

The Pragma Corporation
Financial Sector Initiative
Fourteenth Quarterly Report
For the Period
November 22, 2003 – February 21, 2004

For the
U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT

GENERAL INFORMATION

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ALMATY, KAZAKHSTAN

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A. PROJECT OVERVIEW

I. PROJECT DESCRIPTION

The Pragma Team works with the Kazakhstan Stock Exchange (KASE), the National Bank of Kazakhstan (NBK), the Pension Regulatory Body/State Accumulation Pension Fund (SAPF), the Ministry of Labor and Social Protection, Ministry of Finance, pension fund asset managers, banks, and broker/dealers to implement the Financial Sector Initiative Project.

In September 2001, Mr. Rick Gurley, the CTO for the USAID/CAR Mission, approved the Work Plan that set forth the priorities of the Project *through its completion date*. In August, 2002 Dr. Lewis Tatem became the new CTO of FSI. During the eighth quarterly review, Dr. Tatum approved FSI's work plan through the remainder of the first option exercise, August 2003. In July, 2003 FSI reviewed its activities and received notification that USAID would exercise its option to have FSI continue. In late August, FSI and USAID mutually agreed on revised expected results. The updated work plan that reflects these revised expected results (for completion during the remaining six quarters) was presented to FSI's CTO for approval during FSI's quarterly review (12th & 13th) in December 2003 (*See Attachment 1*).

The priorities of the Project for this period are noted by component in the boxes below.

The project update for this quarterly report will correspond to the activities set forth in the action plan described below and reported by component.

I. SIGNIFICANT EVENTS AND ACHIEVEMENTS

- € NBK REGULATORY FUNCTIONS TRANSFERRED TO NEWLY FORMED AGENCY FOR REGULATION OF FINANCIAL INSTITUTIONS AND MARKETS (AS OF JANUARY 1, 2004)
- € SUPERVISORY AGENCY GIVES PRELIMINARY APPROVAL TO HEDGING OF FOREIGN CURRENCY RISK
- € BANK TUREN ALEM MORTGAGE COMPANY ISSUES ITS FIRST MBS
- € ASSESSMENT OF INSURANCE SUPERVISION DEPARTMENT FOR NEWLY FORMED REGULATORY AGENCY BEGINS
- € AGENCY FOR REGULATION ADVISED ON SYSTEMIC RISK RE: AFFILIATED INSURANCE COMPANIES
- € ACTUARIAL ADVANCED COURSE IV DELIVERED
- € KAZAKHSTAN MORTGAGE GUARANTEE FUND RECEIVES FSI/USAID EQUIPMENT

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- € PRAGMA/FSI COMPLETES VALUATION OF STATE ACCUMULATION PENSION FUND
- € FSI MEETS WITH PRIME MINISTER'S REPRESENTATIVE ON REGIONAL HOUSING FINANCE INITIATIVE
- € FANNIE MAE COMPLETES ASSESSMENT OF KAZAKHSTAN MORTGAGE COMPANY
- € DRAFT CREDIT BUREAU LAW SUBMITTED TO MAZHILIS IN DECEMBER 2003, FSI INVITED TO MAKE MAJOR PRESENTATION TO MEMBERS OF PARLIAMENT
- € NBK SIGNS LETTER SUPPORTING CREDIT BUREAU SHAREHOLDERS MEETING
- € CHAIRMAN OF AGENCY FOR REGULATORY AGREES TO ESTABLISH PRIVATE CREDIT BUREAU FOR CONSUMERS AND SMALL BUSINESS; UPHOLDS CONSUMERS' CONSENT.
- € FSI HOSTS AMBASSADOR OF ISRAEL, EDP AND USAID REPRESENTATIVES FOR PROGRAMATIC DISCUSSIONS
- € FSI MEETS OPIC REPRESENTATIVE
- € FSI MEETS MBIA REPRESENTATIVES

III. PROJECT EXECUTIVE SUMMARY

This Report provides details on the events and activities summarized below, as well as other events and activities regarding the USAID Financial Sector Initiative, as implemented by consultants for The Pragma Corporation (the Project), for the period from November 22, 2003 through February 21, 2004. The report is comprised of four components: Financial Instruments, Pension/Insurance, Mortgage, and Credit Bureau/Credit Rating Agency. Each component section of the report will have a summary with specific activity tasks identified and the status of each task with appropriate commentary, relevant attachments, and reference to administrative issues, if any.

Financial Instruments

In February, Azamat Djoldesbekov, President of KASE, and Pragma/FSI representatives met with the Deputy Director of the Financial Supervisory Agency to discuss the issue of hedging currency risks in the pension fund system. At that meeting, FSA gave tentative agreement to allowing pension funds to use the KASE futures contract, provided (1) pension funds themselves expressed some interest in using the dollar futures contract and (2) Pragma/FSI would develop the methodology for determining and reporting the amount of currency risk in pension fund portfolios.

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BTA Mortgage, the mortgage lending subsidiary of Bank Turen Alem, issued its \$3.0 million pilot mortgage-backed security during February 2004. The issue is a tenge-denominated un-indexed three-year maturity with an embedded put-call feature that allows semiannual re-pricing. This is the second issue of a MBS by a financial institution other than the Kazakhstan Mortgage Company.

By the end of the quarter under review, cumulative corporate bond issuance in Kazakhstan stood at \$1.24 billion of cumulative issuance this year with \$716 outstanding excluding MBS. KMC issuance now stands at \$108 million. The KMC has conducted bi-monthly auctions for the purpose of ensuring predictability to investors and maintaining sufficient liquidity for the purchase of new mortgages.

Currently, the weighted average maturity of outstanding corporate bonds is 5.7 years and the weighted average yield to maturity (YTM) 7.4 percent per annum.

Insurance/Pension

The Association of Insurance Industry Participants was registered in January 2004.

Insurance companies that are affiliated to banks are offering mortgage insurance or down payment insurance. While this is legal under current Kazakh law, using a non-credit insurance (“civilian responsibility”) to insure a credit product (mortgage) represents a serious deviation from prudential fiduciary norms of both insurance and banking. If allowed to continue, this could jeopardize the soundness of both the banking and the insurance industries in Kazakhstan. The practice is outlawed in virtually all developed economies worldwide.

In September, the Government of Kazakhstan reiterated its interest in privatizing the State Accumulation Pension Fund. In response to the statement, the National Bank of Kazakhstan changed the prudential norms, which had governed the SAPF’s investment policies since its inception, to those which now govern the investment policies of private pension funds. At the direction of the National Bank, the management of SAPF also approached Pragma/FSI with a request to value the fund for sale. In the first quarter of 2004, the GOK publicly announced its decision to privatize the SAPF. Pragma/FSI’s completed valuation will provide the Government with an independent, third party assessment of SAPF’s value as an ongoing concern. Potential buyers, whether domestic or international, will in the course of their due diligence undertake their own valuations.

Concurrent with its completion of the valuation, Pragma/FSI received its semiannual visit from Jonathan Woollet, EBRD’s Director of Non-Bank Financial Institutions Operations in London. The EBRD has long expressed an interest in investing in SAPF when the decision was finally taken to privatize it. Pragma/FSI assisted EBRD in arranging a meeting with the Governor of the National Bank of Kazakhstan to discuss EBRD’s possible participation. SAPF is currently a wholly owned subsidiary of NBK.

Mortgage

The Kazakhstan Mortgage Guarantee Fund (KMGF) continued preparing its legal guidelines in cooperation with Pragma/FSI's legal staff and refining insurance products for ultimate sale. Additionally, and related to KMGF and the varying kinds of mortgage guarantees the fund would offer, FSI prepared a paper for the Agency for Regulation that directs attention to systemic risk banks present to when having affiliated insurance companies offering mortgage insurance. In the event of a real estate market meltdown, bank exposure through affiliates can result in massive losses i.e. consolidated balance sheets. *Please see the related insurance component executive summary.*

Pragma/FSI's consultants from the Institute for Urban Economics continued technical assistance to local and regional banks that cooperate with the Kazakhstan Mortgage Company (KMC). Their emphasis included a review of compliance with KMC underwriting standards and efforts for improvement. One structural weakness identified in a KMC roundtable with originating banks was the lack of confidence in independent appraisals. This condition, in turn, has led to banks using their own appraisers. This lack of confidence derives from different appraisers using non-standard methodologies. FSI plans to remedy this deficiency by undertaking a series of roundtables with independent and bank appraisers participating together in order to agree on a standardized approach all appraisers can use to ensure acceptability. Other roundtable findings include unprofessional sales practices. FSI is considering the introduction of licensing requirements for all real estate sales persons. An assessment by FSI staff of real estate selling practices is currently underway. FSI/USAID received a request from the First Deputy Prime Minister Pavlov to assist in the establishment of a pilot regional housing finance program. FSI's COP and FSI's CTO, Dr. Lewis Tatem met with a representative of the Prime Minister's office in Astana, Mr. Kuanganov, to discuss the scope of the request and applicability to FSI's expected results and deliverables. Mr. Kuanganov expressed his desire to execute a Memorandum of Understanding that would detail the technical assistance the Government Of Kazakhstan could expect and the level of cooperation that FSI/USAID could expect from the Government of Kazakhstan. Subsequently, in response to First Deputy Prime Minister Pavlov's request, USAID Mission Director Deikun responded in a letter that limited Pragma/FSI assistance to specific items.

Lawrence Taff, a senior staff member from Fannie Mae, completed his assessment of the KMC in accordance with his pre-approved Scope of Work. Of special concern to the KMC was his evaluation of their operating procedures and duration matching. Dr. Taff also noted the lack of a suitable Government of Kazakhstan "risk free" benchmark (Government yield curve) to assist in pricing KMC issues. The maturity of the Government of Kazakhstan debt is simply too short to provide pricing guidance. FSI expects to receive his final report during the fifteenth quarter.

Cumulative residential mortgage origination during this quarterly period is approximately \$275 million, an increase of approximately \$57 million over the previous quarter. KMC issuance now stands at \$108 million.

Credit Bureau

FSI continued to work on refining the legal framework in order to establish a system of private Credit Bureaus. While the passage of the Credit Bureau Law remained a key focus of efforts

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from November 22, 2003 through February 21, 2004, FSI reached agreement with the Association of Financiers of Kazakhstan and its member banks to hold a Credit Bureau shareholders meeting on March 5th, 2004. The NBK fully supported this initiative. In addition, on February 8th, 2004, FSI met with the Chairman of the Unified Regulatory Agency to review the principle outstanding issues regarding the draft Credit Bureau law. Among the issues discussed during the meeting, the URA agreed to a) establish a private credit bureau which combined consumers and SME data, b) pre-trial procedures for dispute resolution, and c) less regulation and monitoring of the Credit Bureau. Pragma/FSI was invited to the Mazhilis to make a major presentation to the members of Parliament on March 16th, 2004.

Other

USAID and the Embassy of Israel share USAID funding through Israel's donor arm MACHEV. Based on interest expressed by Moshe Kambi, Ambassador of Israel, to David Lucterhand, FSI Chief of Party, for increased cooperation with USAID, FSI set up a meeting with representatives of EDP and Kimberly Rosen, Deputy Director, E&F, and USAID.

At the request of Debra Erb, Director of Housing Programs, OPIC, FSI met to discuss possible opportunities for using OPIC guarantees. Constraints such as OPIC's minimum deal size preclude utilization of such guarantees in the near-term.

FSI's Chief of Party David Lucterhand and Senior Advisor Steve Moody met with representatives of the Municipal Bond Insurance Agency (MBIA) to discuss guarantee possibilities. Minimum deal size is one impediment, but passage of the Securitization Law will present future opportunities as transactions come on stream.

II. PROJECT STAFFING

The following personnel were engaged in project activities this quarter:

- € David Lucterhand, Chief of Party
- € Stephen Moody, Resident Senior Advisor, Financial Instruments, Mortgage, Pension/Insurance
- € Javier Piedra, Resident Senior Advisor, Credit Bureau
- € Natalya Rogozhina, Consultant, Mortgage Training
- € Alexander Kopeikin, Consultant, Mortgage Training
- € Douglas Whitely, Consultant, Mortgage Insurance
- € Sally Merrill, Consultant, National Mortgage Insurance
- € Lawrence Taff, Consultant, Mortgage, Fannie Mae
- € John Wetherhold, Consultant, Pensions

III. ADMINISTRATIVE

FSI has been informed by the NBK, administrative authority for the offices that FSI rents, that the building will undergo major renovation for one month starting July 11. FSI will have to vacate its office space causing operational disruption. FSI IT personnel will endeavor to minimize inconveniences in telephone and other electronic communication. The building administrator will offer alternative space in the building during this period.

David Lucterhand, FSI Chief of Party was absent on leave December 21, 2003 through January 5, 2004 and February 19 through February 21, 2004.

LIST OF ATTACHMENTS

1. Work Plan for the 12th and 13th Quarters, December 2003
2. Quarterly Review, December 2003

B. FINANCIAL INSTRUMENTS

I. COMPONENT DESCRIPTION

This Report provides details on the events and activities relating to the Financial Instruments Component of the USAID Financial Sector Initiative, as implemented by the Pragma/FSI Corporation, during the period from November 22, 2003 through February 21, 2004.

The primary purpose of the Financial Instruments Component is the development of new investment-grade instruments which fill financial needs unmet by the current commercial banking, corporate and municipal finance communities in Kazakhstan, and which expand the selection of corporate or municipal securities in which private Pension Fund asset managers may invest. Secondly, the Financial Instruments Component is intended to extend the yield curve of the Kazakhstani corporate bond market by facilitating the issuance of longer maturities, and to upgrade the quality of new issues by introducing credit enhancement techniques, and by improving both bond indentures and investment memoranda.

II. SIGNIFICANT EVENTS

- € PRAGMA/FSI PREPARES DRAFT LAW ON SECURITIZATION FOR SUPERVISORY AGENCY WORKING GROUP
- € SUPERVISORY AGENCY GIVES PRELIMINARY APPROVAL TO HEDGING OF FOREIGN CURRENCY RISK
- € CUMULATIVE CORPORATE BOND ISSUANCE EXCEEDS \$1.0 BLN
- € BANK TUREN ALEM MORTGAGE COMPANY ISSUES ITS FIRST MBS

III. EXECUTIVE SUMMARY

In a directive dated 10 February, B. Zhamishev, Chairman of the Financial Supervisory Agency, created a securitization working group under the chairmanship of Yelena Bakhmutova, Deputy Chairman of FSA, and named several Pragma/FSI consultants as participants (*See Attachment 1*). As stated in the directive, the working group will prepare a draft law on securitization for submission to Parliament no later than 1 May.

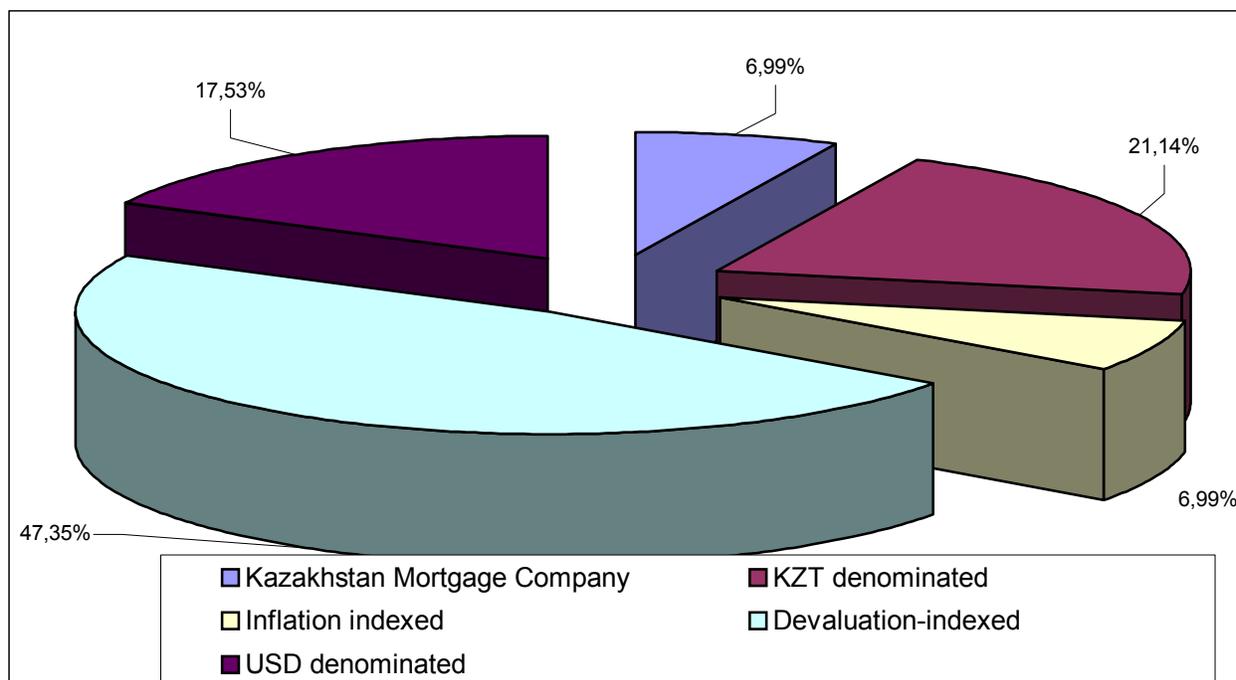
Pragma/FSI advisor and attorneys have been working on the said draft since November (*See Attachment 2*). The draft is modeled on the Italian Law on Securitization which, in the opinion of senior advisors, can be adequately adapted to Kazakh law and circumstance. The cornerstone of the Italian law is the off-balance sheet treatment of securitized assets; that is, assets sold to the SPV are carried in off-balance sheet accounts of the SPV. This structure, which at first seems unwieldy, prevents the income flowing through these accounts from being taxed within the SPV

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itself. A similar structure already exists in Kazakh pension fund legislation and for the same purpose. It can therefore be readily adapted to serve the securitization law.

The first meeting of the securitization working group is scheduled for 25 February.

In 2003, pension funds lost an estimated \$80.0 million due to revaluation of the tenge. Pension funds incur currency risk from two sources: (1) foreign and domestic dollar-denominated bonds and (2) domestic bonds indexed to the dollar, which represent the largest segment of the corporate bond market in Kazakhstan. (See chart below.) Ironically, the practice of indexing domestic issues to the dollar arose in response to pension funds' demand for products that protected them from tenge devaluation.



The pension funds lost money to tenge revaluation because current legislation does not permit pension funds to invest in “derivative” financial instruments. The term derivative includes, of course, futures contracts which are the most common instruments for hedging currency risks. A six-month dollar futures contract is listed on the Kazakhstan Stock Exchange, but pension funds are not allowed to trade it; therefore, the contract doesn't trade at all (*See Attachment 3*).

In February, Azamat Djoldesbekov, President of KASE, and Pragma/FSI representatives met with the Deputy Director of the Financial Supervisory Agency to discuss the issue of hedging currency risks in the pension fund system. At that meeting, FSA gave tentative agreement to allowing pension funds to use the KASE futures contract, provided (1) pension funds themselves expressed some interest in using the dollar futures contract and (2) Pragma/FSI would develop the methodology for determining and reporting the amount of currency risk in pension fund portfolios.

At a subsequent meeting of pension fund representatives, KASE, FSA representatives and Pragma/FSI, the pension funds expressed interest in being able to hedge their currency risk (*See Attachment 4*). Pragma/FSI is now developing the reporting methodology, and the FSA is

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drafting amendments to pension fund legislation which will permit pension funds to hedge currency risk.

During the quarter under review, cumulative issuance of corporate bonds surpassed the benchmark of the one billion dollar level (*See Attachment 5*).

BTA Mortgage, the mortgage lending subsidiary of Bank Turen Alem, issued its \$3.0 million pilot mortgage-backed security during February 2004 (*See Attachment 6*). The issue is a tenge-denominated un-indexed three-year maturity with an embedded put-call feature that allows semiannual re-pricing.

III. ADMINISTRATIVE ISSUES

Stephen Moody was absent from December 16, 2003 through January 5, 2004.

DESCRIPTION AND STATUS OF TASKS

Task 1 - Development of Financial Instruments

| Defined Activity | Progress Made During Quarter/ Proposed Future Actions |
|--|---|
| <p>€ Mortgage-Backed Security</p> | <p>€ SECURED DCA GUARANTEE ADMINISTRATOR</p> <p>€ SECURED BONDHOLDER REPRESENTATIVE</p> <p>€ SECURED LARIBA SHAREHOLDERS' RESOLUTION</p> <p>€ PREPARED DRAFT BOND INDENTURE</p> <p>€ SECURED MINISTRY OF JUSTICE RULING ON PROCEDURES FOR REGISTERING MASTER PLEDGE (MORTGAGE POOL)</p> <p>€ DOCUMENTS SUBMITTED TO NBK AND NSC FOR FINAL REVIEW</p> <p>€ BOND REGISTERED WITH NSC/NATIONAL BANK</p> <p>€ BOND LISTED ON KASE</p> <p>€ FIRST MORTGAGE-BACKED SECURITY PLACED BY SECONDARY MORTGAGE - MARKET FACILITY</p> <p>€ LARIBA BANK MORTGAGE-BACKED SECURITY PLACED</p> |
| <p>€ Social Obligations Bond</p> | <p>€ IDENTIFIED PROSPECTIVE WATER PURIFICATION PROJECTS IN ATYRAU AND MANGISTAU OBLASTS</p> <p>€ COMPLETED DRAFT LETTER OF INTENT BETWEEN OIL COMPANIES AND AKIMATS</p> <p>€ COMPLETED PRESENTATION FOR OIL COMPANIES</p> |
| <p>€ Microlending Project</p> | <p>€ PERFORMED FINANCIAL ANALYSIS OF KCLF</p> <p>€ DETERMINED STRUCTURE OF POTENTIAL BOND OFFERING</p> <p>€ MADE PRESENTATION TO KCLF BOARD OF DIRECTORS</p> <p>€ RESEARCHED KCLF LEGAL STATUS AND REREGISTRATION REQUIREMENTS</p> <p>€ RESEARCHED KCLF BANKING LICENSE</p> |
| <p>€ Warehouse Receipts Project</p> | <p>€ GRAIN WAREHOUSE RECEIPTS REPLACED OLD SOVIET FORM PK-13 AS OFFICIAL CERTIFICATES OF OWNERSHIP OF GRAIN IN LICENSED KAZAKH ELEVATORS</p> <p>€ MET WITH ACDI-VOCA CONCERNING POTENTIAL WAREHOUSE RECEIPTS PROGRAM IN KAZAKHSTAN</p> <p>€ RESEARCHED STRUCTURE OF KAZAKH GRAIN MARKET AND OWNERSHIP OF PRIMARY GRAIN ELEVATORS</p> |

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| | |
|---|---|
| | <ul style="list-style-type: none"> € CONDUCTED SEMINARS ON GRAIN INSPECTION AND GRADING € PARTICIPATED IN WORKING GROUP TO DEVELOP CREDIT PROCEDURES USING GRAIN WAREHOUSE RECEIPTS € WAREHOUSE RECEIPTS REGS APPROVED BY PARLIAMENT € SEMINARS CONDUCTED INSTRUCTING GRAIN INSPECTORS IN THE ISSUANCE, MONITORING AND MAINTENANCE OF GRAIN € WAREHOUSE RECEIPTS RECORDS GRAIN ELEVATOR MUTUAL ASSURANCE SOCIETY REGISTERED WITH MINISTRY OF JUSTICE |
| Principal Protected Notes (PPNs) | <ul style="list-style-type: none"> € INTRODUCED PPNs TO PENSION FUND ASSET MANAGERS € NATIONAL BANK AGREES TO THE PURCHASE OF PPNs BY PENSION FUNDS |

Task 2 - Legal Reform

| Defined Activity | Progress Made During Quarter/Proposed Future Actions |
|---|--|
| <ul style="list-style-type: none"> € National Securities Commission Working Group | <ul style="list-style-type: none"> € CONTRIBUTED DRAFT LANGUAGE AND COMMENTARY TO NEW UNIFIED NSC/KASE BOND REGISTRATION REGULATION € CONTRIBUTED DRAFT LANGUAGE AND COMMENTARY TO NSC MINIMUM REQUIREMENTS FOR BOND INDENTURES AND INVESTMENT PROSPECTUSES. |
| <ul style="list-style-type: none"> € National Bank Working Group | <ul style="list-style-type: none"> € AGREED WITH GOVERNOR OF NATIONAL BANK TO COORDINATE EFFORTS ON A COMPREHENSIVE REFORM OF BANKRUPTCY LAW, PLEDGE LAW AND RELATED ELEMENTS OF CIVIL CODE € INITIATED THE MERGER OF THE LEGAL COMPONENTS OF THE NBK FINANCIAL INSTRUMENTS AND MORTGAGE LENDING WORKING GROUPS € REVIEWED RESUMES AND CONDUCTED INTERVIEWS WITH APPLICANTS FOR ATTORNEY POSITIONS AT NBK € IDENTIFIED FOR NBK WORKING GROUPS THE PRIMARY DEFECTS OF EXISTING PLEDGE LAW € GAVE TESTIMONY BEFORE BUDGET AND FINANCE COMMITTEE ON NATIONAL BANK'S DRAFT LAW TO EXCLUDE PLEDGED ASSETS FROM BANKRUPTCY ESTATE |
| <ul style="list-style-type: none"> € Pledge Registration | <ul style="list-style-type: none"> € HELD PRELIMINARY MEETINGS WITH BTI (REGISTRATION CENTER) ON PROCEDURES FOR REGISTERING MASTER PLEDGE OF MORTGAGE POOL € SECURED MINISTRY OF JUSTICE RULING ON PROCEDURES FOR REGISTERING MASTER PLEDGE (MORTGAGE POOL) € SECURED MINISTRY OF JUSTICE RULING ON ARTICLE 308 OF THE CIVIL CODE |

3. Un-tasked Activities/Accomplishments

| Defined Activity | Progress Made During Quarter/Proposed Future Actions |
|--|---|
| € Bond Index | € DEVELOPED CLEAN PRICE BOND INDEX AND PORTFOLIO PERFORMANCE INDICATOR € INDEX AND INDICATOR MADE AVAILABLE TO PUBLIC BY REUTERS NEW SERVICE € PUBLICATION OF PRAGMA/FSI INDEX METHODOLOGY IN <i>RYNOK TSENNYKH BUMAG</i> |
| € Atyrau Mortgage Lending Project | € PROVIDED LEGAL AND FINANCIAL ANALYSIS ASSISTANCE TO ATYRAU OBLAST FOR LOCAL MORTGAGE LENDING PROGRAM |

LIST OF ATTACHMENTS

1. FSA letter creating the Working Group on the Law on Securitization
2. Pragma/FSI's draft law on Securitization
3. KASE's six-month dollar futures contract
4. Pragma/FSI currency risk presentation prepared for the pension funds
5. Cumulative Corporate Bond Issuance
6. BTA Mortgage Investment Memorandum

C. PENSION AND INSURANCE

I. COMPONENT DESCRIPTION

This report provides details on events and activities relating to the Pension and Insurance Component of the USAID Financial Sector Initiative (FSI), as implemented by the Pragma Corporation, during the period from November 22, 2003 through February 21, 2004.

The purpose of the Pension part of this component is to ensure that Kazakhstan's pension system provides a suitable income for retired, disabled, sole survivors and other Kazakhstani citizens no longer able to provide for themselves.

The objective of this part of the component is to develop a strong, competitive accumulation private pension system, which is well regulated and safeguarded against systemic risk, yet which provides an adequate income for old age pensioners and supports the development of the private financial sector. Specifically, the FSI seeks to establish an effective regulatory body to supervise all components of the accumulation pension system; to assist in the privatization or liquidation of the State Accumulation Pension Fund (SAPF); and to provide technical assistance to monitor, evaluate and respond quickly to specific issues that threaten the continued development of the accumulation system.

The purpose of the Insurance part of this component is to continue existing measures to assist the National Bank (NBK) in developing a strong Department of Insurance Supervision (DIS), and to assist increasingly in the development of the Kazakhstani insurance market and the insurance industry itself.

The major objectives of this part of the component are to continue existing measures to upgrade the legal and regulatory environment of the insurance industry to a level compatible with international standards of insurance commerce; to continue existing measures to strengthen the DIS so that it is able to effectively monitor Kazakhstan's insurance market by implementing improved regulatory and supervisory functions; to continue such training and education as may be appropriate to ensure that the DIS staff is able to implement its regulatory mission effectively; to assist in the development of the insurance market in Kazakhstan (including measures to attract foreign participation to the Kazakhstani insurance market and the provision of education to the public); and to assist in the development of the insurance industry in Kazakhstan (including the provision of training and education to the insurance industry).

The results sought from this part of the component are the development of efficient, reliable insurance regulation and supervision in Kazakhstan; a legal and regulatory framework in Kazakhstan's insurance sector consistent with international standards; the institutional infrastructure necessary to support life insurance activities (actuarial capacity, information systems, etc.); and the development of the private insurance market and industry in Kazakhstan (in particular, the life insurance market and industry).

II. SIGNIFICANT EVENTS AND ACHIEVEMENTS

€ PRAGMA IDENTIFIES ABUSE OF INSURANCE LAW

- € ASSOCIATION OF INSURERS REGISTERED
- € PRAGMA COMPLETES VALUATION OF STATE ACCUMULATION PENSION FUND

III. EXECUTIVE SUMMARY

As early as October 2003, the newly appointed Deputy Chairman of the Mortgage Guarantee Fund had reported that certain banks were requiring borrowers to “insure” their mortgages by making the bank beneficiary of a so-called “civilian responsibility” policy purchased from an insurance company affiliated with the bank.

A “civilian responsibility” policy insures one party in a contract or agreement against loss or damages in the event the other party should not honor said contract or agreement. Since a mortgage is a contract under the terms of which issuing banks run considerable credit risk, it is logical and reasonable for the banks to seek some form of guarantee or insurance against borrower default. The practice was fairly widespread; some affiliated insurance companies were offering packages consisting of life, property and “civilian responsibility” insurance for premiums as low as 1.5% of the face value of the mortgages they insured.

This was brought to the attention of Pragma’s mortgage insurance consultants, Sally Merrill and Doug Whitely, and they were concerned with the issue of “civilian responsibility” insurance (*See Attachment 1*). While legal under current Kazakh insurance law, using non-credit insurance (“civilian responsibility”) to insure a credit product (mortgage) represents a serious deviation from prudential fiduciary norms of both insurance and banking. If allowed to continue, this could jeopardize the soundness of both the banking and the insurance industries in Kazakhstan. The practice is outlawed in virtually all developed economies worldwide.

The first and most obvious threat arises from using insurance companies affiliated with the issuing bank. This practice does not transfer the credit risk inherent in mortgage lending off the banks’ consolidated balance sheets since, as a rule, banks own insurance companies. Thus, if real default rates begin to exceed estimated rates, banks must absorb the losses either in the insurance company or, if the insurance company becomes insolvent, in the mortgage department (or company). In either case, the bank’s capital adequacy is impaired; in the second case, the bank’s capital adequacy is impaired *and* there’s one less insurance company.

Second, in virtually every developed economy, companies issuing credit insurance products (including mortgage insurance) are mono-line companies. That is, the reserves securing credit insurance products cannot be co-mingled with the reserves securing other insurance products such as property, casualty or life. The reason for this is that credit insurance is actuarially quite different from other kinds of insurance; by comparison to the long term trends in life or casualty actuarial models, credit product trends are subject to many more extraneous factors and are, as a consequence, quite volatile.

Last, while “civilian responsibility” might be some kind of credit product, it is not mortgage insurance and using it as such is actuarially unsound.

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Consultants Sally Merrill and Doug Whitely met with FSA Director, Bolat Zhamishev, and brought the issue to his attention. Subsequently, at a meeting in the insurance supervisory department at FSA, Pragma was informed that the FSA would prepare amendments and additions to the Law on Insurance to correct the problems.

The Association of Insurance Industry Participants was registered in January 2004.

The valuation of the State Accumulation Pension Fund, which Pragma began in the last quarter, was completed in the quarter under review. Pragma valued SAPF at \$41.1 million as of 1 January 2004 (*See Attachment 2*).

Concurrent with its completion of the valuation, Pragma/FSI received its semiannual visit from Jonathan Woollet, EBRD's Director of Non-Bank Financial Institutions Operations in London. The EBRD has long expressed an interest in investing in SAPF when the decision was finally taken to privatize it. Pragma/FSI assisted EBRD in arranging a meeting with the Governor of the National Bank of Kazakhstan to discuss EBRD's possible participation. SAPF is currently a wholly owned subsidiary of NBK.

ADMINISTRATIVE ISSUES

Stephen Moody was absent from December 16, 2003 through January 5, 2004.

V. DESCRIPTION AND STATUS OF TASKS

Task 1 Pension – Establishing an Effective, Efficient Unified Regulatory Body

| Defined Activity | PROGRESS MADE DURING QUARTER/PROPOSED FUTURE ACTIONS |
|--|--|
| <ul style="list-style-type: none"> € Prepare a strategy and timetable for achieving the establishment of a unified, independent regulatory body (within 30 calendar days of the start of the activity) | <ul style="list-style-type: none"> € AS PART OF A LARGER MERGER OF REGULATORY BODIES, IN MID-OCTOBER, 2001 THE NBK OFFICIALLY TOOK CONTROL OVER THE STATE ACCUMULATION PENSION FUND. |
| <ul style="list-style-type: none"> € Support political efforts to establish a unified regulatory body | <ul style="list-style-type: none"> € PRAGMA/FSI'S INVOLVEMENT IN THIS AREA HAS BEEN DOWNGRADED FROM A PROACTIVE ROLE TO ONE OF ASSISTANCE. |
| <ul style="list-style-type: none"> Establish standardized (uniform) reports, methodologies, normative acts, and supervision € Unified reporting € Common methodologies € Unified supervision | <ul style="list-style-type: none"> € PRAGMA/FSI CONTINUED TO SUPPORT AND ACTIVELY PARTICIPATE IN MARKET ASSET VALUATION COMMITTEE ACTIVITIES. € PRAGMA/FSI CONTINUED ITS ANALYSIS OF THE COMMISSION FEE STRUCTURE FOR PENSION PLANS, BASED ON A VARIETY OF SCENARIOS. § PRAGMA/FSI CONTINUED TO CONTRIBUTE TO A LEGAL WORKING GROUP ESTABLISHED TO IDENTIFY AND PROCESS REQUIRED AMENDMENTS TO THE PENSION LAW. |

Task 2 Pension – Privatization or Liquidation of the State Accumulation Pension Fund

| Defined Activity | PROGRESS MADE DURING QUARTER/PROPOSED FUTURE ACTIONS |
|---|---|
| <ul style="list-style-type: none"> € Prepare a plan for eliminating the State Accumulation Pension Fund as a dominant market force (within 45 days of the start of the activity) | <ul style="list-style-type: none"> € PRAGMA/FSI’S INVOLVEMENT IN THIS AREA HAS BEEN DOWNGRADED FROM A PROACTIVE ROLE TO ONE OF ASSISTANCE (SEE ABOVE). |
| <ul style="list-style-type: none"> € Resolve technical issues related to the privatization of the SAPF € Clean up duplicate accounts € Prepare financial analysis € Prepare a preliminary design | <ul style="list-style-type: none"> € PRAGMA/FSI’S INVOLVEMENT IN THIS AREA HAS BEEN DOWNGRADED FROM A PROACTIVE ROLE TO ONE OF ASSISTANCE (SEE ABOVE). |
| <ul style="list-style-type: none"> € Strengthen political support for the privatization of the SAPF € Build support from donors, international investors, etc. € Provide local counterparts with supporting analysis | <ul style="list-style-type: none"> € PRAGMA/FSI’S INVOLVEMENT IN THIS AREA HAS BEEN DOWNGRADED FROM A PROACTIVE ROLE TO ONE OF ASSISTANCE (SEE ABOVE). |

Task 3 Pension – Monitoring, Evaluation and Quick Response

| Defined Activity | Progress Made During Quarter/Proposed Future Actions |
|--|--|
| <ul style="list-style-type: none"> € Identify key threats to the pension system and develop a plan for monitoring them (within 30 calendar days of the start of the activity) | <ul style="list-style-type: none"> € PRAGMA/FSI CONTINUES TO MAINTAIN A “WATCHING BRIEF” ON THREATS AND DEVELOPMENTS, USING MEDIA MONITORING AND PROFESSIONAL CONTACTS. |
| <ul style="list-style-type: none"> € Improve record keeping | <ul style="list-style-type: none"> € PRAGMA/FSI’S INVOLVEMENT IN THIS AREA HAS BEEN DOWNGRADED FROM A PROACTIVE ROLE TO ONE OF ASSISTANCE (SEE ABOVE). |
| <ul style="list-style-type: none"> € Improve policies and supervision | <ul style="list-style-type: none"> € SEE “<i>ESTABLISHING STANDARDIZED (UNIFORM) REPORTS, METHODOLOGIES, NORMATIVE ACTS, AND SUPERVISION</i>” € PERFORMED PRELIMINARY LIQUIDITY ANALYSIS |

Task 1 Insurance – Supervision / DIS Efficiency

| Defined Activity | Progress Made During Quarter/Proposed Future Actions |
|---|--|
| <p>€ Assess Department of Insurance Supervision (DIS) current procedures and practices, organizational structure, supervisory framework, use of information technology, staff capabilities and training needs within 60 days of start of contract date for production of User Guide to be established within 30 days of start of contract dates of other relevant areas</p> | <p>€ TASK WAS COMPLETED PRIOR TO QUARTER</p> |
| <p>€ Develop framework for upgrading supervisory procedures and practices within 60 days of start of contract</p> | <p>€ INITIAL FRAMEWORK WAS DEVELOPED PRIOR TO QUARTER</p> |
| <p>€ Implement framework date for production of User Guide to be established within 30 days of start of contract</p> | <p>€ TASK WAS COMPLETED PRIOR TO QUARTER</p> |
| <p>€ Develop and deliver DIS training based on TNA date for production of User Guide to be established within 30 days of start of contract dates of other specific areas</p> <p>€ Identify foreign opportunities</p> | <p>€ TASK WAS COMPLETED PRIOR TO QUARTER</p> |
| <p>€ Develop and implement certification exams for relevant industry participants</p> | <p>€ AREAS (IF ANY) IN RESPECT OF WHICH CERTIFICATION EXAMINATIONS WILL BE REQUIRED ARE TO BE IDENTIFIED IN CONSULTATION WITH DIS</p> <p>€ THIS IS A LONGER-TERM ISSUE AND IS CURRENTLY A LOW PRIORITY</p> <p>€ NO ACTION TAKEN DURING QUARTER</p> |
| <p>€ Develop and implement dispute resolution regime</p> | <p>€ THIS WAS AN AREA IDENTIFIED DURING THE ASSESSMENT PHASE AS REQUIRING TRAINING</p> <p>€ IMPLEMENTATION MAY FACE LEGAL DIFFICULTIES, INCLUDING AMENDMENT OF OTHER LEGISLATION</p> |

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| | <p>€ DIRECTOR OF THE DIS ADVISES THAT HE PREFERS TO KEEP THIS ACTIVITY INTERNAL, INFORMAL AND LOW-KEY, DUE PRIMARILY TO RESOURCE CONSTRAINTS</p> <p>€ NO ACTION TAKEN DURING QUARTER</p> |
|--|--|

Task 2 Insurance – Legal Reform

| Defined Activity | Progress Made During Quarter/Proposed Future Actions |
|--|---|
| <p>€ Develop and pass legislation</p> | <p>€ FINAL DRAFTS OF LAWS FOR MOTOR VEHICLE AND COMMON CARRIER MANDATORY LIABILITY INSURANCE WERE TO BE SUBMITTED TO PARLIAMENT IN DECEMBER, 2001. HOWEVER, THE MAZHILIS REJECTED DRAFTS OF MANDATORY INSURANCE LAW DUE TO THE ABSAENCE OF AN INSURANCE INDEMNITY FUND EFFECTIVELY GUARANTEEING THE MANDATORILY INSURED AGAINST LOSS DUE TO FAILURE OF INSUROR</p> <p>€ DEVELOPED PROPOSAL FOR MANDATORY INSURANCE INDEMNITY FUND</p> |
| <p>€ Develop and promulgate regulations</p> | <p>€ DRAFT REGULATION ON OPERATIONS OF INSURANCE AGENTS PREPARED AND SUBMITTED TO NBK AND ASSOCIATION OF FINANCIERS INSURANCE DIVISION</p> <p>€ PRIOR TO THIS QUARTER, DRAFT REGULATION WHICH WOULD ALLOW INSURANCE COMPANIES TO CALCULATE THEIR OWN PREMIUMS FOR SOME TYPES OF MANDATORY INSURANCE WAS SUBMITTED TO NBK AND PARTIALLY ADOPTED</p> |
| <p>€ Assess rules and regulations within 60 days of start of contract</p> | <p>€ DISCUSSIONS CONTINUED ON HOW TO IMPLEMENT CUSTOMS BONDING INSURANCE</p> <p>€ FURTHER ASSESSMENT WILL FOLLOW THE PROMULGATION OF ALL NECESSARY REGULATIONS UNDER THE NEW INSURANCE LAW</p> |
| <p>€ Develop short-term plan (approved by DIS) to reform rules and regulations within 60 days of start of contract date for production of User Guide to be established within 30 days of start of contract</p> | <p>€ THIS WILL FOLLOW COMPLETION OF THE ASSESSMENT OF THE RULES AND REGULATIONS (SEE PRECEDING BOX)</p> <p>€ NO ACTION TAKEN DURING QUARTER</p> |
| <p>€ Develop and implement consumer protection measures, including trade practices and consumer disclosure requirements</p> | <p>€ NO ACTION TAKEN DURING QUARTER</p> |

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| Develop and implement rules for licensing € brokers € actuaries € auditors € companies € other relevant industry participants | € THESE WILL BE SET OUT IN THE REGULATIONS CURRENTLY UNDER EXAMINATION BY THE NBK € ACTUARIAL LICENSING REQUIREMENTS IMPLEMENTED DURING PAST QUARTER |
| Develop and issue other required regulatory documents: € guidelines € rulings € interpretation bulletins € best practices papers | € THESE ARE LONGER TERM GOALS, AND REFLECT MATURITY OF THE SUPERVISORY PROCESS AND FINE-TUNING OF LEGISLATION AND REGULATIONS. THE DIRECTOR OF THE DIS HAS ACKNOWLEDGED THE EVENTUAL NEED FOR SUCH DOCUMENTS € NO ACTION TAKEN DURING QUARTER |

LIST OF ATTACHMENTS

1. Memorandum on Mortgage Insurance from Sally Merrill and Douglas Whitely
2. Valuation of State Accumulation Pension Fund

D. MORTGAGE

I. COMPONENT DESCRIPTION

This report provides details on events and activities relating to the Mortgage Component of the USAID Financial Sector Initiative, as implemented by the Pragma Corporation, during the period from November 22, 2003 through February 21, 2004.

The primary purpose of the Mortgage Component is to provide technical, advisory, and training assistance to banks and non-bank financial institutions willing to start mortgage lending market operations and assist in developing mortgage origination, and to provide banks with the technical assistance necessary for securitization of mortgage pools in order to demonstrate how mortgage pools can be liquefied and proceeds re-lent. Further, it is to develop and support the legislative and regulatory framework for supporting the mortgage lending industry. A collateral activity, designed to increase mortgage origination as well as increased securitization, includes the introduction of National Mortgage Insurance.

II. SIGNIFICANT EVENTS

€ KMGF CONTINUES DRAFTING MASTER AGREEMENT/RECEIVES EQUIPMENT

€ FSI/IUE CONSULTANTS CONTINUE TECHNICAL ASSISTANCE TO KMC AND ORIGINATING BANKS

€ FANNIE MAE CONSULTANT COMPLETES ASSESSMENT OF KMC

€ FSI/USAID RECEIVES REQUEST FOR HOUSING FINANCE ASISTANCE FROM DEPUTY PRIME MINISTER PAVLOV

€ ACCUMULATION OF MORTGAGE ORIGINATION EXCEEDS \$275 MILLION

III. EXECUTIVE SUMMARY

The Mortgage component and the Financial Instruments component are inter-related.

During the quarter, the Kazakhstan Mortgage Guarantee Fund (KMGF) continued organizational activity. Previously, FSI had requested and received approval from USAID to purchase computer and office equipment for the Fund, not exceeding \$12,000. The KMGF received the equipment during the quarter. Deputy KMGF Director Gulfarus Shaikokova, assumed responsibility for the legal drafting of the master plan that will govern the terms and conditions of the fund with participating banks. FSI attorneys continued to work closely with the new deputy to complete the policy. Consultants from Pragma/FSI's sub-contractor IUE also worked on variants of the business plan to include different LTV ratios for "first tier" coverage i.e. the amount of a mortgage insured against default. The business plan included different premiums for each increase in coverage. For example, if the purchase price is \$10,000, LTV is 30/70 and the mortgage is made for \$7,000 the "top tier" coverage could be for the first 30% of loss or \$2,100. Different premiums assumptions for coverage of up to

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50% were used in the business model to reflect projected risk. These, in turn, were reflected in the business plan. The KMGF then distributed a description of the various products and pricing to banks for comment.

Dr. Lawrence Taff, a senior staff member from Fannie Mae, completed his assessment of the KMC in accordance with his pre-approved Scope of Work (*See Attachment 1*). Of special concern to the KMC was his evaluation of their operating procedures and duration matching. Dr. Taff also noted the lack of a suitable Government of Kazakhstan “risk free” benchmark (Government yield curve) to assist in pricing KMC issues. The maturity of Government of Kazakhstan debt is simply too short to provide pricing guidance. Dr. Taff also noted that a need for software that keeps track of duration for the KMC’s portfolio was not important at this time since the most of the portfolio was composed of floating rate instruments. Prior to his visit, this was a major concern of the KMC. Dr. Taff also met with USAID Mission Director George Deikun to discuss his preliminary findings and recommendations. FSI expects his final report during the fifteenth quarter at which time FSI will present it to USAID and the KMC.

During the thirteenth quarter, an assessment of conditions in Kazakhstan that would allow the introduction of title insurance was completed by Robert Cemovich and Walter Coles, consultants with Stewart Title based in Houston. In his conclusions, Cemovich stated that a title insurance industry was about to emerge in Kazakhstan. Further, he stated that no reserve or guarantee funds are in place. Title Insurance should be regarded as similar to a guarantee fund and not insurance. He recommended hosting a two-day conference on title insurance, involving representatives of the Ministry of Justice, National Bank, KMC, Centers for Real Estate Registration, National Agency for Land Resource Management and interested insurance companies, mortgage companies, banks, real estate professionals, notaries and lawyers. The agenda should address standardization, model regulations, and other topics to ensure integrity and confidence in title insurance. Since then, FSI has repeatedly tried to implement this recommendation with Stewart Title but did not succeed in the fourteenth quarter.

Pragma/FSI’s consultants from the Institute for Urban Economics continued technical assistance to local and regional banks that cooperate with the Kazakhstan Mortgage Company (KMC). Their emphasis included a review of compliance with KMC underwriting standards and efforts for improvement. One structural weakness identified in a KMC roundtable with originating banks was the lack of confidence in independent appraisals. This condition, in turn, has led to banks using their own appraisers. This lack of confidence derives from different appraisers using non-standard methodologies. FSI plans to remedy this deficiency by undertaking a series of roundtables with independent and bank appraisers participating together in order to agree on a standardized approach all appraisers can use to ensure acceptability. Another roundtable finding was unprofessional sales practices. FSI is considering the introduction of licensing requirements for all real estate sales persons. An assessment by FSI staff of real estate selling practices is currently underway (*See Attachment 2*).

FSI/USAID received a request from the First Deputy Prime Minister Pavlov to assist in the establishment of a pilot regional housing finance program. FSI’s COP and FSI’s CTO, Dr. Lewis Tatem met with a representative of the Prime Minister’s office in Astana, Mr. Kuanganov, to discuss the scope of the request and applicability to FSI’s expected results and deliverables. Mr. Kuanganov expressed his desire to execute a Memorandum of

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Understanding that would detail the technical assistance the Government of Kazakhstan could expect and the level of cooperation that FSI/USAID could expect from the Government of Kazakhstan. In response to First Deputy Prime Minister Pavlov's request, USAID Mission Director Deikun responded in a letter that there should be: (1) limited FSI assistance to consultations on the design of the concept, (2) a legal opinion identifying any legal impediments involved in the implementation of the concept and recommending changes or amendments to normative acts, (3) legal assistance in the establishment of the fund, and (4) technical assistance in structuring a bond issue by the fund with sufficient credit enhancements to meet market requirements (*See Attachment 3*). FSI/USAID has not received a response and due to the change in Government at the beginning of 2004, may not.

Cumulative residential mortgage origination during this quarterly period is approximately \$275 million, an increase of approximately \$57 million over the previous quarter. KMC issuance now stands at \$108 million. The KMC has conducted bi-monthly auctions for the purpose of ensuring predictability to investors and maintaining sufficient liquidity for the purchase of new mortgages.

III. ADMINISTRATIVE ISSUES

Commitment by Stewart Title to follow-up on Title Insurance Assessment

David Lucterhand, Senior Advisor, was absent December 19, 2003 through January 5, 2004.

V. DESCRIPTION AND STATUS OF TASKS

Task 1 – Legal and Regulatory Reform

| Defined Activity | Progress Made During Quarter/Proposed Future Actions |
|--|---|
| § Assessment of rules and regulations for the mortgage sector | § COMPLETED BY IUE |
| § Work plan for reform of rules and regulations | § COMPLETED BY IUE |
| § Work plan for development of mortgage default insurance | § COMPLETED BY IUE |
| § Assessment of rules and regulations relevant to default insurance and recommendations for development of such a product, including relevant data collection | § COMPLETED BY IUE AND UI |
| § Implementation of work plan for reform of mortgage lending rules and regulations, including development of needed legislation | § AN AMENDMENT NOW EXISTS THAT EXCLUDES REAL ESTATE COLLATERAL (PLEDGE) USED IN MORTGAGE BACKED-SECURITIES FROM BANKRUPTCY ESTATE CONSTITUTING A MAJOR STEP IN THE REFORM OF BANKRUPTCY STATUTES. |

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Task 2 – Creating Fully Trained Mortgage Banking Personnel

| Defined Activity | Progress Made During Quarter/Proposed Future Actions |
|--|---|
| <p>§ Review of mortgage banking courses and materials developed by Housing Sector Reform Project</p> | <p>§ THIS WAS COMPLETED THROUGH CONSULTATION WITH PRAGMA/FSI'S COP AND IUE STAFF IN MOSCOW.</p> |
| <p>§ Framework for mortgage banking training developed</p> | <p>§ THIS WAS COMPLETED THROUGH CONSULTATION WITH PRAGMA/FSI'S COP AND IUE STAFF IN MOSCOW. THE FIRST MODULE OF COURSES WAS COMPLETED IN APRIL 2000. A REPEAT OF THESE COURSES WAS OFFERED IN MARCH AND APRIL 2002. DELIVERY OF ANOTHER CML COURSE BEGAN IN FEBRUARY 2003, IN COOPERATION WITH THE KAZAKHSTAN MORTGAGE COMPANY (KMC). PARTS TWO AND THREE WERE COMPLETED IN MARCH AND APRIL.</p> <p>§ 62 PERSONS HAVE NOW RECEIVED CERTIFIED MORTGAGE LENDER (CML) DESIGNATION. CML TRAINING IS NOW OFFERED BY THE KMC WITH OVERSIGHT PROVIDED BY IUE.</p> |
| <p>Development of strengthened modules for:</p> <ol style="list-style-type: none"> 1. Alternative mortgage instruments, including spreadsheet program for class use 2. Features of different mortgage securities - "mortgage bank model" use of guarantees 3. Adjust courses to Kazakh situation; develop local case studies 4. Development of loan servicing simulation software | <p>€ THE CML CURRICULUM WAS CUSTOMIZED TAKING INTO ACCOUNT 1, 2 & 3 AND KAZAKHSTANI PRACTICES, AND INCORPORATED INTO THE THREE MODULES COMPLETED IN APRIL 2000 FOR USE BY THE TRAINERS OF THE ALMATY BANK TRAINING CENTER (ABTC). THE CURRENT CURRICULUM WAS FURTHER UPDATED TO EMPHASIZE THE BENEFITS OF SECURITIZATION SINCE KAZAKHSTANI BANKS AS WELL AS THE KMC ARE NOW ISSUING MORTGAGE-BACKED SECURITIES. IT IS ESSENTIAL THAT PRACTITIONERS UNDERSTAND THE RELATIONSHIP BETWEEN PRIMARY ORIGINATION AND SECONDARY MARKET ISSUANCE ESPECIALLY AS IT RELATES TO UNDERWRITING STANDARDS FOR CONFORMING LOANS.</p> <p>§ TWO TRAINERS FROM THE ABTC ATTENDED AND COMPLETED COURSES I, II AND III, AND RECEIVED THE DESIGNATION OF 'CERTIFIED MORTGAGE LENDER'. SINCE THEN, MORTGAGE EXPERTS FROM IUE HAVE PROVIDED ONGOING TECHNICAL ASSISTANCE TO THE ABTC IN TEACHING, COURSE DEVELOPMENT AND CONTENT. DURING A FEBRUARY VISIT AND REVIEW OF MATERIALS AND INSTRUCTOR CONTENT KNOWLEDGE, IUE CONSULTANTS DELAYED DELIVERY OF ABTC'S CML MORTGAGE TRAINING COURSE IN ORDER TO REFINE THE CURRICULUM AND TEACHING METHODS. THE COURSES WERE DELIVERED IN MARCH AND APRIL 2002. HOWEVER, IUE CONSULTANTS DO NOT FEEL THAT TEACHING STANDARDS ARE HIGH ENOUGH TO CONTINUE USING ABTC AS A PROVIDER. AFTER CONSULTATION, THE KAZAKHSTAN MORTGAGE COMPANY AGREED TO BEGIN PROVIDING CML COURSES AFTER APRIL 2003. THE NBK ALREADY</p> |

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|--|---|
| | <p>REQUIRES A CML DESIGNATION FOR ANY BANK MORTGAGE DEPARTMENT EMPLOYEE DOING BUSINESS WITH THE KMC. FSI COMPLETED ‘TRAINING THE TRAINERS’ FOR KMC AT THE END OF APRIL. THE KMC IS NOW CONTINUING THIS COURSEWORK- ENSURING SUSTAINABILITY OF MORTGAGE LENDING TRAINING.</p> <p>THE LOAN SIMULATION SOFTWARE CURRENTLY AVAILABLE HAS NOT BEEN UPDATED DUE TO THE EXPENSE INVOLVED AND USE BY BANKS OF MORE MODERN SYSTEMS. CONSEQUENTLY, THIS EFFORT HAS BEEN CURTAILED. RECOMMENDATIONS FOR SOFTWARE SPECIFICALLY DESIGNED FOR LOAN SERVICING AND CURRENTLY AVAILABLE IS CONTAINED IN THE FANNIE MAE VISIT TO THE KMC.</p> |
|--|---|

Task 3 – Develop Action Plans for Mortgage Lending Infrastructure and Implement Selected Plans

| Defined Activity | Progress Made During Quarter/Proposed Future Actions |
|--|---|
| <p>§ Formation of independent appraisal association</p> | <p>§ THE KAZAKHSTAN SOCIETY OF REAL ESTATE APPRAISERS IS NOW FUNCTIONING AS A REGISTERED LEGAL ENTITY. ITS FORMAL NAME IS THE UNION OF APPRAISERS. FSI CONTINUES TO SUPPORT EDUCATIONAL ACTIVITIES AND IS CONTINUING COOPERATIVE ACTIVITIES WITH THE ARIZONA-KAZAKHSTAN PARTNERSHIP</p> |
| <p>§ Formation of professional real estate brokers association.</p> | <p>§ COMPLETED IN FEBRUARY 2002. A FINAL BUSINESS PLAN WAS PREPARED AND PRESENTED TO THE NBK. THE PLAN INCORPORATED GOVERNOR MARCHENKO’S COMMENTS REGARDING THE NEED FOR DETAILED PROCEDURES FOR PAYING CLAIMS AND RECOVERY BY THE MORTGAGE INSURANCE COMPANY OF KAZAKHSTAN. THE PLAN WAS SUBMITTED TO THE NBK AND APPROVED BY THE BANK’S SUPERVISORY BOARD. IN SEPTEMBER. THE PLAN INCLUDES \$5MILLION IN CAPITAL. PROVIDED BY THE NBK. AND \$1 MILLION FROM USAID TO FUND OPERATIONAL EXPENSES. AS A RESULT, A NATIONAL MORTGAGE INSURANCE WORKING GROUP CONSISTING OF BANKS, THE NBK, THE ALMATY ASSOCIATION OF REALTORS WAS FORMED IN THE SPRING OF 2002. SINCE THEN FSI HAS SUPPORTED THEIR PROFESSIONAL DEVELOPMENT FUNDING SEMINARS AND EDUCATIONAL TRIPS THAT EMPHASIZE ETHICS IN SELLING PRACTICES AND TRANSPARENCY IN REAL ESTATE TRANSACTIONS. DURING THE QUARTER AND IN COOPERATION WITH THE RUSSIAN GUILD OF REALTORS, FSI FUNDED AND PARTICIPATED IN A SEMINAR DEDICATED TO THE USE OF ETHICS IN PROFESSIONAL PRACTICE. FOLLOWING THE AFORESAID ROUNDTABLE, FSI PLANS TO INTRODUCE A PLAN FOR CERTIFICATION AND LICENSING OF REAL ESTATE SALES PERSONS.</p> |
| <p>§ Devise or adjust methodology for appraisal of property that is being mortgaged</p> | <p>§ FSI IN COOPERATION WITH THE KMC AND THE BANKS HELD A ROUND TABLE ON HOW TO IMPROVE COORDINATION. DURING DISCUSSION, MANY PARTICIPANTS HIGHLIGHTED THEIR LACK OF CONFIDENCE IN THE EMPLOYMENT OF A STANDARDIZED APPRAISAL METHODOLOGY. CONSEQUENTLY, FSI ORGANIZED A SEPARATE MEETING WITH THE CHAMBER OF APPRAISERS AND A REPRESENTATIVE OF THE BANKING COMMUNITY, BTA MORTGAGE. AS A RESULT, A MEMO OUTLINING OUTSTANDING</p> |

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| <p>§ Establish methods and terms of mortgage risk insurance</p> | <p>ISSUES DISCUSSED WAS PREPARED BY FSI AND DISDRIIBUTED TO EACH FOR COMMENT. A FOLLOW-UP MEETING IS PLANNED ON HOW BEST TO ADDRESS THESE DEFICIENCIES. THE LACK OF A UNIFORM METHOFOLGY IN APPRAISING REAL ESTATE HAS LED BANKS TO USE FOREGO USING INDEPENDENT APPRAISERS AND EMPLOY THEIR OWN. DURING THE NEXT QUARTER, FSI ANTICIPATES HOLDING ANOTHER ROUNDTABLE WHEREBY THE MARKET PARTICIPANTS WILL TRY AND ARRIVE AT A COMMON APPRAISAL APPROACH.</p> <p>§ A FEASIBILITY STUDY CONDUCTED BY THE URBAN INSTITUTE AND THE INSTITUTE FOR URBAN ECONOMICS IN MOSCOW WAS AND FSI CONSULTANTS WAS SET UP TO ADDRESS THE SPECIFICS OF SETTING PREMIUMS AND DESIGNING THE MASTER POLICY WHICH GOVERNS THE RELATIONSHIP BETWEEN THE BANKS AND THE NATIONAL MORTGAGE INSURANCE ENTITY. AFTER REVIEWING WORKING GROUP RESULTS, THE NBK APPOINTED A NEW CHAIRMAN OF THE KMGF GIVING FSI A COUNTERPART WITH WHOM TO WORK. DEVELOPMENT OF LEGAL DOCUMENTS INCLUDING THE MASTER POLICY WHICH GOVERNS THE RELATIONSHIP BETWEEN THE KMGF AND THE BANKS IS BEING DEVELOPED AND ORGANIZATION OF THE FUND IS NOW UNDERWAY. ADDITIONALLY, DIFFERENT KMGF PRODUCTS HAVE BEEN DISTRIBUTED TO BANKS FOR COMMENT.</p> <p>§ FSI/UI CONSULTANTS ALSO ANALYZED NBK CAPITAL RESERVE REQUIREMENTS FOR MORTGAGE LENDING AND PREPARED A DRAFT MEMORANDUM FOR NBK CHAIRMAN GOVDERNOR MARCHENKO WITH SUGGESTIONS FOR LOWERING THESE REQUIREMENTS ON MORTGAGES HAVING KMGF GUARANTEES. THESE RECOMMENDATIONS WERE GIVEN TO THE NEW KMGF CHAIRMAN PRIOR TO SUBMISSION TO GOVERNOR MARCHENKO.</p> |
| <p>§ System of registration of real estate rights and transactions</p> | <p>§ AN ANALYSIS OF THE OVERALL PROPERTY REGISTRATION SYSTEM WAS COMPLETED. THE ANALYSIS NOTED FEW IMPEDIMENTS TO THE ESTABLISHMENT OF TITLE INSURANCE BE IDENTIFIED. NEXT STEPS INCLUDE ORGANIZING A CONFERENCE OF INTERESTED PARTIES.</p> |

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Task 4 – Rules and Procedures of Retail Mortgage Lending

| Defined Activity | Progress Made During Quarter/Proposed Future Actions |
|--|---|
| <p>Assessment of:</p> <p>§ Bank internal rules and procedures for retail mortgage banking</p> <p>§ External rules and regulations for retail banking</p> | <p>§ COMPLETED AS PART OF THE IUE ASSESSMENT.</p> <p>§ COMPLETED AS PART OF THE IUE ASSESSMENT.</p> |
| <p>§ Work plan to establish rules and procedures for retail mortgage lending</p> | <p>§ COMPLETED AS PART OF THE IUE ASSESSMENT. RESULTS WERE REFLECTED IN UPDATED CML COURSEWORK.</p> |
| <p>§ Standards for mortgage underwriting, loan documentation rules, mortgage contracts</p> | <p>§ THIS WAS UPDATED FOR INCLUSION IN CML COURSEWORK THAT WAS COMPLETED IN APRIL 2002. THE CURRICULUM WAS UPDATED TO REFLECT DEVELOPMENT OF THE SECONDARY MORTGAGE MARKET IN KAZAKHSTAN.</p> |

LIST OF ATTACHMENTS

1. Schedule for Lawrence Taff's trip
2. Memorandum for Round Table
3. Letter to First Deputy Prime Minister Pavlov

E. CREDIT BUREAU/CREDIT RATING AGENCY

I. COMPONENT DESCRIPTION

Credit Bureau

This report provides details on events and activities relating to the Credit Bureau/Credit Rating Component of the USAID Financial Sector Initiative, as implemented by the Pragma Corporation, during the period from November 22, 2003 through February 21, 2004.

The objective of this activity is to establish a Credit Bureau and rating agency capacity in Kazakhstan. A Credit Bureau serves as a financial intermediary between the lender and the borrower in order to stimulate, in the first instance, the SME and retail markets within a free market competitive economic system.

A Credit Bureau helps to develop a solid middle class and produces both short and long term benefits to an economy by empowering the citizens in any country with greater mobility, greater opportunity, and, in the long run, by providing individuals with greater resilience against economic shocks. A Credit Bureau provides products, services, convenience, security, acknowledgment, accessibility, and low costs to all individuals in society. The result of this is increased access to credit across the income spectrum, greater purchasing power for individuals and the improved transparency of small businesses. This message has been clearly received and reconfirmed over the past 3 months by the Government of Kazakhstan and the financial sector.

The practical definition of a Credit Bureau, for design and implementation purposes in Kazakhstan, is one of an impartial entity that will store all past and present credit transactions entered into by a particular legal or physical person, and one that will indicate the manner in which the subject of the credit profile repaid the obligation to the respective creditors. The Credit Bureau will also contain demographic information on the subject to ensure proper identification, information that is pertinent to their creditworthiness, and an indication of the overall risk relating to an applicant as regards the repayment of newly established credit, such as inquiries by other parties with a permissible purpose. The Credit Bureau will provide an avenue for the verification or validation of any information that may be questioned or disputed by the subject of the credit profile. A Credit Bureau serves both parties in a credit transaction and is an excellent tool to reduce risk and facilitate and accelerate the approval process.

The Credit Bureau component of FSI remains a high priority for Kazakhstan. From November 22, 2003 through February 21, 2004, Pragma/FSI built on successes in the last quarter by pushing forward the draft Credit Bureau law, consolidating the commercial banks' interest in Kazakhstan to fund a private Credit Bureau, and deepening awareness in the financial sector of a Credit Bureau's role regarding risk management and increased access to credit for consumers.

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The Government of Kazakhstan is determined to establish a system of private Credit Bureaus that will serve the entire country. Towards this end, the Government of Kazakhstan officially submitted to the Mazhilis the draft Credit Bureau Law in December 2003. During the first two months of 2004, the Mazhilis began preliminary consideration of the law, which is expected to pass both Houses of Parliament by the beginning of the 3rd quarter 2004. In order to ensure successful passage of the law, Pragma/FSI continued to work with all stakeholders, particularly the NBK, the Unified Regulatory Authority and the Association of Financiers of Kazakhstan, to reach a common position on the remaining major Credit Bureau policy items before fully debate of the law begins in March 2004. Pragma/FSI was asked to make a presentation to the Mazhilis on March 16, 2004 in order to better inform the members of Parliament about the functions and objectives of a Credit Bureau.

Preparation for full debate of the Credit Bureau Law remained a key focus of efforts from November 22, 2003 through February 21, 2004. The draft law touches on one of the most sensitive issues surrounding the establishment and operation of a Credit Bureau: the trade-off between the protection of personal privacy and the flow of information. In February 2004, Pragma/FSI reviewed with the Unified Regulatory Authority the importance and purpose of Credit Bureaus within the context of European and North American legal environment.

During the quarter, Pragma/FSI was able to secure additional agreement with the major stakeholders – the government agreed in principle to establish a “universal Credit Bureau”, i.e., a Credit Bureau that would include both SME data and private consumer data in a single Credit Bureau, thus avoiding data fragmentation, and secondly USAID/FSI, Experian Ltd, and individual private banks agreed to sign a Memorandum of Understanding outlining the roles and intentions of the various stakeholders.

Rating Agency

The rating agency part of this component is central to the development of financial markets and for making effective financial intermediation possible in Kazakhstan. Lenders and market participants need to be able to assess risk in order to engage in credit relationships. Moreover, free economies require the open transfer of information among market participants. An informed market also leads to improved prudential lending in traditionally volatile markets, thus stimulating economic growth and development for a larger segment of the population.

The objective of the rating component remains to develop the capabilities for providing valuation services and credible financial information for judging risks inherent in financial instruments in Kazakhstan over the medium term. Other medium term objectives are to develop risk analysis capabilities, to build the confidence and serve the needs of both domestic and international investors by providing them with analysis, advice, and database resources, to enhance investment transparency, and also to prepare the ground for delivery of financial and investment information by offering a range of products and services that meet the credit risk management needs of financial institutions and investors.

II. SIGNIFICANT EVENTS

- € USAID/FSI, EXPERIAN, AND INDIVIDUAL PRIVATE BANKS AGREE TO SIGN MEMORANDUM OF UNDERSTANDING OUTLINING ROLES AND INTENTIONS OF VARIOUS STAKEHOLDERS.
- € MAZHILIS SETS DATE OF MARCH 16, 2004 FOR FSI TO MAKE A PRESENTATION TO THE MEMBERS OF PARLIAMENT. EXPERIAN AGREES TO MAKE A PRESENTATION IN ASTANA
- € FSI AND UNIFIED REGULATORY AGENCY AGREE TO SCHEDULE CREDIT BUREAU SHAREHOLDERS' MEETING, MARCH 5, 2004. EXPERIAN (UK) AND IFC (WASHINGTON) AGREE TO MAKE PRESENTATIONS TO POTENTIAL SHAREHOLDERS.
- € NBK ISSUES OFFICIAL LETTER SUPPORTING FSI INITIATIVE TO HOLD SHAREHOLDERS MEETING FOR PRIVATE CREDIT BUREAU INVESTORS.
- € PRAGMA/FSI MADE AN OFFICIAL MEMBER OF THE WORKING GROUP AT THE MAZHILIS THAT REVIEWS CREDIT BUREAU LAW
- € GOVERNMENT AGREES IN PRINCIPLE TO INCLUDE SME DATA IN PRIVATE CONSUMER CREDIT BUREAU, AVOIDING DATA FRAGMENTATION.
- € CONSUMER CONSENT RECONFIRMED AS KEY PART OF CREDIT BUREAU LEGISLATION

IV. EXECUTIVE SUMMARY

From November 22, 2003 through February 21, 2004, FSI continued to initiate actions to create the framework for a credit reporting system that would meet the needs of Kazakhstan and bring the project from the feasibility/development phase to the implementation phase.

During the past quarter, Pragma/FSI focused on the passage of the Credit Bureau Law, investor relations, and defining the Unified Regulatory Agency's powers and responsibilities with respect to credit bureaus. In addition, FSI continued to expand public awareness by visiting individual banks and building on the messages conveyed in published articles during the previous quarter regarding credit bureaus. Visits to banks, and tangible support from the NBK, led to agreement on holding a shareholders meeting and to signing a Memorandum of Understanding.

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The Memorandum of Understanding will indicate that the banks agree to provide either foundational capital for the Credit Bureau in Kazakhstan or services, and agree to provide their credit information in accordance with the requirements of the law and legislation governing the activities of the Credit Bureau in the Republic of Kazakhstan. When signed, this document will prove to be significant when discussing the specifics of the business plan, shareholder structure and the role of a professional operator such as Experian. Preliminary feedback indicates that all the major banks will sign the Memorandum of Understanding. Non-banking organizations such as Kaztelecom and Experian appeared ready to sign.

FSI, the NBK, the Unified Regulatory Authority and the Association of Financiers of Kazakhstan agreed to schedule a Credit Bureau shareholders' meeting on March 5, 2004. Experian (UK) and IFC (Washington) further agreed to make presentations to potential credit bureau shareholders. Given the importance of the meeting, the NBK signed an official letter of endorsement supporting the shareholders meeting; this letter clearly underscores the urgency of Pragma/FSI's activities (*See Attachment 1*). To further underscore FSI's activities and the upcoming shareholder's meeting, the Chairman of the URA agreed to send out letters of invitation to the entire banking community wherein he emphasized that attendees at the conference should only be the senior management of the banks. Preliminary discussions with the Chairman of the NBK suggested that he would chair the shareholders meeting.

During the quarter, the Mazhilis set a date of March 16, 2004 for Pragma/FSI to make a presentation to the members of Parliament with respect to the Credit Bureau law. Experian agreed to be present in Astana during "the Questions and Answers" period. Experian's visit to the Mazhilis would represent its 4th trip to Kazakhstan. Experian continued to show real interest in helping to establish a Credit Bureau in Kazakhstan, unlike other major private Credit Bureau operators throughout the world.

As was noted in earlier quarterly reports, certain provisions of the draft Credit Bureau law contained a number of features which were not entirely consistent with international best practice and with the 1998 European Union Data Processing laws. However, between November 22, 2003 and February 21, 2004, all major outstanding issues appeared to be brought into line with best practice. The government agreed in principle to include SME data in the private consumer Credit Bureau, thus avoiding data fragmentation and thus recognized the linkage between SME and consumer data for processing purposes. In essence, the government agreed to amend its view in the draft law which had established a split system - a "Consumer Credit Bureau" and a separate "Small Business Bureau". The government also agreed to limit the amount of regulatory oversight which remains a contentious issue. Pragma/FSI continued to argue that while regulation is necessary and the responsibility of the government, some limits must be imposed to avoid "overreach". One other key issue was that consumer consent was reconfirmed as a key part of Credit Bureau legislation because of the need to protect consumer privacy and confidential information. Moreover, the responsibility of "checking" the validity of the consumer consent was shifted from the Credit Bureau to the private banks.

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Discussions continued with banks on how to improve strategies for SME business and consumer finance given the emergence of a Credit Bureau. FSI continued discussions regarding the development of credit scoring products and other services, such as fraud detection for the banking. Credit bureaus offer their clients expert services and products to help detect potential fraud from new and existing clients.

As of February 21, 2004, the draft law does not yet allow insurance companies to participate in the Credit Bureau system. While this is not optimal, the point is still under review. The participation of insurance companies is not critical for Credit Bureau operations at this time in Kazakhstan. Indications remained that the inclusion of insurance data will be a “second step” after demographic and credit information is loaded in the Credit Bureau database.

Discussions with potential international investors continued and revolved around the status of the draft law, the business case, and related technical issues. Experian and the IFC have again reconfirmed their willingness to provide technical assistance and/or strategic investment at the right time and under the right conditions. Experian has been considering a joint venture (direct foreign investment) with the local banks but needs further clarity with respect to the law. Experian has been clear, on the other hand, regarding technical assistance and with respect to hosting an “off shore” Credit Bureau as it is currently developing for Bulgaria and in other markets. Kaztelecon has expressed strong support for the Memorandum of Understanding and has indicated that it will attend the shareholders meeting on March 2003. Pragma/FSI commenced discussions with Kaztelecon during the period regarding their potential participation as a shareholder in the Credit Bureau.

The debate over the role and powers of the Supervisory Body remained a critical issue and is linked to the complex responsibilities of Unified Regulatory Authority” which oversees “data processing”. It is clear, however, that the Government understands the link between information flows, on the one hand, a pillar of free market economic systems, and privacy, on the other. It is expected that the “privacy vs. data flows debate” will figure prominently in the upcoming parliamentary debates at the Mazhilis. As such, Pragma/FSI was named as an official member of the Mazhilis Working Group which will review the Credit Bureau law

The Government upheld previous statements regarding privacy protections and consumer consent. Because of the importance of privacy issues given the historical legacy of the former Soviet Union, this reconfirmation must be considered a major policy shift from earlier drafts of the law. FSI continued to reinforce the concept that any credit reporting system must reflect basic principles which underpin a consumer’s right to privacy (i.e., the right to obtain a credit report within a reasonable time, at a reasonable cost, and in a reasonable way; the right to dispute data and have it corrected in a timely fashion; the right to know the purpose for data collection; the right to limit the type of data collected, the right to limit its transferability; the right to demand that data be accurate; and the right to know that there are remedies in the event of data misuse).

There have been no changes in the draft law regarding investment. International and local private investors are welcome to found a Credit Bureau subject to licensing. The Credit

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Bureau will operate in a competitive free market environment (in other words, there will be no monopoly by the largest banks). The idea of foreign investment, as well as the possibility of establishing a “full file” database, has also been reconfirmed by the Chairman of the Unified Regulatory Authority. In a number of East Asian countries, some Credit Bureaus maintain “negative” databases only, which most experts believe has contributed to over-indebtedness and to poor consumer bank portfolios in countries such as Hong Kong, South Korea and Malaysia. Kazakhstan chose a “full file” system, based on Pragma/FSI’s recommendations.

The Credit Bureau Working Group, which consisted of the major banks in Kazakhstan and the Unified Regulatory Authority, continued to meet on a regular basis in connection with commercial, technical, and legal issues. The Unified Regulatory Authority replaced the NBK as the main participant in the Working Group.

There was no change to FSI’s report last quarter regarding the establishment of a rating agency in Kazakhstan. As such, there was little progress in convincing one of the major rating agencies to develop a long-term interest in Kazakhstan. To date, “brand name” agencies to enter the Kazakhstani market although this situation could change suddenly given current macro economic and banking conditions in Kazakhstan.

The objectives for the establishment of the framework for a credit rating agency, as reflected in previous quarterly reports, continue to be to set the stage for industry ratings and for differentiation among various financial instruments such as junk bonds, public securities, and investment grade or high-yield securities. Other objectives are to develop an effective and practical framework for improving the ability of investors to assess bank and corporate risk, including long and medium term debt, commercial paper, bank loans, preferred stock and common equity, and also to develop an effective and practical mechanism for assessing corporate governance, public finance, markets and competition, and sovereign and transfer risk.

V. ADMINISTRATIVE MATTERS

Javier Piedra, Senior Advisor, was absent December 27, 2003 through January 18, 2004.

FSI contracted Mr. Anvar Akmetov, a financial and credit specialist, on a short term basis.

III. DESCRIPTION AND STATUS OF TASKS

Task 1 – Credit Bureau

| Defined Activity | Progress Made During Quarter/Proposed Future Actions |
|--|---|
| <p>PHASE I</p> <ul style="list-style-type: none"> € Complete a feasibility study on the possibility of establishing a Credit Bureau in Kazakhstan € Analyse the legal environment for the creation of a Credit Bureau | <p>€ COMPLETED - FOR DETAILS SEE 6TH QUARTERLY REPORT</p> |
| <p>PHASE II</p> <ul style="list-style-type: none"> € Develop a Credit Bureau in Kazakhstan € Develop and Distribute a business plan and a detailed operations/technical implementation plan € Design a marketing and PR campaign € Develop the legislative package and actively resolve any legal issues € Work toward drafting a Credit Bureau law. | <p>COMPLETED OR INITIATED AS OF FEBRUARY 21, 2004:</p> <ul style="list-style-type: none"> € USAID/FSI, EXPERIAN, AND INDIVIDUAL PRIVATE BANKS AGREE TO SIGN A MEMORANDUM OF UNDERSTANDING OUTLINING THE ROLES AND INTENTIONS OF THE VARIOUS STAKEHOLDERS. € MAZHILIS SETS DATE OF MARCH 16, 2004 FOR PRAGMA/FSI TO MAKE A PRESENTATION TO THE MEMBERS OF PARLIAMENT. EXPERIAN AGREES TO MAKE A PRESENTATION IN ASTANA ALSO. € NBK SUPPORTS IN OFFICIAL LETTER PRAGMA/FSI INITIATIVE TO HOLD A SHAREHOLDERS MEETING FOR PRIVATE CREDIT BUREAU INVESTORS. . € FSI CONTINUED TO HONE DRAFT CREDIT BUREAU LAW FOR THE GOVERNMENT THROUGH REGULAR MEETINGS WITH THE BANKERS ASSOCIATION AND WITH THE UNIFIED REGULATORY AGENCY € PRAGMA/FSI MADE AN OFFICIAL MEMBER OF THE WORKING GROUP AT THE MAJALIS WHICH WILL REVIEW THE CREDIT BUREAU LAW € GOVERNMENT AGREES IN PRINCIPLE TO INCLUDE SME DATA IN PRIVATE CONSUMER CREDIT BUREAU, THUS AVOIDING DATA FRAGMENTATION. € CONSUMER CONSENT RECONFIRMED AS KEY PART OF CREDIT BUREAU LEGISLATION BECAUSE OF THE NEED TO PROTECT CONSUMER PRIVACY BEFORE TRANSFER OF PRIVATE INFORMATION TO THIRD PARTIES € PRAGMA/FSI CONTINUED TO HONE DRAFT CREDIT BUREAU LAW FOR THE GOVERNMENT THROUGH THE REGULAR MEETINGS OF THE BANKERS ASSOCIATION/NBK WORKING GROUP € SIGNIFICANT GAINS IN MARKETING CREDIT BUREAU TO NON-FINANCIAL SECTOR |

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| <p>PHASE III</p> <ul style="list-style-type: none"> € Establish a Credit Bureau in Kazakhstan € Create a credit reporting system € Construct a data base | <ul style="list-style-type: none"> € FSI AND UNIFIED REGULATORY AGENCY AGREE TO SCHEDULE CREDIT BUREAU SHAREHOLDERS' MEETING ON MARCH 5, 2004. € EXPERIAN (UK) AND IFC (WASHINGTON) AGREE TO MAKE PRESENTATIONS TO POTENTIAL CREDIT BUREAU SHAREHOLDERS. |
|---|--|

Task 2 – Credit Rating Agency

| Defined Activity | Progress Made During Quarter/Proposed Future Actions |
|--|---|
| <ul style="list-style-type: none"> € Create conditions and interest favorable to establishing a credit rating agency in Kazakhstan by holding second credit ratings training. € Identify credit agency willing to establish office in Kazakhstan | <ul style="list-style-type: none"> € NO SIGNIFICANT CHANGE SINCE THE 11TH QUARTERLY REPORT. NO MAJOR RATING AGENCY SUCH AS MOODY'S OR S&P HAS SHOWN INTEREST IN THE KAZAKHSTANI MARKET DURING THE LAST QUARTER. IT IS EXPECTED THAT INTEREST WILL GROW AS THE ECONOMY CONTINUES TO CONSOLIDATE AND BANK CREDIT EXPANDS. |

LIST OF ATTACHMENTS

1. Letter of Endorsement from National Bank of Kazakhstan

OVERVIEW ATTACHMENTS

Quarterly Review/Month 39

Almaty, December 12, 2003

Financial Sector Initiative Kazakhstan

Establishing the leading Edge

Sponsored by:

The US Agency for International Development

Presented by:

The Pragma Corporation



Establishing the leading edge

Today's Presentation includes:

- I. Progress review (through month 39)
June through November 2003**
- II. The project's financials**
- III. FSI financial instruments (explanation)**



Financial Sector Initiative in
Kazakhstan

Establishing the leading edge

The Leading Edge in Financial Sector Development...

- Creating opportunities for creation of a Middle Class though increased access to credit;
- Interventions that are timed to political and economic opportunities as they arise;
- Developing financial market infrastructure and economic growth in Kazakhstan.



Financial Sector Initiative in
Kazakhstan

Establishing the leading edge

To Build Investment Capacity and Wealth, FSI is developing :

- Financial instruments for domestic investment
- The mortgage industry including the primary and secondary Mortgage market
- The insurance industry and consolidation of pension funds
- A Credit Bureau for Kazakhstan



Financial Sector Initiative in
Kazakhstan

Establishing the leading edge

Developing financial instruments for domestic investment

1. Corporate bonds (1)
2. Warehouse receipts (1)

Structured instruments (5)

1. Mortgage Backed Securities (2)
(1 completed)
2. Asset-backed security (1)
3. Principal protected note (1)
4. Kazakhstan Mortgage Company bond (1)
(2 completed)

Total (7)



Financial Sector Initiative in
Kazakhstan

Establishing the leading edge

The 100th Anniversary of Flight (Kitty Hawk-NC)

THE ANALOGY

(Taxi to take-off, climb, cruise, descend, land, and taxi to destination)

1. Taxi/takeoff – Research and assessment, identify and design intervention, time and launch
2. Climb/cruise –
 - a) Developing support infrastructure
 - b) Developing products and markets
 - c) Issuance and investment (trade) in the market place
3. Descent/landing –
 - a) Developing liquidity
 - b) Eliminating impediments
4. Taxi/destination –
 - a) Progressive removal of TA
 - b) Sustainability



Financial Sector Initiative in
Kazakhstan

Establishing the leading edge

Financial Instrument

The Example of Mortgage Backed Securities (MBS)

From \$500,000 to \$65 M to \$200 M to \$700 M est.)

Cruise

issuance

- 1- Lariba MBS (starting in Feb. 2000)
(Jan. 2003 - Jan 2006) \$500,000/3yr. bond
- 2- Kaz. Mortgage Company Bond (starting Jan. 2001)
(Oct. 2002, Oct. 2005) \$4 M/3yr. bond
- 3- Kaz. Mortgage Co. Agency Bond
(Oct. 2003, Oct. 2013) \$60 M/10yr. bond

Descent/
landing

Liquidity

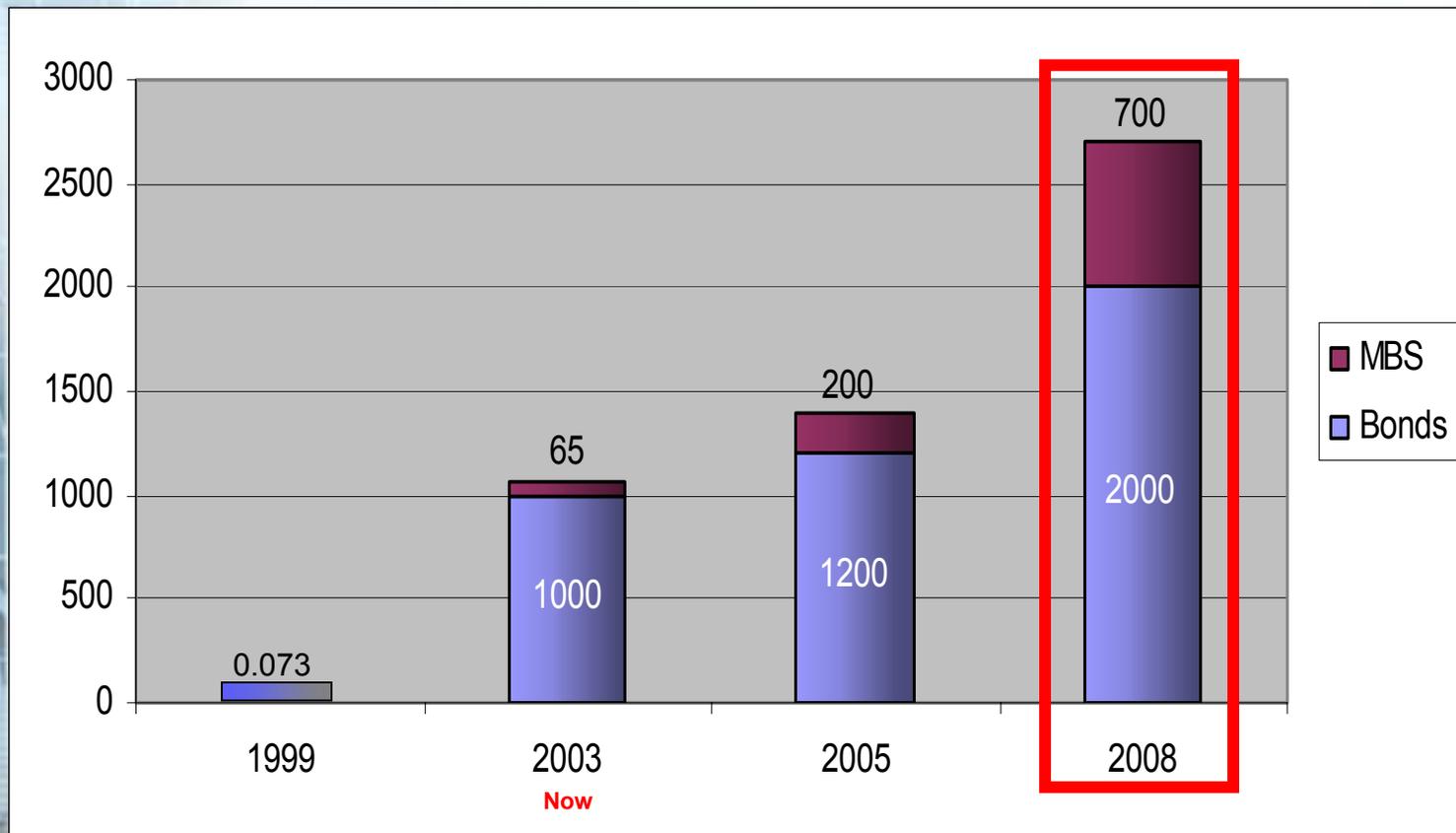
- Increased issuance of mortgage and asset backed securities
- Enhanced trade of mortgage and asset backed securities
(Feb. 00 - Aug. 2005)
- THE NEW FRONTIER - Ensuring sufficient volume through Securitization: the use of special purpose vehicles to issue bonds collateralized by credit card receivables, car loans, real estate leases etc. to reduce risk.

A value added activity to our contract (Oct. 2004- Oct. 2008)

Establishing the leading edge

THE NEW FRONTIER

Millions USD



Financial Sector Initiative in Kazakhstan

Establishing the leading edge

Developing the mortgage industry

During the past six months:

1. Completed assessment of real estate registration centers
2. Created the KMGF
3. Provided TA to management of newly created KMGF
4. Organized round table discussions between KMC and the banking community
5. Provided TA to banks throughout Kazakhstan

Through April 2004

1. Introduce title insurance
2. Assist KMGF to become operational
3. Harmonize KMC and bank underwriting standards
4. Continue TA to banks regionally



Establishing the leading edge

**Development of:
Insurance industry and the Pension fund**

During the past six months:

1. Formed and directed insurance legal working group
2. Developed the Insurance Industry Association

Through April 2004

1. Development of Annuities
2. Provide TA to the Unified Financial Services Agency
3. Continue assistance to the Insurance Industry Association



Establishing the leading edge

Development of the Credit Bureau

During the past six months:

1. Signed Protocol with NBK – confirms establishment of private credit bureau for 1st time
2. Drafted and completed the credit bureau law
 - Privacy protection secured
 - Government agrees to single regulator
3. Moscow (Visa Int. financed) and Kiev CB Conferences
4. De-linked establishment of CB from passage of law

Through April 2004

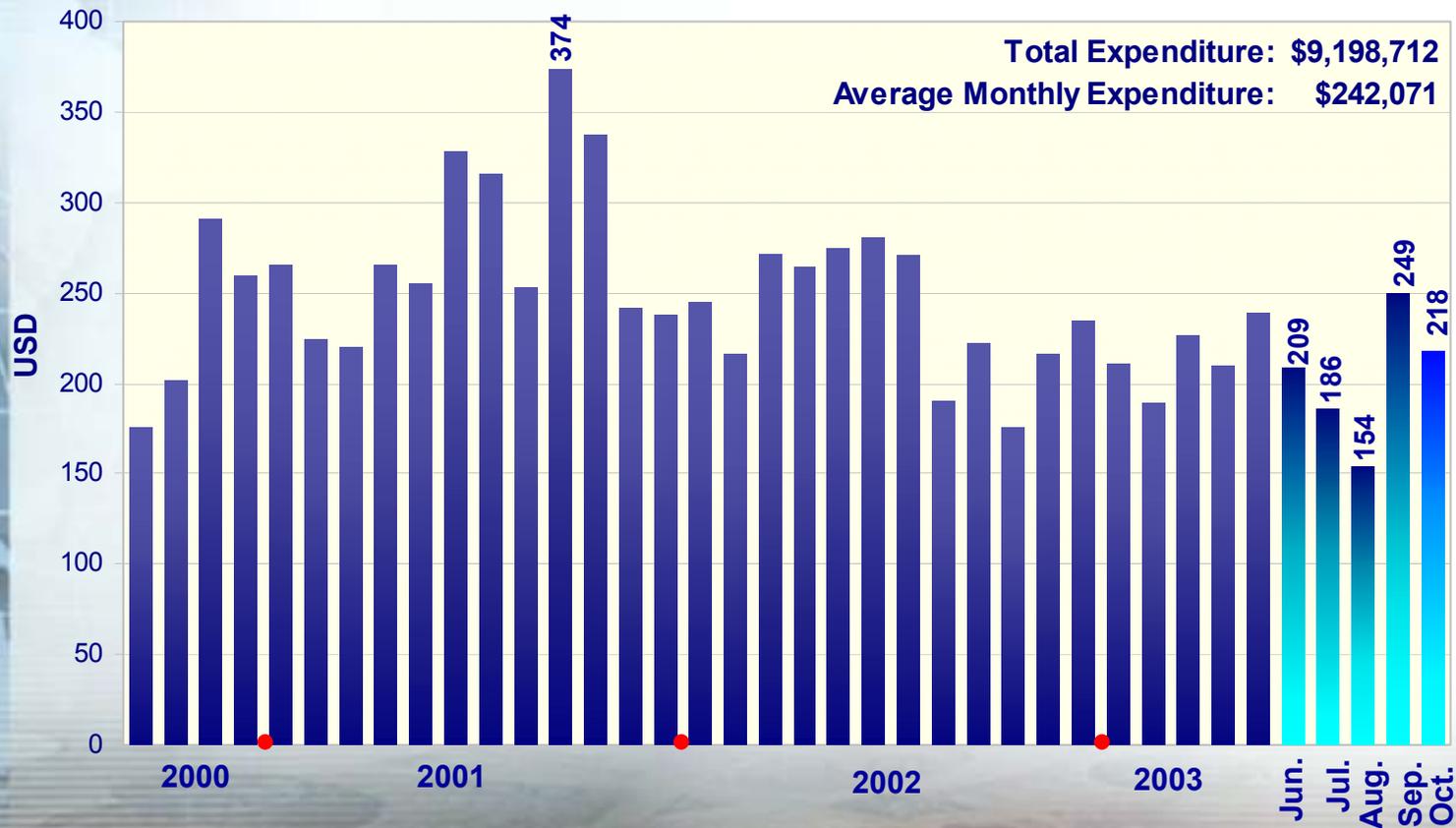
1. Revise investor business plan (secure buy-in)
2. Public Education
3. Education of the Majilis



Establishing the leading edge

Financial Sector Initiative

Cumulative Project Expenditure By
Month through October 31, 2003
(USD 1000)



Establishing the leading edge

Financial Sector Initiative

FSI Budget
through October 31, 2003
(USD 1000)



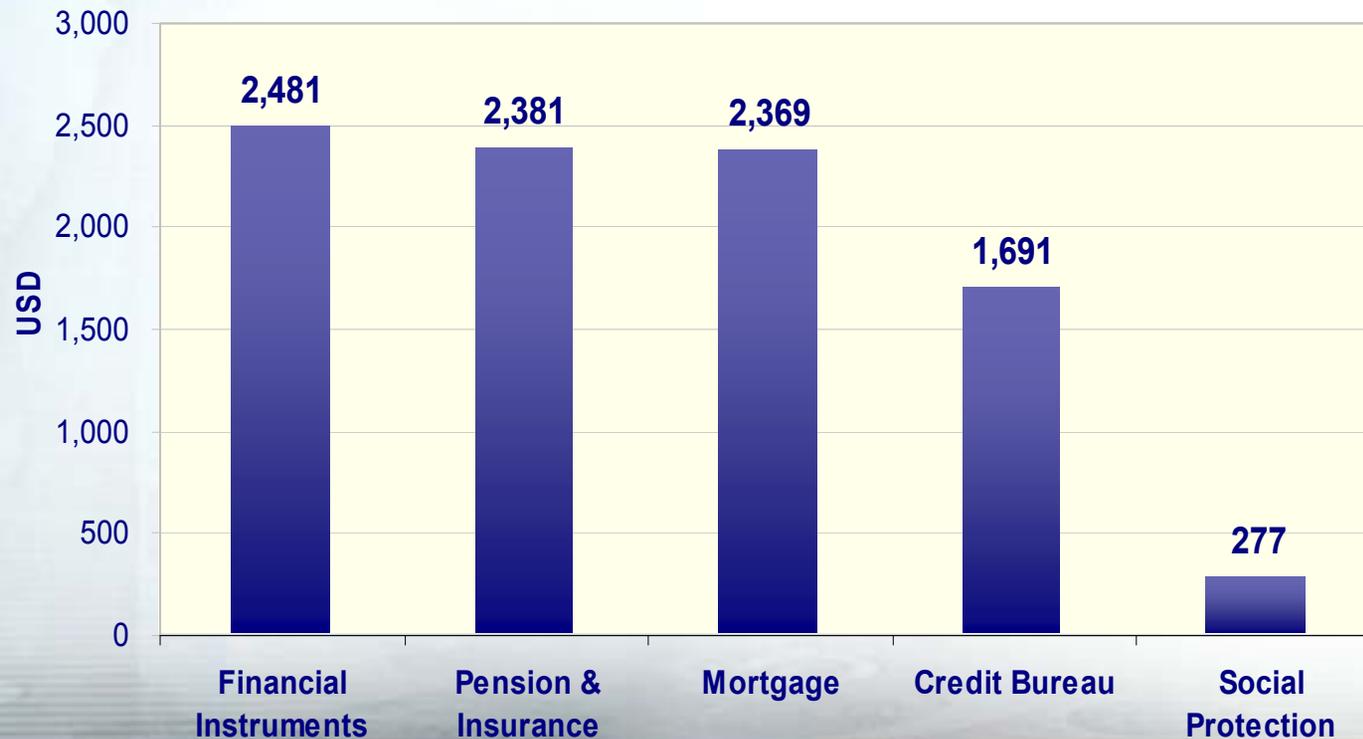
November 2003



Establishing the leading edge

Financial Sector Initiative

Cumulative Project Expenditure By
Component through October 31, 2003
(USD 1000)



November 2003



Establishing the leading edge

The Leading Edge

FSI Financial Instruments

Definitions:

A financial instrument is an IOU using assets to secure an issue.

Example: warehouse receipts; corporate bonds (2)

A structured financial instrument is a bond using **specific assets not before used** to **secure** an issue. Each instrument represents a new **class** of security.

Example: mortgage – backed securities; lease-backed securities; securities collateralized by credit card receivables, car loans or future income streams, and principal protected notes. (1)

Individual **classes** of securities structured with **features never before used** in previous structures are also new financial instruments.



Financial Sector Initiative in
Kazakhstan

Establishing the leading edge

The Leading Edge

Examples of discrete features include: floating rate coupons with imbedded options; coupons indexed to inflation; Dollar indexed and Tenge denominated issues. These are applicable to any class of security.

Mortgage – backed securities (MBS) are bonds collateralized by mortgages. They are also a **class of security**. Further refinement into categories such as corporate or agency; covered or pass – thru, within that **class** of security, constitutes a **new** financial instrument.

Note - NBK capital reserve requirements vary according to the structure of the security i.e., risk.

THE NEXT FRONTIER - securitization

Securitization refers to when a pool of **specific collateral is isolated** from general corporate assets and transferred from one corporate balance sheet to another (buy/sell agreement) via the use of legal entities (SPVs) and trust administration.

Securitization represents the next level of financial evolution and risk reduction in Kazakhstan. It will be coincident with specific legislation drafted by FSI and supported by the NBK



FINANCIAL INSTRUMENTS ATTACHMENTS



БҰЙРЫҚ

ПРИКАЗ

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Алматы қ.

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**О создании рабочей группы по разработке проекта Закона Республики
Казахстан «О секьюритизации»**

В целях разработки проекта Закона Республики Казахстан «О
секьюритизации» **ПРИКАЗЫВАЮ:**

1. Создать Рабочую группу в следующем составе:

Руководитель Рабочей группы:

Бахмутова Е.Л. – заместитель Председателя Агентства Республики Казахстан по
регулированию и надзору финансового рынка и финансовых организаций (далее
– Агентство);

Заместитель руководителя Рабочей группы:

Еденбаев Е.С. – Директор Департамента стратегии и анализа Агентства;

Члены Рабочей группы:

Ташметов М.Ж. – начальник управления пруденциального регулирования
Департамента надзора за субъектами рынка ценных бумаг и накопительными
пенсионными фондами Агентства;

Усенбекова Л.Е. – заместитель начальника управления стратегии и методологии
надзора Департамента стратегии и анализа Агентства;

Нургалиева Л.К. – главный специалист управления выпуска и обращения
финансовых инструментов Департамента надзора за субъектами рынка ценных
бумаг и накопительными пенсионными фондами Агентства;

Турсунов А. С. – главный специалист – юрисконсульт управления правового
обеспечения регулирования финансового рынка Юридического департамента
Агентства;

№ 0000048

Хусайнова Э.Б. – главный специалист управления стратегии и методологии надзора Департамента стратегии и анализа Агентства;

Бейсембинов А.Н. – заместитель начальника управления правового обеспечения валютного регулирования и контроля Юридического департамента Национального Банка Республики Казахстан;

Шокыбасова А.А. – заместитель начальника управления правового обеспечения расчетных отношений и учета Юридического департамента Национального Банка Республики Казахстан;

Акмамбет М.К. – заместитель Председателя Совета Ассоциации финансистов Казахстана;

Бабенов Б.Б. – вице-Президент ЗАО «Казахстанская фондовая биржа»;

Джанкобаев Т. – Директор, корпоративные финансы Корпорации PRAGMA/USAID;

Ивлев В. – юрист Корпорации PRAGMA/USAID;

Мули С. – старший консультант Корпорации PRAGMA/USAID;

Пирожкова Н. – юрист Корпорации PRAGMA/USAID;

Пьедра Х. – старший консультант Корпорации PRAGMA/USAID;

Сатыбалдиев А.И. – юрист ЗАО «Казахстанская фондовая биржа»;

Таимова М. – старший юрист Корпорации PRAGMA/USAID;

Якупбаева Ю.К. – эксперт Ассоциации финансистов Казахстана;

Секретарь рабочей группы:

Рысымбетов Б.Х. – ведущий специалист управления стратегии и методологии надзора Департамента стратегии и анализа Агентства;

2. Департаменту стратегии и анализа довести настоящий Приказ до сведения всех членов Рабочей группы.

3. Рабочей группе в срок до 01 мая 2004 года подготовить проект Закона Республики Казахстан «О секьюритизации».

4. Контроль за исполнением настоящего приказа возложить на заместителя Председателя Бахмутову Е.Л.

Председатель



Жамишев Б.Б.

Жамишев Б.Б. (Е.А.Иманов)

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| SIX MONTH USD1,000 FUTURES | |
|--------------------------------------|---|
| Code in the trade system: | FUSDYYMMUN , where F – code of futures market, USD – code of the futures, YYMM – futures execution year and month, UN – code of non-delivery futures |
| Type: | futures contract without delivery of the base asset |
| Kind: | futures |
| Base asset: | U.S. dollar |
| Standard quantity of the base asset: | 1,000 (one thousand) |
| Execution term: | <u>six months</u> |
| Execution day: | <u>last Friday of calendar month</u> |
| Execution: | without delivery of the base asset by paying (receiving) the difference between the purchase (selling) price of the contract and the final settlement price of the base asset |
| Price measurement unit: | in Kazakhstani tenges per U.S. dollar with double digit accuracy |
| Tic: | 0.01 |
| Value of the tic: | 10 Kazakhstani tenges |
| Opening price of the session: | weighted average price of previous successful trades |
| Final settlement price: | weighted average exchange rate of the base asset on TOD terms for the last five main sessions of KASE till the execution day, including the execution day |
| Settlement price change limit: | not specified |
| Limit per market share: | not specified |
| Depository margin rate: | 5% of the value of opened position at the price of this position |
| Calendar spread discount: | <u>40%</u> |
| Guarantee fee: | 1% of the value of one contract |
| Minimum number of guarantee fees: | 500 |
| First trading day: | <u>last Friday of calendar month that is six months from the execution day</u> |
| Last trading day: | last business day prior to the execution day |
| Exchange commission: | 1% of monthly design index for one contract purchase and sale, including performance of contract, commission fee is imposed once a month on the grounds of the stock exchange's |

| | |
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| | bills. |
| Term for settling net-liabilities of clearing members to KASE: | by 6:00PM of the day the Exchange trades, where net-liabilities incurred, were held |
| Schedule of the trades: | each business day from 11:30AM to 5:00PM Almaty time |
| Main mode of the trades: | open trades method in electronic trading system of KASE, including remote access mode |
| Additional mode of the trades: | absent |

SIX MONTH USD/EUR FUTURES

| | |
|--------------------------------------|--|
| Code in the trade system: | FU_ YYMMUN , where F – code of futures market, U_ – code of the futures, YYMM – futures execution year and month, UN – code of non-delivery futures |
| Type: | futures contract |
| Kind: | futures |
| Base asset: | euro |
| Standard quantity of the base asset: | 1,000 (one thousand) |
| Execution term: | <u>six months</u> |
| Execution day: | <u>last Friday of calendar month</u> |
| Execution: | without delivery of the base asset by paying/receiving the difference between the purchase/selling price of the contract and the final settlement price of the base asset |
| Price measurement unit: | U.S. dollar for euro with four digit accuracy |
| Tic: | 0.0001 U.S. dollars |
| Value of the tic: | 0.1 U.S. dollars, recalculated in tenge at weighted average KZT/USD rate by the results of the Exchange's trades held on settlement day. |
| Opening price of the session: | weighted average price of previous successful trades |
| Final settlement price: | USD/EUR rate set by the Federal Reserve System of USA (source, Reuters terminal) on the contract execution date |
| Settlement price change limit: | not specified |
| Limit per market share: | not specified |
| Depository margin rate: | 5% of the value of opened position at the price of this position |
| Calendar spread discount: | <u>40%</u> |

| | |
|--|--|
| Guarantee fee: | 1% of the value of one contract |
| Minimum number of guarantee fees: | 500 |
| First trading day: | <u>last Friday of calendar month that is six months from the execution day</u> |
| Last trading day: | last business day prior to the execution day |
| Exchange commission: | 1% of monthly design index for one contract purchase and sale, including performance of contract, commission fee is imposed once a month on the grounds of the stock exchange's bills. |
| Term for settling net-liabilities of clearing members to KASE: | by 6:00PM of the day the Exchange trades, where net-liabilities incurred, were held |
| Schedule of the trades: | each business day from 11:30AM to 5:00PM Almaty time |
| Main mode of the trades: | open trades method in electronic trading system of KASE, including remote access mode |
| Additional mode of the trades: | absent |

SIX-MONTH FUTURES FOR THE YIELD OF INTERNATIONAL SECURITIES OF THE REPUBLIC OF KAZAKHSTAN

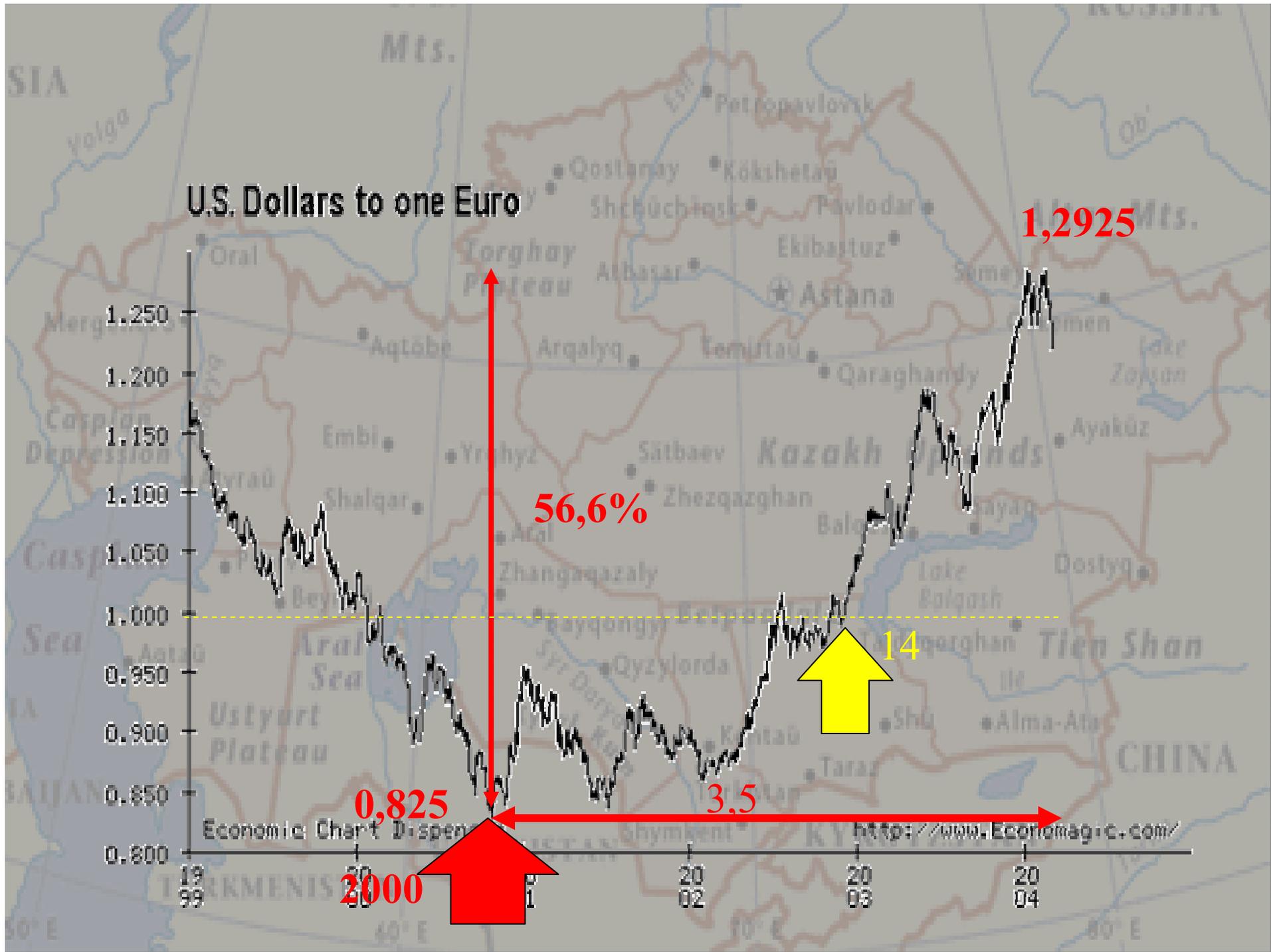
| | |
|--------------------------------------|---|
| Code in the trade system: | F ENUY Y MMUN_ n , where F – code of futures market, ENU – code of the futures, Y MM – futures execution year and month, UN – code of non-delivery futures, n – number of issue |
| Type: | futures contract |
| Kind: | futures |
| Base asset: | international securities (eurobonds) of Kazakhstan of a certain issue |
| Standard quantity of the base asset: | eurobonds of Kazakhstan of this issue in the total amount of 1,000 (one thousand) US dollars on debt's par value |
| Execution term: | <u>six months</u> |
| Execution day: | <u>last Friday of calendar month</u> |
| Execution: | without basic assets delivery; with payment/receiving of difference between the cost of futures contract at the price of purchase/sale and its cost at final settlement price |
| Price measurement unit: | yield of eurobonds of Kazakhstan of this issue to maturity is four decimal figures |

| | |
|--------------------------------|--|
| Tic: | 0.0001 |
| Value of the tic: | 0.0001 percentage points of the yield to maturity |
| Opening price of the session: | weighted average price of previous successful trades |
| Final settlement price: | <p>weighted average yield to maturity of eurobonds of Kazakhstan of this issue for five days – last four days of stock exchange's trades on them and the day of execution.</p> <p>In case deals with eurobonds of Kazakhstan of this issue are not made within the mentioned four days of stock exchange's trades, weighted average yield to maturity of eurobonds of Kazakhstan of the given issue for last five days of successful exchange's trades during the last month before the day of execution is used as the final settlement price. In case of absence of the mentioned number of days of successful stock exchange's trades, the definitive settlement price is determined by the stock exchange's Risk committee in accordance with the methods accepted by it.</p> |
| Cost of futures contract: | <p>rounded to two decimal figures volume of deal in tenge at the stock exchange's weighted average rate on the day of making of this deal at "dirty" price of eurobonds of Kazakhstan of given issue, where "dirty" price is determined by the formula:</p> $P_{dirty} = P_{clean} + \frac{Y \times (D/360) \times (1 + Y \times (D/360))}{1 + Y \times (D/360)}$ <p>where:</p> <ul style="list-style-type: none"> – "dirty" price of eurobonds of Kazakhstan of the given issue; – yield to maturity of eurobonds of Kazakhstan of the given issue; – size of periodical (except the last) interest rate of eurobonds of Kazakhstan of the given issue; – size of the last interest rate on eurobonds of Kazakhstan of the given issue plus par value of the debt of these eurobonds; – number of days before redemption of eurobonds of Kazakhstan of the given issue |
| Settlement price change limit: | not specified |
| Limit per market share: | not specified |
| Depository margin rate: | 5% of the value of opened position at the price |

| | |
|--|--|
| | of this position |
| Calendar spread discount: | <u>40%</u> |
| Guarantee fee: | 1% of the value of one contract |
| Minimum number of guarantee fees: | 500 |
| First trading day: | <u>last Friday of calendar month that is six months from the execution day</u> |
| Last trading day: | last business day prior to the execution day |
| Exchange commission: | 1% of monthly design index for one contract purchase and sale, including performance of contract, commission fee is imposed once a month on the grounds of the stock exchange's bills. |
| Term for settling net-liabilities of clearing members to KASE: | by 6:00PM of the day the Exchange trades, where net-liabilities incurred, were held |
| Schedule of the trades: | each business day from 11:30AM to 5:00PM Almaty time |
| Main mode of the trades: | open trades method in electronic trading system of KASE, including remote access mode |
| Additional mode of the trades: | absent |



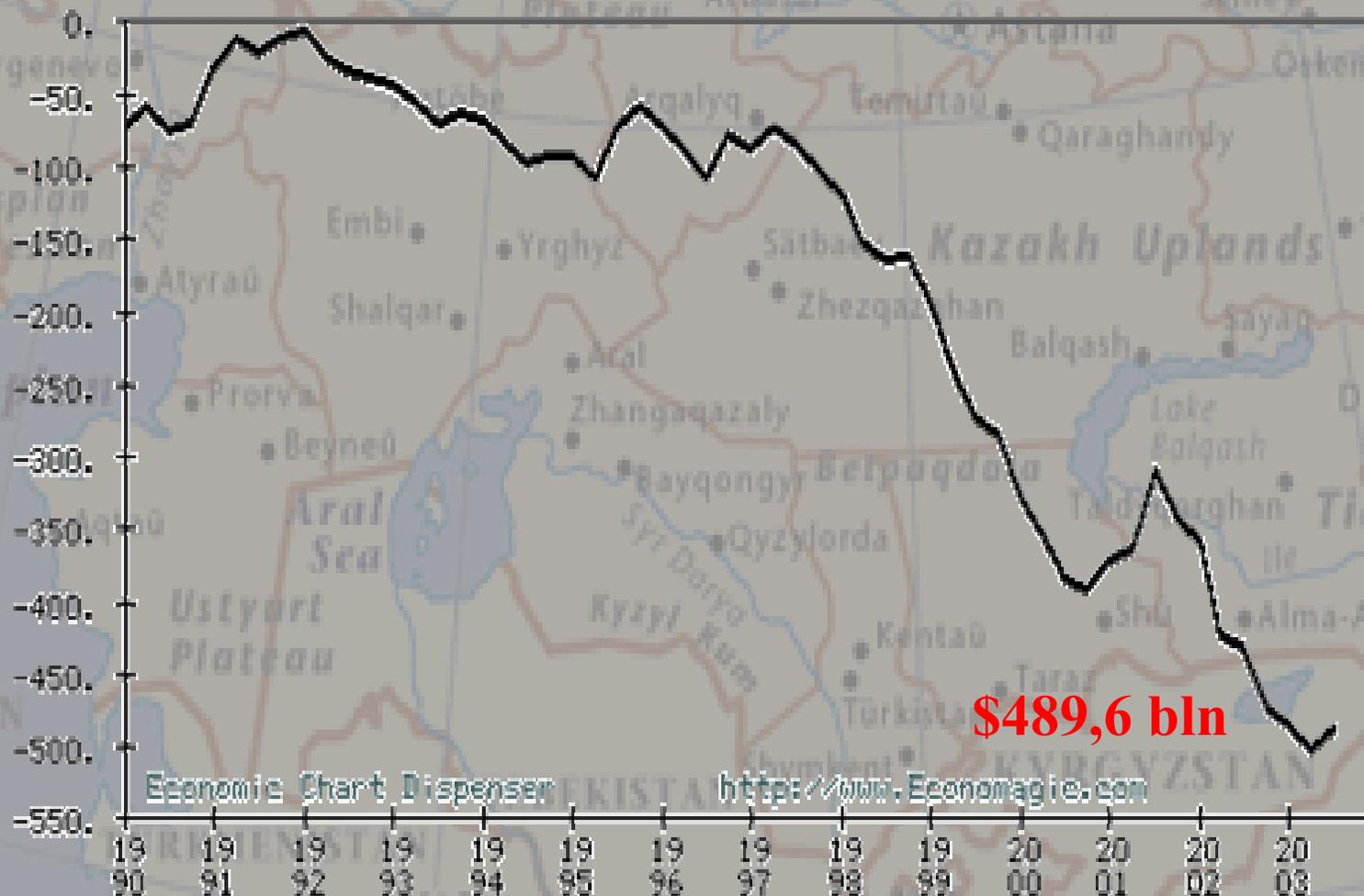
Financial Sector Initiative in Kazakhstan



Elliot Wave Count



Net exports of goods and services; Billions of dollars SAAR

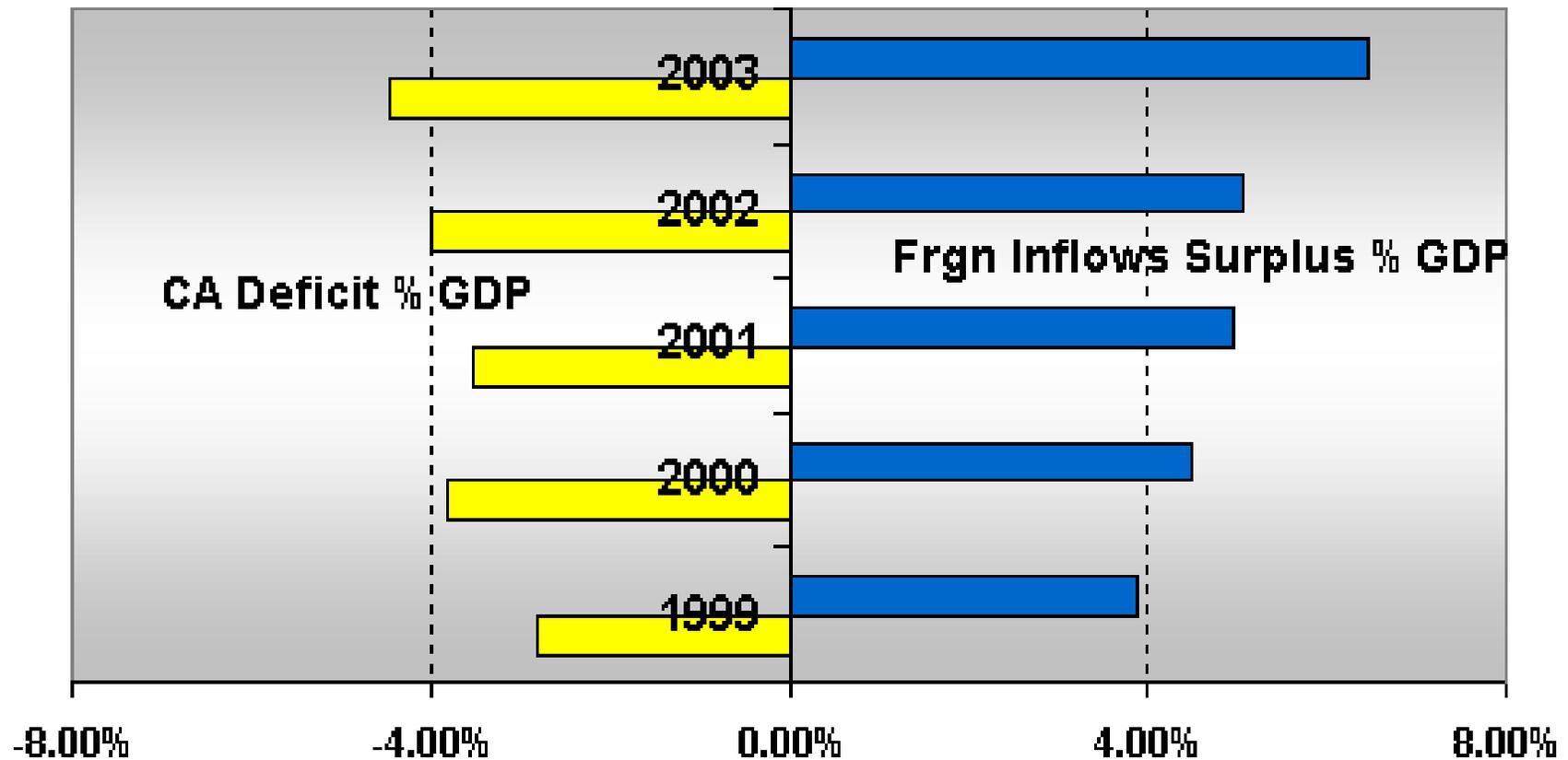


\$489,6 bln

Economic Chart Dispenser

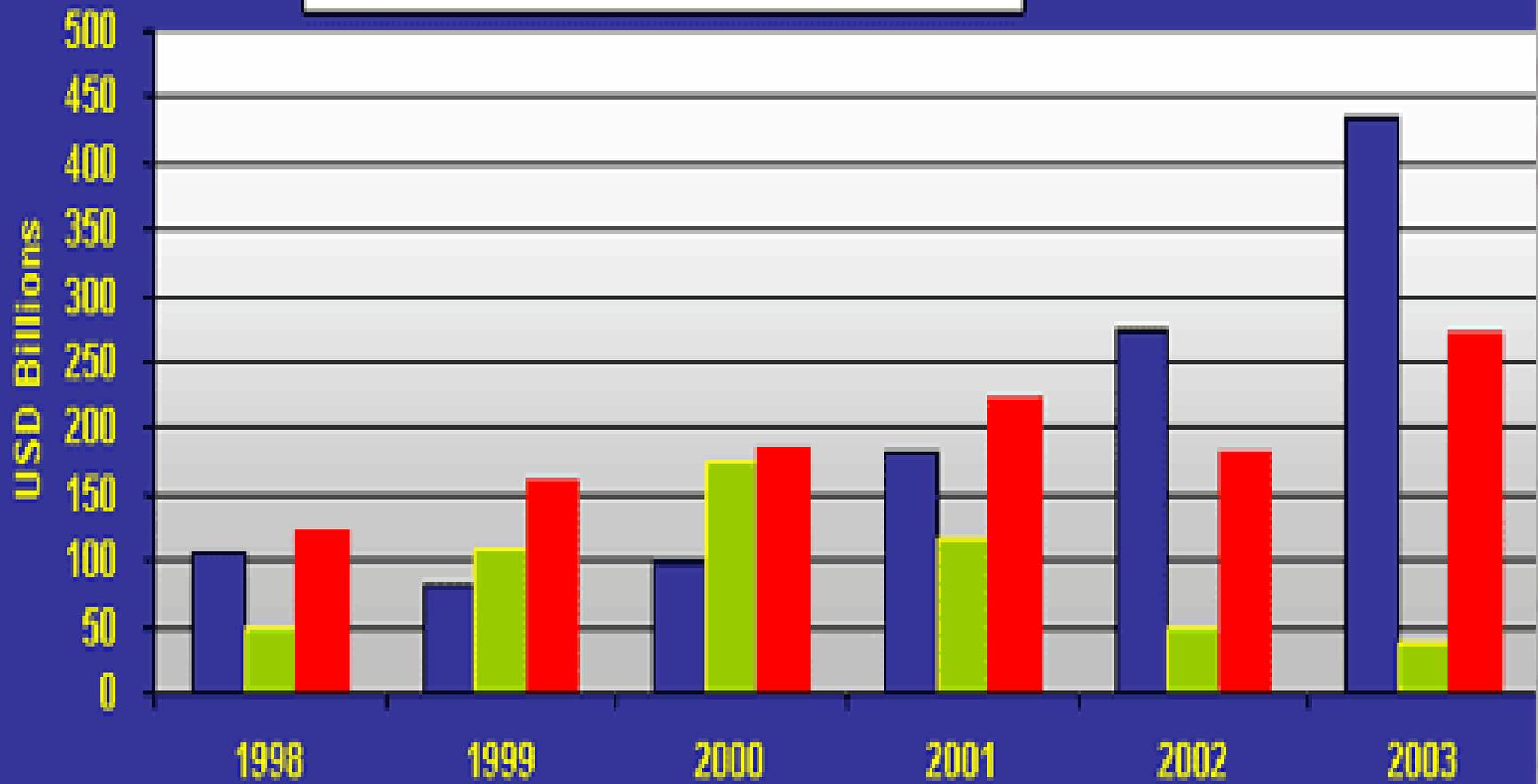
<http://www.Economagic.com>

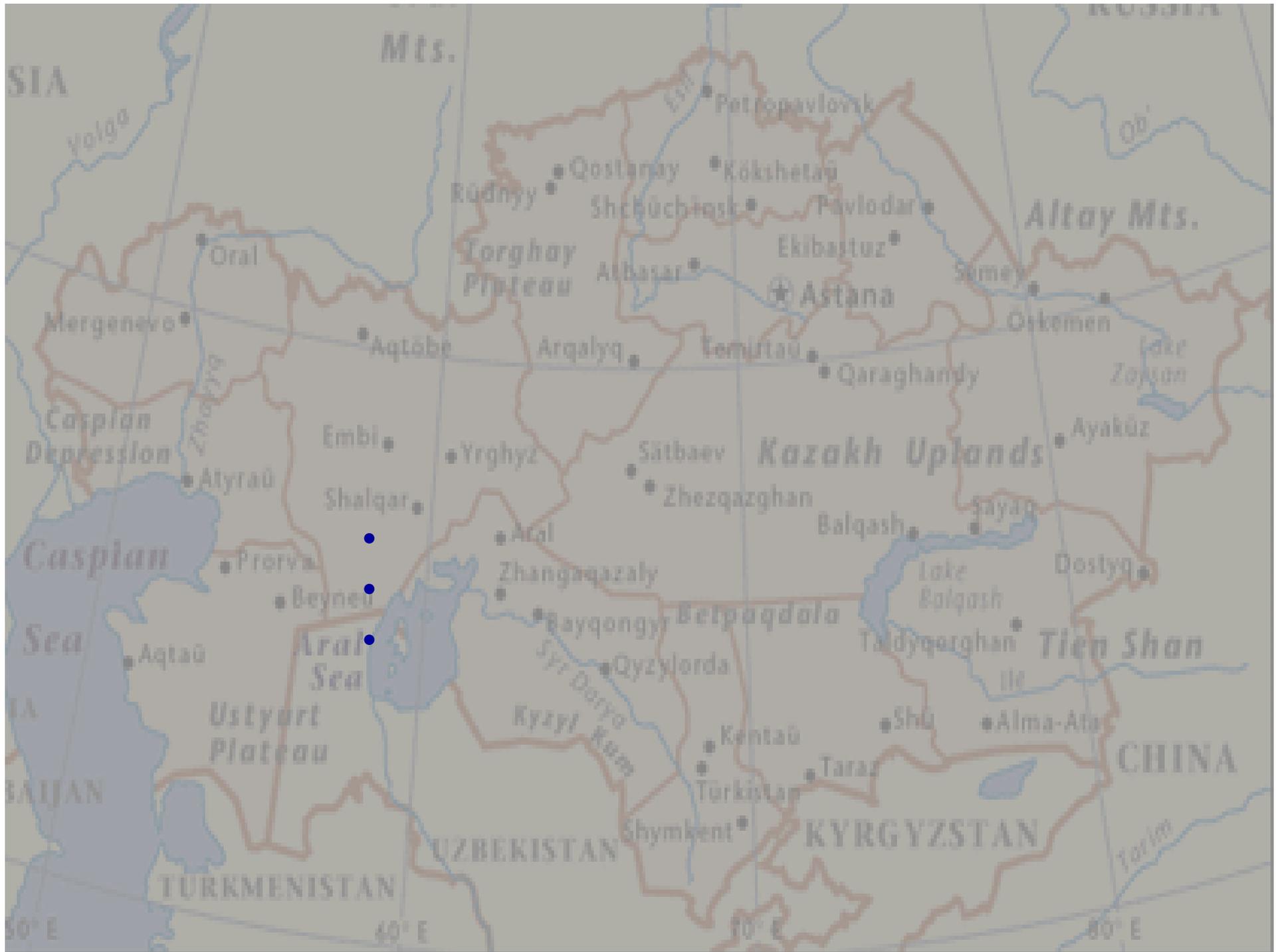
Capital Inflows vs Trade Deficit as % of GDP

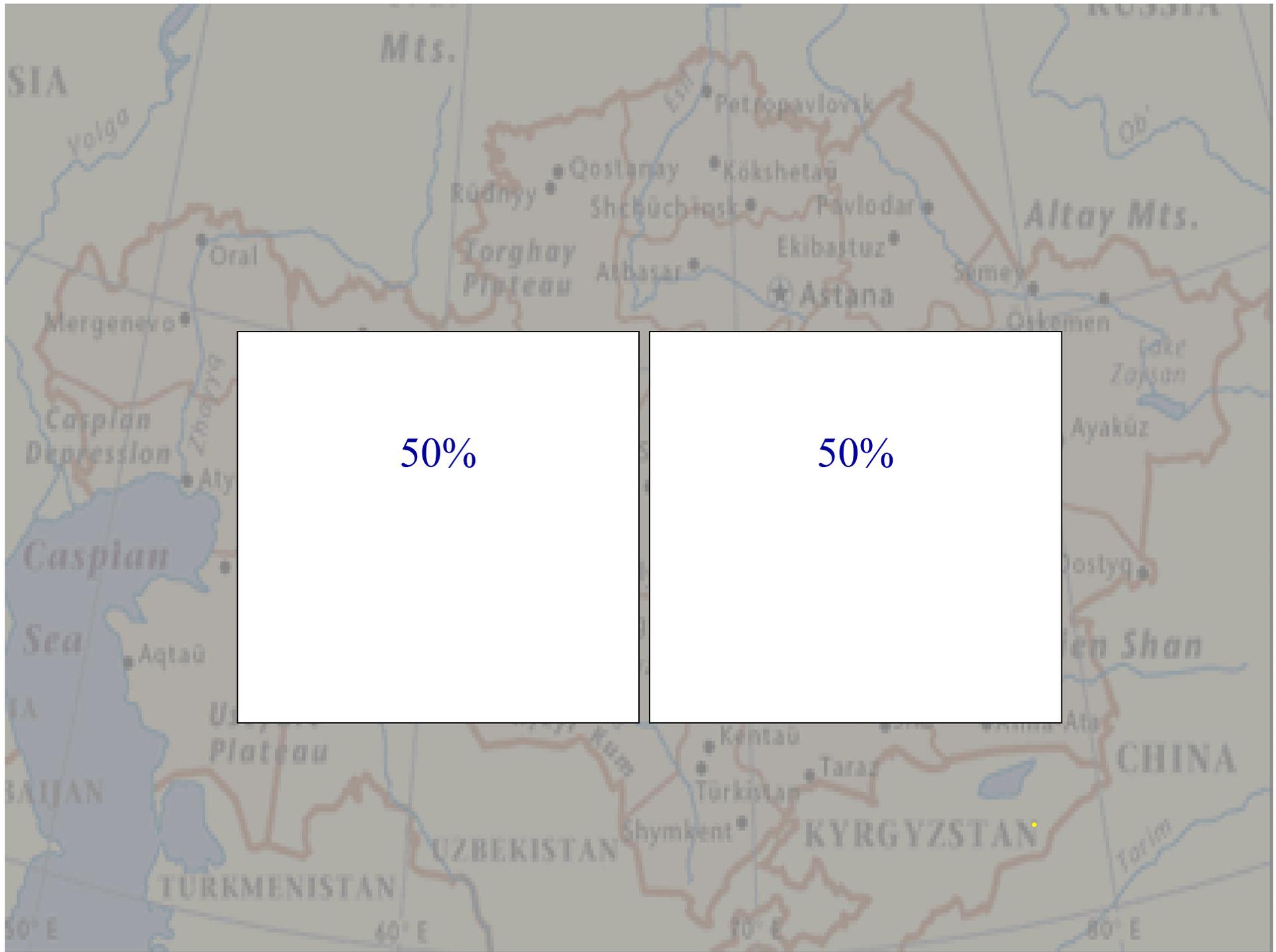


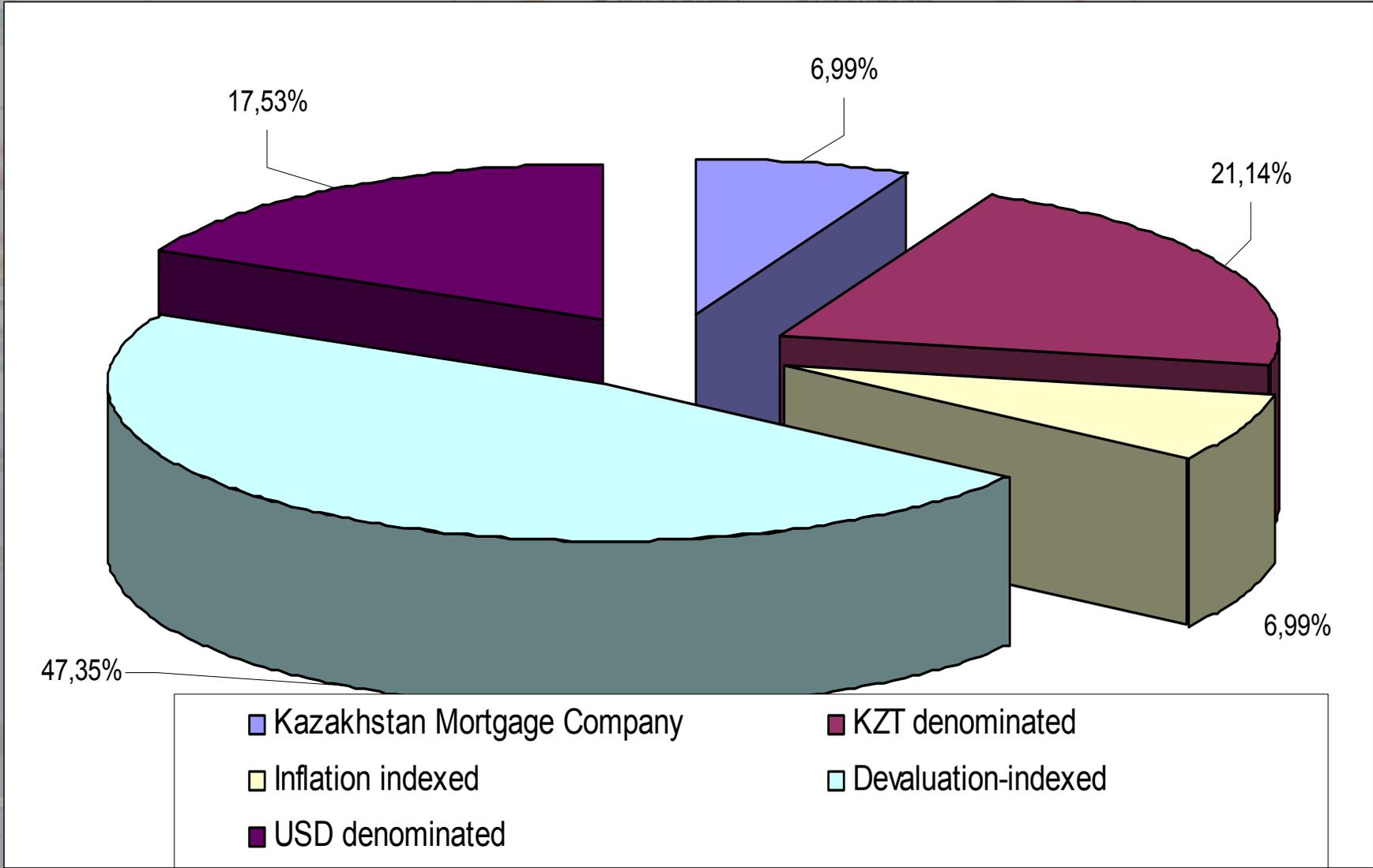
Treasuries & Corp Bonds are Favorite Amid Foreigners

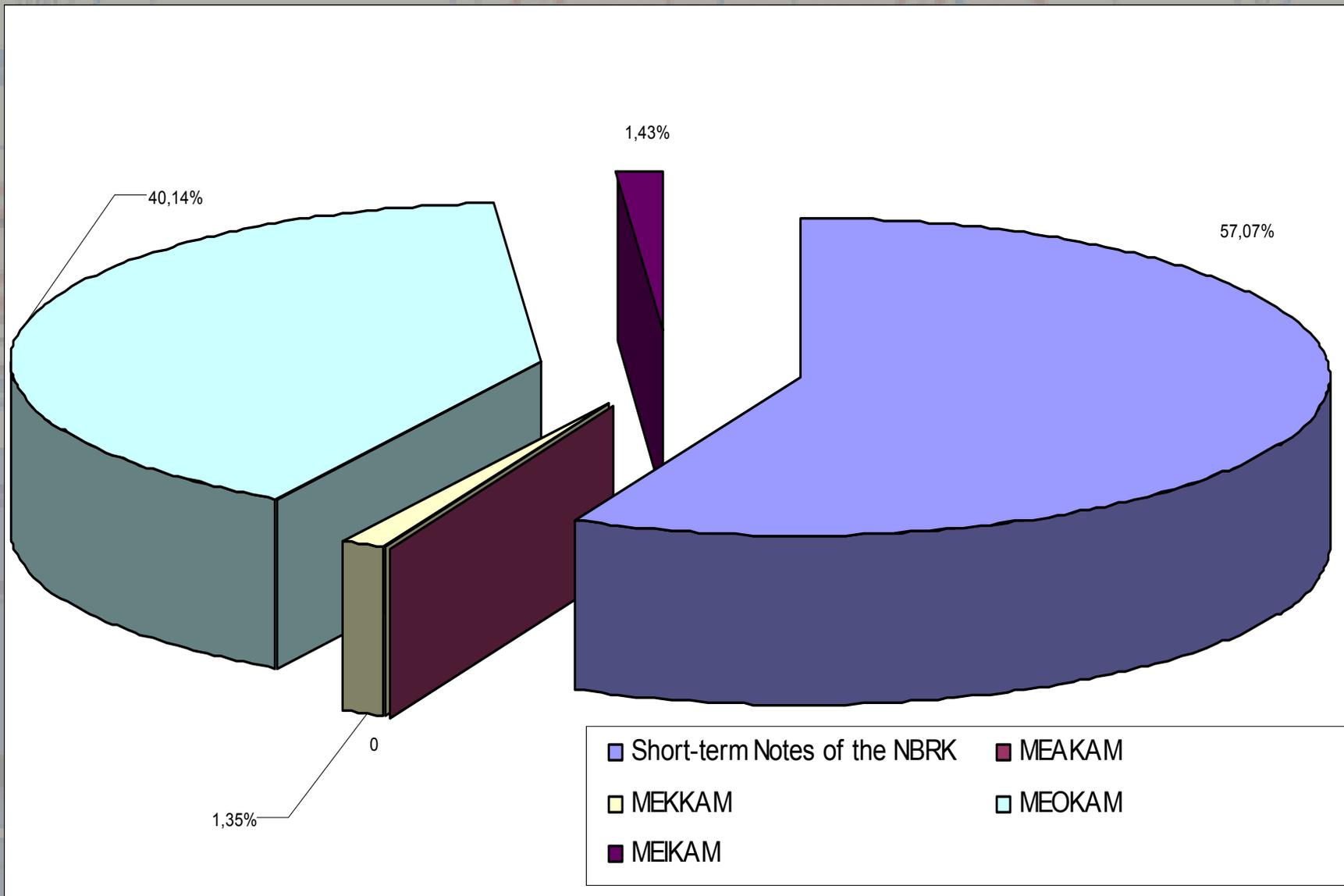
■ Trsy & Agcy Bonds ■ Stocks ■ Corp Bonds

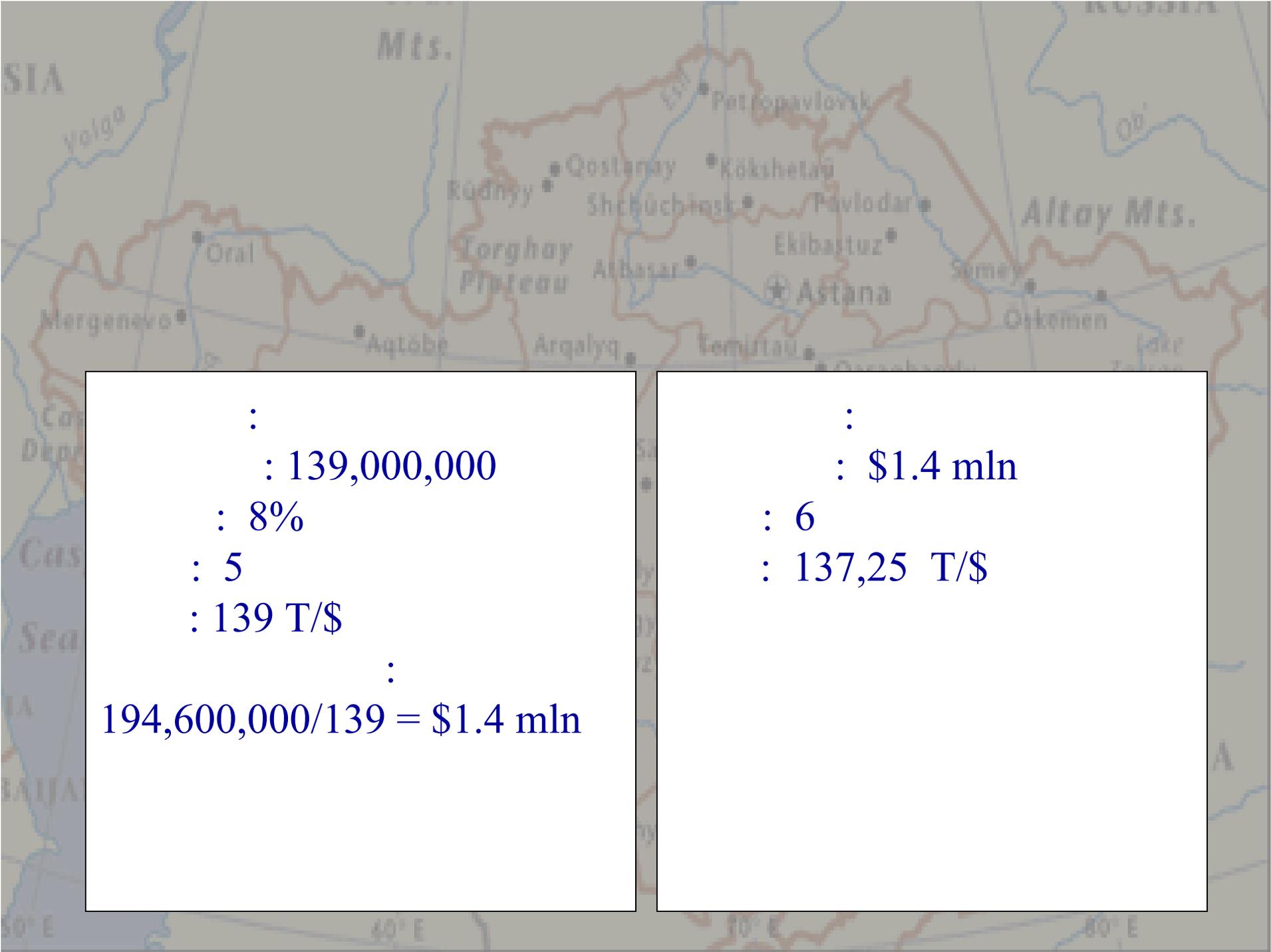






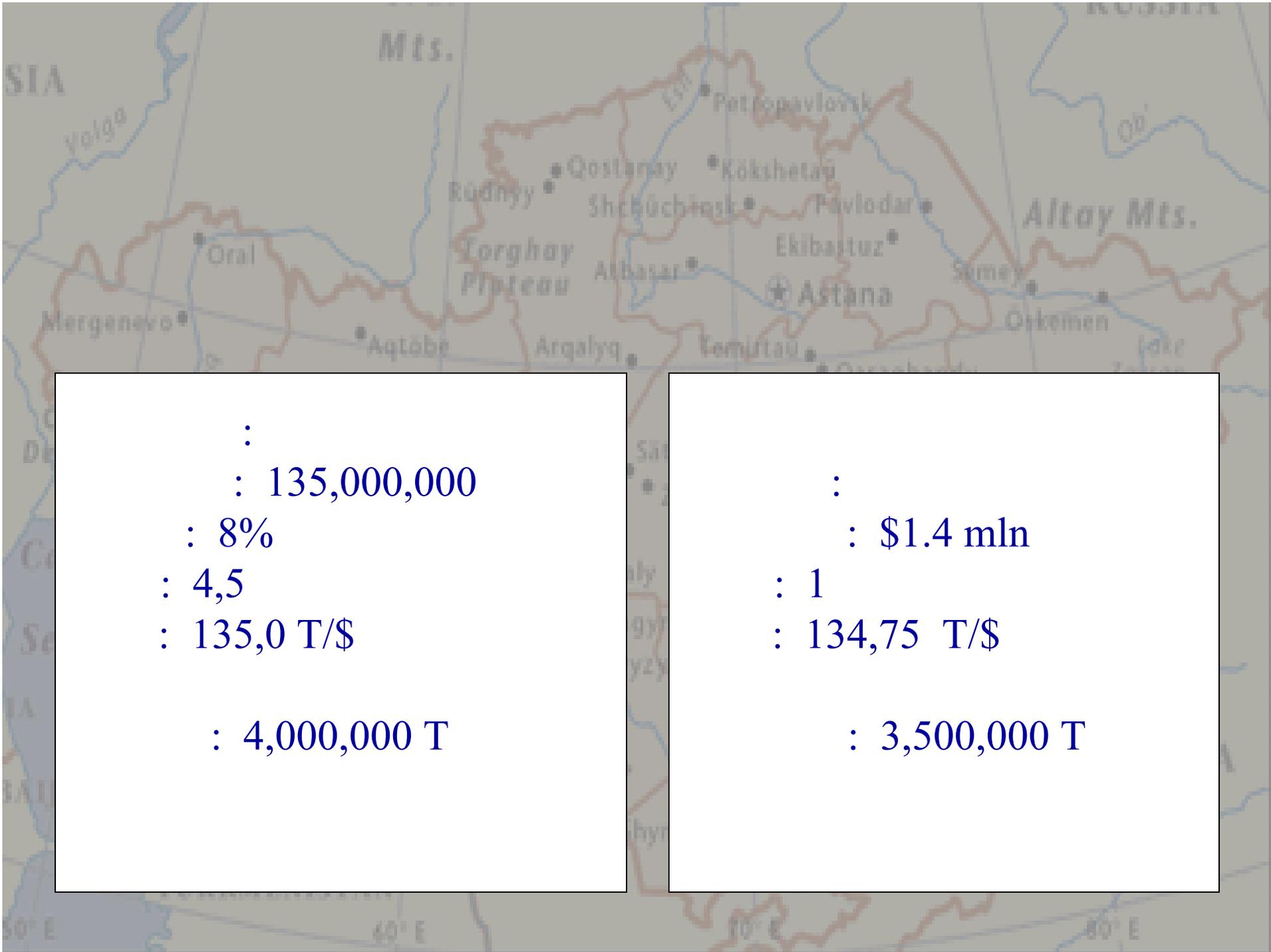






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: \$1.4 mln
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: 135,000,000

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: 4,5

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: 4,000,000 T

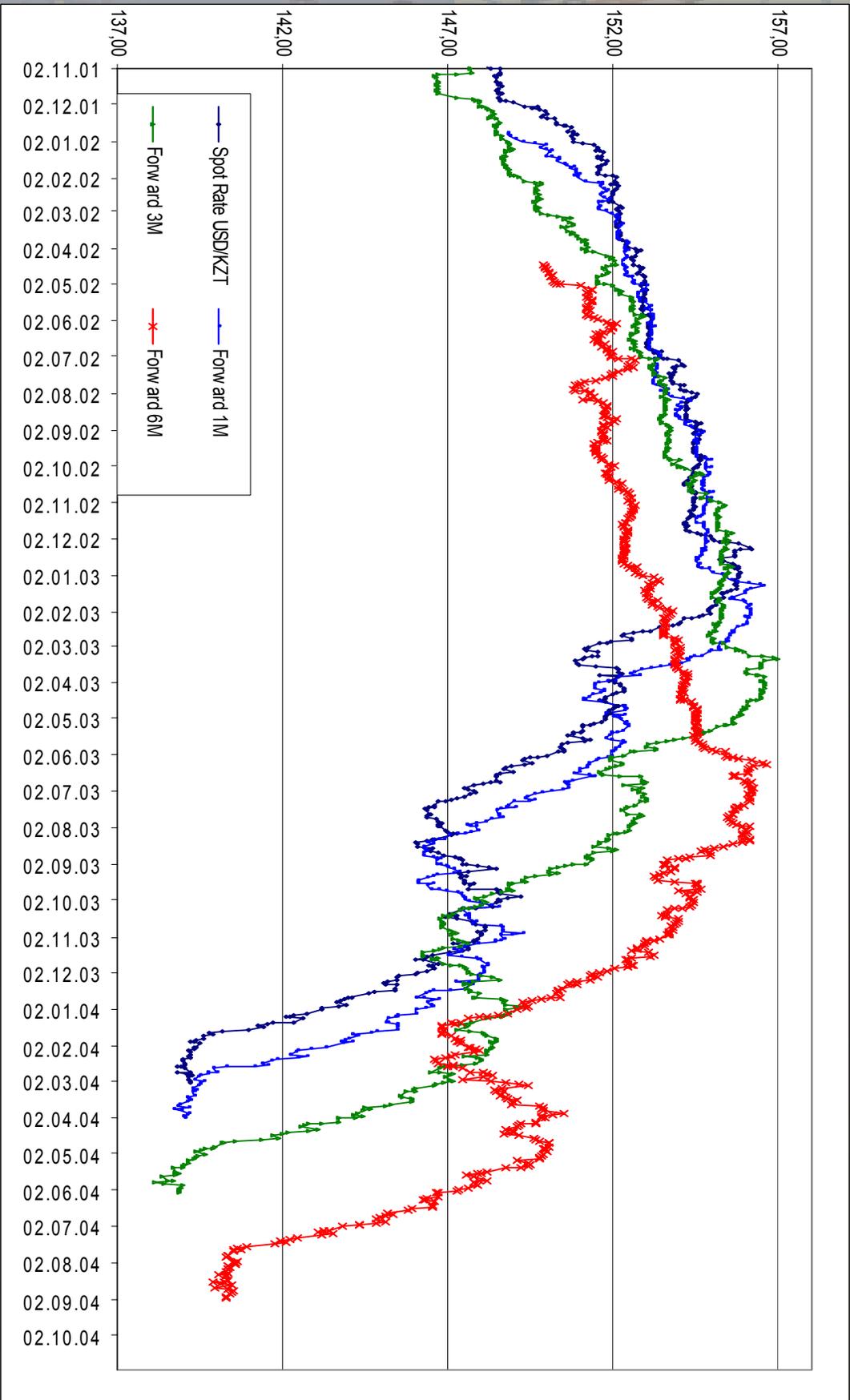
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: \$1.4 mln

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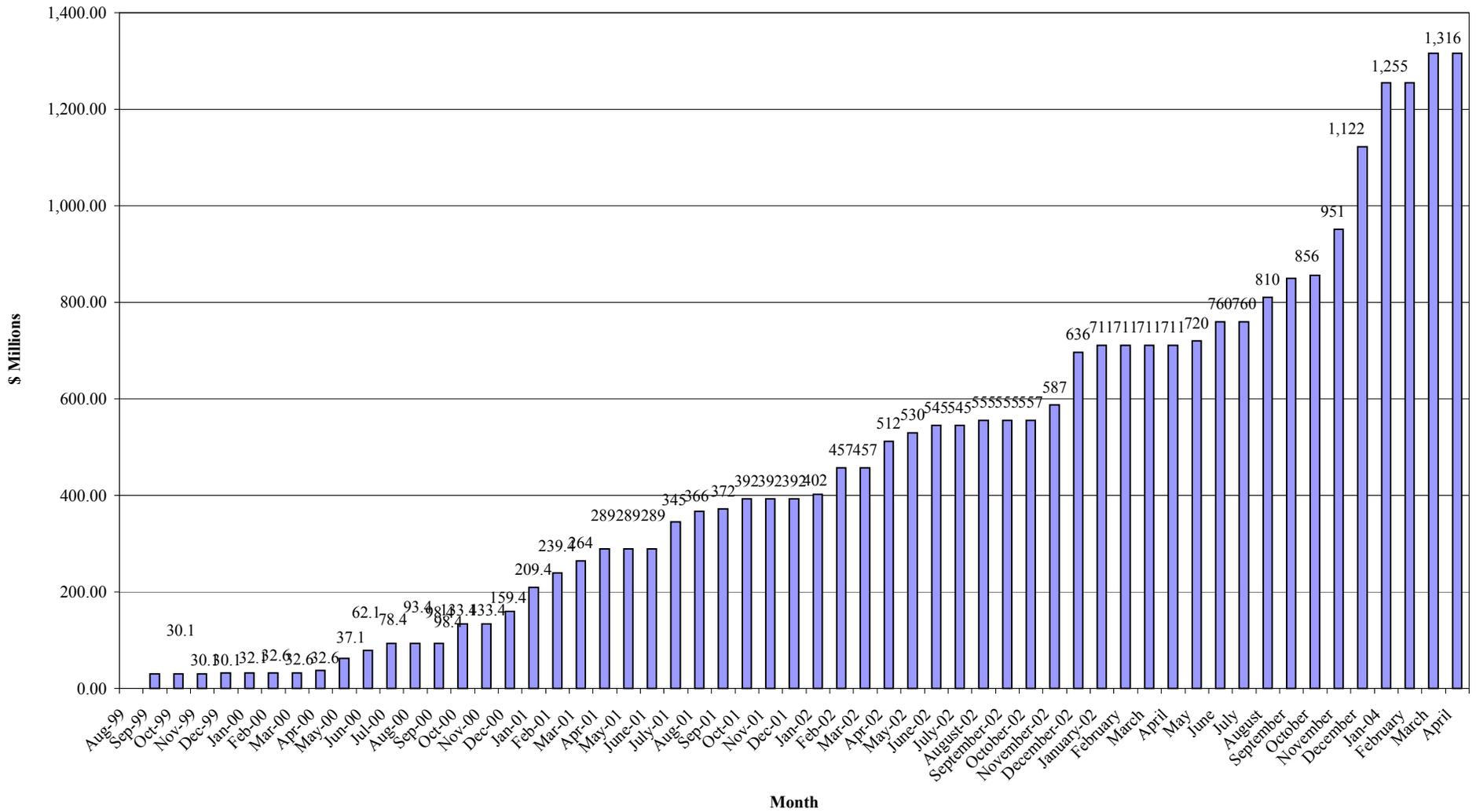
: 134,75 T/\$

: 3,500,000 T





Cumulative Growth in Corporate Bond Issuance, \$ millions: August 1999 - April 2004



Source: Kazakhstan Stock Exchange
Financial Sector Initiative

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| | 23/04/03 | - | 14,163, .311 |
| | 03/04/03 | . | , 99, 4 |
| | 04/07/03 | . | 194, .111 |
| - | 19/08/03 | . | , 27, .308 |
| | 25/09/03 | . | / . . - ,32 |
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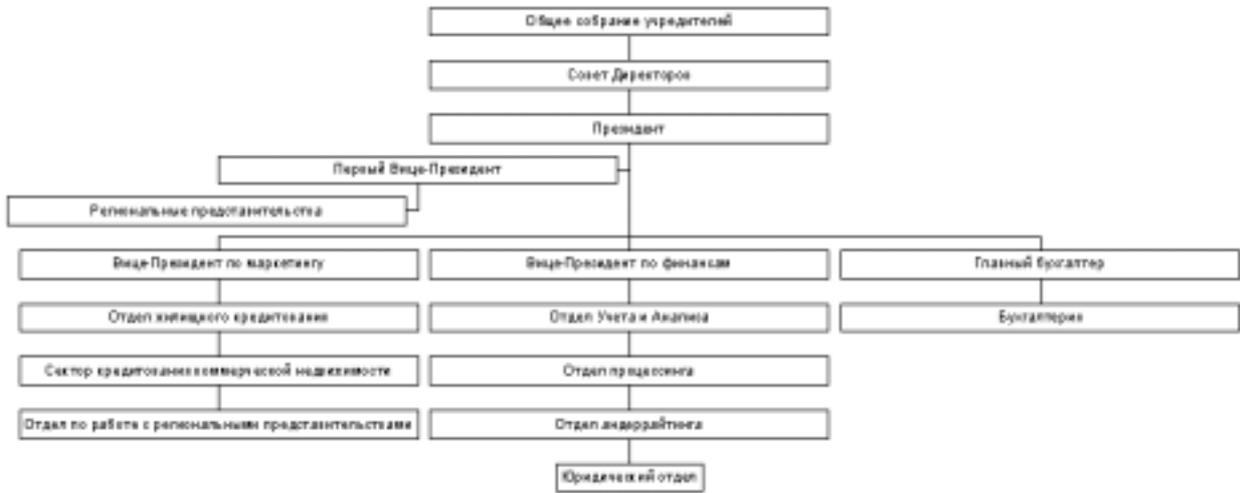
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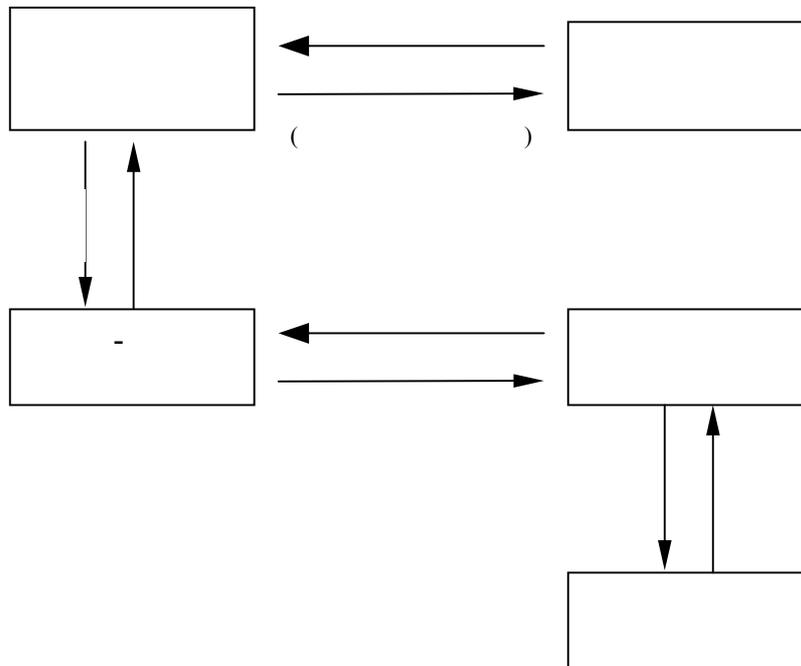
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| 3 | 4 | 5 | 7 | 8 | 15 | 27 | 40 | 70 | 96 |
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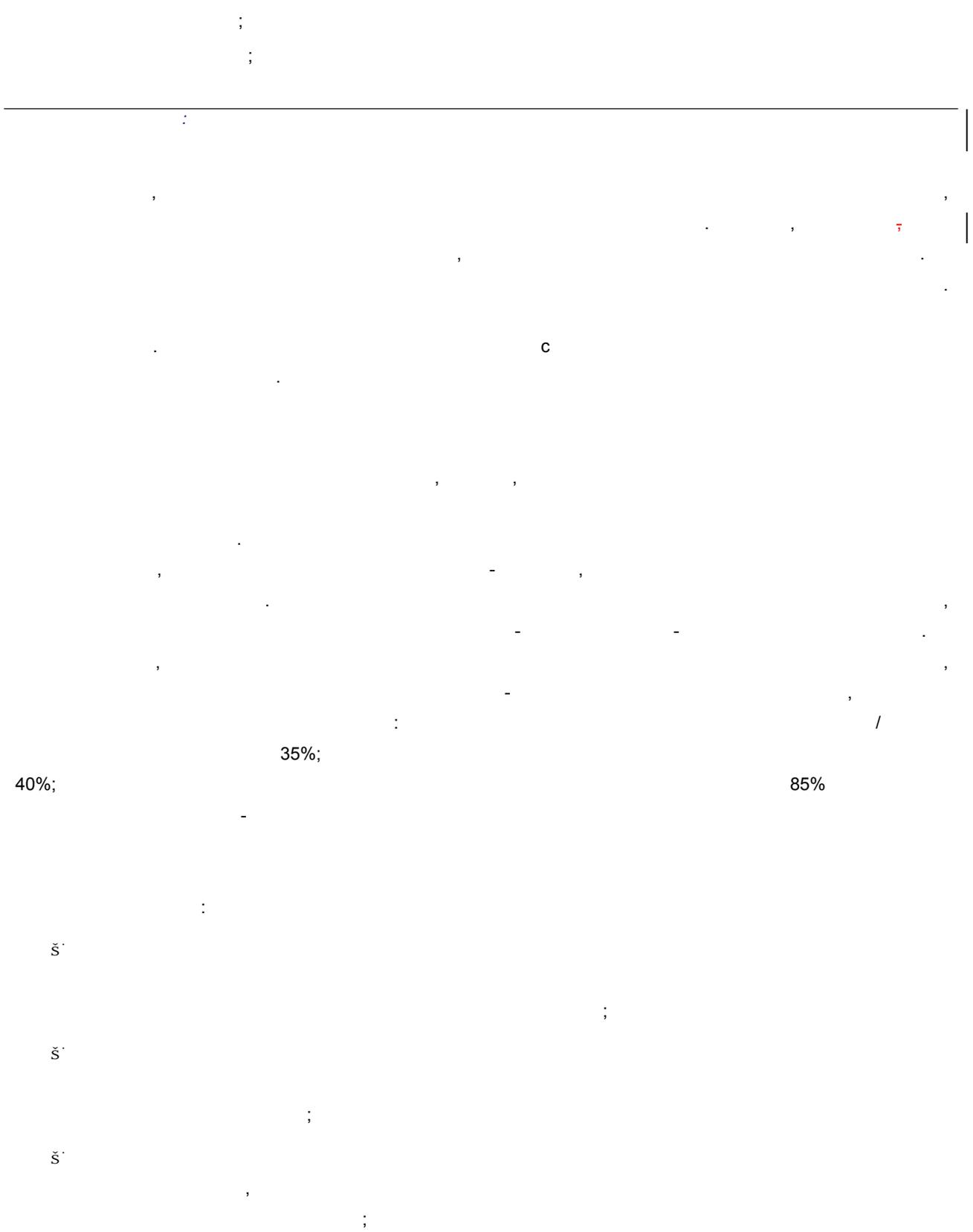
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| | 1 | 2003 | 2002 | 2001 | 2000 | | | |
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| | 7 660 | 3,15% | 6 716 | 9% | 1 224 | 4,11% | 77 | 5,71% |
| | 20 218 | 8,31% | 13 105 | 17% | 1 405 | 4,71% | 39 | 2,89% |
| | 104 323 | 42,86% | 14 565 | 18% | 6 546 | 21,96% | 427 | 31,65% |
| | 47 469 | 19,50% | 28 920 | 37% | 8 534 | 28,63% | 573 | 42,48% |
| | 29 633 | 12,18% | 13 838 | 18% | 7 945 | 26,66% | 41 | 3,04% |
| | 11 793 | 4,85% | 7 871 | 10% | 1 754 | 5,88% | 147 | 10,90% |
| | 3 305 | 1,36% | 1 116 | 1% | 535 | 1,80% | 0 | 0,00% |
| | 18 990 | 7,80% | 7 439 | 9% | 1 862 | 6,25% | 45 | 3,34% |
| | 243 391 | 100% | 93 570 | 100% | 29 805 | 100% | 1349 | 100% |
| | | | 1 | | 243 391 | | | |
| | | | 42,86% | | | | 104 323 | |

2003

1 2003 8,31% 20 218

2000

15.

| | 1 | 2003 | 2002 | 2001 | 2000 |
|--|----------|-------------|-------------|-------------|-------------|
| | 5% | 5% | 1% | - | - |
| | 5,3% | 5,9% | 1,2% | - | - |
| | 16,4% | 19,2% | 19,6% | 21% | - |
| | 14% | 21% | 19% | - | - |
| | 88% | 79% | 6% | - | - |
| | 4% | 4% | 12% | - | - |
| | 23% | 23% | 73% | - | - |
| | 63% | 59% | 93% | - | - |
| | 94% | 77% | 90% | 5% | - |
| | 5% | 5% | 9% | 98% | - |
| | 3% | 18% | 4% | 2% | - |

: TAS

16.

| | 1 | 2003 | 2002 | 2001 | 2000 | | | |
|--|------------------|----------------|------------------|----------------|----------------|----------------|---------------|----------------|
| | 140 512 | 3,31% | 331 266 | 17,79% | 16 717 | 3,80% | 762 | 1,93% |
| | 3 990 937 | 94,05% | 1 425 093 | 76,52% | 395 640 | 89,85% | 2 052 | 5,18% |
| | 34 863 | 0,82% | 12 748 | 0,68% | 0 | 0,00% | 0 | 0,00% |
| | -15 462 | -0,36% | -1 634 | -0,09% | 0 | 0,00% | | 0,00% |
| | 11 582 | 0,27% | 24 178 | 1,31% | 3 668 | 0,83% | 35 368 | 89,35% |
| | 30 000 | 0,71% | 100 | 0,01% | 0 | 0,00% | 0 | 0,00% |
| | 4 262 | 0,10% | 1 778 | 0,10% | 19 | 0,00% | 25 | 0,06% |
| | 46 298 | 1,09% | 43 150 | 2,32% | 24 162 | 5,49% | 1 296 | 3,27% |
| | 35 | 0,00% | 12 861 | 0,69% | 132 | 0,03% | 80 | 0,20% |
| | 275 | 0,01% | | 0,00% | | 0,00% | | 0,00% |
| | 4 243 302 | 100,00% | 1 849 540 | 100,00% | 440 338 | 100,00% | 39 583 | 100,00% |

| | | | | |
|-----------|------|------|------|-----------|
| 31 | 2002 | 129% | 1 | 2003 |
| 4 243 302 | 180% | 1 | 2003 | 3 990 937 |
| 94,05% | | | | |

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| 10 815 | 2 372 | 8 443 |
| 4 306 | 375 | 3 931 |
| 51 015 | 4 717 | 46 298 |

| 18. | | | | | | | | | |
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| | 1 | 2003 | 2002 | 2001 | 2000 | | | | |
| | | 470 531 | 11,79% | 115 433 | 8,10% | 47 477 | 12,00% | 0 | 0% |
| | | 624 582 | 15,65% | 148 210 | 10,40% | 70 028 | 17,70% | 0 | 0% |
| | | 1 023 276 | 25,64% | 354 848 | 24,90% | 62 907 | 15,90% | 0 | 0% |
| | | 109 352 | 2,74% | 86 931 | 6,10% | 44 312 | 11,20% | 0 | 0% |
| | | 113 343 | 2,84% | 78 380 | 5,50% | 9 891 | 2,50% | 0 | 0% |
| | | 135 692 | 3,40% | 220 889 | 15,50% | 66 863 | 16,90% | 2 052 | 100% |
| | | 34 322 | 0,86% | 5 700 | 0,40% | 4 748 | 1,20% | 0 | 0% |
| | | 454 967 | 11,40% | 163 886 | 11,50% | 58 159 | 14,70% | 0 | 0% |
| | | 624 582 | 15,65% | 128 258 | 9,00% | 25 321 | 6,40% | 0 | 0% |
| | | 191 565 | 4,80% | 0 | 0,00% | 0 | 0,00% | 0 | 0% |
| | | 0 | 0,00% | 2 850 | 0,20% | 5 935 | 1,50% | 0 | 0% |
| i | | 81 016 | 2,03% | 119 708 | 8,40% | 0 | 0,00% | 0 | 0% |
| | | 127 710 | 3,20% | | | | | | |
| | | 3 990 937 | 100% | 1 425 093 | 100% | 395 640 | 100% | 2 052 | 100% |

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|------|---|------------------|-------------|------------------|-------------|----------------|----------------|-------------|-------------|
| | 1 | 2003 | 2002 | 2001 | 2000 | | | | |
| 1 3 | | 7 982 | 0,20% | 86 931 | 6,10% | 45 103 | 11,40% | | |
| 3 5 | | 59 864 | 1,50% | 493 082 | 34,60% | 188 720 | 47,70% | 2052 | 100,00% |
| 5 7 | | 630 568 | 15,80% | 175 286 | 12,30% | 46 290 | 11,70% | | |
| 7 10 | | 805 770 | 20,19% | 648 417 | 45,50% | 115 527 | 29,20% | | |
| 10 | | 2 486 753 | 62,31% | 21 376 | 1,50% | - | 0,00% | | |
| | | 3 990 937 | 100% | 1 425 093 | 100% | 395 640 | 100,00% | 2052 | 100% |

| 20. | | | | | | | | |
|-----|------------------|-------------|------------------|-------------|----------------|-------------|--------------|-------------|
| | 1 | 2003 | 2002 | 2001 | 2000 | | | |
| | 3 523 029 | 88,28% | 1 215 604 | 85,30% | 377 045 | 95,3% | 2 052 | 100,00% |
| | 467 908 | 11,72% | 209 489 | 14,70% | 18 595 | 4,7% | 0 | 0,00% |
| | 3 990 937 | 100% | 1 425 093 | 100% | 395 640 | 100% | 2 052 | 100% |

88,28% 3 523 029

| 21. | | | | | | | | |
|--------|------------------|-------------|------------------|-------------|----------------|-------------|--------------|-------------|
| | 1 | 2003 | 2002 | 2001 | 2000 | | | |
| 14,00% | 971 259 | 34,00% | | | | | | |
| 15,00% | 84 557 | 2,96% | 7 111 | 0,50% | 0% | 0 | 0 | 0,00% |
| 16,00% | 442 780 | 15,50% | 55 467 | 3,90% | 0% | 0 | 0 | 0,00% |
| 16,50% | 108 552 | 3,80% | 3 129 | 0,22% | 0% | 0 | 0 | 0,00% |
| 17,00% | 272 524 | 9,54% | 164 980 | 11,60% | 54 169 | 14% | 0 | 0,00% |
| 17,50% | 268 524 | 9,40% | 19 911 | 1,40% | 0 | 0% | 0 | 0,00% |
| 18,00% | 211 106 | 7,39% | 193 141 | 13,58% | 0 | 0% | 0 | 0,00% |
| 18,50% | 13 998 | 0,49% | 0 | 0,00% | 0 | | | |
| 19,00% | 244 529 | 8,56% | 455 260 | 32,01% | 151 206 | 39% | 0 | 0,00% |
| 20,00% | 96 555 | 3,38% | 107 806 | 7,58% | 27 669 | 7% | 0 | 0,00% |
| 21,00% | 79 986 | 2,80% | 340 200 | 23,92% | 139 125 | 36% | 2 052 | 100% |
| 22,00% | 62 275 | 2,18% | 75 237 | 5,29% | 17 537 | 5% | 0 | 0,00% |
| | 2 856 643 | 100% | 1 422 243 | 100% | 389 705 | 100% | 2 052 | 100% |

16-18%.

| 22. | | | | | | | | | |
|-----|------|------------------|-------------|------------------|-------------|----------------|-------------|--------------|-------------|
| | 1 | 2003 | 2002 | 2001 | 2000 | | | | |
| | | 3 411 054 | 85,47% | 1 049 865 | 73,67% | 367 470 | 92,88% | 2 051 | 100,00% |
| | | 579 883 | 14,53% | 375 227 | 26,33% | 28 170 | 7,12% | 0 | 0,00% |
| | | 3 990 937 | 100% | 1 425 093 | 100% | 395 640 | 100% | 2 051 | 100% |
| 1 | 2003 | | | | | | | | 85,47% |

| 23. | | | | | | | | | |
|-----|------|------------------|----------------|---------------------|-------------|----------------|-------------|--------------|-------------|
| | 1 | 2003 | 2002 | 2001 | 2000 | | | | |
| | | 3 936 358 | 98,63% | 1 363 023,00 | 96% | 395 640 | 100% | 2 052 | 100% |
| | | 44 203 | 1,11% | | | | | | |
| 1 | | | 0,00% | 62 070,00 | 4% | | | 0 | 0% |
| 2 | | 39 766 | 1,00% | | | | | | |
| 3 | | | 0,00% | | | | | | |
| 4 | | 4 437 | 0,11% | | | | | | |
| 5 | | | 0,00% | | | | | | |
| | | 10 376 | 0,26% | | | | | | |
| | | 3 990 937 | 100,00% | 1 425 093,00 | 100% | 395 640 | 100% | 2 052 | 100% |
| 1 | 2003 | | 98,63% | 3 936 358 | | | | | |

| 24. | | | | | |
|-----|---|--------|-------|------|------|
| | 1 | 2003 | 2002 | 2001 | 2000 |
| | | 15 462 | 1 634 | 0 | 0 |

15 462

1 2003

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| | 1 | 2003 | 2002 | 2001 | 2000 |
|--|----------|-------------|-------------|-------------|-------------|
| | | 1 425 093 | 395 640 | 2 052 | 0 |
| | | 11 335 283 | 1 557 230 | 511 363 | 2 052 |
| | | 8 769 439 | 527 777 | 117 775 | 0 |
| | | 3 990 937 | 1 425 093 | 395 640 | 2 052 |

30 000

26.

| | 1 | 2003 | 2002 | 2001 | 2000 |
|--|----------|-----------------------|-----------------------|---------------------|--------------------|
| | | 3 559 506 88,74% | 1 267 251 72% | 375 912 94% | 0 0,00% |
| | | 1 844 0,05% | 643 0% | 0 0% | 23 2,67% |
| | | 40 158 1,00% | 474 761 27% | 1 257 0% | 821 97,33% |
| | | 23 852 0,59% | 11 915 1% | 22 045 6% | 0 0,00% |
| | | 385 994 9,62% | 0 0% | 0 0% | 0 0,00% |
| | | 4 011 354 100% | 1 754 570 100% | 399 214 100% | 844 100,00% |

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2003 385 994 . 9,62%

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|--------|---------------|---------------|---|-------|------------|-------------|
| « » | 9 500 000 USD | 9 500 000 USD | 3 | 15% | 17/02/2003 | 40-10-2 () |
| « » | 2 500 000 USD | 2 500 000 USD | 3 | 15% | 02/08/2003 | 40-10-10() |
| « » | 2 500 000 USD | 2 500 000 USD | 3 | 15% | 22/01/2003 | 40-10-1() |
| « » | 7 500 000 USD | 7 500 000 USD | 3 | 15% | 07/05/2003 | 40-10-3 () |
| « i » | 2 400 000 USD | 2 400 000 USD | 1 | 13,5% | 20/09/2003 | 120/03 |
| | 5 000 000 USD | 3 000 000 USD | 7 | 9,3 % | 28270 | 27/05/2003 |

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| | 1 | 2003 | 2002 | 2001 | 2000 |
|--|---|----------------|---------------|---------------|---------------|
| | | 40 000 | 40 000 | 40 000 | 40 000 |
| | | 48 667 | 1 124 | 0 | |
| | | | 53 846 | 1 124 | -1 261 |
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| | | 231 948 | 94 970 | 41 124 | 38 739 |

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PENSION & INSURANCE ATTACHMENTS

DRAFT

January 29, 2004

To: Anvar Saidenov and Bolat Zhamishev
From: Sally Merrill and Douglas Whiteley, The Urban Institute and David Lucterhand and Steve Moody, The Pragma Corporation
cc. Arman Mekishev and Gulfairus Shaikakova, Guarantee Fund for Mortgage Credit

Re: Mortgage Guarantee Insurance Regulation, Banking Regulation, and Loan Purchases by the Kazakhstan Mortgage Company of Loans with "Downpayment" Insurance

Dear Mr. Saidenov and Mr. Zhamishev,

This note constitutes a brief clarification to the attached memorandum of January 26, 2004 to Mr. Zhamishev. As discussed therein, we are increasingly concerned with the risk implications stemming from the provision of mortgage guarantee insurance by insurance companies in Kazakhstan that do not conform to appropriate international standards for credit guarantee insurance. The regulatory framework which has been proposed for mortgage guarantee insurance is based on international best practice for an industry known to face a potential for high risk. Internationally, mortgage insurance companies are conservatively capitalized; subject to conservative risk-to-capital parameters; are at "arms length" from lenders; are nearly universally monoline, that is, offering only the MI product; and have premiums actuarially priced to address long-term economic changes in the market.

In contrast, a number of insurers in Kazakhstan are offering a form of mortgage guarantee insurance (which we have noted as "downpayment" insurance), in some cases in combination with life and property insurance, at what appears to be extremely low rates. In the long-term, the expected volatility in the housing market, or especially a more serious downturn, could result in serious consequences for these companies and their parent companies, some of which are banks. Thus, we suggest that the regulatory framework be reviewed. In addition, it is not advisable for the Kazakhstan Mortgage Company to purchase or encourage high LTV loans guaranteed in this manner since it places an added risk on the banks' balance sheets which has not been appropriately capitalized.

In many countries worldwide, both public and private insurance companies provide mortgage guarantee insurance. This approach could also be welcome and beneficial in Kazakhstan. However, it would be advisable for the Kazakhstan insurance companies to establish MI entities conforming to the regulatory framework described above.



**VALUATION
OF THE
STATE ACCUMULATION PENSION FUND**

**Almaty, Kazakhstan
January 2004**

Financial Sector Initiative

The Pragma Corporation / USAID / Central Asia Republics

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Section 1

Executive Summary

**VALUATION
OF THE
STATE ACCUMULATION PENSION FUND
Almaty, Kazakhstan
January 2004**

Executive Summary

This valuation of the State Accumulation Pension Fund (SAPF) has been prepared at the request of the National Bank of Kazakhstan and SAPF management by the Financial Sector Initiative, a USAID project being implemented by The Pragma Corporation in Kazakhstan. Its purpose is to establish an independent third-party estimate of the value of SAPF's continuing operations as of January 2004. Pragma arrived at its valuation by modeling SAPF's after-tax net operating profits (NOPLAT) over a fifteen-year investment horizon then discounting the free cash flows back to present value at an emerging market hurdle rate. **The discounted cash flow method under the moderate improvement scenario (see below) yields a value of KzT 5.756 billion (US\$41,117,468.00), which is 4.3 times SAPF book value as of 31 December 2003, and equates to 6.37% of Funds under Management.**

Key components of the valuation include:

€ **2.66% -- SAPF Average Annual Real Rate of Return on assets under management**

Pragma arrived at this rate by importing the ten-year average annual real rate of return (4.91%) of a group of investment funds and unit trusts in the Lipper Category of "World Bond Funds" and reducing that rate by (1) 40 basis points to reflect deficiencies in risk management within SAPF and (2) an additional 185 basis points to reflect inadequacies in Kazakhstan's general investment environment and particularly in the supervisory and regulatory agency. These adjustments are amortized over three different time periods (scenarios) which assume incremental improvements within SAPF and its investment and regulatory environment.

€ **13% -- hurdle rate at which investor discounts SAPF annual earnings**

Pragma adjusted the Lipper Aggressive Equity Hurdle Rate (11%) up to an Emerging Market Hurdle Rate (13%) to reflect investor discomfort with the fact that SAPF's Commission on Investment Income—the fund's primary source of earnings—is administratively set instead of market-driven and can, therefore, be reduced at any time.

Applying a real rate of return to net monies under management allows the analyst to ignore local inflation and inflation-driven adjustments to other components of the NOPLAT model. SAPF Expenses in the model are a function of pension assets under management. Extraordinary non-inflation-related expenses can occur, of course, and for

that reason Expenses in the model should be understood as average annual expenses, just as the rate of return is understood as the average annual real rate of return.

However, Pragma has made adjustments to other components in the model based on factors which are not inflation-driven.

€ **Net Contributions are assumed to grow at an average annual rate of 3.0%.**

Net Contributions are defined as total contributions plus transfers into SAPF less transfers out of SAPF. The assumption actually addresses transfers out of SAPF which, it suggests, will slow at a rate equivalent to 1.5% average annual growth in Net Contributions. Privatization of SAPF could significantly affect this rate, especially if investors include a Western strategic investor or an international financial institution.

€ **Pension Payouts are assumed to grow at an average annual rate of 2.5%.**

Pension payouts of all types (pensions, mortality payments and emigration withdrawal) are estimated to grow at an average annual rate of 2.5% for the entire pension system in Kazakhstan.

€ **Asset Allocation and the Structure of SAPF Investment Portfolio over Time.**

Critical to the NOPLAT model are assumptions concerning the structure of SAPF's investment portfolio. The underlying assumption in the model is that the SAPF portfolio will take on the characteristics of what Lipper categorizes as a "World Bond Fund;" that is, an investment fund or unit trust the greater portion of whose portfolio is invested in non-US fixed income sovereign and corporate securities, including mortgage-backed securities. Inasmuch as SAPF's liabilities are denominated in tenge, its portfolio should be invested as much as prudently possible in Kazakhstan sovereign, corporate and mortgage-backed issues, which would automatically put SAPF in the "World Bond Fund" category. Importantly, portfolios of funds in this category typically have durations in the range of three to six years.

€ **Incremental Improvement Scenarios**

SAPF has been valued under three scenarios for incremental improvement in both the fund itself and its investment and regulatory environment. The three scenarios are rapid (five years), moderate (eight years) and slow (fifteen years). The model amortizes the 225 basis points of discounts to annual real rate of return from 4.91% to 2.66% over the time period in each scenario.

The full text of the valuation includes an assessment of SAPF's systemic (i.e., non-investment) risk prepared by Mr. Steven Dore in May 2003 and portfolio and asset allocation analysis performed by Mr. John Wetherford in December 2003. The NOPLAT model was developed specifically for SAPF by resident Pragma consultants.

The Pragma Corporation,
Almaty, 12 March 2004

Section 2

Overview

The State Accumulation Pension Fund (SAPF) was established in connection with the implementation of pension reform in Kazakhstan that was concerned with the transition from a PAYG (solidarity) system to an accumulation system. SAPF started its activities on January 1, 1998 and in the initial stages SAPF acted exclusively as a pension fund: it attracted and accumulated pension contributions, provided individual accounting and worked with the contributors/recipients. The National Bank of Kazakhstan performed the function of asset management company for the State Accumulation Pension Fund. The State Fund has managed the pension assets itself since the middle of August 1999 and has also obtained a license to engage in broker-dealer activities (although they do not have the right to keep clients' accounts).

The Fund was set up in the form of a Closed Joint-Stock Company with 100% Government participation and is a national company. The Government of Kazakhstan is the Fund's founder and is entitled to transfer its rights and authorities with regard to the Government's shareholding to the National Bank of the Republic of Kazakhstan. The SAPF Board of Directors includes representatives from the National Bank, the Ministry of Finance and the SAPF General Director.

The SAPF head office is in Almaty, but it also has an additional branch in Astana and a large network of regional representative offices in the regional centers. The Fund's activity can be divided in accordance with the functions it performs – pension asset accumulation and management – as follows:

- € Work with contributors/recipients;
- € Pension asset accounting and operations with pension assets;
- € Investment management for pension assets and the SAPF own funds;
- € Accounting and reporting;
- € Information technology;
- € Administration and economic activities;
- € Internal audit.

The Fund is managed by the following bodies:

- € The General Meeting of the Shareholders is the highest body;
- € The Board of Directors is the Management Body;
- € The General Director is the Executive Body;
- € The Auditing Commission is the Supervisory Body.

The Fund's Management also includes:

- € Two Deputy Directors (one in charge of working with clients and the other in charge of asset management);
- € The Executive Director;
- € The Technical Director and
- € The Chief Accountant.

There are 194 employees in total, including 60 people in the regional subdivisions (between 2 and 5 people in each). There is also a network of agents (who are not included in the Fund's permanent staff).

The Agency of the Republic of Kazakhstan for the Regulation and Supervision of the Financial Market and Financial Institutions is the state authorized body that supervises and regulates the Fund's activity (before January 2004 this was the National Bank of the Republic of Kazakhstan).

The Fund operates on the basis of the Law "On Pension Provision in the Republic of Kazakhstan" and on the basis of other regulatory acts that govern operational and investment activities and those that set the prudential norms.

In accordance with the Rules for Pension Asset Investment Management the Fund has the right to place the pension assets in certain financial instruments (those that have the lowest risk level) within strictly specified limits.

Competitive Environment

Kazakhstan's pension system is represented by an accumulation pension system (personal savings in pension funds) and a PAYG (solidarity) system.

As the accumulation system only started in January 1998 most pension payments are currently paid out from the state solidarity system. However, with further development of the accumulation system and with an increase in individual pension savings, the role of the state system of pension provision will be significantly reduced to one where it merely provides the necessary minimum subsistence level for those people that reach the retirement age but do not have sufficient savings.

The accumulation pension system is represented by 16 accumulation pension funds, including the State Accumulation Pension Fund (see Table 1). Seven Pension Asset Management Companies manage the assets of fourteen pension funds. Two pension funds – the accumulation pension fund of the Narodny Bank and State Accumulation Pension Fund manage the pension assets themselves.

With a wide network of regional representative offices (16 regions) and as a pension fund "by default" until 2002 (having not signed contracts with the contributors), SAPF, in terms of both the accumulated and managed assets and the number of contributors, still occupies the leading position among other pension funds and asset management companies (24.5% and 37.8%, respectively). Its "by default" status has also provided it with the unrivalled conditions in that it covers most of the population. This being said, the average income of its contributors, upon which pension contributions into the fund are calculated, is significantly lower in the State Fund when compared with those in the non-state pension funds. About 50% of all accounts are nominal accounts, i.e. pension contributions are paid into them irregularly, and this is largely due to the seasonal nature of the contributors' work. More detailed information on this problem and other problems facing the Fund, such as erroneous accounts, accounts that have been opened without contracts being signed, etc. and the risks related to these problems can be found in the report for the period of May 1 – 23, 2003. This report is attached to the chapter on "Risk Analysis Report".

Table 1
A Share of Financial Institutions in the Accumulation Pension System
as of January 1, 2004

| Pension Asset Management Company/ Accumulation Pension Fund | Pension Assets | | Contributors | |
|--|----------------|---------------|------------------|----------------|
| | KZT, mln | in % | Contributors | in % |
| ABN AMRO Asset Management | 30.100 | 8.2% | 200.365 | |
| "CAPF Philip Morris Kazakhstan" | 845 | 0.2% | 1.222 | 0.0% |
| "APF Capital" | 2.392 | 0.6% | 57.419 | 0.9% |
| "ABN AMRO –KaspjMunaiGas APF" | 26.862 | 7.3% | 141.724 | 2.3% |
| ZHETYSU | 63.036 | 17.1% | 911.543 | |
| "APF "UlarUmit" | 63.036 | 17.1% | 911.543 | 14.8% |
| Ak Niet | 1.039 | 0.3% | 34.284 | |
| "NSAPF named after Kunaev" | 1.039 | 0.3% | 34.284 | 0.6% |
| BTA Asset Management | 31.979 | 8.7% | 510.527 | |
| "NSAPF "Kazakhstan" | 10.582 | 2.9% | 127.914 | 2.1% |
| "NSOAPF "Kurmet" | 15.590 | 4.2% | 313.025 | 5.1% |
| "OAPF "Otan" | 5.807 | 1.6% | 69.588 | 1.1% |
| Aktiv-Invest | 13.812 | 3.7% | 410.963 | |
| "NSAP Valyut-Transit Fund" | 13.812 | 3.7% | 410.963 | 6.7% |
| BESTINVEST | 41.878 | 11.4% | 496.913 | |
| "APF "Senim" | 16.347 | 4.4% | 148.363 | 2.4% |
| "APF "Korgau" | 5.581 | 1.5% | 83.907 | 1.4% |
| "APF "Kazakhmys" | 10.657 | 2.9% | 99.559 | 1.6% |
| "ONSAPF "NefteGas-DEM" | 9.294 | 2.5% | 165.084 | 2.7% |
| NURTRUST | 7.812 | 2.1% | 198.212 | |
| "Narodny Pension Fund" | 7.812 | 2.1% | 198.212 | 3.2% |
| "APF of Narody Bank of Kazakhstan" | 88.950 | 24.1% | 1.068.609 | 17.3 % |
| "State Accumulation Pension Fund" " | 90.321 | 24.5% | 2.332.900 | 37.8 % |
| Totally in all APFs | 368.929 | 100.0% | 6.164.316 | 100.0 % |

In contrast to non-state accumulation pension funds that pursue an aggressive marketing policy to attract contributors, SAPF activity in this area is more focused on providing information and explanations, rectifying wrongly opened accounts (closing any account that has been opened with the wrong name and transferring its contents to the correct account) and on signing contracts with the contributors if they do not have such contracts. Nevertheless, even with no marketing strategy the outflow of pension savings from SAPF to other funds continues to decrease.

The very same Rules for Pension Asset Management that were applied to other non-state pension asset management companies have been applicable to SAPF since September 24, 2003. An analysis of the investment portfolio and investment risks will be provided in the "Methodology" section. However, it should be noted here that SAPF is not only the largest pension fund, but also the largest asset management company.

At present SAPF's leading position is undisputable, although, from a competitive point of view, the Fund should not rest on its laurels and should take certain measures to maintain this position (see "Risk Analysis Report").

Section 3

Methodology

This analysis uses discounted cash flows (DCF) to value the State Accumulation Pension Fund. DCF valuation is especially applicable to companies in emerging markets, where there are no benchmarks for comparative analysis: companies' performance histories are short and mergers and acquisitions of similar companies of comparable size and operations few or non-existent.¹ The cash flows are discounted using a NOPLAT (Net Operating Profit Less Adjusted Taxes) model developed by Pragma Corporation consultants. The model uses real rates of return thereby ignoring inflation, which in Kazakhstan is relatively high and hard to predict with any precision. It discounts SAPF's cash flows at a "benchmark" hurdle rate of 13% (emerging market equity investment).²

The critical issue in this valuation, however, is not the hurdle rate, but the rate at which the model grows SAPF's income streams. At six years, SAPF's performance history is sufficient for projecting an average annual real rate of return over the fifteen-year investment horizon the model uses; however, those six years include a three- or, perhaps, four-year start-up period during which the standard deviation of both investment income and expense allocation is understandably higher than desirable for modeling. But the better argument against basing a ten-year average annual real rate of return on SAPF's own performance history is the "benchmark" issue: to what do you compare SAPF's average annual real rate of return to measure the reasonableness of the projection? Among the universe of investment funds and unit trusts to which SAPF belongs, what is the best measure against which SAPF's projected annual returns can be tested?

Kazakhstan Asset Management Companies

| Asset Management Company | Assets under management (mln US\$) | Average performance (99-03) | Last year performance (2003) |
|---------------------------------|---|------------------------------------|-------------------------------------|
| SAPF | 645.82 | 10.41% | 1.87% |
| Narodnyi Bank Kazakhstan | 635.35 | 13.69% | 0.54% |
| Zhetysu | 450.25 | 13.84% | -0.88% |
| BestInvest | 233.03 | 7.89% | -1.23% |
| BTA Asset Management | 228.76 | 4.38% | -1.16% |
| ABN AMRO | 277.30 | 6.89% | 0.09% |
| Aktiv-Invest | 98.72 | 4.45% | -0.53% |
| NurTrust | 55.99 | 13.77% | 0.69% |
| Total/Weighted Average | 2,625.78 | 10.52% | -0.34% |

Geographically, of course, SAPF belongs the group of eight asset management companies (KUPA), which collectively manage all assets in Kazakhstan's accumulation pension fund system. (SAPF also belongs to the group of sixteen accumulation pension

¹ At least one other pension fund in Kazakhstan has been valued by US valuation specialists, but the results of that valuation are not available to the public. Likewise, the values at which two or three pensions funds have merged or were acquired are not public information.

² Hurdle rate is the Internal Rate of Return an investor requires of a potential investment.

funds; however, since this analysis is concerned with average annual rate of return on investment, only those pension funds, which manage their own assets—of which SAPF is one—belong to the smaller category of KUPA.) Geography aside, while it appears SAPF’s performance can be compared to that of certain management companies in this group, in fact, it cannot: SAPF has been operating under the regulatory prudential norms governing all other KUPA only since September 26, 2003. At this point, SAPF’s annual performance is still not comparable to those of other KUPA.

However, the greatest disadvantage of measuring SAPF’s projected performance on the basis of geography alone is that the geography itself doesn’t get measured; that is, measuring SAPF’s performance against that of other asset management companies in Kazakhstan actually zeroes out the potential impact of Kazakhstan’s investment and regulatory environment on SAPF’s projected performance. Kazakhstan is considered an emerging market precisely because certain sectors of its economy are not fully developed; among the underdeveloped sectors of Kazakhstan’s economy is the financial sector, which includes not only the stock and bond markets in which SAPF invests, but also the regulatory agencies determining the extent to which SAPF may invest in both domestic and foreign markets. The fact that SAPF (and other KUPA) currently do, and will continue to, invest in both domestic and foreign markets suggests that they belong to a larger universe of asset managers (i.e., investment funds and unit trusts) which operate in markedly more developed investment and regulatory environments. This valuation takes the view that proper valuation of SAPF compares its investment performance to that of some larger universe of investment funds and unit trusts; fully cognizant that the past is no guarantee of future performance, this valuation nevertheless “imports” the average annual rate of return of a Lipper peer group of funds comparable to SAPF in size, investment policy and portfolio composition.

Lipper Peer Group

SAPF’s primary source of income is the fifteen (15) percent success fee it receives on investment income. The fund also receives a 0.02 percent commission on total assets under management: however, the driving force behind the growth of SAPF income is investment performance.

Composition of a Typical Lipper Global Bond Fund Portfolio

| | % of Total Net Assets |
|--|-----------------------|
| <u>CORPORATE NOTES/BONDS</u> | 44.27 |
| <u>FGN. CURRENCY DENOMINATED BONDS</u> | 31.68 |
| <u>GOVERNMENT AGENCY SECURITIES</u> | 8.93 |
| <u>US\$ DENOMINATED FGN. GVT.</u> | 6.54 |
| <u>CONVERTIBLE SECURITIES</u> | 4.51 |
| <u>PREFERRED STOCK-NON CONVERTIBLE</u> | 0.52 |
| <u>TREASURY NOTES/BONDS</u> | 0.47 |
| <u>COMMON STOCK</u> | 0.13 |

Source: CBSMarketwatch.com

The structure of SAPF’s investment portfolio will change over the proposed investment horizon. However, based on evaluation of SAPF’s investment policy and its current portfolio and after consultations with the fund’s asset managers, Pragma has determined that the primary characteristics of SAPF’S portfolio will consistently resemble those of funds Lipper categorizes as a “global bond funds;”³ that is, funds whose assets are, in large part, dollar- and foreign currency-denominated non-US sovereign and corporate debt issues. In the case of SAPF, tenge-denominated sovereign and corporate issues, including Kazakhstan Mortgage Company’s mortgage-backed securities (i.e., “foreign bonds”), should constitute a large percentage of the fund’s assets because the fund’s liabilities—future pension payouts—are denominated in tenge. As far as possible, SAPF should avoid currency mismatches between assets and liabilities, and hedge those that arise. That will not always be possible, however, and from time to time SAPF’s investment portfolio will incur currency risk.

A Lipper Global Bond Fund Investment Policy

Investment Policy: The Fund seeks high total investment return through a combination of current income and capital appreciation. The Fund seeks to attain its objective by normally investing substantially all of its assets in debt securities, although up to 20% of its assets may be invested in preferred stocks.

Lipper categorizes some 92 funds as “global fixed income” funds;⁴ not all 92 funds are included in SAPF’s peer group, however, which this analysis has filtered using two other parameters: (1) fund size (over \$500 million in assets) and (2) history of operation (minimum ten years). The ten-year operational history parameter significantly reduces the number of funds in the peer group.

Lipper Peer Group Performance History

| | Fund Return | Peer Group Average | S&P 500 |
|--------------------|----------------|-----------------------|------------|
| 1-Wk | 1.34% | 0.58% | 2.82% |
| 4-Wk | -0.22% | -0.06% | 2.49% |
| 13-Wk | 7.18% | 3.62% | 9.64% |
| YTD | 2.10% | 1.48% | 4.23% |
| 1-Yr | 28.05% | 9.00% | 41.19% |
| 3-Yr (Annualized) | 13.97% | 7.38% | -3.20% |
| 5-Yr (Annualized) | 10.36% | 6.41% | -0.70% |
| 10-yr (Annualized) | 10.28% | 6.62% | 11.06% |

Source: CBSMarketwatch.com

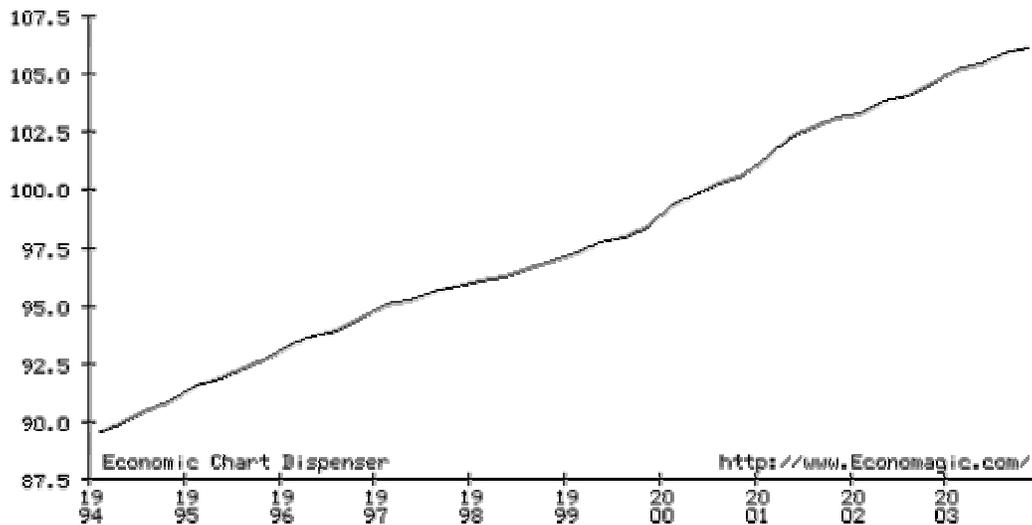
Lipper peer groups are industry benchmarks. Lipper’s quintile and percentile rankings are based on a fund’s performance over a given period by comparison to the average performance of its peers. In addition to total return performance, Lipper also

³ See Attachment One.

⁴ See Lipperleaders.com

ranks funds by expense (or “load” to the investor), tax efficiency, consistency of return and preservation of capital. This analysis concerns itself only with performance—that is, total return annualized over a ten-year history of investment—and uses the average peer group performance as its starting point.

Implicit Price Deflators for Gross Domestic Product: 1994-2003



Lipper peer group averages are nominal and annualized. In order to be imported for use in the NOPLAT model, they have been adjusted for annualized inflation using the GDP Implicit Price Deflator for the period December 1993 through December 2003. (Lipper funds report in US Dollars.) Annual inflation during the period averaged 1.71 percent. Thus, the ten-year average annualized real rate of return for SAPF’s Lipper peer group is 4.91 percent (6.62-1.71). (It should be noted here that Lipper’s peer group performance histories are dynamic; that is, they change by a couple of basis points as frequently as every month to reflect the most recent month’s results. And they are not weighted: recent performance carries no more weight in the average than does past performance.)

**One, Three and Five-Year Annualized Performance:
Inflation adjusted Real Rates of Return**

| Annualized Performance | Kazakhstan KUPA | Lipper Peer Group | State Accumulation Pension Fund |
|-------------------------------|------------------------|--------------------------|--|
| One Year | 0.60% | 7.43% | 1.87% |
| Three Years | 2.80% | 5.56% | 6.14% |
| Five Years | 6.03% | 4.57% | 10.41% |
| Ten Years | n/a | 4.91% | n/a |

Sophistication Factor

If SAPF were ranked in the fiftieth percentile (the very middle) of its Lipper Global Fixed Income Fund peer group, its ten-year average annual real rate of return

would be 4.91%. However, SAPF would also have, on average, all the other attributes its peer group funds enjoy in terms of (1) investment infrastructure and environment, (2) regulation and supervision, and (3) risk management expertise and investment experience. Clearly, an Almaty-based fund in operation for five years does not have the risk management expertise and investment experience of a New York-based fund in operation for ten years; these are shortcomings in the fund itself by comparison to its peers. But neither does SAPF have access to the entire spectrum of investment-grade instruments available to its western peers or to the futures, options and other derivatives markets its peer funds use to control risks and enhance performance. These are not shortcomings of the fund, but shortcomings of the fund's investment environment or its regulatory institutions, or both. They will nonetheless have a negative impact on SAPF's average annual performance, reducing it to some level below 4.91% for some period of time.

This analysis identifies eight factors in three broad categories, both in SAPF and in its environment, which require adjustment to the projected average annual performance. There follows a brief description of each factor and the adjustment in basis points each appears to merit.

It bears noting here that the basis-point discounts assessed on each factor (for lack of a better term, collectively called the "sophistication factor") are necessarily subjective and approximate: why twenty-five basis points instead of, say, twenty-seven? In fact, all assumptions used in a valuation are, to some extent, subjective and approximate; valuations generally are only as good as their weakest assumption. However, by identifying several factors to be discounted, this valuation dilutes the subjectivity and approximation to some extent; no individual factor is so heavily weighted that an error of judgment in its discount invalidates the entire valuation. Further, all of the discounts have been negotiated; that is, the discounts applied below have been arrived at in discussions among the valuation specialists, the consultants and SAPF management. Management, of course, knows SAPF—its strengths and weaknesses—better than anyone else, and its agreement to a given discount carries much more weight than the opinions or inclinations of others involved in the valuation. While subjective and approximate, the discounts discussed below are nevertheless reasonable. The best any valuation can do is to create a *reasonable expectation* of performance and value.

Risk Management Expertise and Investment Experience

1. Lack of Risk Management Committee

Discount: 25 bps

Sound investment successfully balances risk and reward. Too often in the investment decision-making process, however, Investment Committees show greater enthusiasm for analyzing an investment's potential rewards than for thorough analysis of its risks. To insure that risk gets equal treatment with reward, investment funds in advanced economies create a Risk Management Committee specifically tasked with identifying, measuring and managing investment risks. Within a fund, the Risk Management Committee is an organizational unit which operates in parallel with the Investment Committee. Its primary functions are (1) determining the level of risk which comports with the fund's stated Investment Policy, (2) identifying the various risks associated with each investment, and (3) managing the risk of the portfolio as a whole. The more funds diversify their investments, the greater the need for a Risk Management Committee.

SAPF has long since reached that degree of diversification, and this analysis strongly recommends SAPF install a Risk Management Committee as soon as possible.

2. Concentration of Trading Experience (Key Personnel Risk) Discount: 15 bps

A danger inherent to all investment funds and trading companies is the tendency for one or two individuals to dominate investment or trade decision-making. Investment and Risk Management Committees diffuse the danger somewhat, but the best insurance against so-called Key Personnel Risk is to hire more and better-trained investment managers and traders and assign them portions of the portfolio to manage. Hiring and training and retaining good investment managers is an expensive, long-term undertaking which SAPF has not yet addressed in earnest. Key Personnel Risk persists at SAPF.

3. Lack of Unified Management Information System Discount: 0 bps

This deficiency is discussed at length in Mr. Steven Dore's systems risk analysis of May 31, 2003. (See Attachment X.) SAPF management has budgeted monies to correct the deficiency in 2004 and 2005; the budgeted amounts appear in the model's expenses for those years. Therefore no discount has been assessed on this item.

Investment Infrastructure and Environment

4. Absence of government (risk free) yield curve Discount: 35 bps

At the end of 2003, SAPF's investment portfolio had a duration of slightly more than one year—rather short-term for a pension fund whose liabilities clearly have a longer duration. At the time, however, SAPF was working under a number of constraints which, in aggregate, demanded a front-loaded portfolio; that is, investments of short duration. One of those constraints is that yield curves on Kazakhstan's bond markets—both corporate and government—are essentially flat, offering investors no incentive to extend the term of their investments.

There appear to be two reasons for this. First is the shortage of domestic investment grade corporate instruments (discussed at greater length below) which makes Kazakhstan's a buy-and-hold environment. The second reason, however, is that real rates of return on recent government (MEOKAM) issues are net negative—i.e., interest rates on longer term issues (up to ten years) are lower than current rates of inflation. MEOKAM currently account for 93.5 percent of all domestic Minfin issues; the inflation-linked MEIKAM account for only 3.3 percent. Whether this is government aggressively foisting its desire for lower rates on the investing public or simply the result of an ill-conceived primary dealer network, the absence of a realistic government yield curve at term contributes to the shortage of (profitable) financial instruments and costs primary dealers, banks and pension funds millions in lost revenue. Ironically, in the end, because primary dealers (commercial banks) must cover the losses associated with MEOKAM issues with profits from other forms of lending, the government's artificially low yields keep lending rates to the public high.

The severity of the problem will lessen in April 2004 when the current primary dealer system is dismantled and MinFin begins auctioning inflation-indexed (MEIKAM) issues on the Kazakhstan Stock Exchange. For now, however, and for some time to come, it represents a serious deficiency in SAPF's investment environment.

5. *Lack of hedging of foreign currency risk*

Discount: 25 bps

Unhedged foreign currency exposure accounted for losses to Kazakhstan’s pension fund accumulations estimated at about \$80 million dollars in 2003. The losses arose not only in connection with foreign, dollar-denominated asset, but also in connection with domestic tenge-denominated, dollar-indexed assets—primarily, domestic corporate bonds. KUPA are unable to hedge their foreign currency exposure because (1) current law does not allow KUPA to engage in hedging operations and (2) the six-month dollar futures contract on the KASE is not currently traded. (There is a relatively active interbank forwards market in the dollar, however.)



The inability to hedge foreign currency exposure is a severe limitation on all KUPA and one cause of the perception of a shortage of financial instruments. (See Point 6, below.)

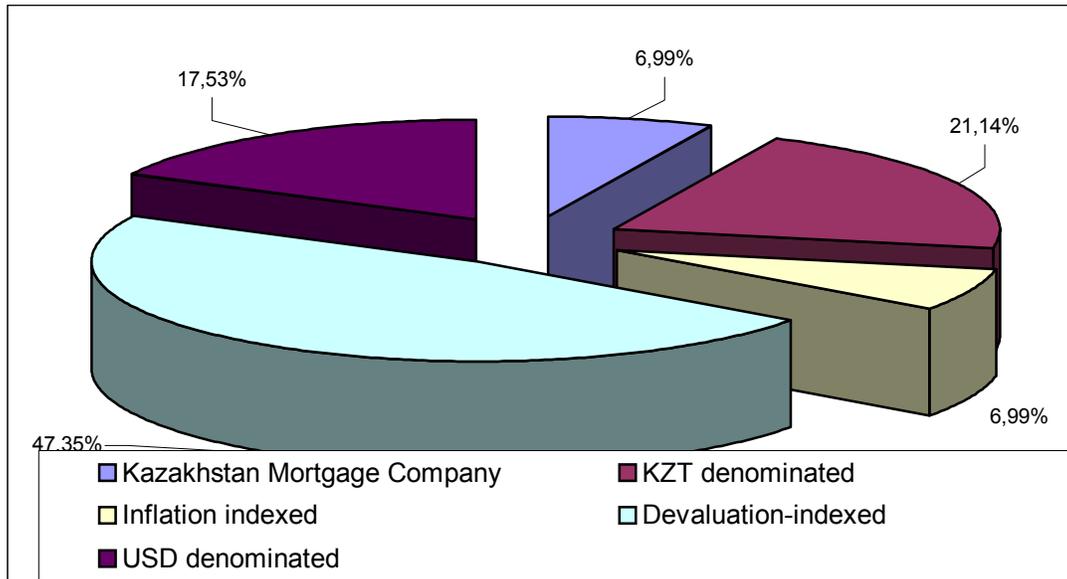
Recently, there have been discussions between the Regulatory Agency and KASE with an end toward reactivating the futures market in foreign currencies and allowing KUPA to hedge their currency exposure. On the basis of these discussions, this analysis discounts this item only 25 basis points, implying the hedging problem will be solved sooner rather than later, but also suggesting that hedging currency exposure is only a partial solution to a larger problem.

6. *Shortage of domestic investment grade instruments*

Discount: 50 bps

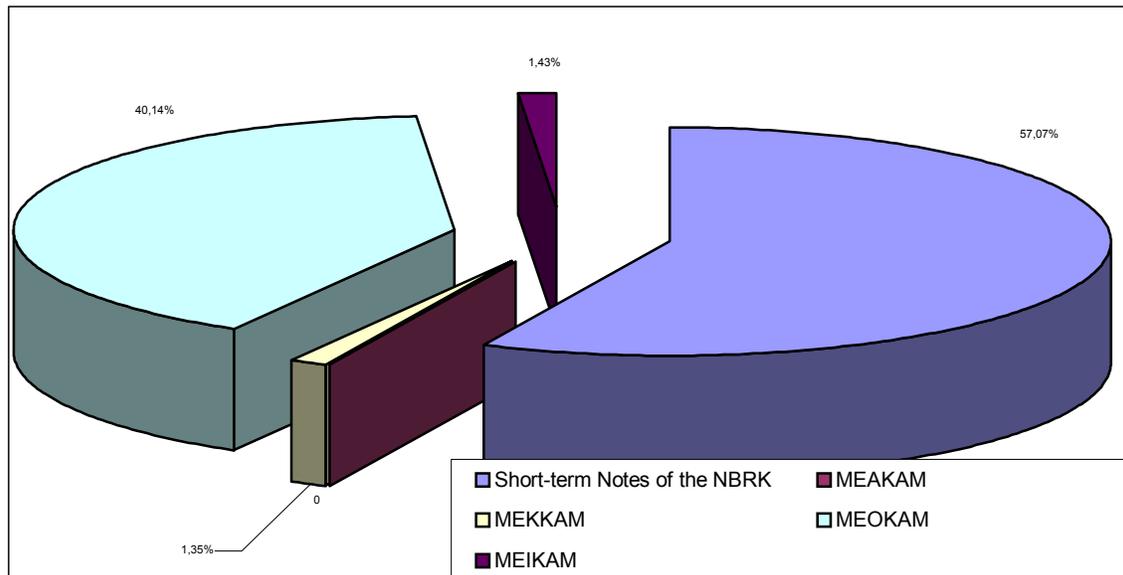
First of all, there is no “shortage of financial instruments.” At least, globally. At the end of 2001, the global bond market (consisting of all government and corporate domestic and international issues worldwide) was estimated at \$37.2 trillion, of which 47.3 percent were US issues. Add to that the total capitalization of the world’s stock markets, about \$25.0 trillion, to get the total value of the world’s capital markets: approximately \$62.2 trillion.

Structure of Corporate Issues in Kazakhstan



Currently, however, there is a shortage of instruments in which Kazakhstan’s asset managers can profitably invest, and there are three reasons for the shortage. First, Kazakhstan’s inflation rate, as measured by the CPI, is high relative to low interest and inflation environments worldwide. Even hedged, the rate of return on a US Ten Year Treasury yielding 4.04 percent is net negative after adjusting for tenge-denominated inflation. Second, the dollar is weak in relation to most of the world’s currencies, including the tenge, and as mentioned above, the KUPA cannot yet hedge their currency risk. And last, as discussed at greater length below, the regulatory agency has been slow to expand prudential norms for investment with the result that KUPA and pension funds have not been allowed to make some investments which could have produced greater returns under current conditions.

Structure of Government Issues



The prevailing conditions have forced the KUPA to focus their investments on domestic issues, which should be priced to reflect local inflationary expectations. Presently, there are KzT 529.6 billion (\$3.78 billion) of domestic issues, of which 393.7 are government (National Bank and MinFin) and 135.9 corporate (including Kazakhstan Mortgage Company). Of the KzT 393.7 billion government issues, 57.07 percent are short term NBK Notes, but only 1.43 percent are MEIKAM inflation-linked bonds with maturities up to ten years. The lion's share of government longer term issues, KzT 158.0 billion of MEOKAM, are not properly priced and, therefore, yield net negative real rates of return. Moreover, fully 64.88 percent (KzT 88.17 billion, or \$629.8 million) of outstanding corporate issues are either dollar-denominated or dollar-indexed, meaning their purchase entails currency exposure which must be hedged to protect yields to maturity. Including the mortgage-backed securities of Kazakhstan Mortgage Company, there are only KzT 47.7 billion (\$340.7 million) of pure tenge corporate issues. Thus, out of total government and domestic issues, KUPA can invest in only KzT 53.06 billion (\$379 million) which are properly priced (or inflation-linked) and do not entail currency risk. Fifty-three billion tenge is only 14.4 percent of current pension accumulations.

So there is a severe shortage of financial instruments in Kazakhstan's investment environment. Hedging currency risk will, of course, relieve the tightness somewhat, as will new, longer term government inflation-linked issues. The core macroeconomic problems here, however, are the dollarization of Kazakhstan's economy and domestic inflation. Unfortunately, neither will go away very soon.

Regulatory Environment

7. Lack of broad investment industry experience in Regulatory Agency Discount: 75 bps
Since its inception in 1998, the role of the regulator has evolved rapidly from that of a watchdog agency intent on preventing embezzlement, fraud and large-scale systemic mistakes in a fragile financial sector with a nascent private pension fund system, to that of a helmsman intent on protecting the safety of passengers and crew while steering Kazakhstan's financial sector on a potentially perilous course in poorly charted waters. Helmsmen have to know where they're going. Unfortunately, in the investment business, you know where you're going only if you've been there before.

While the National Bank and Regulatory Agency appear to have done an admirable job as watchdog, key personnel have little or no direct experience in the investment industry in Kazakhstan or elsewhere. There is, therefore, a very high likelihood that they are going to make mistakes, or move too slowly or uncertainly, or simply move in the wrong direction—at least, for the next few years, while personnel gain experience and insight. The mistakes or uncertain moves will cost the KUPA, including SAPF, investment income. The currency risk hedging issue, discussed above, is a case in point.

8. Success fee on investment income not market-driven Discount: 0 bps

The fact that the Regulatory Agency can unilaterally change the success fees on investment income and funds under management is a investment risk best addressed not in real rate of return, but in the hurdle rate at which net income is discounted in the model. This perceived deficiency is the primary reason the analysis raises the hurdle rate

from 11 percent (aggressive equity investment) to 13 percent (venture capital or emerging market equity investment).

The discounts set forth above total 225 basis points, which lower SAPF average annual real rate of return in the NOPLAT model from 4.91 percent to 2.66 percent.

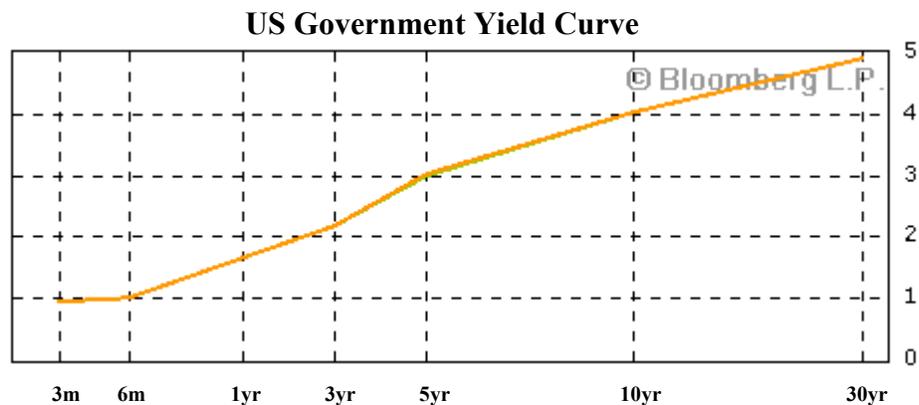
Hurdle Rate

The Capital Asset Pricing Model defines hurdle rate (Expected Return, or **ER**) as the risk-free rate of return (**R_f**, US Treasury Notes or Bonds, for example) plus some risk premium [**η_i(R_m - R_f)**], where **η_i** is the beta of the investment and **R_m** is the expected market return. The equation is usually written thus:

$$\mathbf{ER} = \mathbf{R}_f + \mathbf{\eta}_i(\mathbf{R}_m - \mathbf{R}_f). \quad (1)$$

Beta is the volatility (covariance, ω^2) of an individual investment relative to overall market volatility (standard deviation, or ω); it measures the risk of the proposed investment compared to the risk of the market as a whole. A beta of 1.0 indicates investment risk equivalent to that of the market. Betas greater than 1.0 are riskier, betas less than 1.0 less risky, than the overall market.

The market to which this analysis refers is, of course, the subset of global fixed income funds, as defined above, which constitutes SAPF's Lipper peer group. There is no SAPF beta relative to this peer group and, unfortunately, Lipper will not share its full data on the peer group nor its proprietary methodology for measuring beta for members of the peer group with Pragma analysts. However, using known values for **ER**, **R_f** and **R_m**, the analysis can solve the CAPM equation for the beta implied by the hurdle rate of 13 percent or any other hurdle rate.



The risk-free security (**R_f**) in the calculation will be a fifteen-year US Government security (actually, the fifteen-year tail of a 30-year bond). The fifteen-year investment horizon of the security corresponds to the investment horizon over which SAPF's free cash flows are discounted. As the Bloomberg chart above indicates, the yield on such a security is currently about 4.25 percent. Inflationary expectations at this term, as indicated by the ten-year inflation-indexed US Treasury Note, are about 2.30 percent. The real risk-free rate of return is then 1.95 percent.

The expected market return (R_m) is, of course, the ten-year average rate of return of SAPF's Lipper peer group: 6.62 percent. Thus, from (1) we get

$$13 = 1.95 + \eta_i(6.62 - 4.25) \quad (2)$$

$$\frac{11.05}{2.37} = 4.66 = \eta_i \quad (3)$$

A beta of 4.66 is extremely high and, therefore, justifies a hurdle rate almost twice as high as the rate of return on the Lipper peer group. Is it reasonable, however? Well, not necessarily. No one is questioning whether a high level of risk justifies a high level of reward. It does. However, high levels of reward do not always entail high risks or, at least, high betas. For example, the best performing fund in the Lipper peer group has an average annual return of 10.86 percent, but its beta compared to the peer group is only 0.33. The anomaly arises because the CAPM beta actually uses similarity or dissimilarity of performance (covariance) to distinguish the individual risk of a security from the "random volatility" of a larger group of securities. Clearly, the best performing fund in a group of funds is dissimilar from the other funds in the group. It might, in fact, incur greater risks than the rest of the group, but its performance consistently compensates for the risks and its beta is, therefore, low.

The issue here, however, is somewhat different. The beta implied by (3) above is actually the beta for SAPF *and its investment and regulatory environment*. If we add back to the Lipper peer group average annual rate of return the 185 basis points of discounts attributable to SAPF's investment and regulatory environment, the implied beta for SAPF—2.62—is somewhat more reasonable. Regardless of the implied beta of the investment, however, any investor—domestic or foreign—should keep the hurdle rate at minimum 13% to reflect the fact that commissions on investment income are set by the regulatory agency, and not by market factors (competition).

Incremental Improvement Scenarios

Optimism is a precondition for investment. One invests because one anticipates some degree of improvement in the investment environment generally and in the target investment specifically. The NOPLAT model used to value SAPF incorporates a feature which provides for incremental improvement at three different rates: rapid, moderate and slow. Each essentially adds back the discounts taken above to SAPF's average annual real rate of return, raising it from 2.66% in the first year to 4.91% in some future year. The rapid improvement scenario brings SAPF to the 4.91% return in five years; the moderate and slow scenarios in eight and fifteen years, respectively. The results are summarized in the table below.

| Scenario | Valuation (in mln Tenge) | Valuation (in mln USD) | Multiple of Book Value | Percent of Funds under Management | Multiple of Gross Revenues |
|-----------------|-----------------------------|---------------------------|---------------------------|---|-------------------------------|
| Rapid | 6,240 | 44.573 | 4,66 | 6,91% | 4,27 |
| Moderate | 5,756 | 41.117 | 4,31 | 6,37% | 3,94 |
| Slow | 5,127 | 36.622 | 3,83 | 5,68% | 3,51 |

Section 4

NOPLAT

Scenario 2. Medium Growth

| | | | | | | | | | | | | | | | | | | | | |
|--------------------------------------|--------|---------------|-------|----|-------|-------|--|--|--|--|--|--|--|--|--|--|--|--|--|--|
| Real Return | 2.66% | | | | | years | | | | | | | | | | | | | | |
| Net Contributions Growth | 3.00% | Rapid Growth | 2.25% | 5 | 0.45% | 4.91% | | | | | | | | | | | | | | |
| Commissions on Investment Income | 15.00% | Medium Growth | 2.25% | 8 | 0.28% | | | | | | | | | | | | | | | |
| Commissions on Pension Assets | 0.02% | Slow Growth | 2.25% | 15 | 0.15% | | | | | | | | | | | | | | | |
| Pension Payouts as % of beginning PA | 2.50% | | | | | | | | | | | | | | | | | | | |
| Corporate Income Tax | 30.00% | | | | | | | | | | | | | | | | | | | |
| Hurdle Rate | 13.00% | | | | | | | | | | | | | | | | | | | |
| Expenses as % of Income | 42.30% | | | | | | | | | | | | | | | | | | | |

| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
|--------------------------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| Moderate Growth in Real Return | 2.66% | 2.94% | 3.22% | 3.50% | 3.79% | 4.07% | 4.35% | 4.63% | 4.91% | 4.91% | 4.91% | 4.91% | 4.91% | 4.91% | 4.91% |
| Adjustments to Expenses | 2.25% | 1.97% | 1.69% | 1.41% | 1.13% | 0.84% | 0.56% | 0.28% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% |

Pension Accumulations, million of Tenge

| | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
|--|---------------|---------------|---------------|---------------|---------------|---------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|
| Pension Accumulations, beginning period | | 33,867 | 43,857 | 58,885 | 75,650 | 90,321 | 99,801 | 109,784 | 120,324 | 131,481 | 142,990 | 155,218 | 168,236 | 182,121 | 196,957 | 212,836 | 229,335 | 246,473 | 264,272 | 282,755 |
| Net Contributions | 22,949 | 5,424 | 9,044 | 9,094 | 9,517 | 9,802 | 10,096 | 10,399 | 10,711 | 11,032 | 11,363 | 11,704 | 12,055 | 12,417 | 12,789 | 13,173 | 13,568 | 13,975 | 14,395 | 14,826 |
| Investment Earnings | 13,345 | 6,347 | 8,083 | 10,188 | 8,027 | 2,533 | 3,084 | 3,705 | 4,403 | 4,800 | 5,627 | 6,550 | 7,576 | 8,717 | 9,985 | 10,774 | 11,593 | 12,445 | 13,329 | 14,247 |
| Commissions on Investment Income | 1,334 | 635 | 807 | 1,019 | 1,189 | 380 | 463 | 556 | 661 | 720 | 844 | 982 | 1,136 | 1,308 | 1,498 | 1,616 | 1,739 | 1,867 | 1,999 | 2,137 |
| Commissions on Pension Assets | | | | | 181 | 217 | 240 | 264 | 289 | 316 | 344 | 373 | 404 | 438 | 473 | 511 | 551 | 592 | 635 | 679 |
| Pension Payouts | 1,093 | 1,147 | 1,292 | 1,498 | 1,502 | 2,258 | 2,495 | 2,745 | 3,008 | 3,287 | 3,575 | 3,880 | 4,206 | 4,553 | 4,924 | 5,321 | 5,733 | 6,162 | 6,607 | 7,069 |
| Pension Accumulations, end period | 33,867 | 43,857 | 58,885 | 75,650 | 90,321 | 99,801 | 109,784 | 120,324 | 131,481 | 142,990 | 155,218 | 168,236 | 182,121 | 196,957 | 212,836 | 229,335 | 246,473 | 264,272 | 282,755 | 301,944 |

Pension Fund P&L, million of Tenge

| | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
|-------------------------------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|--------------|--------------|--------------|--------------|--------------|
| Income from operating activity | 271 | 1,375 | 791 | 1,012 | 1,231 | 1,462 | 597 | 702 | 820 | 950 | 1,036 | 1,188 | 1,355 | 1,541 | 1,745 | 1,971 | 2,127 | 2,290 | 2,459 | 2,634 | 2,816 |
| Income from own investments | | | | | | | 27 | 42 | 54 | 68 | 86 | 106 | 132 | 162 | 199 | 230 | 266 | 304 | 346 | 392 | 441 |
| Expenses | 84 | 237 | 409 | 424 | 437 | 580 | 258 | 303 | 353 | 407 | 443 | 507 | 577 | 654 | 738 | 834 | 900 | 969 | 1,040 | 1,114 | 1,191 |
| Net Profit before Tax and Dividends | 187 | 1,137 | 382 | 588 | 794 | 882 | 365 | 442 | 521 | 610 | 678 | 787 | 911 | 1,050 | 1,206 | 1,368 | 1,493 | 1,626 | 1,765 | 1,912 | 2,066 |
| Corporate Income Tax | 55 | 334 | 123 | 174 | 231 | 250 | 110 | 132 | 156 | 183 | 204 | 236 | 273 | 315 | 362 | 410 | 448 | 488 | 529 | 573 | 620 |
| NOPLAT | 132 | 804 | 259 | 414 | 564 | 632 | 256 | 309 | 365 | 427 | 475 | 551 | 637 | 735 | 844 | 957 | 1,045 | 1,138 | 1,235 | 1,338 | 1,446 |
| Dividends | 5 | 380 | 130 | 207 | 282 | 316 | | | | | | | | | | | | | | | |
| Retained Earnings | 127 | 424 | 130 | 207 | 282 | 316 | 256 | 309 | 365 | 427 | 475 | 551 | 637 | 735 | 844 | 957 | 1,045 | 1,138 | 1,235 | 1,338 | 1,446 |
| | | 406.9% | -42.4% | 27.9% | 21.6% | 18.8% | -59.2% | 17.7% | 16.7% | 15.9% | 9.1% | 14.6% | 14.1% | 13.7% | 13.3% | 12.9% | 7.9% | 7.6% | 7.4% | 7.1% | 6.9% |

Valuation

| Year | NOPLAT | Discount Factor | PV NOPLAT |
|------|--------|-----------------|------------------------------------|
| 2004 | 256 | 0.88 | 226 |
| 2005 | 309 | 0.78 | 242 |
| 2006 | 365 | 0.69 | 253 |
| 2007 | 427 | 0.61 | 262 |
| 2008 | 475 | 0.54 | 258 |
| 2009 | 551 | 0.48 | 265 |
| 2010 | 637 | 0.43 | 271 |
| 2011 | 735 | 0.38 | 276 |
| 2012 | 844 | 0.33 | 281 |
| 2013 | 957 | 0.29 | 282 |
| 2014 | 1,045 | 0.26 | 272 |
| 2015 | 1,138 | 0.23 | 263 |
| 2016 | 1,235 | 0.20 | 252 |
| 2017 | 1,338 | 0.18 | 242 |
| 2018 | 1,446 | 0.16 | 231 |
| | 11,759 | 0.16 | 1,880 |
| | | | million of T million of USD |
| | | | 5,756 41.117468 |

Value

Statement of changes in equity

| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
|------------------------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|--------|--------|--------|
| Beginning Equity | 1,338 | 1,914 | 2,223 | 2,587 | 3,015 | 3,490 | 4,041 | 4,678 | 5,413 | 6,257 | 7,215 | 8,260 | 9,398 | 10,633 | 11,971 |
| Retained profit | 256 | 309 | 365 | 427 | 475 | 551 | 637 | 735 | 844 | 957 | 1,045 | 1,138 | 1,235 | 1,338 | 1,446 |
| Issue of New Shares/buy back | 320 | | | | | | | | | | | | | | |
| Other Adjustments to Equity | | | | | | | | | | | | | | | |
| Ending Equity | 1,914 | 2,223 | 2,587 | 3,015 | 3,490 | 4,041 | 4,678 | 5,413 | 6,257 | 7,215 | 8,260 | 9,398 | 10,633 | 11,971 | 13,417 |

Scenario 3. Slow Growth

| | | | | | | | | | | | | | | | | | | | | |
|--------------------------------------|--------|--|---------------|-------|----|-------|-------|--|--|--|--|--|--|--|--|--|--|--|--|--|
| Real Return | 2.66% | | | | | | years | | | | | | | | | | | | | |
| Net Contributions Growth | 3.00% | | Rapid Growth | 2.25% | 5 | 0.45% | 4.91% | | | | | | | | | | | | | |
| Commissions on Investment Income | 15.00% | | Medium Growth | 2.25% | 8 | 0.28% | | | | | | | | | | | | | | |
| Commissions on Pension Assets | 0.02% | | Slow Growth | 2.25% | 15 | 0.15% | | | | | | | | | | | | | | |
| Pension Payouts as % of beginning PA | 2.50% | | | | | | | | | | | | | | | | | | | |
| Corporate Income Tax | 30.00% | | | | | | | | | | | | | | | | | | | |
| Hurdle Rate | 13.00% | | | | | | | | | | | | | | | | | | | |
| Expenses as % of Income | 42.30% | | | | | | | | | | | | | | | | | | | |

| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
|----------------------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| Slow Growth in Real Return | 2.66% | 2.81% | 2.96% | 3.11% | 3.26% | 3.41% | 3.56% | 3.71% | 3.86% | 4.01% | 4.16% | 4.31% | 4.46% | 4.61% | 4.76% |
| Adjustments to Expenses | 2.25% | 2.10% | 1.95% | 1.80% | 1.65% | 1.50% | 1.35% | 1.20% | 1.05% | 0.90% | 0.75% | 0.60% | 0.45% | 0.30% | 0.15% |

Pension Accumulations, million of Tenge

| | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
|--|---------------|---------------|---------------|---------------|---------------|---------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|
| Pension Accumulations, beginning period | | 33,867 | 43,857 | 58,885 | 75,650 | 90,321 | 99,801 | 109,667 | 119,951 | 130,687 | 141,912 | 153,665 | 165,985 | 178,916 | 192,505 | 206,798 | 221,850 | 237,715 | 254,453 | 272,128 |
| Net Contributions | 22,949 | 5,424 | 9,044 | 9,094 | 9,517 | 9,802 | 10,096 | 10,399 | 10,711 | 11,032 | 11,363 | 11,704 | 12,055 | 12,417 | 12,789 | 13,173 | 13,568 | 13,975 | 14,395 | 14,826 |
| Investment Earnings | 13,345 | 6,347 | 8,083 | 10,188 | 8,027 | 2,533 | 2,946 | 3,400 | 3,897 | 4,440 | 5,033 | 5,679 | 6,382 | 7,146 | 7,976 | 8,877 | 9,854 | 10,914 | 12,062 | 13,306 |
| Commissions on Investment Income | 1,334 | 635 | 807 | 1,019 | 1,189 | 380 | 442 | 510 | 585 | 666 | 755 | 852 | 957 | 1,072 | 1,196 | 1,332 | 1,478 | 1,637 | 1,809 | 1,996 |
| Commissions on Pension Assets | | | | | 181 | 217 | 240 | 263 | 288 | 314 | 341 | 369 | 399 | 430 | 463 | 497 | 533 | 571 | 611 | 654 |
| Pension Payouts | 1,093 | 1,147 | 1,292 | 1,498 | 1,502 | 2,258 | 2,495 | 2,742 | 2,999 | 3,267 | 3,548 | 3,842 | 4,150 | 4,473 | 4,813 | 5,170 | 5,546 | 5,943 | 6,361 | 6,803 |
| Pension Accumulations, end period | 33,867 | 43,857 | 58,885 | 75,650 | 90,321 | 99,801 | 109,667 | 119,951 | 130,687 | 141,912 | 153,665 | 165,985 | 178,916 | 192,505 | 206,798 | 221,850 | 237,715 | 254,453 | 272,128 | 290,808 |

Pension Fund P&L, million of Tenge

| | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
|-------------------------------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|--------------|--------------|--------------|
| Income from operating activity | 271 | 1,375 | 791 | 1,012 | 1,231 | 1,462 | 597 | 682 | 773 | 873 | 980 | 1,096 | 1,221 | 1,356 | 1,502 | 1,659 | 1,828 | 2,011 | 2,208 | 2,421 | 2,650 |
| Income from own investments | | | | | | | 27 | 40 | 49 | 60 | 72 | 87 | 104 | 124 | 147 | 174 | 205 | 241 | 282 | 329 | 382 |
| Expenses | 84 | 237 | 409 | 424 | 437 | 580 | 258 | 294 | 334 | 376 | 421 | 471 | 523 | 580 | 642 | 708 | 779 | 856 | 938 | 1,027 | 1,123 |
| Net Profit before Tax and Dividends | 187 | 1,137 | 382 | 588 | 794 | 882 | 365 | 428 | 489 | 557 | 631 | 712 | 801 | 899 | 1,007 | 1,125 | 1,254 | 1,396 | 1,552 | 1,722 | 1,910 |
| Corporate Income Tax | 55 | 334 | 123 | 174 | 231 | 250 | 110 | 128 | 147 | 167 | 189 | 214 | 240 | 270 | 302 | 337 | 376 | 419 | 465 | 517 | 573 |
| NOPLAT | 132 | 804 | 259 | 414 | 564 | 632 | 256 | 299 | 342 | 390 | 441 | 498 | 561 | 629 | 705 | 787 | 878 | 977 | 1,086 | 1,206 | 1,337 |
| Dividends | 5 | 380 | 130 | 207 | 282 | 316 | | | | | | | | | | | | | | | |
| Retained Earnings | 127 | 424 | 130 | 207 | 282 | 316 | 256 | 299 | 342 | 390 | 441 | 498 | 561 | 629 | 705 | 787 | 878 | 977 | 1,086 | 1,206 | 1,337 |
| | | 406.9% | -42.4% | 27.9% | 21.6% | 18.8% | -59.2% | 14.2% | 13.5% | 12.8% | 12.3% | 11.8% | 11.4% | 11.1% | 10.7% | 10.5% | 10.2% | 10.0% | 9.8% | 9.6% | 9.5% |

Valuation

| Year | NOPLAT | Discount Factor | PV NOPLAT | |
|------|--------|-----------------|-----------------------------|------------------------------|
| 2004 | 256 | 0.88 | 226 | |
| 2005 | 299 | 0.78 | 234 | |
| 2006 | 342 | 0.69 | 237 | |
| 2007 | 390 | 0.61 | 239 | |
| 2008 | 441 | 0.54 | 240 | |
| 2009 | 498 | 0.48 | 239 | |
| 2010 | 561 | 0.43 | 238 | |
| 2011 | 629 | 0.38 | 237 | |
| 2012 | 705 | 0.33 | 235 | |
| 2013 | 787 | 0.29 | 232 | |
| 2014 | 878 | 0.26 | 229 | |
| 2015 | 977 | 0.23 | 225 | 3.83 times Book Value |
| 2016 | 1,086 | 0.20 | 222 | 5.68% Funds under Management |
| 2017 | 1,206 | 0.18 | 218 | 3.51 times Revenue |
| 2018 | 1,337 | 0.16 | 214 | |
| | 10,393 | 0.16 | 1,662 | |
| | | | million of T million of USD | |
| | | | 5,127 36.622262 | |

Value

Statement of changes in equity

| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
|------------------------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|---------------|---------------|
| Beginning Equity | 1,338 | 1,914 | 2,213 | 2,555 | 2,945 | 3,387 | 3,885 | 4,446 | 5,075 | 5,780 | 6,567 | 7,445 | 8,422 | 9,509 | 10,714 |
| Retained profit | 256 | 299 | 342 | 390 | 441 | 498 | 561 | 629 | 705 | 787 | 878 | 977 | 1,086 | 1,206 | 1,337 |
| Issue of New Shares/buy back | 320 | | | | | | | | | | | | | | |
| Other Adjustments to Equity | | | | | | | | | | | | | | | |
| Ending Equity | 1,914 | 2,213 | 2,555 | 2,945 | 3,387 | 3,885 | 4,446 | 5,075 | 5,780 | 6,567 | 7,445 | 8,422 | 9,509 | 10,714 | 12,051 |

Section 5

Risk Analysis Report

by Charles Dore

Overview and Executive Summary of Observations and Recommendations

We conducted interviews at the central location of the GNPf during the period of May 12th through May 20th. The interview process began with general department overviews presented by the Department Heads in the General Director's office, completed with additional interviews of key department heads. This process included a discussion of processes, staffing and associated risks. Department heads were asked for suggestions about key priorities for their organizations which have been noted. In addition to the interview process, various documents, charts and reported financial numbers were gathered and analyzed.

The market risk of investments was not reviewed or addressed in our work. Those responsible for managing participant assets have expressed a need for clarification of investment policy in light of the increasing contributions to invest and decreasing assets qualified for investment. Further work and assessment is needed for this area and function.

Our initial scope of work was more narrowly defined and related to auditing risks. We were quickly satisfied that the overall operating system was adequately and effectively controlled and consistent with existing standards within the United States. As a result of our confidence in this aspect of the GNPf operation, we expanded our scope to look at broader risks related to readiness for competition in an evolving marketplace.

From our work we gained a very favorable impression of the staff and the overall organization. The staff is professional and this professionalism is reflected in all aspects of GNPf daily operations. It is our opinion that there is a considerable wealth of talent in the GNPf that can be effectively led along the crucial road of change so that the GNPf can compete effectively in the marketplace. In our work we have tried to offer a roadmap to help lead the way.

Our work is intended to provide a map of the road over the next several years. Since the GNPf is in an active marketplace, it must compete just like any other fund. The steps GNPf must take to become a more effective and ongoing marketplace competitor, are key to its long-term future regardless of any decision about privatization. It is the process of preparing for this transition that is of greatest importance long-term. The following are the findings we have made as a result of our work.

Overall Risk: GNPf Market Readiness

Marketing readiness is the central risk regardless of the decision to privatize. The maturing pension market will force all funds compete harder to attract and retain contributors. The GNPf must be ready to compete and gain market share by changing the mindset of all staff. Changing the mindset is the first step, and involves creating a competitive sense or spirit in all staff. This is typically accomplished through training and active management follow up at all levels.

Enhancing market readiness by changing the mindset will involve training all staff in the fundamentals of marketplace competition. The knowledge and perspective gained from

training can then be applied concretely in each department. The results of change management will sharpen the analytical and critical business thinking of all staff on such things as business drivers or the functions that drive each department's business processes, accountability, competitive compensation, marketing, budgeting, and planning to list but a few examples.

Along with changing the mindset of the organization, the following must be done to optimize market readiness and minimize the risk of becoming non-competitive:

1. Establish a strategic planning and budgeting process

Initially this process will be hard given the lack of a Management Information System (MIS). However, without this process, the road becomes unclear, so it should start as soon as possible.

The process should include:

- a.) Defining a market position for GNPf in pension market
- b.) Identifying marketing opportunities and implications for GNPf as Kazakhstani pension providers consolidate to five or six providers within a few years
- c.) Assessing capabilities of available pension software based on market defined market position mentioned in "a.)" above

Obtaining a competitive edge may not come through software advantages, but more likely from investment performance and service delivery or execution off essentially similar platforms. However, examining available delivery platforms against the market definition developed in "a.)" above is a worthwhile exercise

- d.) Establishing cost drivers that in turn can be used to develop Return on Investment (ROI) parameters for future analyses of all types

Over time, the process will be refined with marketing and budget data from an MIS database.

2. Select and install a Management Information System (MIS)

Without MIS, there is a significant organizational risk to an efficient business operation regardless of privatization. MIS will enable departments immediate access to all manner of data within the organization. This will create a quantum leap in how GNPf does business.

The decision to implement an MIS system is an absolute necessity, and a significant risk to business operations the longer it is delayed. An MIS system is like a mirror, because it helps you look at yourself. As senior management at the GNPf have acknowledged, without this mirror, the GNPf cannot really know itself and how it does business. Without an integrated MIS system, all business functions will be effected negatively from customer service to accounting. And negative effects on customer service will create more participant transfers to competitors and decreased revenues.

3. Review Premises and Representative Offices

In Almaty there appears to be a space shortage that must be addressed in order to remain in compliance with Labor Regulations so budgeted hires can join GNPf, and the ongoing business operation is not compromised.

As part of strategic planning process, profitability of 17 regional offices must be measured against providing support from Almaty. Profitability can be measured by establishing regional account income and expense statements. As a result GNPf can measure the cost effect of office closures on data integrity and the ability to enroll and service contributors or participants in the absence of such offices. Since it is our understanding that most representative offices have one year, renewable leases, closing any unprofitable branches would be easier and less costly.

4. Complete the disaster recovery program as soon as possible

Moving old servers to Astana for back-up by first of 2004 is a good first step in a series of steps that should lead to a completed disaster recovery plan. As GNPf management acknowledges, without such a program in place, business interruptions could seriously harm the fund in all ways.

5. Centralize training within the HR function

We would encourage centralizing and expanding the training authority, including budget accountability, to acclimate new staff and representatives and to ensure continuous inflow of professional knowledge and staff growth and development. Such training goes well beyond basic skills and certifications programs currently in place. Under the current GNPf organization structure, HR is the most logical place for this centralized function.

2002 GNPf training budget of Kzt 3.6 million against actual expenditure of Kzt 1.5 million suggests recognition of need but unexploited resources.

6. Obtain legal clarity regarding pension law statutes that may negatively effect GNPf and the pension industry.

Greater clarity in the law will help GNPf with respect to concluding the project related to unidentified accounts as well as those without legal agreements on file.

a.) As many as 908,727 accounts with average balances of less than Kzt 10,000 still have no agreements with the GNPf on file as required by the law beginning 01/2003. It is expected that this number will be reduced to 300,000 by 2006. Beyond that, the staff is not optimistic about further substantial reduction to this number.

Beginning 01/2004, we recommend that these accounts be segregated within GNPf with respect to staff access and data security, to minimize risk of unlawful transfer or distribution. Since these accounts represent an income stream to GNPf, we would suggest projecting income versus account maintenance (Kzt 184 in 2002) to highlight the positive implications of this revenue stream to attract possible buyers.

b.) There is an approximate GNPf liability Kzt3.2 million (\$210k) in agent commissions for accounts without executed agreement (assuming at 12/31/03 500k still without legal agreement on file). We believe that you can view this as an “account payable” and accrue this amount.

As stated above, we are concerned about legal uncertainties related to the disposition of these accounts at the end of the 8 years as required by the law. Accordingly, we urge the GNPf to lobby for clarification of this law.

Additional Considerations

1. Offset increased marketing expense related to attracting and retaining contributors against fund income to spread costs over all participants
2. Negotiate lower annual external auditing contract with PW based on their increased reliance upon work of Internal Auditing
3. Encourage participants to obtain fundholder servicing via internet to reap cost benefits and maintain a competitive edge. This project is a good example of a service that can be strategically positioned to gain market advantage while simultaneously reducing costs.
4. Continue and increase active participation in industry groups. This involvement is an example of a way to leverage industry position and influence marketplace
5. Encourage constant monitoring of all business processes for outsourcing opportunities. This is another example of the type of competitive thinking that should be encouraged up to and after privatization, and which will increase after the GNPf competitive mindset is sharpened.

6. Quantified financial drivers can assist in furthering the discussion related to GNPF risks. The results of our work is contained in the **NOTES** section at the end of our report.

The pages that follow are intended to expand the findings noted above, and to provide additional detail by department.

II. Investment Department (Includes Portfolio Recordkeeping, Financial Market and Risk Management Research, Portfolio Recordkeeping, and Trading Departments) (5/12)

The key metrics or functions of the Investment Office relate to investment research, portfolio accounting, portfolio management, and trading. These functions apply to both the GNPF assets as well as to the assets in the fund, i.e., the participants' assets.

The Investment Office and its related departments were reviewed in meetings on Monday, May 12, 2003. Among items discussed was the organizational structure of the department as well as the investment process and the challenges faced in light of the existing investment policy and the shrinking availability of investment grade assets.

Drivers

Approximately 25 trading transactions are completed each day, with the average amount of outside purchases ranging between \$5-\$8 million, and the remaining Kzt \$1-\$3 billion. It is a mandatory requirement to invest contributions within 10 days of receipt, so there is an ebb and flow of investment activity based on payrolls processed.

Cash available for investment is netted against distributions to maximize the percentage of assets available to invest. The practice of netting is commonplace in the United States and benefits the participants by ensuring that their money stays invested.

The quality of investments is based on government regulations that will prove challenging in the future, especially, as the fund stabilizes its customer base and contributions grow and distributions slow. In such a likely scenario, the amount of assets for investment will grow, while the market of available investments meeting the government criteria will shrink. In such a case the GNPF will run a substantial risk of violating the requirement to invest participant contributions within 10 days of receipt.

Another function performed in the Investment Office relates to collecting and providing official GNPF figures. This work is performed in the Financial Market and Risk Management Department, off of a database with two weeks worth of active data (older data is archived due to current storage data problems).

Risks Identified

The Investment Office staff has noted a decreasing number of assets for investment which meet regulatory requirements. This creates a possible violation of the government requirement to invest all contributor assets within 10 days of receipt, as well as the natural temptation to push the regulations to the extreme in order to ensure that contributor assets are promptly invested.

This risk is compounded by probable fund growth due to a stable participant base and contribution flow. When these are added to a steady rate of return that is likely with the fixed asset portfolio objectives of the fund, participant balances will become more significant resulting in a corresponding decrease in the opportunities for netting contributions against distributions. This will create greater pressure on liquidity needs, which may in turn force the Investment Office to keep cash on hand in short-term equivalents thereby indirectly lowering the fund return. While this "virtuous circle" is not unusual with funds, it underscores the need for reexamination of the fund investment parameters.

Risks Quantified

It is hard to provide a detailed quantification based on probabilities. While we have recommended elsewhere that the entire Investment Office be reviewed with respect to the risks we have discussed above, we can note here a potential risk for the fund to incur costs of lost investment opportunity that could create additional fund cost as investment staff attempt to guarantee investment performance that meets or exceeds inflation. Having contributions to invest and no investments that meet established parameters will make it increasingly more difficult for the Investment Office to meet its fund obligations and remain in compliance with the 10 day investment requirement.

Recommendations

As part of a follow up to an inquiry we made regarding the number of inactive and unidentified accounts, we identified the Financial Market Risk Management Research Department, a subdivision of the Investment Office, as the keeper of official numbers for the GNPF. These included the number of inactive and unidentified accounts, which was the focus of one follow up question.

While it is not unusual for several different units of an organization to have several different perspectives on a number or function, a central Management Information System (MIS) would help all units involved, as all departments would have the same data available from the same system, stored and protected centrally. This particular follow up question underscores management's realization of the need to identify and install a comprehensive MIS system.

Consistent with the scope of our review, we recommend a more detailed review of present GNPF investment policy and objectives with consideration of broadening the categories and investment quality parameters to ensure greater flexibility in investing. Not only will such a review help persuade regulators of the need to increase the flexibility for investments, but will ensure long-term greater compliance with the need to meet the 10 day asset investment requirement. At any rate, the solution to this critical risk is an unresolved, systemic problem for all Kazakhstani providers, as was proactively noted by the Investment Office staff during our discussions.

III. Pension Fund Holder Relations Office (5/13&5/16) or Client Administration Department (Includes Operation and Coordination Departments)

This office or department is responsible for servicing the participants or contributors in all respects except fund investment. The office has two major subdivisions: Operation Department and Coordination Department. Also, the unit has management responsibility for the 17 representative office--including the Astana office--as well as the two Almaty offices.

The responsibilities of this office include new account opening, account transfers in and out of the fund, preparation of distributions based on participant applications, correspondence, routine participant account maintenance including address changes, payer and representative relations, and daily client servicing. The correspondence function includes participant, payer, and representative inquiries and responses. There is also a participant or contributor "HotLine", which is a service for participants who wish to contact the GNPF by telephone.

The department and its sub-departments were reviewed on May 13th and 16th.

Drivers

The drivers are related to the key transactional processes within the department. They are:

1. Monthly number of transfers in and time to set-up account
1,500 , 2-3 days if in good order (get assets fast)
2. Monthly number of transfers out and time to set-up account
15,000 to 20,000 3-4 days if in good order
10% transfers typically not in good order
3. Monthly number of new accounts
4. Average time researching participant inquiries (from Almaty oblast)
Performed after close of business at 6 by staff of
6-7. Average is 6 per day.
5. Average number of participants visiting Center/Staff
300/10 Of 300, 20 are confirmations related to past contributions
6. Average daily payment requests per operator (who verifies data and creates payment order) 200-300/6-7 with 5 returns for completion or correction
7. Prepare approximately 200 agent commission payments by 10th of new month (Verify calculations of agents commission payment request)
8. Control generation and distribution of approximately 1million annual

9. participant statements during each January/February as prescribed by law
Service through resolution of inquiry, at least 1,000 participant HotLine Calls
10. Prepare approximately 100 written responses to written participant
Inquiries per month
11. Training of representatives through the system

Extraordinary Driver

Beginning 01/2003, GNPF is no longer default fund for mandatory contributions. Prior to 01/2003, as default fund, GNPF was not required by law to obtain contributor/participant agreement. On 01/2003, GNPF became obligated to obtain agreement for all accounts. Over 4 years, approximately 1 million accounts were opened without agreements. Work has been done to reduce this amount to about 908k with average balances of less than Kzt 10,000. This year, GNPF has obtained agreements for 150k accounts with balances greater than Kzt 10,000. Government realizes that job is big, and has extended deadline on GNPF for obtaining agreements for remaining 908k. This is a “short-term” driver in the sense that it requires resources and time, but income is received to offset the costs.

Risks Identified

The risks associated with any client services department or function relate to the transactions processed. Potential risks such as misallocation of contributions due to poor or incomplete data, both in receipt and distribution of participant assets that could result in exposure to internal fraud related to inactive contributor accounts, were adequately controlled.

However, there is a potential risk related to accounts without agreements ("non-compliant" accounts) and inactive accounts. The total number of accounts within these groups is large, but the asset size is small. The group of accounts without legal agreements on file has been the focus of a concerted effort to dramatically reduce the number by virtually all groups within the GNPF. This effort has provided good results to date, and there is expected to be about 300,00 remaining by the end of 2006.

However, the potential risk of misallocation applies to inactive and non-compliant accounts as much as if not more than the daily processing risk of contribution data described above. These accounts generate a consistent revenue stream that more than offsets their annual maintenance costs of approximately Kzt 180 in 2002, so there is a minor cost disincentive to working to identify the accounts after a certain period. As the success of the research effort naturally slows, the risk for misallocation will increase.

Regardless of the revenue stream we recommend that these accounts be effectively segregated within the existing system as soon as possible. This segregation should include additional access codes with limited staff authorized to work on these accounts. Monthly confirmations regarding assets and number of accounts in this category should be preformed and submitted to the Internal Auditing Department.

In addition, as has been mentioned elsewhere, we urge GNPf to seek legal clarification regarding these inactive and non-compliant accounts. This clarification could include changes to the existing pension law affecting them, especially regulations related to the ownership rights of such funds after the statutory eight years of account inactivity.

Observations

Our discussion with management touched upon staffing. We learned that 70% of department staff have two or more years of service. Staff tenure averages at least a year of service before they are "stolen" by the competition. However, staff frequently return to GNPf for a variety of reasons, including the fact that salary differences are not that different at the competitor funds, and working conditions may in fact be better.

We also noted the planned introduction of a participant/contributor website for later this year. As use of the internet spreads in Kazakhstan, the introduction of this website will help drive down the cost of routine inquires that would otherwise go to the HotLine or branch offices in the form of participant calls and branch visits.

The overall functions operating within this department are adequately and effectively controlled. Apart from the issues mentioned related to the inactive and non-compliant accounts, we did not observe any weaknesses in the system of internal controls that would seriously jeopardize the daily functions of the departments.

Risks Quantified

We have noted that the 17 branch and two Almaty offices servicing participants should be analyzed against overall maintenance costs and revenue stream. There is a potential risk of excessive cost, should these offices not undergo a cost/benefit analysis. This analysis would include the cost of maintaining each office against the number of new clients it processes through its offices. To establish effective comparisons, a similar analysis would include the cost of gathering new participants, ensuring quality service and accurate contribution flows, minimization of participant transfers out, etc., without the offices. Comparing the results of these two analyses would help management determine the overall effectiveness of each office.

The risk financial loss due to misapplied contributor funds in the unidentified and non-compliant account categories has been mentioned in the **Risks Identified** section above.

The overall market readiness risk mentioned in the **Executive Summary** has a specific application to each department. While there are many examples of how the transformation to

market readiness will assist management and staff in their competitive thinking, we will offer two to the client administration management team. They are:

1. Establishing effective client service measurements: Examples of these would include average participant wait in line before being served, the length of time a participant is waiting before a HotLine staff member answers the call, how fast statements are produced, timeliness of transfers into GNPF, etc.
2. Quantifying the drivers listed above into measurements of staff performance and overall staffing requirements. The drivers listed above are not a complete list of the key functions of the department. They serve as examples. By evaluating the list, making necessary additions and changes, management can develop key staffing parameters. These parameters can be used to evaluate performance (Example: Each clerk should be able to process 100 applications a day without an error to be eligible for a promotion) and develop staffing for peak periods, vacations, etc. (Example: 2,000 applications per day, with each staff member processing 100 per day means we need 20 staff to process a day's work.).

Without such measurements in place, effective client service may become poor very quickly, and costs wasted on inefficient processes or representative offices. Poor client service could ultimately mean lost participants, lost participant assets, and, of course, lost revenue.

Recommendations

Implementation of a MIS system will ultimately enable the Client Administration Department to identify and measure key departmental drivers more easily. In addition, a MIS system will enable multiple views of transactional data that can be used to analyze cost, processes, and efficiencies, not to mention a better way to reconcile Social Individual Codes (SIC) with Tax Identification Numbers, to help resolve more unidentified accounts.

IV. Accounting Departments (Includes Accounting and Pension Asset Operation Department, Accounting and Reporting Department, and Planning and Budget Control Department) (5/15)

The accounting functions were reviewed on May 15, 2003. In all three units reviewed, we noted the presence of adequate and effective controls related to departmental risks.

The first accounting function reviewed was the Accounting and Pension Asset Operation Department. The main function of this department is to establish and maintain the daily asset value of all pension assets. The factor or unit value of the fund assets is established and used as the basis of calculating distributions, purchases, and tax payments. Also, this department performs account maintenance, (including identifying and combining multiple accounts into one account for one participant).

Accounting and Pension Asset Operation Department

Drivers

1. 500-600 Daily Payments Processed
2. 2,000-3,000 transfer of assets (TOA) out of the GNPF are processed approximately three times a week
3. Mandatory month-end government reporting due by 5th day of new month requires 4 hours of staff preparation just to run the reports
4. Daily contribution returns of 1,500 totaling (500 for new accounts) Kzt 3-5 million essentially automated but takes ½ day to complete process
5. 20 Contributions totaling Kzt 500k returned back to GNPF each month
6. Time researching and responding to participant inquiries
7. Monthly agent payment preparation of Kzt 1million to 40-50 agents

Extraordinary Driver

Beginning 01/2003, GNPF is no longer default fund for mandatory contributions. Prior to 01/2003, as default fund, GNPF was not required by law to obtain contributor/participant agreement. On 01/2003 GNPF became legally obligated to obtain agreement for all accounts. Over 4 years, approximately 1 million accounts were opened without agreements.

Work has been done to reduce this amount to about 908k with average balances of less than Kzt 10,000. This year, GNPF has obtained agreements for 150k accounts with balances greater than Kzt 10,000.

Government realizes that the job is big, and has extended the deadline for GNPF to obtain agreements for remaining 908k participants.

This is a “short-term” driver in the sense that it requires resources and time.

Risks Identified

The absence of a comprehensive Management Information System (MIS) including department budget accounting, poses a significant risk to ongoing efficient department operation.

Observations

As with all GNPF departments, there is a real need for a comprehensive MIS to enable more efficient problem resolution related to day-to-day processing that is time sensitive, and research that can occur any day.

The pension asset cash reconciliation function is performed right next to cash control function is efficient, but seems to be a potential risk.

Risks Quantified

The risk of not processing daily contributions daily is minimal and is at present considered immaterial. The system seems to effectively enable prompt return of unidentified or incorrect participant contributions. However, if volumes grow, the half-day it presently takes to prepare and return them could lengthen and jeopardize their timely return.

The list of drivers is not complete. Using our drivers as a base, we encourage further evaluation to revise the list with a mind to developing it into a serious system of department cost analysis. Such a process should be initiated as soon as possible. While this process can begin quickly, it will gain in sophistication once an MIS is installed.

Recommendations

We would recommend separating the functions of cash reconciliation from cash control to ensure greater independence of the two key functions, thereby reducing risks associated with appropriate segregation of duties.

Accounting and Reporting Office (5/15)

The Accounting and Reporting Office is responsible for organizing and reporting the accounting of the GNPF and the participant assets in accordance with the legislation of the Republic of Kazakhstan.

Drivers

1. External report preparation, monthly quarterly and annually
Daily, ½ hour, monthly one day, quarterly one day (detailed comments often involve more time and must be approved by General Director, given their financial importance and necessary public disclosure)
2. Manages the approval cycle for all fund expenditures
3. Monthly agent payments processing totaling Kzt 1million to 40-50 agents
4. Responsiveness to unit managers' ad hoc requests for department data (Dependent upon system, which would not as frequent a case once a MIS system is installed)
5. Payroll processing (to move to HR when function is staffed properly)

Risks Identified

The only risk note is the potential for delay in obtaining data to produce government mandated reports which in turn can create a situation of "non-compliance" with state regulations. While this risk is minimal financially, and even operationally, fund growth and market readiness for competition demand a new and efficient method of gathering data for all manner of mandated reporting. The introduction of a Management Information System (MIS) could help make the process of gathering financial data for reporting more efficient.

Observations

As stated above, the department will benefit from a MIS system that incorporates the new mandated accounting system into its overall data management.

Risks Quantified

The risks relate to assessment of fines due to delays in providing government mandated Reports. As the growth in the fund increases, the prompt gathering and reporting of mandated financial data will become more challenging, and thus the potential risk of fines increases.

Recommendations

As part of the overall preparation for market readiness, we recommend a thorough review of the "Chart of Accounts" or account categories used for revenue, expenses, assets and liabilities. While we did not review this chart, we believe that it will be necessary to enhance it and possibly reorganize it so that it can aid GNPf in a more accurate and detailed accounting of its activities. While several accounting departments could be responsible for this review, we believe that this department can be responsible for managing the process. The process should be performed in conjunction with the 2004 fiscal budget preparation. As a first step to installing an effective MIS system, this work will result in a better understanding of what financial data is needed to improve knowledge of the GNPf business functions.

As a direct result for this department, the increased efficiency in obtaining and organizing current financial data for mandated government reporting will ensure promptness and compliance with all reporting requirements. Subsequently, the knowledge gained in the budgeting process and "Chart of Account" review will benefit conversion to a MIS system.

Planning and Budget Supervision Department (5/15)

Drivers

1. Provide organizational budget development and reporting
2. Maintain overall accounting and budget monitoring and control
3. Establish and maintain cash control (in the sense of a "treasury" function) over invested assets, making recommendations on creating liquidity as necessary

4. Analyze organizational efficiency based on developed budget norms and cost drivers
5. Provide planning based on budget data

Risks Identified

All of these functions are critical to a successful and market ready GNPF. However, there appear to be two distinctly different types of functions required of this department: (1) Tactical and; (2) Strategic.

The tactical functions relate to creating the budget, ensuring its successful input into the accounting system, reporting on the budget at regular intervals, making daily cash projections similar to the treasurer's function in the United States, and controlling the budget with respect to procedures and control.

Strategic functions performed in this department include planning and projecting the direction of GNPF with respect to market positioning, assessing the organizational structure with respect to the forward thinking and positioning, and making recommendations to the Director General of the GNPF and his management team as necessary.

Observations

The creation of this function is timely. Recognizing the functional need for strategic planning, marketing, and budgeting is a prerequisite for market readiness. But at this point, the function is too big for one individual. Given its significance with respect to the overall success of the GNPF as a worthy market competitor, the function should, in all or part of its responsibilities as defined, be a direct report to the Director General of GNPF.

The importance of developing a budget process for fiscal year 2004, and starting that process no later than the first of September is critical to the effective transformation of the GNPF to become competitive. While the systems will not be in place to perform a thorough budget process, the process should be done regardless to begin to educate and instill a budgetary discipline in all staff.

Risks Quantified

It is important that the budget process begin as soon as possible, and in no event later than September. The risk to GNPF of not attempting a budget process for fiscal year 2004 is a delay of at least one year in realizing the benefits of a full blown budgeting process with cost centers, reporting, and the like.

Recommendations

We recommend immediate creation of a budgeting plan for the budgeting process to commence no later than September. This process would include a review of the drivers noted in this report, a review of the "Chart of Accounts" and a presentation of key projects (MIS

system, new telephone calling system, etc.) and their budgets. Also, a projection of participant account and asset growth should be established that is used to drive staffing needs in each department.

Staffing is a significant expense in any finance-related business. As part of the budget planning process, each department should determine the time it takes to perform all substantial functions of the department, and project 2004 staffing needs accordingly. Such department work can be aggregated for the entire organization to come up with a set of staffing requirements. From these, and salary data by department, a budget can be approximated, and a 2004 budget developed for review by the General Director and the Board.

V. Technical Department (Includes Software and Development, System Support and Technical Maintenance, and Data and Security Sectors) (5/19)

We reviewed the Technical Departments noted above on May 19, 2003. As we have consistently noted, it is our opinion from what we observed, that the basic system of internal operating controls is adequate and effective when balanced against the existing risks.

Drivers

1. Managing the process of software system installation, maintenance and enhancement
2. Maintaining, directly or through outsourcing arrangements, more than 10 major system modules (including accounting, Reuters, investments, etc.)
3. Identifying a new comprehensive system that can satisfy all users and be effectively maintained by IT staff
4. Data security related to location, government encryption requirements, and regional office servicing

Risks Identified

From several discussions with GNPf staff, we learned of concerns related to the hardware and its capacity to maintain service levels that are sufficient to meet client servicing needs and provide effective support for all operating departments. These comments underscore the need for the installation of the three new Hewlett Packard servers scheduled for completion in October of this year.

Observations

Since pension fund software development in Kazakhstan is basically limited there is little opportunity to leverage existing systems for organizational advantage, since essentially all fund providers use the same software. Therefore, the only way to gain market advantage through software, would be to identify a software platform from outside of Kazakhstan that could improve the quality of reporting to participants, as well as other services planned or envisioned for the future. Such services could include annuity or installment payment

processing for eligible participants, financial planning, etc, related to targeting a participant's desired retirement date, etc.

As part of a complete analysis of the 17 representative offices mentioned in the **Client Administration Department** section, we would urge the department to determine and communicate their representative office support and maintenance costs to the Client Administration Department. This step would help that department better quantify its representative office costs, and provide a more thorough analysis.

The IT management mentioned a projected 2005 implementation of the new MIS system. This is a very ambitious goal, if the following have yet to be done or arranged for completion by January, 2004:

1. Thorough assessment of each department's needs based on a questionnaire and several follow-up meetings.
2. Development of a proposal based on the data received from item #1.
3. Commencement of a bid process that involves between 3-5 prospective bidders.
4. Interview all finalists at the GNPF.
5. Select final candidate.
6. Negotiate contract price to include support of installation and post-installation phases, and price discounts if provider fails to meet **clearly** established goals.

In our discussions with staff a concern related to database integrity and the planned MIS conversion was mentioned. The database integrity issue was related to a period of asynchronous operation more than one year ago, which is still causing extra staffing and expense to correct. Before any conversion, it would be mandatory to synchronize active/back-up servers with the data warehouse and perform a rigorous scrubbing before an entire system conversion could begin. While such occurrences are not unusual in the business world, this is a labor-intensive effort that must be addressed for an effective conversion. We did not determine how much time would be necessary to ensure a high degree of data integrity, but the very necessity of such a project telegraphs the urgency to the above steps should GNPF desire a full database conversion and a new MIS system by 2005.

Also, IT staff mentioned a desired goal of having a Government Tax Department database terminal available to research and identify corporate "payables" to the fund. The total payable obligation to all funds in the entire system is Kzt 2 billion (\$13.3 million), which poses a potential risk to the entire pension system in that upon retirement, several prospective retirees may have under-funded retirement savings. It is estimated that nearly 50% of this payable is due to participants currently at the GNPF.

With respect to data security, the recent purchase of Checkpoint Software's (NASDAQ: CHKP) Firewall product is a positive move in the direction of enhanced data security. Check Point Software Technologies is a worldwide leader in securing the Internet. It is the confirmed market leader of both the worldwide VPN and firewall markets. The company's Secure Virtual Network (SVN) architecture provides the VPN and security infrastructure that

uniquely enables secure and reliable Internet communications. We believe this purchase to be a sound business investment.

Disaster recovery and back up electricity supplies will be improved from 30 minutes to 60. This is a huge increase in back-up and should be commended, along with continuing the goal to complete a full scale disaster recovery plan as soon as possible.

Finally, with the implementation of a website, there is a concern about the sufficiency of current bandwidth/frame relay for organizational expansion and competitive data flow once encryption is implemented. This concern should be addressed as a budget and planning item in the 2004 budget process.

Risks Quantified

IT management discussed the contemplated budget of \$1-\$5 million for the new MIS system. We were not clear as to whether this budget included other supporting modules for portfolio accounting, fixed assets, participant recordkeeping, and distributions. If there is a lack of clarity within GNPf regarding what is expected from a new MIS system, then the discussions mentioned above would be the place and opportunity to establish clear expectations for such a "make or break" expenditure.

As mentioned before, the absence of a comprehensive MIS system is second only to the mindset transformation as the greatest single risk to the future competitiveness of GNPf. Such a statement should reinforce the importance of identifying and securing a suitable MIS system within three years. It is our estimation that the current systems could effectively support GNPf for another three years, with each year yielding a decline in the ability to access, process, and transmit data timely. And finally, the longer a conversion is put off, the larger the task, so again, we suggest, the sooner the work is begun, the better.

Recommendations

In addition to the seriousness of identifying and implementing a comprehensive MIS system, which has been mentioned elsewhere in this report, we also recommend that IT continue its openness to outsourcing options as they arise. Also, we would further encourage IT's effort to develop a training and certification program for staff development and retention.

If the training function is centralized as we have recommended, the IT department can describe its training goals and needs in much the same manner as systems users will describe their desired system. With the centralized training function as the project leader, they can identify alternatives and develop a program for the IT departments while the IT department addresses the mission critical project of the MIS system.

As mentioned above, the consolidation of tax identification numbers, social identification codes and perhaps passport numbers will help IT as much as it does the Client Administration Department. Urging the government to consolidate these numbers will ultimately lead to easier GNPf research and less requests of IT for special research reports.

**VI. Functions Under the Responsibility of Executive Director (5/19)
(Includes the Legal Department, Sector of Personnel Management, Administrative Office, and Administration and Logistics Department)**

The Executive Director is responsible for several key staff functions critical to the smooth and efficient operation of the GNPF. We reviewed these units on May 19, 2003. Among the functions these groups perform are employee file maintenance and quarterly compliance testing of departments selected by the Sector of Personnel Management (HR), paper and document circulation, archiving, and incoming and outgoing paper file maintenance performed in accordance with data security department guidance in the Administrative Office, risk monitoring of pension assets and compliance with all legal regulations in the Legal Department, and maintenance and monitoring of GNPF premises and plant including fixed asset control, and utility contract negotiations, in the Administration and Logistics Department.

We note that the payroll function will move from the Accounting and Reporting Department when the HR function is staffed to assume the function.

Based on our review, we noted an adequate and effective system of internal controls as balanced against the associated risks in each department under the responsibility of the the Executive Director.

Drivers

The concept of drivers related to staff functions is more difficult to quantify. Assessing organizational deliverables is more a function of corporate philosophy than business success. Many global organizations have elected to outsource one or more of these functions, with human resources and employee benefits outsourcing a significant trend for larger organizations in the United States. However, outsourcing the management of facilities is also done in many countries, assuming such services are offered or available.

Risks Identified

Apart from the overall GNPF risk related to the absence of an effective MIS system, the risks associated with these functions relate to: (1) Procuring suitable premises systemwide that sufficiently comply with the labor regulation requirement that each staff member have 10-12 square meters of working space and; (2) Attracting and retaining qualified staff for growth in an uncertain environment with respect to GNPF.

Observations

The average age of GNPF employees is 31, and the turnover is 11% annually. Without further differentiation, the average age suggests a mature and stable workforce. If this is a correct assessment, then the risk identified above could relate to the lower staff levels where pay is most often more competitive and tightly controlled. It is not unusual in the United States to have high turnover in the entry-level job categories. Many organizations believe that

it is cheaper to experience such turnover at the entry levels, than pay a higher salary to ensure greater stability and minimal turnover. Alternatively, the cost of attracting, identifying, interviewing, hiring, and training new employees--even at the lowest levels--can be a burden to the bottom line. Either way, knowing the job market, having an effective staffing strategy, and adjusting the GNPf view as the market dictates is the best way to ensure effective staffing for at the best possible price.

Risks Quantified

Delays in hiring new staff could result in inefficient business operations. Also, hiring of new staff without legally required workspace could introduce non-compliance and possible government fines. It is recommended that, as part of the item noted in the Executive Summary, a reevaluation of GNPf office space against projected staffing is required.

To ensure an effective process we would recommend that this analysis of premises be performed in conjunction with the budget planning and preparation process for 2004. Without a clear understanding of premises, costs weighted against their benefits cannot be made.

Recommendations

Beyond the 2004 budget planning and preparation, we would recommend a thorough strategic analysis that includes assessment of long-term growth and staffing needs. This analysis would be part of the strategic planning process mentioned in the Executive Summary.

To help perform this analysis, a staffing model should be developed. An Excel spreadsheet is an excellent means to develop this staffing model and the model would be developed in conjunction with GNPf management, using their input, observations, objective transactional data, etc.

Based on the input, a set of drivers would be developed for each department. We would encourage the use of those noted in this report as a basis for finding others and refining those presented. From the drivers, metrics would be established for each critical function, based on transactions performed. After a reasonable set of transactions is established for each function, current staffing by department can be added to determine current staffing. Factoring in peak periods, vacations and illness, a model can be built for the entire year, in monthly increments. While this data can be effectively used to manage present and future staffing needs, it is a model. Models need refinement and human judgement to ensure their proper use in decision making. But, after the first model is completed, we believe that GNPf management will have an entirely new appreciation of staffing and its affect on critical business processes within each department.

VII. Internal Auditing (5/20)

We reviewed the internal auditing function on May 20, 2003. Internal Auditing function ensures that the system of internal controls within the GNPF is adequate and effective as balanced against the existing risks noted in each function. The staff was professional, knowledgeable, and eager to transform the function into a system of "continuous monitoring".

Continuous monitoring is an auditing concept that integrates the auditing function into the larger organization, by encouraging a consultative approach to risk and the adequacy and effectiveness of audit controls. In the continuous monitoring program, audits are conducted more regularly than in traditional environments, and findings are dealt with in a more consultative manner, since the final outcome of better audit controls and the removal of potential risks is in the best interest of all parties.

Within the GNPF, market readiness is best exemplified by the consultative approach taken by the Internal Auditing Department. Based on our review, we believe that the consultative approach fits perfectly in the overall framework of readying GNPF for the competitive environment.

Drivers

The drivers related to the Internal Auditing function are the number of audits performed, and the risks or exposures identified and corrected as a result. With an effective Internal Auditing function in place, we believe that the GNPF can persuade its external auditors, PriceWaterhouseCoopers (PWC), to rely more on the work of that function, and spend less time in their audits as a result. This reliance is of course an argument for a lower negotiated fee from the external auditors, so the most important cost driver of this department can be measured against the external auditing cost savings it can deliver.

Risks Identified

In any Internal Auditing function, failure to identify risks and communicate them effectively to senior management could result in substantial exposure to fund and contributor assets. Given our work and that of the external auditors, we believe that this risk is sufficiently mitigated.

Observations

Like all other GNPF departments, Internal Auditing would benefit from MIS through obtaining easier access to data necessary to perform their unit audits, which in turn would reduce the audit time and enable the function to perform more audits. Performing more audits could result in greater GNPF coverage, further reliance by PWC on the Internal Auditing Function, and ultimately, lower external auditing costs.

Risks Quantified

Based on our work, it is our belief that the current management and structure is operating effectively relative to the business processes and functions involved.

Recommendations

Beyond MIS, we would encourage management to support a training effort including possible creation of an auditor certification program based on work done by the Internal Auditing Department head. With a centralized training function in place, the details necessary to make a comprehensive function could be organized and the proper program alternatives presented to Internal Auditing management for their review and approval.

VIII. CONCLUSION

The GNPF is at an exciting stage in its development. The day-to-day operations are functioning adequately. Now is the time to being the next step in the evolution of the GNPF, to market readiness and a competitive spirit. These steps are not easy, but there is greater risk to the GNPF in remaining as it is. The change in mindset is the first such step along this road and can be done in many ways. Instilling a competitive spirit within an organization is not an impossible task, and many of the management staff seem ready to acquire this new way of thinking about a business. But the process must begin soon.

Shortly, the information systems will begin to fail the users for a variety of reasons. These reasons would include the ability of the system to handle additional workloads--assuming the GNPF continues to grow its participant account number and assets--and staffing. Without a complete overhaul of the MIS system, and introduction of a new one, routine data requests by all departments will become monumental efforts of time and money.

As the systems fail the users, employees become frustrated and the staff morale deteriorates. More experienced staff will be attracted to the shrinking number of fund providers, seeking a future and an efficient place to work. Loss of experienced talent in a tight job market is a major blow to any organization, and further complicates its ability to function effectively.

Concurrent with the effort to select and install a MIS system, is the need for strategic planning and a rigorous, disciplined budgeting process. While these processes would be aided substantially by a MIS system, beginning them this year is an absolute necessity to ensure they are adequate and effective in the years to come. Since such processes take time to learn and years to refine, the sooner they are begun the better. As we have recommended elsewhere, the functions of budgeting and strategic planning/marketing should be accountable to the Director General, as they are too key to the overall success of the GNPF to be hidden within a department.

The staff functions performed under the capable guidance of the Director General are critical to ensuring a smooth operation of the GPNF. Ensuring an adequate and effective working environment is key to business operations worldwide, as is continuous monitoring of legislation and regulations which may influence or redirect the focus of the business at large. The HR function will be of greater assistance to the entire business when the payroll function is performed under that umbrella along with changes to the approach for evaluating employees and centralization of the training function mentioned above. As suggested elsewhere, effective market competition necessitates effective performance evaluation against well communicated business goals tied directly to compensation, or in other words, a Management by Objectives (MBO) strategy.

While there are many things to do, and the work seems almost overwhelming, we believe that the GPNF leadership can and will make the changes necessary to ensure a competitive future. And we stand ready to assist them in whatever way we can, so that the road they take is not taken alone.

NOTES

1. A general explanation of Return on Investment (ROI)

Return on Investment (ROI) is arguably the most popular metric when you need to compare the attractiveness of one business investment to another. Your return on investment equals the present value of your accumulated net benefits (gross benefits less ongoing costs) over a certain time period divided by your initial costs. It is expressed as a percentage over a specific amount of time; in IT purchasing, three years is the most common time span since technology is often effectively obsolete after three years. The equation for a 3-year ROI is:

$(\text{net benefit year 1} / (1 + \text{discount rate}) + \text{net benefit year 2} / (1 + \text{discount rate}) + \text{net benefit year 3} / (1 + \text{discount rate})) / \text{initial cost}$.

So if the initial cost for your manufacturing company's small new software roll-out was \$10,000, your annual benefits minus annual costs are constant at \$5,000 for the next three years, and the discount rate is 10%, your 3-year ROI would be:

$(\$5,000 / (1 + .1) + \$5,000 / (1 + .1)^2 + \$5,000 / (1 + .1)^3) / \$10,000 = 124\%$

While ROI tells you what percentage return you will get over a specified period of time, it does not tell you anything about the magnitude of the project. So while a 124% return may seem initially attractive, would you rather have a 124% return on a \$10,000 project or a 60% return on a \$300,000 investment? That is why you will often want to know the Net Present Value.

2. There are many recordkeeping software providers in the United States. Several of them provide call center, recordkeeping, distribution, and website, software. I have had user experience with two of these software systems provided by the following vendors:

SunGard EBS
104 Inverness Center Place
Birmingham, Alabama 35242
Tel: 1-800-327-6664
Fax: 205-437-7991
www.ebs.sungard.com

Schwab Retirement Technologies
Tel: 1-800-628-2416
www.schwabrt.com

Both of the above have substantial capabilities, but given the current Kazakhstan pension environment, I would begin research with the system provided by Schwab Retirement Technologies, as it is a less costly system that offers many of the system modules you need. There are other alternatives out there, and if you are interested in one, let me know.

We do not believe that GNPf will find a complete and comprehensive MIS system that offers modules for all of the functions envisioned. This underscores the need to take a critical assessment of all existing systems and departmental needs to obtain the broadest possible understanding of what any MIS system must do for GNPf, and what is a key system. The sooner this assessment begins the better.

Once the key systems are identified, shopping for a MIS system is more focused. And, Assuming that there is no comprehensive MIS system available without substantial modification for the needs of GNPf, looking at key systems that will link to the MIS system is the next likely step. And the systems mentioned above, along with several others, have several of the key modules needed by the GNPf.

MORTGAGE ATTACHMENTS

14/16

Schedule for Larry Taff: Almaty, 19 – 23 January

Monday, 19 January

09:00 – Pick up at the hotel
09:30 – 10:00 David Lucterhand
10:00 – 12:00 BTA-Mortgage President Murat Yuldashev
12:30 – 14:00 Lunch with David Lucterhand and Stephan Moody
14:30 – 16:00 KMC Chairperson Maiko Sagyndykova
16:00 – 17:30 KMC/Discretionary
18:00 – 19:00 Anvar Saidenov, Governor, National Bank of Kazakhstan

Tuesday, 20 January

09:00 – Pick up at the hotel
09:15 – 09:45 Pragma's office
10:00 – 11:30 Kazkommerzbank Director Mr. Apsebetov + risk management person
11:30 – 12:30 Pragma/Discretionary
13:00 – 14:00 Lunch
14:30 – 15:30 Lewis Tatem, USAID
15:30 – 18:00 KMC/Discretionary

Wednesday, 21 January

09:00 - Pick up at the hotel
09:15 – 09:45 Pragma's office
10:00 – 11:00 ABN-AMRO Asset Manager Chairperson Alina Aldambergen
11:30 – 12:30 Pragma/Discretionary
13:00 – 14:00 Lunch
14:00 – 16:40 KMC/Discretionary
17:00 – 18:00 State Accumulation Pension Fund and Asset Manager (Kurmanov and Koryagin)

Thursday, 22 January

09:00 - Pick up at the hotel
09:15 – 10:45 Pragma's office
11:00 – 12:00 NBK Supervisory Body Chairman Bolat Zhamishev (to be confirmed)
13:00 – 14:00 Lunch
14:00 – 18:00 KMC/Discretionary
19:00 – 21:00 Dinner with Mr. and Mrs. D.C.M. Lucterhand

Friday, 23 January

09:00 - Pick up at the hotel
09:30 – 12:00 Wrap-up with KMC
12:00 – 13:45 Lunch
14:00 – 15:00 Exit Briefing, George Deikun, Mission Director, USAID/Central Asia Republics
15:30 – 18:00 Final meetings/Tour of Almaty

Airport pick up time to be confirmed



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Draft

MEMORANDUM

The mortgage market in Kazakhstan has developed at a very rapid rate. Mortgage lending volumes for last year grew at least 150%. An acute lack of new affordable housing, the leading mortgage banks expanding their activities, new market players penetrating the market and the successful operations of the Kazakhstan Mortgage Company have provided for stable growth in the mortgage lending market.

However, there are factors that hinder market development. Inadequate residential real-estate appraisals is one such factor, directly increasing a mortgage lender's credit exposure, and, accordingly, negatively impacting a bank's decision on the origination of a mortgage loan. Forecasts on possible changes in the market environment over a loan period are very often disregarded when conducting real property appraisals for mortgage lending. The comparative method of appraisal is preferred over any other methods. This sometimes results in unjustifiable overstating in the appraisals. Appraisal professionals sometimes demonstrate low professionalism, etc.

Developing appropriate residential real property appraisal methods within the framework of a working group that has the participation of mortgage lending professionals and professional appraisers is seen to be the most effective way to resolve these issues. This also includes introducing such methods into the training curriculums, accrediting training centers, certifying appraisers according to a jointly developed program, systematically monitoring appraisal work on its conformation to the approved methodology, and improving the qualifications of residential real property appraisal professionals, etc.

We, consequently, deem it necessary to arrange a round table that will be attended by representatives from mortgage banks, professional appraisers, and the Kazakhstan Mortgage Company so that the burning issues can be discussed and acceptable ways of solving them can be worked out.

The round table meeting will be held on January 28th, at 3:00p.m. in the conference room # 512, at the following address: 67 Aiteke bi (in the building where the Kazakhstan Stock Exchange is located). Due to the building's tightened entrance procedures we would appreciate it if you could advise USAID/The Pragma Corporation Financial Sector Initiative of the names of the participants beforehand on telephone numbers 50-43-53/54/60.



**UNITED STATES AGENCY FOR INTERNATIONAL DEVELOPMENT
CENTRAL ASIA REPUBLICS (USAID/CAR)**

Kazakhstan - Kyrgyzstan - Tajikistan - Turkmenistan - Uzbekistan

USAID/CAR Regional Office

Park Palace, 41 Kazibek bi St., Almaty 480100, Republic of Kazakhstan

Tel.: (3272) 507612; 507617; Fax: (3272) 507636; 507635; 506890

December 23, 2003

Dear Mr. First Deputy Prime Minister:

Thank you for your letter of November 19, 2003 in which you are requesting technical assistance in the design of a pilot project for the development a regional housing finance fund. We find your proposal very interesting and at this time are able to support the establishment of such a regional fund.

The assistance that we would like to offer would come through an existing USAID project, the Financial Sector Initiative (FSI) that is being implemented by The Pragma Corporation. Our FSI team consists of expatriate and local staff and is led by Mr. David Lucterhand.

Specifically, USAID/FSI can assist in the following: 1) consultations on design of the concept; 2) a legal opinion identifying any legal impediments involved in the implementation of the concept and recommending changes or amendments to normative acts; 3) legal assistance in the establishment of the fund; and 4) technical assistance in structuring a bond issue by the fund with sufficient credit enhancements that meet market requirements.

Please note, however, that our current resources permit us to provide only the assistance specified above. Should the concept be approved by the Government of Kazakhstan, full implementation would require substantial resources. Given our anticipated funding for Kazakhstan, for continued collaboration, we would expect financial and other support from the Republic of Kazakhstan. Subject to mutual agreement regarding the levels of financial and other support each party will provide, we can develop and enter into an MOU to implement the concept.

His Excellency

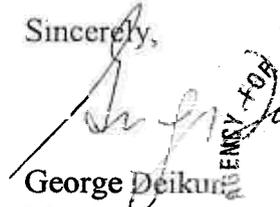
Alexander Sergeevich Pavlov

First Deputy Prime Minister

Astana

Please inform us of your decision regarding the proposed approach. We look forward to our continued cooperation over the coming months.

Sincerely,



George Deikun
Mission Director





**UNITED STATES AGENCY FOR INTERNATIONAL DEVELOPMENT
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23 декабря 2003 г.

Уважаемый господин Первый Заместитель Премьер Министра!

Благодарю Вас за письмо от 19 ноября 2003 г., в котором Вы просите оказать техническую помощь в разработке пилотного проекта по развитию регионального фонда жилищного финансирования. Мы находим Ваше предложение очень интересным, и в настоящем можем оказать поддержку в создании такого регионального фонда.

Помощь, которую мы можем оказать может быть предоставлена через существующий уже проект ЮСАИДа по развитию финансового сектора (РФС), осуществляемого корпорацией Прагма. Команда проекта РФС состоит из зарубежного и местного персонала, а г-н Дэвид Лактерхэнд руководит этим проектом.

В особенности, ЮСАИД/РФС может помочь в следующем: 1) консультации в разработке концепции; 2) составление правового заключения с выявлением всевозможных юридических аспектов, которые могут препятствовать осуществлению концепции, и с рекомендациями по изменению и дополнению нормативно-правовых актов; 3) юридическая помощь в учреждении фонда; а также 4) техническое содействие в разработке структуры выпуска облигаций фонда с достаточными кредитными льготами и отвечающими требованиям рынка.

Однако, пожалуйста отметьте, что на сегодняшний день располагаемые нами ресурсы позволят нам предоставить лишь то содействие, которое мы обозначили выше. В случае одобрения концепции Правительством Казахстана, ее реализация потребует существенных ресурсов. С учётом ожидаемого уровня финансирования наших программ в Казахстане, для дальнейшего сотрудничества потребуется финансовая и другая поддержка со стороны Казахстана. В случае обоюдной договорённости относительно размеров финансового и других вкладов каждой из сторон, мы готовы будем подписать Меморандум о взаимопонимании с целью реализации разработанной концепции.

Его превосходительству

Александр Сергеевичу Павлову

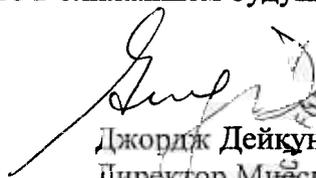
Первому Заместителю Премьер Министра

Республики Казахстан

Астана

Пожалуйста, уведомите нас о Вашем решении относительно вышеизложенного подхода. Надеемся на наше дальнейшее сотрудничество в ближайшем будущем.

С уважением,


Джордж Дейкун
Директор Миссии



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Ассоциация Финансистов
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Уважаемые господа,

Национальный Банк Республики Казахстан поддерживает инициативу
Корпорации Прагма и Ассоциации Финансистов Казахстана по созыву в
ближайшем будущем собрания потенциальных акционеров частного кредитного
бюро в Казахстане.

И.о. Председателя

А. Сайденов

№ 0013613