or disability pensions.

If the international community is expected to operate under this law, it is recommended that a new official English translation be obtained. When this law is next amended, it should probably be subjected to a complete re-drafting with the assistance of an outside consultant with international experience. If the Government of Kazakhstan is serious in its intent to join the European Union (EU) at some future date, the redraft should also take into consideration the EU directive on pensions.

Annuity Law

A separate and comprehensive annuity law should be drafted and enacted.

Currently, the law of annuities is included in, and derived from, parts of other laws (e.g. pension, insurance, employer's obligatory liability). This "patch work" approach is confusing and leads to inconsistencies and misinterpretations. At some point in the future, a comprehensive and detailed annuity law should be drafted, preferably with international assistance and, perhaps, reflecting the EU requirements.

DISABILITY ANNUITIES

Law No. 30 of 7th February 2005 of the Republic of Kazakhstan Concerning the Obligatory Insurance of Civil Law Liability of Employers for Causing Harm to Lives and Health of Employees in the Course of their Performance Work (Service) Duties
(Employers Obligatory Insurance Law)

Comments to this Law are restricted to those that fall within the scope of the project; namely, to proposed recommendations designed to create and grow a thriving annuity market.

Primary Recommendations:

B. b. i. Revise the Employers Obligatory Insurance Law to require that the mandated coverage (one times employer's annual payroll) be increased.
Amend Article 16 to read:

"Amount of insurance shall be determined by the agreement on the obligatory insurance of employers liability, but it must not be less than **(insert number) times** the annual work remuneration fund of all the employees in view of the personnel categories (industrial, administrative, managerial, support personnel)."

(replace "insert number" with a numerical figure and add language in **bold** to existing language)

II The employer should be required to provide, and to certify, to the insurance company the following information with the payment of each premium:

The name of the worker;
The worker's social identification code (SIC);
The occupational category of the worker;
The amount of wages for the worker; and
The amount of the premium being paid for the worker.

Add a new Article 11, paragraph 6, subparagraph 11 to read:

"11) that with each premium payment the employer should also provide to the insurance organization the following information, certified by the employer as to its authenticity: 1) the name of the worker; 2) the worker's social identification code (SIC); 3) the occupational category of the worker; 4) the amount of wages for the worker; and 5) the amount of the premium being paid for the worker."

Insurance Law

Law No 126 of 18th December 2000 of the Republic of Kazakhstan Concerning Insurance Business (Insurance Law)

Primary Recommendations:

II A. a Extend the investment policy of the accumulation pension funds to the life insurance companies, including giving insurance companies access to hedging tools, the 15-year government bond and recommending the introduction of a 20-year government bond.

Amend Article 11, paragraph 2, sub paragraph 1) to read:

"1) investment activities in accordance with the procedure provided for by the regulatory legal acts of the Authorized Body**, except for insurance organizations that provide pension annuity payments whose investment activities are carried out under the Procedures for Pension Assets Investment Management."**

(add language in **bold** to existing language)

Amend Resolution 941, paragraph 72 to read:

"Long term savings treasury bonds shall be placed with the accumulation pension funds **and insurance organizations that provide pension annuity payments**, provided that the first half of the term of circulation shall be envisaged for accumulation pension funds **and insurance organizations that provide pension annuity payments**, and after expiration of the stated term, trading shall be

exercised on a free basis."

(add language in **bold** to existing language)

Amend Regulation 264, Chapter 1, paragraph 1 to read:

"**An insurance company that is organized and licensed to do business under Article 6, paragraph 2 of Law No. 126 of 18th December 2000 of the Republic of Kazakhstan Concerning Insurance Business (life insurance company-hereinafter),** and/or a pension asset management company (the Company-hereinafter) and/or an accumulation pension fund licensed for pension assets management (the Fund-hereinafter) may independently invest the pension assets of each individual fund that they manage in the below-mentioned financial instruments in the following percentage amounts of the total amount of pension assets (including current volume of investments and balances of investment accounts of the Fund with a custodian at the custodian at the transaction date)

(add the language in **bold** to the existing language)

II B.a.i. Revise the Rules on Increasing the Size of Regular Insurance Indemnity Payments Within the Term of Annuity Contracts On the Grounds of an Actuary's Report and The Requirements to the Content of this Report Approved by Resolution #374 dated December 27, 2004 of the Board of the Republic of Kazakhstan Agency for Regulation and Supervision of the Financial Market and Financial Organization (Rules) to allow the life insurance companies to revise the pension annuity payment levels based on emerging mortality data experience.

Add a new subparagraph 3) to paragraph 5 of Chapter 2 of the Rules to read:
"3) A change, either negative or positive, between the mortality assumption made in the original pricing and the actual emerging mortality experience.

II B. a. v. **Revise the Insurance Law to add a comparable statement on the benefits paid from pension annuities by any life insurance company.**

Add a new Article 17 to read:

"The state shall guarantee to recipients the safety of the pension annuity paid by insurance companies in the amount of the benefit promised in the original contract."

Secondary Recommendations: References are to this Insurance Law

Article 3 Definitions:

The definitions should be numbered for easier reference.

Insurance organization (insurer)	this definition includes both a "general insurance" (property and casualty) company and a "life insurance" (annuity) company. In Kazakhstan, it is necessary to get a separate license for each activity and no company may hold both, although a holding company may have two separate subsidiaries, one general and the other life. It becomes confusing when reading the law as to which company is being discussed because there is no distinction in the term used for each. This definition should be deleted and replaced by two separate terms that would reflect this distinction and should read: "general insurance organization – a legal entity that carries out the activities listed in Article 6, paragraph 3 of this Law." "life insurance organization- a legal entity that carries out the activities listed in Article 6, paragraph 2 of this Law."

APPENDIX

The Tax Code

The Code of 12th June 2001 of the Republic of Kazakhstan Concerning Taxes and other Obligatory Payments to the Budget (The Tax Code)

Comments to this Law are restricted to those that fall within the scope of the project; namely, to propose recommendations designed to create and grow a thriving annuity market.

To the English language reader: If the English seems awkward it is because it is constructed to aid in the translation into Russian.

Primary Recommendation:

II. A. b. Eliminate the 15% tax on bond investment income of life insurance companies and create parity between the taxation of investment income of a pension fund and a life insurance company.

Add new Article 131, paragraph 1-1, subparagraph 3 to read:

"Investment income which is paid to insurance organizations that carry out the activities listed in Article 6, paragraph 2 (life insurance sector) of Law No. 126 of 18th December 2000 of the Republic of Kazakhstan Concerning Insurance Business."

FINAL REPORT
SMALL BUSINESS DEVELOPMENT FUND (SBDF) GUARANTEE PROGRAM
Assumes an exchange rate of KZT135:USD1

TABLE OF CONTENTS

I. INTRODUCTION & SUMMARY

The Small Business Development Fund (SBDF), established in 1998 by the Government of Kazakhstan (GOK), has been directed to ensure that its present allocation of KZT4.6B (USD34MM) is in the hands of Small & Medium Enterprise (SME) borrowers by means of guarantees to be provided to domestic commercial banks (the Guarantee Program) by year-end 2005. An additional KZT5B (USD37MM) and KZT6B (USD44MM) will be made available to the Fund for the same purpose in 2006 and 2007, respectfully.

At the request of the Minister of Industry & Trade (to USAID), this Consultant spent just over thirty days (between August 29 – October 28, 2005) in Kazakhstan, reviewing current conditions in the Kazak banking market, advising the Fund's management on the design of the Guarantee Program, and delivering Risk Management Training to Fund employees who would be involved with the Guarantee Program. This assignment followed the completion of a related Sustainability Analysis done for USAID by Douglas Whitley.[1]

The GOK's rationale to provide an additional USD125MM in term financing to SMEs at a time when the Kazak banking sector is already over-extended to this same sector is questionable. Further, the changing design parameters of the Fund's Guarantee Program are often at variance with 'international best practices,' as an example an open-ended term, charging guarantee fees as high as 4%, and the failure to allow for pilot testing. Despite basing this new Program on OECD examples existing regulations are imprecise. The consultant believes that the Fund's management decision to use a default rate of 7% when recent evidence from the EBRD proves that well-run SME on-lending programs in Kazakhstan can be managed with losses of less than 2% overly conservative.

[1] Small Entrepreneurship Development Fund, Sustainability Analysis, Douglas E. Whiteley, September 20, 2005. Comparisons between the two reports are difficult because the Fund's management changed the parameters of the Guarantee Program, in some cases dramatically, between the times of the two reports' completion.

Fees paid to OECD government institutions in relation to notional guarantee amounts and tenors (U.S., Japan, France, Germany, UK)

	Fee*	Tenor	Guarantee Amount	Comment
U.S.	<2.75%	<25 years		SBA
Japan	1%^			Loan Guarantee Associations
France	2-3%		40-75%	Institute of Mutual Guarantee
U.K.	2-2.5%		70-80%	Government Loan Guarantee Scheme
Germany	2%	10-15 years	<80%	Association of Mutual Guarantee Banks

* per annum
^ insurance coverage also sought

II. THE KAZAK BANKING SECTOR AND SMALL & MEDIUM ENTERPRISES

Small and medium enterprises (SMEs) are typically defined by development agencies in accordance with the one or more of the following criteria:

Ownership	Private (i.e. no State Ownership)
Employees	50-250
Turnover	Varies
Loan Size	USD5,000 - 250,000
Loan Purpose	Working Capital or Capital Expenditure

According to the EBRD's latest Kazakhstan country strategy paper, SMEs, defined as enterprises with between 50 and 250 employees, account for 98% of the total registered enterprises in Kazakhstan. Non agricultural enterprises in this sector operate mainly in the service sector (81%) while those in industry operate mostly in the food and light industrial sectors. The EBRD reports that bank loans to this small business sector increased 70% between the end of 2002 and June 2004 and accounted for over 20% of total loans outstanding.[2]

The traditional motivator for the establishment of a government or development agency-sponsored guarantee program is to spur the local banking sector to make loans to sectors where they would ordinarily not because of credit concerns. However, in Kazakhstan at present 'against a backdrop of favorable macroeconomic conditions and continuing growth of the resource base, the credit market remained one of the dynamically developing segments of the financial markets in 2004.'[3] NBK's Annual Report further

[2] EBRD Kazakhstan, Country Strategy, November 2, 2004, P. 27
[3] 2004 Annual Report of the National Bank of Kazakhstan, page 39

touts that loans grew by 52% in 2004 and the ratio of bank credit to GDP stood at 16.8% as of December 31, 2004.[4] Another telling measure of loan activity in the Kazak banking sector is the Loan to Deposit Ratio which, for the sector as a whole, stood at 118% in 2004 a time when most former Soviet Republics and Balkan countries struggled to reach 100%, the expected norm in OECD countries.[5]

Unfortunately, like most other central banks, NBK does not publish the amount of loans granted to SMEs but the EBRD provides firm evidence that significant credit has been granted to this sector since 1998, the year in which the Kazakhstan Small Business Program (KSBP) was established to facilitate the distribution of credit provided by EBRD to local SMEs through selected Kazak banks. From inception through August 2005, KSBP had processed over 160,000 SME loans while realizing a default rate, defined as non- performing for 90 days or more, of only 1.56% (value of USD2.97MM): on August 31, 2005 KSBP boasted 49,600 loans outstanding with a value of USD367MM.[6]

III. THE FUND'S HISTORICAL ACTIVITY & PRESENT STRATEGY

The Fund's primary activity has been to receive funds from both the EBRD (through KSBP) and the ADB which in turn were on lent to SMEs through select banks. As of June 30 2005 the Fund had extended KZT18.797B (USD139.2MM) in total financing through these two donor channels including:

- EBRD – KZT12.811 (USD94.8MM)
- ADB – KZT5.986B (USD44.3MM)

The Fund's outstanding loan portfolio as of Mar 1 2005 was KZT 16.45B (USD121.85MM), representing 87% utilization.[7]

The present activities of the Fund take their initiative from the President's message of February 18, 2005 entitled 'Kazakhstan on the way of accelerated economic, social and political modernization.' In response, the Fund promulgated (in April 2005) a new three year strategy (2005-2007) which recommended a continuation of the training and consultative services for potential borrowers in the new financial activity of project finance, leasing, and guarantees. The emphasis in this April 2005 document is however toward the micro-credit market rather than SMEs.[8] An accompanying document (an exhibit to the aforementioned document) specifies the amount of the GOK's budget which will be committed to the effort while going to outline the manner in which primarily developed countries (U.S., Italy, Japan, Germany, South Korea, Denmark,

[4] op.cit., page 40
[5] At year-end 2004 customer deposits were KZT 1,255.4 billion while net loans were KZT1,484 billion. Op.cit. pp 39-40
[6] Kazakhstan Small Business Program - News, August 2005
[7] Statistics on loan utilization were taken from documents provided to Pragma Corporation by the Fund including a December 2004 spreadsheet entitled 'Crediting Flow for 1997-2004' and a March 2005 memo entitled 'Programs for Financial Support of Small Business'
[8] Introduction, Development of 'Small Business Development Fund,' JSC 2005-2007 Strategy

Great Britain, France, Mexico, Chile, and Brazil) have gone about boosting an entrepreneurial culture.[9]

IV. COMMENTARY ON DESIGN FEATURES

The following are recommendations that we believe the Fund should implement to be consistent with OECD guidelines

A. PROGRAM

Size of Program: KZT4.6 billion (available in 2005) to be increased by KZT 5 billion in 2006 and KZT6 billion in 2007.

Life of Program: no defined end date…while the maximum tenor of loans to be granted by Banks under this Program will be five years, the Fund's managers, on apparent advise from their Chairman, refuse to assign an end date to the Program, stating that in theory loans can be rolled over infinitely. *This is not a prudent practice as loans with a theoretic indefinite maturity are loans that are likely never to be repaid.*

Eligible Banks: While well established domestic banks are preferred by the Fund's management, there is nothing in the existing Program Regulations to prohibit allocations of the Fund's Guarantee to any of Kazakhstan's 36 licensed commercial banks. *This Consultant strongly urges market testing of the Guarantees with one bank at the outset and then, upon a successful pilot period, rolling the Program out to additional banks. Additionally, as the amount which each bank can qualify for will be client driven (interested SMEs will bring their preferred bank to the Fund), at a minimum the Fund should establish sub-limits for all domestic Kazak banks.*

Eligible Borrowers: SMEs who have attained a certain financial position. There are no restrictions in terms of geography however the agricultural, gambling, and firearms industry have been excluded. *The existing regulations are unclear about lending to start-ups, a risky practice unless restricted to known investors..*

Loan Purpose: to upgrade, modernize, and expand physical infrastructure. *Existing regulations make no mention of working capital loans although the stated policy seems to be that banks can extend the un-guaranteed portion of loans for this purpose.*

B. GUARANTEE

Guarantee: The Fund will provide its Guarantee to the Bank for between 50-80% of the nominal amount of each loan, depending on the Borrower's assessed credit quality and the viability of the transaction under consideration.

[9] 'Program for Accelerated Measures on Development of Small and Middle Size Entrepreneurship in the Republic of Kazakhstan for 2005-2007'

Guarantee Fee: The Fund will charge the Borrower a one time front end fee of between 3-4% for use of its Guarantee and an ongoing fee of 3-4% p.a. thereafter on the outstanding amount under the Guarantee commitment. *Such fees for extending a Guarantee are high (see table above). It is unclear if such a surcharge will be acceptable to borrowers, especially in an environment where banks are extending credit liberally without a Government Guarantee Program.*

Evidence of the Fund's Guarantee: The Fund's Guarantee, covering between 50-80% of the committed amount, will be evidenced by the investment of securities issued by companies in the KASE 'A' listing. *Existing regulations do not stipulate whether these securities will be placed with the Participating Bank or held by the Fund and if at the Bank, will the Bank have the right of offset in the event of a Borrower's default. If not addressed in the Fund's own regulations, then this point should be addressed in the documentation between itself and the Banks. Further, such documentation between Bank and Fund must ensure that Bank may not draw under the Guarantee until having completed a rigorous recovery process, i.e. for at least 90 days after the initial default.*

Use (by the Bank) of the Guarantee: *Any losses experienced by the Borrower should be shared on a pro-rata basis by the Bank and the Fund, equally, in other words, the Fund should avoid allowing the Bank taking a' first loss' position but, again, this point is not addressed in the Regulations.*

C. LOAN STRUCTURE

New Loans: only

Required Structure: all lending must be first evidence by a Letter of Credit issued on behalf of Borrower by Bank.

Size of Individual Loans: The minimum amount which can be guaranteed is USD100,000 (minimum loan size = USD125,000) while the maximum is USD430,000 (maximum loan size USD860,000). The Fund expects the average loan amount will be USD150,000 and that between 280 and 450 loans will be made in 2005. *USD150,000 is a very large average loan size for SMEs (see above). The number of loans expected in the remainder of 2005 is very ambitious if starting in November!*

Currency of Loans: as all transactions are envisioned to involve the import of equipment, most loans will be denominated in USD and the foreign exchange risk will be assumed by the Borrower. *Having SMEs assume five year currency risk in a volatile emerging market is not without peril.*

Tenor of Loans: up to five years, at which point they become renewable…*as above this Consultant has questioned the logic of making 'renewable' loans available*

Interest Rates: Banks will be permitted to charge commercial interest rates…*typically Banks extending credit under a Guarantee would reduce their market interest rates accordingly however this point is not addressed in the Regulations*

Repayment of Principal and Interest: All loans will include a one year grace period for principal repayments after which equal principal payments will be made on monthly or quarterly basis. Interest payments will be paid monthly from the loan's origination date.

Penalty Interest: In the event that a Borrower is more than five (5) business days overdue on the payment of principal or interest to the Bank, the Bank has the right to charge its customary penalty interest charges which shall be for its account and not that of the Fund.

D. COLLATERAL & SECURITY

Bank's Collateral: Banks will be allowed to take collateral from each approved Borrower in accordance with commercial terms but for only that portion of its loan which is not guaranteed, i.e. between 20-50%. However, the Bank's collateral cannot come from the equipment being financed.

Fund's Collateral: The Fund will expect to be collateralized for up to 50% of its guaranteed position through liens on the equipment being purchased by the loan proceeds.

E. MONITORING

'Best practices' in the on going monitoring (or servicing) following initial loan disbursement is key to ensuring timely repayment. The Fund's Management did not wish this Consultant to spend any time reviewing their procedures in this regard.

F. INSURANCE

Throughout this assignment, the Fund's Management referred to their desire to have local Kazak insurance companies insure the Guarantees that the Fund would provide to the Banks. While this is an interesting concept currently there are no insurance companies underwriting such types of insurance policy.

V. RISK MANAGEMENT TRAINING

The Training Syllabus was written by this Consultant based on prior similar engagements in transition economy countries (primarily Albania, Kenya, and Moldova). The Syllabus consisted of a series of Power Point presentations, handouts, and two cases delivered over a 20 hour plus period, divided into three full days (Kokshetau and Aktobe) or five half days (Almaty).

Fund participants were asked to assume that they were acting as a bank and therefore forced to make the same risk management decisions on loans requests required by the bank. This premise was based on the assumption that a decision to grant the Fund's

Guarantee to a bank would require Fund employees to consider the same risk criteria that the bank had employed in order to recommend the loan to the Fund. While effort was made to relate to customs and traditions in Kazak banking, the participants were asked to view all credit decisions from the standpoint of 'international best practices.'

Throughout effort was made to relate the training to Kazakhstan or to experiences from the former Soviet Union. The first case, on Credit Scoring, was adopted from a live situation that occurred in Latvia in 2000 while the second case sought to encompass all of the main themes of the Syllabus into a fictitious (but hopefully realistic) Kazak environment.

Risk Management Training was conducted over a three week period in the Fund's three regional offices – Almaty, Kokshetau, and Aktobe. The overwhelming majorities of the Fund's participants were within a year of graduation from University and had no prior working experience, either in the public or private sector. Less than 10% of the total participants (4) had ever worked in a commercial bank.

At the end of each session a Final Exam was given to the participants to test their retention of the Syllabus materials. Participants were required to answer 25 questions based on True/False, Multiple Choice, and fill in the blank. A grade of 70% or better was required to 'pass.' Notwithstanding the participant's youth and lack of practical experience, 60% of those tested scored 80% or better with the average score being 80.76%, attesting to the fact that the majority of those who participated in the training were capable of retaining and understanding the materials presented. Less than 10% of the 43 participants (4) 'failed' to score a grade of 70% or more.

Complete results of the Final Exam are attached as Exhibit A.

All participants were surveyed (anonymously) at the end of each course to determine how well they felt the Training met their needs. Just less than half of those surveyed (16/34) felt that the Training they had received would make a 'very big' difference in the Fund's future operations while 38% said that they would 'aggressively' recommend such training to colleagues with the Fund.

Complete results of the Satisfaction Survey are attached as Exhibit B.

Richard L. Smith
Chappaqua, NY
November 8, 2005

MORTGAGE ATTACHMENTS