The Pragma Corporation

Financial Sector Initiative

Twenty First Quarterly Report

For the Period

August 22, 2005 – November 25, 2005

For the

U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT

GENERAL INFORMATION

CTO USAID/CAR	• Lewis Tatem
PROJECT MANAGER	• Mohammad Fatoorechie
CHIEF OF PARTY	• John K. Pascal

ALMATY, KAZAKHSTAN

Table of Contents

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. Tatem approved FSI's work plan though 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. An updated work plan, reflecting expected results through the completion of the project in August 2005, was submitted to USAID and approved.

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.

II. SIGNIFICANT EVENTS AND ACHIEVEMENTS

- PRAGMA/FSI CONTINUES TO WORK TO AMEND THE MINFIN VERSION OF THE LAW "ON SECURITIZATION"
- THE ON THE GROUND ANALYSIS FOR THE DEVELOPMENT A STATE ANNUITY COMPANY PROJECT REQUESTED BY THE FSA WAS COMPLETED
- THE ACTUARIAL TRAINING PROGRAM TO PROVIDE GREATER SUPPORT FOR A SELF SUSTAINING ACTUARIAL INDUSTRY CONTINUED WITH THE DELIVERY OF COURSES 5A AND 5B BY MIKE SZE
- CREDIT RISK UNDERWRITING TRAINING COURSE FOR THE SMALL ENTREPRENEURSHIP DEVELOPMENT FUND WAS GIVEN IN THREE CITIES IN KAZAKHSTAN BY RICK SMITH

- CONSULTANT NORM MASTERS COMPLETES HIS ANALYSIS AND REVIEW FOR THE KAZAKHSTAN MORTGAGE CORPORATION'S DEVELOPMENT OF A DATA SCORING CENTER
- NORM MASTER RETURNED TO KAZAKHSTAN TO DEVELOP AN OPERATING MANUAL FOR THE FIRST CREDIT BUREAU
- THE "*FIRST CREDIT BUREAU*" OF KAZAKHSTAN OFFICIALLY RECEIVED ITS OPERATING LICENSE FROM KAZAKHSTAN'S FINANCIAL SUPERVISORY AGENCY (FSA).
- PRAGMA/FSI NAMED TO FSA WORKING GROUP ON PENSION FUND BENCHMARKING AND REPORTING
- PRAGMA/FSI MEETS WITH NBK TO DEVELOP CURRENCY AND INTEREST RATE SWAPS
- SENIOR ADVISOR STEVE MOODY ADDRESSES INTERNATIONAL MORTGAGE CONFERENCE ORGANIZED BY BTA IPOTEKA

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 May 22, 2005 through August 21, 2005. 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 the course of August - November 2005 we continued bringing the official draft law "On Securitization" in line with the rating agencies' legal criteria and economic rationale. After a series of meetings, Kazakhstan's FSA/ MoF accepted part of our proposed changes to this effect. This was officially endorsed at a forum of capital market participants. In addition Pragma and Standard and Poor's Rating agency (S&P) are working with Chadbourne & Parke (CP), S&P's preferred international legal firm with offices in Almaty, to conduct due diligence on the recommended draft in the context of Kazakhstan's Civil Code legislation.

Insurance/Pension

During the quarter under review, four foreign consultants aided by our local staff finished a comprehensive study of the annuity markets and the development of a State Annuity Company, for the Financial Supervisory Agency. The team consisted of Martha Kelly Annuity Expert, Rob Dowsett insurance expert, David Bardsley Legal Expert and Charlie Becker Mortality Expert. In addition our local staff members Aigul Seitenova, Dina Urzhumova Tatyana Afanasyeva Vladimir Semizhonov and Dzhamilya Kurmangalieva worked on the report. The study is in response to FSA's request for assistance in setting up a State Annuity Company. The Pragma/FSI study of the annuity market in Kazakhstan encompasses all aspects of the issue—actuarial, demographic, financial and legal. Based on analysis of retirement demographics and mortality in Kazakhstan, the development tenge-denominated fixed-income instruments, the study will determine if a viable whole-life annuity can be structured at the present time Based on the same analysis, the study will estimate the on-going cost to government, of a State Annuity Company operations in the coming years.

Actuarial Training Program to "Provide Greater Support for a Self Sustaining Actuarial Training" began with courses being given by international annuity expert Mike Sze and two local trainers. The first training course 5A began on November 11th for 8 days of training. Course 5B followed for the same number of days. In accordance to USAID/FSI plan, the local actuaries are gradually taking over the actuarial training program. There are currently 16 fully qualified actuaries who have passed all six actuarial examinations and 50 that are at different levels of study.

Mortgages

Norm Masters began is on the ground research and review for the Kazakhstan Mortgage Corporation on the development of a Credit Scoring Center in Kazakhstan. The purpose of this study was to examine the existing processing functions in order to see how best to introduce credit scoring and workflow automation at KMC.

The report addressed each of the following sub headings:

- The Company KMC and general observations and findings:
- The KMC processes and underwriting
- Recommendations for the software KMC requires
- The Information technology department

Credit Bureau

The "*First Credit Bureau*" of Kazakhstan officially received its operating license from Kazakhstan's Financial Supervisory Agency (FSA). The Credit Bureau has been loading data and testing it now remains for the Credit Bureau's clients to sign a General Agreement in order to start issuing actual credit reports. A draft including comments and changes to the GA has been circulated to the clients with a meeting scheduled for December 12th.

Mr. Norm Masters a specialist in technical aspects of credit bureau information systems began his review to aid in the development of an operating manual for the credit bureau.

IV. PROJECT STAFFING

The following personnel were engaged in project activities this quarter:

- John K. Pascal, Chief of Party
- Stephen S. Moody, Resident Senior Advisor, Financial Instruments, Mortgage, Pension/Insurance
- Javier Piedra, Resident Senior Advisor, Credit Bureau
- Michael Sze, Consultant, Actuarial
- Martha Kelly, Annuity Expert, State Annuity Company
- Rob Dowsett Insurance Expert, State Annuity Company
- David Bardsley Legal Expert, State Annuity Company
- Norm Masters , Credit Bureau Expert

V. ADMINISTRATIVE

None.

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 August 22, 2005 through November 21, 2005.

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. Secondarily, 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 CONTINUES TO WORK TO AMEND THE MINFIN VERSION OF THE LAW “ON SECURITIZATION”

- DEVELOPING SWAP MARKETS FOR PENSION FUNDS

III. EXECUTIVE SUMMARY

Growth would be stalled until the weak banks could be recapitalized. Monetary policy is ineffective in such a situation. <u>Such events are not theoretical</u>. They happened in parts of the United States economy between 1984-1992, particularly in Texas following a sharp decline in oil prices in 1986, and in other parts of the U.S. following a bust in real estate prices in the early 1990s. Because Kazakhstan has a National Fund for the purpose of adding stability to the economy in the <u>event of an adverse shock, some consideration should be given to how the Fund might be used to help recapitalize the banking system</u> so that, if necessary, stimulative monetary policy can more quickly assist in reviving economic growth.

PRAGMA/FSI CONTINUES TO WORK TO AMEND THE MINFIN VERSION OF THE LAW “ON SECURITIZATION”

In the course of August - November 2005 we continued bringing the official draft law “On Securitization” in line with the rating agencies’ legal criteria and economic rationale. After a series of meetings, Kazakhstan’s FSA/ MoF accepted part of our proposed changes to this effect. This was officially endorsed at a forum of capital market participants. In addition Pragma and Standard & Poor's Rating agency (S&P) are working with Chadbourne & Parke (CP), S&P's preferred international legal firm with offices in Almaty, to conduct due diligence on the recommended draft in the context of Kazakhstan's Civil Code legislation.

The following comments from Chadbourne were received from Standard & Poor's Rating agency (S&P) on Bankruptcy remoteness of the SPV and transfer of assets. These remain major concerns of the version of the law currently in the Majilis:

1. Enforceability of limited recourse and non-petition language. In order to make sure that the SPV will not be filed into bankruptcy by one of its creditors, we expect all creditors to be bound by limited recourse and non-petition provisions. Limitation of recourse language usually provides that creditors' claims will be limited to assets backing the rated debt. Besides, such language may subordinate such creditors' claims to the claims of holders of the rated notes. Non-petition language provides that creditors (including note holders and other transaction parties) will not file the SPV into bankruptcy and will not join in any bankruptcy filing prior to the end of a specific period after all of the rated debt is paid in full. Such language must be binding and enforceable also in case of bankruptcy of SPV's bankruptcy. We understand that there's no certainty whether limited recourse and non-petition provisions will constitute legal, valid, binding and enforceable obligations of the SPV.

2. Employees of SPV. According to S&P's legal criteria for securitization transactions of an SPV must not have employees because claims based on employment law are usually difficult to predict and cannot be covered by limited recourse/non-petition. Hence presence of employees may jeopardize bankruptcy remoteness of the SPV. We understand that in accordance with the Draft Securitization Legislation the SPV needs to have a managing body that would include at least one independent director. We also understand that such director may be viewed as an employee even in the absence of a labor contract. This may pose an obstacle to achieving bankruptcy remoteness3. Comfort on tax liabilities of SPV. Usually tax authorities cannot be made a party to the inter-creditor arrangements and hence cannot be bound by limited recourse and non-petition language. For this reason we usually expect to receive comfort that tax authorities will not have a valid claim against the SPV while rated notes are outstanding. In many jurisdictions we receive a tax ruling to that effect. We understand that this issue has not been addressed in the Draft Securitization Legislation.

4. Security over assets of SPV. In accordance with S&P bankruptcy remoteness criteria, SPV must grant holders of the rated notes a perfected security interest over its assets. Such a security interest reduces incentives of the parent or any other creditor of the SPV to file the SPV into bankruptcy. To achieve the same effect, the Draft Securitization Legislation introduces the notion of segregated assets. However, provisions covering segregation of assets in the draft law stipulate that segregated assets will be available not only to the note holders, but also to entities providing services for the securitization (clause 7 (2)).

Transfer of assets:

1. Need for corporate approval of the transfer of assets. We understand that the sale of securitized assets may require an approval as a major transaction and as a transaction. This may be an obstacle to efficient transfer of assets for securitization.

2. Executory contracts. We also understand that in accordance with the bankruptcy laws a bankruptcy administrator may set aside an agreement merely because it's entered into for a period of more than a year. This may pose a threat to various future flow deals (e.g. leasing receivables securitizations).

3. Bank secrecy legislation. We understand that transfer of information on borrowers to the SPV may result in violation of bank secrecy laws. While this violation may not necessarily lead to invalidation of an asset sale, it may be an obstacle to effective structuring of securitization transactions.

Developing Currency Swap Markets

The primary problem of developing an active tenge-dollar futures market is that the tenge is a marginal (as opposed to reserve) currency. While there might be as much as a billion dollars of demand for a tenge-dollar futures contract today, it is simply not enough to sustain an orderly futures market without the intervention of the National Bank. And the National Bank is extremely reluctant to get involved in trading a tenge-dollar futures contract. The primary reason for NBK's reluctance is personnel: in the narrow market that would result from futures trading among pension funds, banks and perhaps oil exporters, the NBK trader would have inordinate access to all participants' "books;" that is, he would know everyone's position in the market at a given time. That kind of information is invaluable, and those who possess it become sought-after individuals. NBK would never be able to retain its futures traders for any meaningful length of time. The NBK's second objection to getting involved in futures trading is that derivatives seriously complicate the calculation of Value at Risk (VaR), which NBK is obliged to do at the end of every business day. In fact, futures are linear derivatives and, therefore, do not overly complicate VaR calculations; obviously, however, futures would add considerably to the volume of trades included in the VaR calculation.

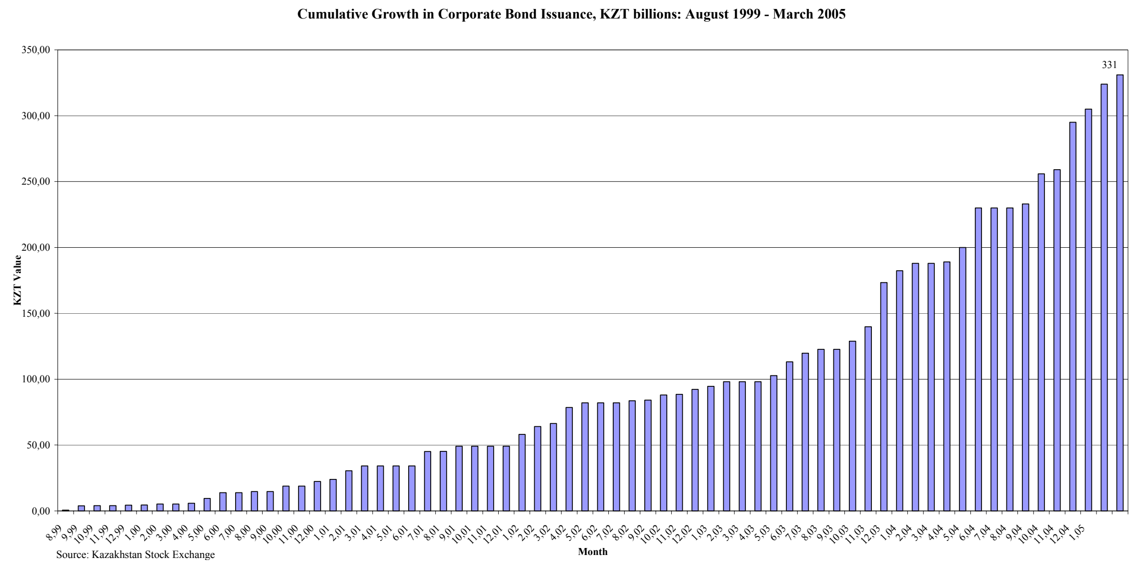
Currency swaps, on the other hand, are non-linear derivatives. Further, they are not liquid instruments and can be difficult to evaluate. The most critical aspect of swaps, however, is the swap counterparty. Probably the best approach to developing a swap market in Kazakhstan will be an effort to initiate swaps between pension funds and their affiliated banks.

Corporate Bond Issuance

At the end of Q II, cumulative corporate bond issuance in Kazakhstan stood at approximately KZT 414 billion (US$ 2.908 billion). Last year's quick pace of issuance does not appear to have slowed.

Figure 2. Cumulative Corporate Issuance

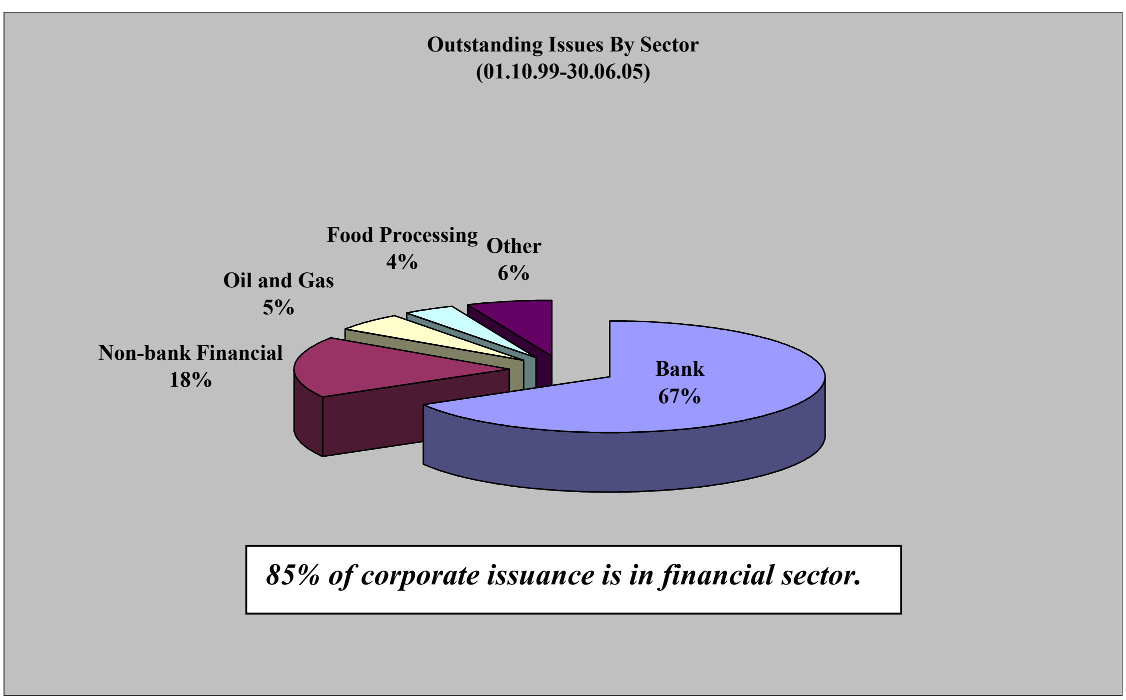
(09.99-06.05, monthly)



It is worth noting that, unsurprisingly, the Kazakh corporate market is dominated by financial issues. (See Figure 3, below.) Fully 67% of outstanding issues are bank issues; some 18% are mortgage-backed bonds, the bulk of which have been issued by Kazakhstan Mortgage Company. The high concentration of financial sector issues reflects, of course, the rapid development of the commercial banking sector as well as the relatively slow growth of the so-called "real sector"—manufacturing. The lack of diversification in Kazakhstan's bond market is a double-edged sword. On the one hand, since the banking sector is strong, the quality of outstanding issues would appear to be relatively high. On the other hand, if growth in the banking sector should slow, the high rate of growth in the bond market will also slow.

Figure 3. Corporate Issuance by Sector

(30 June 2005)



BTA International Mortgage Conference

In November, FSI Senior Advisor Steve Moody delivered a presentation to an international audience at a conference sponsored by BTA Ipoteka. The presentation compared Kazakhstan's "covered" mortgage securities to the potential MBS which the law "On Securitization" will enable. The presentation is attached.

IV. ADMINISTRATIVE ISSUES

Senior Advisor Steve Moody was absent during November 18-December 8.

V. DESCRIPTION AND STATUS OF TASKS

Task 1. Development of Financial Instruments

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

	• 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 RECORDSGRAIN ELEVATOR MUTUAL ASSURANCE SOCIETY REGISTERED WITH MINISTRY OF JUSTICE
• **Principal Protected Notes (PPNs)**	• INTRODUCED PPNs TO PENSION FUND ASSET MANAGERS • NATIONAL BANK AGREES TO THE PURCHASE OF PPNs BY PENSION FUNDS CSFB CALLS ON PENSION FUNDS

Task 2. Legal Reform

Defined Activity	Progress Made During Quarter/Proposed Future Actions
• **National Securities Commission Working Group**	• 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.
• **National Bank Working Group**	• 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 BANKRUTCY ESTATE
• **Pledge Registration**	• 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

• **Securitization**	▪ FORMATION OF FSA SECURITIZATION WORKING GROUP ▪ FIRST MEETING; PRAGMA PRESENTATION ▪ FIRST DRAFT OF LAW ▪ MINISTRY OF FINANCE WORKING GROUP FORMED ▪ FIRST MEETING OF MOF WORKING GROUP

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 METHODOLGY IN *RYNOK TSENNYKH BUMAG*
• **Atyrau Mortgage Lending Project**	• PROVIDED LEGAL AND FINANCIAL ANALYSIS ASSISTANCE TO ATYRAU OBLAST FOR LOCAL MORTGAGE LENDING PROGRAM

LIST OF ATTACHMENTS

1. Review of Securitization law by Chadbourne Clark
2. Letter from Standard & Poor’s
3. Steve Moody’s presentation to BTA Mortgage Conference

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 May 22, 2005 through August 21, 2005.

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

- ANALYSIS FOR THE DEVELOPMENT A STATE ANNUITY COMPANY PROJECT REQUESTED BY THE FSA IS COMPLETED
- THE ACTUARIAL TRAINING PROGRAM TO PROVIDE GREATER SUPPORT FOR A SELF SUSTAINING ACTUARIAL INDUSTRY CONTINUED WITH THE DELIVERY OF COURSES 5A AND 5B BY MIKE SZE

- CREDIT RISK UNDERWRITING TRAINING COURSE FOR THE SMALL ENTREPRENEURSHIP DEVELOPMENT FUND WAS GIVEN IN THREE CITIES IN KAZAKHSTAN BY RICK SMITH

III. EXECUTIVE SUMMARY

ASSISTANCE IN SETTING UP THE STATE ANNUITY COMPANY

In response to FSA's request for assistance in setting up the State Annuity Company, Pragma/FSI began a comprehensive study of the annuity market in Kazakhstan, encompassing all aspects of the issue—actuarial, demographic, financial and legal. Based on analysis of retirement demographics and mortality in Kazakhstan and the volume, term and yield of tenge-denominated fixed-income instruments, the study will determine if a viable whole-life annuity can be structured at the present time and, if not, estimate how long it will take, at reasonable rates of economic growth, for annuity-sustaining conditions to develop. Based on the same analysis, the study will estimate the on-going cost to government, were the proposed State Annuity Company to begin operations in the current year. In view of the potentially adverse impact of a State Annuity Company's operations on the national insurance industry, the study will recommend alternatives to the State Annuity Company. Finally, the study will recommend plan of action with a time-line for developing the annuity sector of the private insurance industry.

The study will be conducted by a team of four to five expatriate consultants with the support of Pragma/FSI's local actuarial, legal and financial staff. The expatriate consultants have expertise in demographics and mortality, annuities, insurance (annuity) company operations and administration (including accounting), and actuarial science. A separate scope of work was developed for each area of expertise.

Four specific scopes of Work were developed for up to two and a half months each. The work was conditional on receiving a no-cost extension through mid-February of 2006 (six month no-cost). The final report will be submitted in November.

- ANALYSIS FOR THE DEVELOPMENT A STATE ANNUITY COMPANY PROJECT REQUESTED BY THE FSA IS COMPLETED

During the quarter under review, four foreign consultants aided by our local staff finished a comprehensive study of the annuity markets and the development of a State Annuity Company, for the Financial Supervisory Agency. The team consisted of: Martha Kelly Annuity Expert, Rob Dowsett insurance expert, David Bardsley Legal Expert and Charlie Becker Mortality Expert. In addition our local staff members Aigul Seitenova, Dina Urzhumova Tatyana Afanasyeva Vladimir Semizhonov and Dzhamilya Kurmangalieva worked on the report. The study is in response to FSA's request for assistance in setting up a State Annuity Company. The Pragma/FSI study of the annuity market in Kazakhstan encompasses all aspects of the issue—actuarial, demographic, financial and legal. Based on analysis of retirement demographics and mortality in Kazakhstan, the development tenge-denominated fixed-income instruments, the study will determine if a viable whole-life annuity can be structured at the present time Based on the same analysis, the study will estimate the on-going cost to government, of a State Annuity Company operations in the coming years.

The report was divided into four sections:

SECTION I: PENSION ANNUITIES Overview of the pension system and retirement income

SECTION II: STATE ANNUITY COMPANY AND POSSIBLE ALTERNATIVES reviews annuity product development, operations and organization functions, financial viability, future financial performance and makes recommendations on the alternatives to the State Annuity Company.

SECTION III: SUMMARY OF RECOMMENDATIONS proposes changes that need to be implemented to improve the life insurance and annuity market in which the State Annuity Company and other life insurance companies will operate.

SECTION IV: ANNEXES contains the Projections of the Annuity Market, the State Annuity Company Financial Projections and the Legal Environment and Financial Sector Laws

The report included 18 recommendations for the development of the Annuity market and the development of a State Annuity Company. Included in the report were recommendation for the development of the SAC and financial projections concluding it would take at least 10 years for the SAC to turn a profit.

The following are some highlights:

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

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

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

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

---

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

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

which is tax free.

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

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

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

- THE ACTUARIAL TRAINING PROGRAM TO PROVIDE GREATER SUPPORT FOR A SELF SUSTAINING ACTUARIAL INDUSTRY CONTINUED WITH THE DELIVERY

Actuarial Training Program to "Provide Greater Support for a Self Sustaining Actuarial Training" began with courses being given by international annuity expert Mike Sze and two local trainers. The first training course 5A began on November 11th for 8 days of training. Course 5B followed for the same number of days. In accordance to USAID/FSI plan, the local actuaries are gradually taking over the actuarial training program. There are currently 16 fully qualified actuaries who have passed all six actuarial examinations and 50 that are at different levels of study.

Course 5A, covers pension and social security as outlined in the insurance regulations issued by the FSA. There will be a special emphasis on life annuity products. The continued efforts of Mike Sze and Course 5B covers asset/liability modeling as outlined in the insurance regulations issued by the FSA. The course will emphasize how to use the modeling process to set insurance premiums, and teach stochastic simulation in fund accumulation and annuity purchase for pension programs in Kazakhstan.

The ongoing great efforts by Mike Sze, Dina Urzhumova and the two trainers have had excellent results as in course 5A as close to a 60% of the students passed while still maintaining the quality and difficulty of the testing and courses. Course 5B required an oral presentation by groups and all passed.

- CREDIT RISK UNDERWRITING TRAINING COURSE FOR THE SMALL ENTREPRENEURSHIP DEVELOPMENT FUND WAS GIVEN IN THREE CITIES IN KAZAKHSTAN BY RICK SMITH

The second area of assistance was undertaken for the SEDF was done by Rick Smith. The consultant developed and delivered a credit training program to the staff of the SEDF on loan guarantee underwriting standards. The consultant was also tasked with reviewing current underwriting standards and advising them on internationally credit underwriting procedures for the Fund.

Credit Training

The Syllabus consisted of a series of Power Point presentations, handouts, and two cases delivered over a 20 hour plus period, divided into three full days (Kokshetau and Aktobe) or five half days (Almaty).

Fund participants were asked to assume that they were acting as a bank and therefore forced to make the same risk management decisions on loans requests required by the bank. This premise was based on the assumption that a decision to grant the Fund's Guarantee to a bank would require Fund employees to consider the same risk criteria that the bank had employed in order to recommend the loan to the Fund. While effort was made to relate to customs and traditions in Kazak banking, the participants were asked to view all credit decisions from the standpoint of 'international best practices.'

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

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

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

Reviewing current underwriting standards and advising on internationally credit underwriting procedures for the Fund.

In the area of credit underwriting standards the consultant is concerned that the Fund is rushing too quickly and seems reluctant to implement standard international lending practices.

"The changing design parameters of the Fund's Guarantee Program are often at variance with 'international best practices,' as an example an open-ended term, charging guarantee fees as high as 4%, and the failure to allow for pilot testing".

"This Consultant strongly urges market testing of the Guarantees with one bank at the outset and then, upon a successful pilot period, rolling the Program out to additional banks.

Additionally, as the amount which each bank can qualify for will be client driven (interested SMEs will bring their preferred bank to the Fund), at a minimum the Fund should establish sub-limits for all domestic Kazak banks".

A concern of the consultant and the Pragma FSI staff is that the current rate proposed as an underwriting is no commercially viable and will do little to help develop SME lending

At the onset of the work done by our first consultant Doug Whitley in June the Fund was considering charging a 1% fee for taking the guarantee risk of commercial bank loans to SME companies. The new Chairman later insisted on using a 3-4% fee which in our view would be in excess of international norms and would render the idea of the SME guarantee fund as economically unacceptable to the SME borrower. Under a 4% fee scenario the Fund could absorb defaults of over 20% and still have its original capital after five years. A 20% default rate compares with an estimated 2% default experience of the current EBRD program in Kazakhstan.

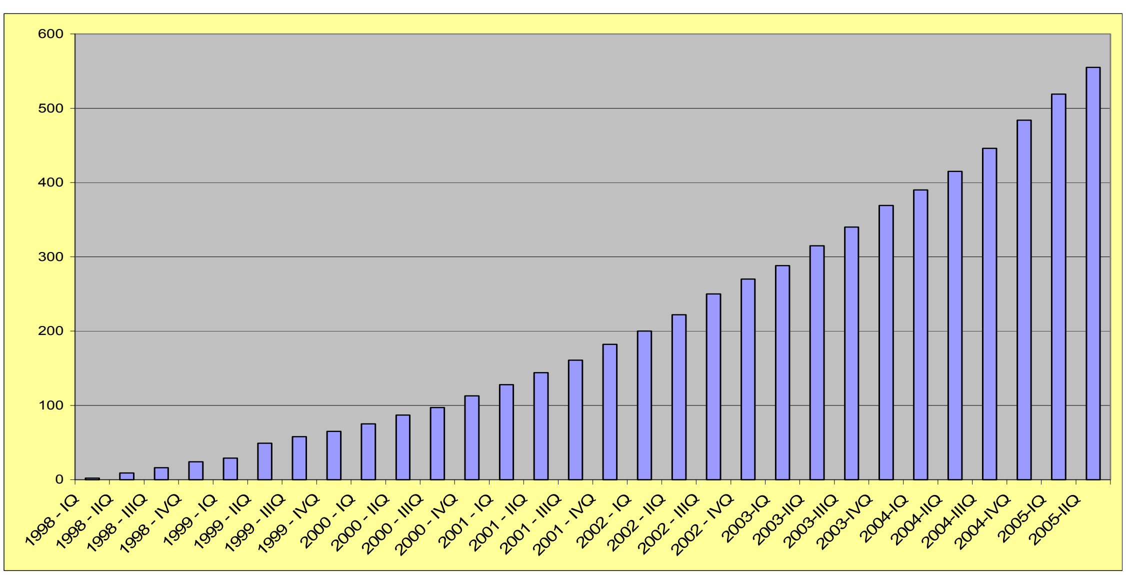
PRAGMA/FSI NAMED TO FSA WORKING GROUP ON PENSION FUND BENCHMARKING AND REPORTING

During the quarter under review, at the direction of FSA the Association of Financiers convened a meeting of the Association of Asset Managers (AAM) to which Pragma/FSI presented the conclusions of its analysis of pension fund reporting and benchmarking. There was considerable discussion of benchmarking issues, especially the issue of developing a representative "internal" benchmark against which all pension funds can regularly compare their own performance.

As a result of this meeting, the members of the AAM resolved to form a regular working group under the direction of FSA and with the participation of Pragma/FSI.

Pension Assets
At the end of the first quarter, assets in the private pension fund system totaled KZT 519 billion. *(See Figure 4, below.)*

Figure 4: Pension Assets
(Quarterly, 1998-2005, in billions of KZT)



IV. ADMINISTRATIVE ISSUES

None.

IV. DESCRIPTION AND STATUS OF TASKS

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

Defined Activity	PROGRESS MADE DURING QUARTER/PROPOSED FUTURE ACTIONS
• **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)**	• AS PART OF A LARGER MERGER OF REGULATORY BODIES, IN MID-OCTOBER, 2001 THE NBK OFFICIALLY TOOK CONTROL OVER THE STATE ACCUMULATION PENSION FUND.
• **Support political efforts to establish a unified regulatory body**	• PRAGMA/FSI'S INVOLVEMENT IN THIS AREA HAS BEEN DOWNGRADED FROM A PROACTIVE ROLE TO ONE OF ASSISTANCE.
Establish standardized (uniform) reports, methodologies, normative acts, and supervision • **Unified reporting** • **Common methodologies** • **Unified supervision**	• 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
• **Prepare a plan for eliminating the State Accumulation Pension Fund as a dominant market force (within 45 days of the start of the activity)**	• PRAGMA/FSI'S INVOLVEMENT IN THIS AREA HAS BEEN DOWNGRADED FROM A PROACTIVE ROLE TO ONE OF ASSISTANCE (SEE ABOVE).
• **Resolve technical issues related to the privatization of the SAPF** • **Clean up duplicate accounts** • **Prepare financial analysis** • **Prepare a preliminary design**	• PRAGMA/FSI'S INVOLVEMENT IN THIS AREA HAS BEEN DOWNGRADED FROM A PROACTIVE ROLE TO ONE OF ASSISTANCE (SEE ABOVE).
• **Strengthen political support for the privatization of the SAPF** • **Build support from donors, international investors, etc.** • **Provide local counterparts with supporting analysis**	• ECONOMIC COUNCIL APPROVED PRIVATIZATION OF ALL OR PART OF SAPF IN OCTOBER 2003. • PRAGMA/FSI COMPLETED VALUATION OF SAPF AS OF 1 JAN 04 IN FEBRUARY 2004. • PRAGMA/FSI INITIATED CONTACT BETWEEN NATIONAL BANK OF KAZAKHSTAN AND EBRD IN MARCH 2004

Task 3 Pension – Monitoring, Evaluation and Quick Response

Defined Activity	Progress Made During Quarter/Proposed Future Actions
• **Identify key threats to the pension system and develop a plan for monitoring them (within 30 calendar days of the start of the activity)**	• PRAGMA/FSI CONTINUES TO MAINTAIN A "WATCHING BRIEF" ON THREATS AND DEVELOPMENTS, USING MEDIA MONITORING AND PROFESSIONAL CONTACTS.
• **Improve record keeping**	• PRAGMA/FSI'S INVOLVEMENT IN THIS AREA HAS BEEN DOWNGRADED FROM A PROACTIVE ROLE TO ONE OF ASSISTANCE (SEE ABOVE).
• **Improve policies and supervision**	• SEE "*ESTABLISHING STANDARDIZED (UNIFORM) REPORTS, METHODOLOGIES, NORMATIVE ACTS, AND SUPERVISION*" PERFORMED PRELIMINARY LIQUIDITY ANALYSIS

Task 1 Insurance – Supervision / DIS Efficiency

Defined Activity	Progress Made During Quarter/Proposed Future Actions
• **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**	• TASK WAS COMPLETED PRIOR TO QUARTER
• **Develop framework for upgrading supervisory procedures and practices within 60 days of start of contract**	• INITIAL FRAMEWORK WAS DEVELOPED PRIOR TO QUARTER
• **Implement framework date for production of User Guide to be established within 30 days of start of contract**	• TASK WAS COMPLETED PRIOR TO QUARTER
• **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** • **Identify foreign opportunities**	• TASK WAS COMPLETED PRIOR TO QUARTER
• **Develop and implement certification exams for relevant industry participants**	• AREAS (IF ANY) IN RESPECT OF WHICH CERTIFICATION EXAMINATIONS WILL BE REQUIRED ARE TO BE IDENTIFIED IN CONSULTATION WITH DIS • THIS IS A LONGER-TERM ISSUE AND IS CURRENTLY A LOW PRIORITY • NO ACTION TAKEN DURING QUARTER
• **Develop and implement dispute resolution regime**	• THIS WAS AN AREA IDENTIFIED DURING THE ASSESSMENT PHASE AS REQUIRING TRAINING • IMPLEMENTATION MAY FACE LEGAL DIFFICULTIES, INCLUDING AMENDMENT OF OTHER LEGISLATION • DIRECTOR OF THE DIS ADVISES THAT HE PREFERS TO KEEP THIS ACTIVITY INTERNAL, INFORMAL AND LOW-KEY, DUE PRIMARILY TO RESOURCE CONSTRAINTS

	• NO ACTION TAKEN DURING QUARTER

Task 2 Insurance – Legal Reform

Defined Activity	Progress Made During Quarter/Proposed Future Actions
• **Develop and pass legislation**	• 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 • DEVELOPED PROPOSAL FOR MANDATORY INSURANCE INDEMNITY FUND
• **Develop and promulgate regulations**	• DRAFT REGULATION ON OPERATIONS OF INSURANCE AGENTS PREPARED AND SUBMITTED TO NBK AND ASSOCIATION OF FINANCIERS INSURANCE DIVISION • 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
• **Assess rules and regulations within 60 days of start of contract**	• DISCUSSIONS CONTINUED ON HOW TO IMPLEMENT CUSTOMS BONDING INSURANCE • FURTHER ASSESSMENT WILL FOLLOW THE PROMULGATION OF ALL NECESSARY REGULATIONS UNDER THE NEW INSURANCE LAW
• **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**	• THIS WILL FOLLOW COMPLETION OF THE ASSESSMENT OF THE RULES AND REGULATIONS (SEE PRECEDING BOX) • NO ACTION TAKEN DURING QUARTER
• **Develop and implement consumer protection measures, including trade practices and consumer disclosure requirements**	• NO ACTION TAKEN DURING QUARTER
Develop and implement rules for licensing:	• THESE WILL BE SET OUT IN THE REGULATIONS CURRENTLY UNDER EXAMINATION BY THE NBK

• **brokers** • **actuaries** • **auditors** • **companies** • **other relevant industry participants**	• 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 • DRAFTED LEGISLATION ENABLING MORTGAGE INSURANCE

LIST OF ATTACHMENTS

1. Annuity Report for SAC
2. SEDF Credit Training Report

D. MORTGAGE

I. COMPONENT DESCRIPTION

This report provides details on events and activities relating to the Mortgage Component of the USAID Financial Protection Initiative, as implemented by the Pragma Corporation, during the period from May 22, 2005 through August 21, 2005.

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 to 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. Other activities include the establishment of a uniform methodology for real-estate appraisal and the certification and licensing of real estate sales practitioners.

II. SIGNIFICANT EVENTS

- CONSULTANT NORM MASTERS COMPLETES HIS ANALYSIS AND REVIEW FOR THE KAZAKHSTAN MORTGAGE CORPORATION'S DEVELOPMENT OF A DATA SCORING CENTER

Norm Masters began is on the ground research and review for the Kazakhstan Mortgage Corporation on the development of a Credit Scoring Center in Kazakhstan. The purpose of this study was to examine the existing processing functions in order to see how best to introduce credit scoring and workflow automation at KMC.

The report addressed each of the following sub headings:

- The Company KMC and general observations and findings:
- The KMC processes and underwriting
- Recommendations for the software KMC requires
- The Information technology department

Please see final report from Norm Masters

Outstanding Mortgages

According to Pragma's Mortgage Lending Survey, at the end of June 2005, outstanding mortgages in reporting banks stood at KZT 193 billion.

Динамика ипотечного портфеля
казахстанских банков и ипотечных организаций (млн. тенге): II квартал 2005 г.

	Кредиты на приобретение жилья	
	Сумма	Кол-во
Казкоммерцбанк *		
Выдано за период:	8,135.50	2,461.00
Остаток на конец периода	37,068.12	
БТА Ипотека		
Выдано за период:	4,420.04	1,317.00
Остаток на конец периода	20,493.64	7,547.00
Банк ТуранАлем		
Выдано за период:	5,068.98	1,771.00
Остаток на конец периода	17,209.93	7,090.00
Народный банк Казахстана		
Выдано за период:	14,146.78	3,218.00
Остаток на конец периода	51,843.06	18,462.00
АТФ Банк		
Выдано за период:	3,485.70	1,167.00
Остаток на конец периода	13,353.40	5,654.00
Банк ЦентрКредит		
Выдано за период:	5,848.00	1,924.00
Остаток на конец периода	12,652.00	7,102.00
Астана-Финанс		
Выдано за период:	318.47	66.00
Остаток на конец периода	1,879.47	463.00
Техаka Банк (данные первого квартала)		
Выдано за период:	175.70	19.00
Остаток на конец периода	681.02	74.00
Альянс Банк		
Выдано за период:	2,260.00	475.00
Остаток на конец периода	4,350.00	1,195.00
Темирбанк		
Выдано за период:	2,095.60	935.00
Остаток на конец периода	4,851.20	1,064.00
КИК		
Выдано за период:	4,548.51	1,284.00
Остаток на конец периода	28,711.82	12,305.00
Итого выдано за период	50,503.28	14,637.00

Итого остаток	193,093.66	60,956.00

IV. ADMINISTRATIVE ISSUES

None.

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 CONSITUTING A MAJOR STEP IN THE REFORM OF BANKRUPTCY STATUATES.

Task 2 – Creating Fully Trained Mortgage Banking Personnel

Defined Activity	Progress Made During Quarter/Proposed Future Actions
• **Review of mortgage banking courses and materials developed by Housing Sector Reform Project**	• THIS WAS COMPLETED THROUGH CONSULTATION WITH PRAGMA/FSI'S COP AND IUE STAFF IN MOSCOW.

• **Framework for mortgage banking training developed**	• 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. • 62 PERSONS HAVE NOW RECEIVED CERTIFIED MORTAGE LENDER (CML) DESIGNATION. CML TRAINING IS NOW OFFERED BY THE KMC WITH OVERSIGHT PROVIDED BY IUE.
Development of strengthened modules for: **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**	• 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 PRACT- ITIONERS UNDERSTAND THE RELATIONSHIP BETWEEN PRIMARY ORIGINATION AND SECONDARY MARKET ISSUANCE ESPECIALLY AS IT RELATES TO UNDERWRITING STANDARDS FOR CONFORMING LOANS. • 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 MORTAGE 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 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. 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 REPORT TO THE KMC.

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

Defined Activity	Progress Made During Quarter/Proposed Future Actions
• **Formation of independent appraisal association**	• 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.
• **Formation of professional real estate brokers association.**	• 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 IS DISCUSSING WITH POTENTOIAL COUNTERPARTS A PLAN FOR CERTIFICATION AND LICENSING OF REAL ESTATE SALES PERSONS.
• **Devise or adjust methodology for appraisal of property that is being mortgaged**	• FSI IN COOPERATION WITH THE KMC AND THE BANKS HELD A ROUND TABLE ON HOW TO IMPROVE COORDINATION. DURING DISCUSSION, MANY PARTICIPANTS HIGHLIGHTEFD 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 ISSUES DISCUSSED WAS PREPARED BY FSI AND DISDRIBUTED TO EACH FOR COMMENT. A FOLLOW-UP MEETING IS PLANNED ON HOW BEST TO ADDRESS THESE DEFICIENCIES. THE LACK OF A UNIFORM METHOFOLOGY IN APPRAISING REAL ESTATE HAS LED BANKS TO USE FOREGO USING INDEPENDENT APPRAISERS AND EMPLOY THEIR OWN. DURING THE NEXT QUARTER, FSI IS HOLDING ANOTHER ROUNDTABLE WHEREBY THE MARKET PARTICIPANTS WILL TRY AND ARRIVE AT A COMMON APPRAISAL APPROACH. • DEVELOPMENT OF LEGAL DOCUMENTS INCLUDING THE MASTER POLICY WHICH GOVERNS THE RELATIONSHIP BETWEEN THE KMGF AND THE BANKS AND ORGANIZATION OF THE FUND IS NOW COMPLETE.
• **Establish methods and terms of mortgage risk insurance**	• 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 KMFG CHAIRMAN PRIOR TO SUBMISSION TO GOVERNOR MARCHENKO. WITH THE ESTABLISHMENT OF THE NEW AGENCY FOR REGULATION, FSI MET WITH ITS NEW CHAIRMAN, MR. ZHAMISHEV TO BRIEF HIM ON THE MATTER.
▪ **System of registration of real estate rights and transactions**	▪ AN ANALYSIS OF THE OVERALL PROPERTY REGISTRATION SYSTEM WAS COMPLETED. THE ANALYSIS NOTED FEW IMPEDIMENTS TO THE ESTABLISHMENT OF TITLE INSURANCE BE IDENTIFIED. FSI ANTICIPATES THAT THE PRIVATE SECTOR WILL SOON OFFER TITLE INSURANCE.

Task 4 – Rules and Procedures of Retail Mortgage Lending

Defined Activity	Progress Made During Quarter/Proposed Future Actions
Assessment of: ▪ **Bank internal rules and procedures for retail mortgage banking** ▪ **External rules and regulations for retail banking**	▪ COMPLETED AS PART OF THE IUE ASSESSMENT. ▪ COMPLETED AS PART OF THE IUE ASSESSMENT.
▪ **Work plan to establish rules and procedures for retail mortgage lending**	▪ COMPLETED AS PART OF THE IUE ASSESSMENT. RESULTS WERE REFLECTED IN UPDATED CML COURSEWORK.
▪ **Standards for mortgage underwriting, loan documentation rules, mortgage contracts**	▪ 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.

LIST OF ATTACHMENTS

1. Report by Norm Masters on Credit Scoring for the KMC

E. CREDIT BUREAU/CREDIT RATING AGENCY

I. COMPONENT DESCRIPTION

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 May 22, 2005 through August 21, 2005.

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.

Both academic research and international experience demonstrate that private Credit Bureaus help to develop a solid middle class and produce 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 is increased access to credit across the income spectrum, greater purchasing power for individuals and the improved transparency of small businesses. It is Kazakhstan's clear understanding of the link between data sharing, the credit markets and economic develop that explains the NBK's extraordinary cooperation at all levels of this project.

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.

It is highly likely, because of FSI's ongoing discussions with the FSA and the insurance industry that the credit bureau database will eventually manage insurance related information. The idea is to develop 4 products:

Product development:

1. A central database of all insurance policies issued in Kazakhstan by insurance companies. - Insurance Companies would be able to access the database for all policy applicants to ensure persons do not have similar policies with other companies. After the population of this database, each company's policyholders would be matched against the database and if policyholders

were found to have similar policies with other companies, a report would be prepared, providing this information to the affected Insurance Companies. This information would be contained in a sub database of the credit bureau that could be accessed by insurance companies. For each access (search), the insurance company would be charged a fee.

2. A central database that lists accident/theft claims, both past and present. - When an accident or theft claim is filed with any insurance company that insurance company, by checking with the credit bureau, would be able to determine if a similar accident/theft claim has been filed with another company against the same occurrence. They would further provide details of that claim, to the credit bureau database, for the benefit of other companies who may also be checking on a similar claim. This procedure is designed to eliminate fraud that occurs when a person files more than one claim on a particular accident or particular automobile theft.

3. A similar database, to #2, that would list claims for disability and life insurance. The same procedure would be followed as #2.

4. A central database that lists names and details of individuals who have or have attempted to commit fraud on any insurance company in Kazakhstan. When an accident occurs, and a claim is filed, the detailed information would be checked with the database to determine if there has been any fraud conducted in the past by the individual filing the claim. When a fraud is committed, that information is filed with the database.

Analysis continues to see how best to develop these products and services, and it is highly unlikely that the Credit Bureau will not success.

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 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

- DEVELOPMENT OF AN OPERATING MANUAL FOR THE FIRST CREDIT BUREAU BY NORM MASTERS

- THE "*FIRST CREDIT BUREAU*" OF KAZAKHSTAN OFFICIALLY RECEIVED ITS OPERATING LICENSE FROM KAZAKHSTAN'S FINANCIAL SUPERVISORY AGENCY (FSA).

The "*First Credit Bureau*" of Kazakhstan officially received its operating license from Kazakhstan's Financial Supervisory Agency (FSA). The Credit Bureau has been loading data and testing it now remains for the Credit Bureau's clients to sign a General Agreement in order to start issuing actual credit reports. A draft including comments and changes to the GA has been circulated to the clients with a meeting scheduled for December 12th.

The official licensing of the Credit Bureau is a major accomplishment for Kazakhstan. Kazakhstan's Credit Bureau is the first fully operational Credit Bureau in the CIS that both is consistent with international best practice and contains over 98% of consumer related information from the banking sector in a single database at a single location. Unlike in many other countries, Kazakhstan's Credit Bureau is 100% owned by the private sector; it contains both positive data (clients with a good credit history) and negative data (clients with a poor credit history); non-financial institutions (any non-bank creditor) can participate in the credit bureau system; and it operates with the technical assistance of Creditinfo Group (Iceland), one of the major international credit bureau operators in developing markets.

Mr. Norm Masters a specialist in technical aspects of credit bureau information systems began his review to aid in the development of an operating manual for the credit bureau.

III. EXECUTIVE SUMMARY

From August 22, 2005 through November 21, 2005, FSI continued to initiate actions to develop the Kazakhstan Credit Bureau

IV. ADMINISTRATIVE MATTERS

During the quarter, Mr. Javier Piedra, Senior Advisor, coordinated the Credit Bureau Component of the FSI.

V. DESCRIPTION AND STATUS OF TASKS

Task 1 – Credit Bureau

Defined Activity	Progress Made During Quarter/Proposed Future Actions
PHASE I • **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**	• COMPLETED - FOR DETAILS SEE 6TH QUARTERLY REPORT
PHASE II • **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.**	**COMPLETED** • ALL MAJOR TASKS COMPLETED • KAZAKHSTAN CREDIT BUREAU PROJECT IN IMPLEMENTATION PHASE • FCBK SHAREHOLDERS CONFIRMED: HALYKBANK, TURANALEM, KAZKOMMERTZ, ATF, CENTERCREDIT, ALLIANCE, TSESNABANK. OTHER SHAREHOLDERS EXPECTED TO JOIN.
PHASE III • **Establish a Credit Bureau in Kazakhstan** • **Develop a credit reporting system** • **Construct a data base** • **Ensure sustainability**	COMPLETED OR UNDERWAY • KAZAKHSTAN CREDIT BUREAU PROJECT IN IMPLEMENTATION PHASE AND CONTINUES TO CARRY OUT ACTIONS TO IMPLEMENT BUREAU • ON JUNE 24, FIVE SHAREHOLDERS AGREE TO INCREASE THE FCB'S CAPITAL TO US$ 1,500,000. • INSURANCE COMPANIES SIGN A LETTER OF INTENT AGREEING TO ESTABLISH A UNIFIED DATABASE FOR INSURANCE COMPANIES THAT IS LINKED TO THE FCB. • DATA BASE STRUCTURE FOR EXISTING SHAREHOLDERS OF FCB FINALIZED. THE FIRST VERSION OF THE DATABASE STRUCTURE FOR INSURANCE COMPANIES HAS BEEN PREPARED. • ASTANA FINANCE JOINS FCB SHAREHOLDER GROUP. • SIGNIFICANT PROGRESS IN REACHING AGREEMENT WITH PUBLIC RECORD HOLDERS (AUTOMOBILE, TRAFFIC AND PENSION) TO TRANSFER DATA TO THE FCB. • FCB COMPLETES NEGOTIATIONS WITH THE SUPPLIERS OF COMPUTER HARDWARE. • SOFTWARE CUSTOMIZATION ADVANCED AND AHEAD OF SCHEDULE SIGNIFICANT GAINS IN MARKETING CREDIT BUREAU TO NON-FINANCIAL SECTOR

Task 2 – Credit Rating Agency

Defined Activity	Progress Made During Quarter/Proposed Future Actions
• **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**	• NO SIGNIFICANT CHANGE SINCE THE 11TH QUARTERLY REPORT.

LIST OF ATTACHMENTS

None

FINANCIAL INSTRUMENTS ATTACHMENTS

90 Shevchenko Street, 3rd Floor, Almaty 050022, Kazakhstan
tel + 7 (3272) 585-088 **fax** + 7 (3272) 588-084

CHADBOURNE & PARKE LLP

memorandum

Wr Igor Iassenovets, Legal Counsel
Standard & Poor's

Iurp Chadbourne & Parke LLP

Gdwh November 3, 2005

Uh Securitization in Kazakhstan

- DRAFT -

Set forth below are our responses to the issues that you asked us to address in your questionnaire regarding the Kazakhstan Securitization Bill and Supporting Legislation sent by e-mail message in final form on 25 September 2005 (the "Questionnaire"). Our responses are set out in the order posed in the Questionnaire. Our answers are based upon the assumption that the draft securitization bill and all supporting amendments to the relevant Kazakhstan legislation have been enacted and become effective.

I. **SPE Bankruptcy Remoteness:**

a. General

1) Is there special regime for creation and operation of SPE's under Kazakh law?

There is a special regime for establishment and operation of SPEs (which will be Kazakhstan legal entities) under Kazakhstan law, set forth in the draft Law On Securitization (the "**Securitization Bill**") and relevant supporting legislative amendments to certain Kazakhstan Laws (the "**Proposed Amendments**").

2) What bankruptcy rules will be applicable to an insolvent / bankrupt SPE?

The following Kazakhstan laws are applicable to an insolvent/bankrupt SPE:

(a) The Civil Code of the Republic of Kazakhstan dated 27 December 1994 (the "**Civil Code**");

(b) The Law of the Republic of Kazakhstan On Bankruptcy dated 21 January 1997 (the "**Bankruptcy Law**").

3) How do these rules define insolvency / bankruptcy (i.e. what test must be satisfied for an SPE to be deemed bankrupt / insolvent)?

The Bankruptcy Law provides the following relevant definitions:

"payment inability" ("*neplatezhesposobnost"*) is the inability of a debtor to perform monetary obligations and other claims of monetary nature [as they fall due];

"insolvency" ("*nesostoyatelnost"*) is the inability of a debtor to satisfy in full claims of creditors under monetary obligations including payroll claims recognized by a court or formally admitted by the debtor;

"bankruptcy" is the insolvency of a debtor recognized by a court decision which serves as the basis for the debtor's liquidation (winding up);

"bankrupt" is a debtor whose insolvency was established by court.

Bankruptcy cases are considered and decided by courts pursuant to general civil procedure rules.

Bankruptcy is established by a court decision either (i) on the basis of a petition filed by a debtor with a court (voluntary bankruptcy); or (ii) on the basis of a petition filed by creditors or other statutorily authorized persons (as discussed below) with a court (compulsory).

Except for certain limited instances, a bankruptcy case would be considered by a court only if the aggregate threshold amount of creditors' claims to a debtor is at least 150 times the monthly evaluation index (the total of which is currently the equivalent of approximately $ 1,100 USD).

The grounds for filing a petition with a court by a creditor for judicial recognition of a debtor as bankrupt is the debtor's payment inability. Under the Bankruptcy Law, a debtor is deemed unable to pay if such debtor fails to perform its respective obligations within three months from the instance when such obligations fall due and payable.

The grounds for filing a petition with a court by a debtor for its recognition as bankrupt is the debtor's insolvency (as defined above).

4) Who has the right to initiate voluntary and involuntary insolvency /bankruptcy proceedings for an SPE and what conditions must be satisfied in order for such proceedings to be commenced (i.e. shareholder / director resolutions in the case of voluntary winding-up ; SPE not paying its debts as they fall due in the case of involuntary winding-up)?

The bankruptcy procedure can be initiated by filing a petition with a court by a debtor, creditor(s) and the prosecutor. The prosecutor may file a bankruptcy petition in the following instances: (i) when the prosecutor discovers elements of false bankruptcy; (ii) when acting to the protect the interests of the Republic of Kazakhstan and state bodies which act as creditors; and (iii) when acting to protect the interests of the creditors of a missing debtor;

The tax authorities and other state authorized agencies may also initiate the bankruptcy procedure (as creditors) in relation to the outstanding taxes and other mandatory payments to the budget. In addition, bankruptcy procedures can be initiated by legal entities and natural persons acting as creditors under contractual obligations. A bankruptcy procedure is deemed initiated from the date on which a court has issued the bankruptcy proceeding opening ruling.

In the event of a voluntary bankruptcy by a debtor, the debtor may file a petition with a court on the basis of a resolution of either (i) the corporate body authorized by such entity's corporate documents; (ii) the owner of the debtor's assets or the body authorized by the owner. If (a) the owner of the debtor's assets, (b) the authorized body of the owner, (c) the debtor's founders or (d) the authorized body of the debtor, adopts a decision on the debtor's liquidation, then the debtor must file a bankruptcy petition with a court, or appeal to the authorized corporate body to file such petition if the debtor's assets are insufficient to satisfy creditors' claims in full.

The Securitization Bill also establishes additional requirements that are relevant in the context of an SPE's voluntary bankruptcy. Article 6 of the Securitization Bill provides that the voluntary reorganization or liquidation of an SPE can be effectuated by the SPE with the consent of the authorized regulatory agency. The consent is granted only if one of the following two conditions is satisfied: either (i) a report on the results of the repayment of bonds issued by such SPE was approved by the authorized regulatory agency; or (ii) the SPE's bondholders' register was closed due to a default under the terms and conditions of the issuance of the bonds by such SPE.

5) Is there an automatic stay or moratorium imposed by the law in case the SPE is petitioned / filed into bankruptcy? Does the stay or moratorium commence immediately upon petition / filing or does it only take effect upon a judicial determination of bankruptcy?

The Bankruptcy Law provides for an automatic stay or moratorium. Specifically, pursuant to Article 28 of the Bankruptcy Law, such moratorium is imposed as soon the bankruptcy proceeding is initiated (i.e., a court opening ruling is made). Article 28 provides for the following pursuant to the moratorium:

(a) the right of the owner of the debtor’s assets (its authorized body), as well as the right of the founders (participants) and all corporate bodies of a legal entity/debtor, to alienate the debtor’s assets, are terminated;

(b) enforcement of earlier court decisions or arbitration awards, other than tortious liability for damages to well-being and health (but not including moral damages), are suspended;

(c) any creditors’ claims to the debtor may be brought only within the bankruptcy procedure;

(d) it is prohibited to bring an enforcement action against funds kept on the debtor’s bank accounts to satisfy claims of its creditors, the tax authorities and other state authorized agencies for outstanding taxes and other mandatory payments to the budget; this prohibition to enforce against the debtor's funds extends to non-disputable claims subject to summary enforcement proceeding (ie., automatic enforcement without the debtor’s consent), as well as foreclosure with respect to the debtor’s assets; and

(e) the authorized persons of the debtor are prohibited to dispose of shares or a stake in the debtor’s assets owned thereby.

6) Does the law impose a time period limitation on any bankruptcy stay or moratorium?

The Bankruptcy Law does not provide time limitations on such bankruptcy moratorium. Rather, it appears to be effective throughout the entire period of the bankruptcy proceeding.

7) Is the SPE regulated by any public authority (e.g. central bank, financial supervisor)? If yes, what are the key requirements and contents of the regulation?

Yes, under the Securitization Bill and the Proposed Amendments, it appears that the SPE is regulated by a public authority. Such authority is the National Bank of Kazakhstan (possibly acting through the Agency for Financial Supervision).

Under the Securitization Bill, the National Bank has the authority to:

(a) effectuate state registration of bonds issued by the SPE;

(b) exercise supervision over the SPE’s activity and conduct inspection of its activity;

(c) adopt regulations containing requirements for SPEs with respect to, *inter alia*, senior management, and adopt regulations as to the documents to be filed by SPEs with the National Bank to obtain consent for corporate reorganization and liquidation of SPEs;

(d) issue consent for voluntary corporate reorganization and liquidation of the SPE;

(e) exercise control over the activity of the liquidation committee of the SPE;

(f) issue written instructions on elimination of identified violations of securities and securitization legislation; and

(g) perform other functions and powers in accordance with Kazakhstan law.

Also, certain proposed amendments to the Law of the Republic of Kazakhstan "On Accounting and Financial Reporting" provide that regulation of the accounting and financial reporting system of financial organizations and SPEs as established under Kazakhstan securitization legislation shall be effectuated by the National Bank through enactment of legal acts (i.e., regulations) and methodological recommendations. These proposed amendments to the Law on Accounting and Financial Reporting also provide that such regulation if necessary would be implemented in coordination with the Agency for Financial Supervision. They also provide that the National Bank is responsible for the development and approval of regulations for the accounting and financial reporting system of SPEs established under Kazakhstan securitization legislation.

8) Can the SPE purchase physical assets, such as for example real estate or lease equipment? Are there any other restrictions imposed on the ownership of physical or intangible assets located in your jurisdiction? Are there any restrictions on the SPE owning assets located outside of your jurisdiction (e.g. foreign bank accounts)?

Neither the Securitization Bill nor existing Kazakhstan legislation explicitly impose any restrictions on an SPE as to the purchase of physical assets. We are not aware of any general restrictions imposed on the ownership of physical and intangible assets in Kazakhstan, other than property withdrawn from general commercial circulation due to the public interest. (Such property includes, for example, guns, drugs, and other illegal items.) The Securitization Bill does not impose any restrictions on an SPE's ability to own assets located outside Kazakhstan, although currency control laws do provide certain requirements in this regard.

b.) Restrictions on objects and powers

9) Is it possible to introduce legally enforceable restrictions on activities of an SPE?

Yes, it is possible to introduce legally enforceable restrictions on activities of an SPE.

10) If so, where should such restrictions be provided for (transaction documents, constitutional documents of the SPE)?

Such restrictions can be imposed either by incorporating relevant provisions into an SPE's corporate charter and/or by contract (e.g., in the prospectus, the subscription agreement or other transaction document).

11) Is it possible to ensure that the documents providing for restrictions on objects and powers of the SPE are not amended without a written notice to S&P for as long as the rated debt is outstanding?

Under the principle of freedom of contract recognized by Kazakhstan law, the parties may agree to include a "no amendment" covenant or restriction (i.e., restrictions on amendments without a prior written notice to S&P for as long as the rated debt is outstanding). If a contract includes S&P as a contracting party, S&P may also require that the SPE furnish comfort letters and constitutional documents certified by a public notary as of a certain date. In practice, it may be difficult to monitor compliance with the above-mentioned covenant or restriction, but, if a violation is recognized, and if S&P is contracting party, S&P should be able to enforce the covenant or restriction, or have a claim for damages.

12) What will be the legal consequences of violation of such restrictions?

In the absence of a specific prohibition in the corporate charter to undertake certain transactions, the entity has the capacity to engage in such transactions. If the constitutive documents of a legal entity do explicitly prohibit the undertaking of certain transactions, such transactions would potentially still be enforceable. Pursuant to Article 159 (11) of the Civil Code:

> Where a legal entity concludes a transaction (i) that is beyond the scope of its permitted activities as set forth in its constitutive document, or (ii) for which it does not have a license, or (iii) which falls beyond the competence of the legal entity's body which concluded the transaction, a court may deem such transaction invalid (based upon a lawsuit by such legal entity, its founder (or participant) or a state agency effectuating control or supervision over the activity of the legal entity), *if it is proved that the other party in the transaction knew or should have known about such violations*. (emphasis added).

As such, the non-breaching party should be able to enforce such restrictions unless there were certain relevant statutory or corporate limitations in respect of certain transactions and it is proved that the other party to such transaction knew or should have known about such violations of the limitations.

13) Does an SPE need to have employees or to lease premises?

There is nothing under applicable Kazakhstan law, which explicitly requires an investor or other entity to have employees and lease premises. However, the Securitization Bill specifically requires appointment of a managing director as an "executive body" of the SPE by the "representative of the noteholders." Such independent director could be deemed an employee of the SPE. Therefore, under Kazakhstan legislation, payroll, tax, social and other liabilities may potentially arise in connection with the appointment of the independent director.

(c) Debt limitations

14) Is it possible to impose legally enforceable restrictions on the right of an SPE to issue additional debt unless that debt is either (i) fully subordinated to the outstanding debt, or (ii) rated by Standard & Poor's at the same level as the outstanding debt (at the time of issuance and at all times thereafter)?

There are no provisions under Kazakhstan law that would make it impossible to enforce restrictions on the right of the SPE to issue additional debt unless that debt is either (i) fully subordinated to the outstanding debt, or (ii) rated by Standard & Poor's at the same level as the outstanding debt (at the time of issuance and at all times thereafter). Parties may contractually agree to include such restrictions.

15) If so, where should such restrictions be provided for (transaction documents, constitutional documents of the SPE)?

We believe it would be prudent to incorporate such restrictions in both the relevant transactional documents and constitutional documents of the SPE.

16) Is it possible to ensure that the documents providing for restrictions on objects and powers of the SPE are not amended without a written notice to S&P for as long as the rated debt is outstanding?

As a practical matter, it is very difficult to ensure that the constitutional documents providing for restrictions on objects and powers of the SPE are not in fact amended without a written notice to S&P. The only practical way is to obligate the SPE and/or the originator to provide, on a regular basis, a "non-amendment" comfort letter with a copy of the constitutional documents acknowledged by a notary public. However, the SPE could not unilaterally amend the transactional documents.

17) What will be the legal consequences of violation of such restrictions?

Please see our answer in item (b) 11.

18) Are there any limitations on foreign ownership of the debt or equity of the SPE?

Neither the Securitization Bill nor the Proposed Amendments contain any restrictions as to foreign ownership of the debt or equity of the SPE.

(d) Limitation of Recourse and Non-petition

19) Will limited recourse and non-petition language be enforceable under Kazakh law?

As regards a limited recourse provision (i.e., a limitation of recourse pursuant to which the creditors agree that their recourse is limited to those defined assets backing the relevant rated debt), under Article 8(2) of the Civil Code, waiver by citizens and legal entities from exercising their rights does not entail termination of such statutory rights, except for instances provided by legislative acts. Therefore, we believe that the parties may not contractually provide for an outright general restriction of the statutory right of recourse. In cases in which the parties merely limit their right of recourse to the assets backing the rated debt, the relevant provisions of the Civil Code arguably would not be violated. However, in view of the above provision of the Civil Code and in the absence of relevant precedents, it remains unclear as to whether Kazakhstan courts would uphold the enforceability of a limited recourse provision.

20) Can limited recourse and non-petition obligations be imposed on note holders?

Please see our discussion in item 19 above regarding a waiver of statutory rights. The right to file a bankruptcy petition is granted to creditors under the Bankruptcy Law. As such, the non-petition obligations could potentially be viewed as a waiver by the noteholders of their statutory rights and be unenforceable. However, as noted above, this remains an untested area.

21) Which parties, if any, cannot be covered by limited recourse and non-petition language?

Subject to the provisions of Article 8.2 of the Civil Code that may affect the enforceability of limited recourse and non-petition provisions generally, we are not aware of such private parties. However, the state agencies, such as the prosecutor's office or tax authorities can not be a party to such private contractual provision.

However, as stated earlier, under Article 17.2 of the Bankruptcy Law, a debtor is obligated to file a bankruptcy petition with a court in instances where the owner of its assets, its authorized agency, the founders or a corporate body of a debtor, decide to liquidate such debtor, and its assets are insufficient to satisfy creditors' claims in full.

d. Independent directors

22) Can constitutive documents require introduction of an independent director?

Yes, the constitutive documents may provide for introduction of an independent director.

23) What kind of fiduciary duties does a director have?

Kazakhstan law does not have the legal concept of fiduciary duties. However, Article 62 of the Joint Stock Company Law, dated May 13, 2005 (the "**Company Law**"), provides that the "authorized persons" of a company (i) must perform their obligations conscientiously and undertake their best efforts to achieve the interests of the company and shareholders; (ii) cannot either use the company's assets or let the assets be used in contravention to the company's charter and the resolutions of the shareholders' general meeting and of the board of directors, or use such assets by directors for their personal needs or abuse their powers when effectuating transactions with their affiliated persons; (iii) are obligated to ensure the integrity of the accounting and financial reporting system, including by conducting an independent audit; and (iv) must control the disclosure and granting of information concerning the company's activity in accordance with Kazakhstan legislation.

Under the Company Law, "an authorized person" is a member of a company's board of directors, a member of a company's executive body (or a person who solely exercises the powers and authority of the executive body). As such, all directors within the board of directors, a company's CEO or its senior executive officers fall within the definition of "authorized persons."

The company's CEO and members of the executive body are liable to the company for damage caused by their actions or inaction in accordance with Kazakhstan law. The Company may on the basis of the shareholders' general meeting resolution bring a lawsuit as to the recovery of damages or losses caused to the company. Please also note that the Company Law contains special rules for "interested party" (conflict of interest) transactions and provides liability for violation of these rules by the interested parties (i.e., disgorgement of profits and compensation of losses to the company). Article 51 of the Law of the Republic of Kazakhstan On Limited

Liability Partnerships dated April 22, 1998 (the "**Partnership Law**") also provides that members of the executive body must discharge their duties in the interests of the partnership conscientiously and reasonably. The Partnership Law provides for similar "conflicts of interest" provisions which contain certain restrictions as to the ability of the members of the executive body to enter into certain "self-interested" transactions.

Furthermore, the doctrine of "piercing the corporate veil" does not exist *per se* under the Kazakhstan legal system. However, officers and directors of an entity may be held liable for the acts or liabilities of such entity pursuant to Article 44.3 of the Civil Code of Kazakhstan dated 27 December, 1994 (the "**Civil Code**") if the bankruptcy of a legal entity is caused by its incorporators, shareholders or participants and the assets of such bankrupt entity are insufficient to satisfy the claims of such entity's creditors.

Generally, the Civil Code specifies that damages/losses are deemed to be expenditures which were incurred or which would have been incurred by a person or entity whose rights were violated, property was lost or destroyed or in the event of loss of profits, as well as which would otherwise have been realized.

The Criminal Code of the Republic of Kazakhstan dated 16 July, 1997 (the "**Criminal Code**"), also provides for criminal liability for actions or inaction by a company's officials. For instance, Article 228 of the Criminal Code stipulates that the misuse of power by management with respect to realizing illegal gains or benefits or causing damage to other persons shall be penalized by imposing fines equivalent to approximately three thousand dollars, or by imposing a fine equivalent to the offending person's wage or salary for a period from two to five months. Alternatively, an official may be required to engage in compulsory social work for a time period up to 240 hours, or such official may be imprisoned for up to 2 years.

24) Who can appoint directors? Once appointed can directors / independent directors be removed? If so by whom and by what process?

Generally, with respect to joint stock companies, the Company Law provides for two types of management: (i) the "Board of Directors" which is a management body with supervisory authority and (ii) the "executive body" (management board or a sole officer, equivalent to a CEO) which is responsible for day-to-day management of a company's business.

Members of the Board of Directors are elected by the shareholders at the general shareholders meeting. Once elected, directors can be removed by a shareholders' vote through a duly convened shareholders meeting. Articles 36.1.(5) and 55.3 of the Company Law specifically provide for early termination of all or some of the directors by a simple vote of the general shareholders' meeting. The powers of such directors are terminated as soon as the board of directors is notified to that effect in writing.

Under the Company Law, the executive body is appointed and removed by the board of directors. Article 5.1 of the Securitization Bill provides that the SPE's executive body must include a managing director to be appointed by the representative of the SPE's bondholders.

25) What is the procedure for voluntary bankruptcy filing?

See generally our answer in item a.3 and 4, above.

26) Who has the right/obligation to decide to initiate the process of a voluntary/ involuntary bankruptcy filing?

Please see generally our answer in item a.3 and 4, above.

27) If directors have the power to initiate voluntary or involuntary insolvency / bankruptcy proceedings can the independent directors have a veto power over such initiation?

Under the Company Law, the decision on winding-up / liquidation of a company falls within the exclusive competence of the general shareholders' meeting and independent directors would not be able to control the process.

28) Is it a requirement that directors initiate insolvency / bankruptcy proceedings when certain circumstances exist?

No, there is no statutory requirement that directors initiate insolvency / bankruptcy proceedings. It is within the competence of the general shareholders' meeting.

29) Is there liability for failure to make such a decision?

The law does not explicitly provide for liability for failure to make such a decision.

e. No merger or reorganization

30) Will "no merger or reorganization" covenants be enforceable under Kazakhstan law?

Yes, "no merger or reorganization" covenants should be enforceable under Kazakhstan law. Kazakhstan does not provide any express limitations on such covenants. However, under Article 6.1 of the Securitization Bill, a voluntary reorganization or liquidation of the SPE may be undertaken only upon permission of the authorized agency.

f. Substantive consolidation/separateness covenants

31) Is there a notion of substantive consolidation under Kazakh law? If so, what are the circumstances where it can be applied?

There is no such legal notion as substantive consolidation under Kazakhstan law.

32) Under what circumstances can one entity be consolidated with insolvency/bankruptcy estate of another entity?

In bankruptcy proceedings supervised by a Kazakhstan court applying Kazakhstan law, one entity cannot be consolidated into the bankruptcy estate of another entity.

33) Would adherence to the separateness covenants listed in the S&P criteria assist in supporting a view of non-consolidation?

In our view, adherence to the separateness covenants listed in the S&P criteria should assist in supporting a view of non-consolidation.

34) In a domestic issuance, is there a document that is enforceable by the note holders and cannot be amended without their consent where such covenants could be included?

The Law On Securities Market dated July 2, 2003 and the NBK Resolution provide for an agreement to be entered into by and between the issuer and the representative (broker/dealer) of note holders. The relevant covenant could be incorporated into such agreement. Furthermore, this could also be incorporated into the bond issuance prospectus. Article 9.4 of the Securities Law explicitly prohibits an issuer from changing the terms and conditions of the issuance and placement of bonds or of the bond circulation. It also prohibits changing the terms and conditions of the payment of interest and repayment of principal as established by the issuance prospectus, if such changes would prejudice the rights and interests of the bondholders.

g. Security interest over assets

35) Is it possible for an SPE to secure its obligations to noteholders by way of pledging / granting security over all of its assets?

The Securities Law explicitly provides for the issuance of secured notes (i.e., the performance of obligations assumed under the notes are secured by either a pledge of the issuer's assets or a bank guarantee). Therefore, it is possible to create a security interest over all of its assets either separately with respect to certain individual assets or with respect to the entire enterprise as “an on-going concern” (i.e., as “a property complex,” a term used by the Civil Code). Under Article 309.2 of the Civil Code, the security interest (i.e., mortgage) to be granted over the “property complex” extends to all of the assets, including movable and immovable property, receivables and copyrights, as well as those assets acquired in the future during the effective period of the security interest over the property complex.

With respect to the pledged property rights, please note that a pledge of property rights is not subject to mandatory state registration in order to be valid. The security interest would be validly created and enforceable upon the due execution of the pledge agreement, even if such agreement is not subsequently registered. However, there is a statutorily established procedure for voluntary registration of pledges of movable property in Kazakhstan. If such pledge is registered according to such voluntary procedure, then the registered pledgeholder would have priority with respect to the pledged rights vis-à-vis all unregistered pledgeholders and all subsequently registered pledgeholders.

Furthermore, Article 7.1 of the Securitization Bill provides that "the segregated assets" under each securitization transaction are segregated from (a) the SPE's own funds, (b) any other assets earmarked for any other securitization transaction, or (c) assets that are owned by any other person. Under Article 7.2 of the Securitization Bill, as soon as the SPE's prospectus for the issuance of the notes is registered, the enforcement by creditors in respect of the segregated assets can be made solely for purposes of the SPE's performance of obligations and payment of costs related exclusively to a specific securitization transaction. The effect of this provision is to ensure that certain identifiable assets are segregated for a specific securitization transaction to satisfy the obligations of the SPE.

As such, the above statutory provision regarding the segregated assets, together with the Proposed Amendments, is intended to provide for the sufficiency of the SPE's assets in order to satisfy its obligations under a securitization transaction. This provision of the Securitization Bill and the Proposed Amendments do not per se establish a security interest under Kazakhstan law, however, they ensure that the segregated assets are only available to the noteholders or other relevant creditors in the event of the SPE's liquidation or bankruptcy.

36) How will such security interest affect rights of other creditors of the SPE in case of bankruptcy proceedings?

Generally, with certain statutory exceptions (as described below), a secured creditor of an SPE would enjoy a higher order of priority vis-à-vis other unsecured creditors, as described in item 37 below.

37) What priority rights would exist over the rights of secured parties in the event of bankruptcy / insolvency proceedings for an SPE?

In the event of a bankruptcy of an SPE, the Bankruptcy Law establishes a general hierarchy of claims for settlements with creditors for business entities other than banks:

(a) claims of citizens arising from tortious acts (i.e., damage to health and well-being) of the entity;

(b) outstanding payroll obligations (including mandatory statutory payments such as alimony and transfers to the pension fund), as well as copyright payments;

(c) secured creditors;

(d) taxes and other mandatory payments to the Budget;

(e) unsecured creditors.

Unless claims of a higher priority category are fully settled, claims of a lower priority category may not be paid. Funds and securities held in custody are outside of the bankruptcy estate and the reach of the liquidator. Secured creditors will receive priority to the extent of the value of the collateral with the remaining amount of any unsettled claim to be treated as an unsecured claim.

Please note that in the case of bankruptcy of entities other than banks, the order of priority for the satisfaction of secured claims would be higher than those of banks.

The procedures are virtually the same regardless of whether an entity is involved in a voluntary or compulsory bankruptcy.

38) In the context of a domestic issuance, in which transaction documents will such security interest be provided for?

Such security interest can be created in the pledge agreements to be separately executed by the relevant parties. Alternatively the provisions on creation of a security interest over certain assets can be incorporated into the agreement to be executed by and between the representative of note holders and the issuer. However, from a practical standpoint, it would be advisable to execute and register/perfect separate pledge agreements.

39) Is it possible to grant security interests over all assets of the SPE, including economic benefits of, for example, derivative contracts, liquidity facilities, subordinated loans, bank accounts and permitted investments? Do such security interests survive a bankruptcy / insolvency of the grantor of the security?

Under Article 301 of the Civil Code, any property/assets (either moveable or immovable) including goods and property rights, as well as receivables, may be pledged with the exception of things withdrawn from commercial turnover (i.e., things deemed illegal under the law, such as drugs, guns, etc.) and claims inextricably related to the personality of a creditor (e.g., alimony, compensation for harm/damage caused to life or health, etc.). As such, it appears that Kazakhstan law does not prohibit using economic benefits under derivative contracts, liquidity facilities, subordinated loans, bank accounts and permitted investments as collateral. Such security interests should survive the security grantor's bankruptcy and the secured obligations should be satisfied in accordance with the hierarchy of claims described in item 37, above.

h. Multi-issue vehicles

40) Can the SPE carry out more than one securitisation transaction? If yes, what rules exist under Kazakh law which would ensure segregation among the different asset pools?

Article 1.15 of the Securitization Bill provides the following definition of an SPE: "a legal entity, established pursuant to the current Law, the exclusive activity of which is the conducting of one or several securitization transactions" (*emphasis added*). In addition, Article 7 of the Securitization Bill specifies that segregated assets must be separated from any other assets of a special financial company in each securitization transaction. [*emphasis added*] However, the mechanics of such separation or segregation is unclear.

Article 8.1 requires a special financial company to maintain separate accounting records and financial reports with respect to segregated assets. However, Kazakhstan law is unclear as to whether there must be separate accounting for each segregated assets pool or for all aggregate segregated asset pools.

41) Can the SPE issue different series of notes over time backed by a global pool of receivables?

The Securitization Bill is silent as to whether an SPE can issue different series of notes over time. The Securitization Bill in Article 9.1, however, provides that an SPE must obtain receivables from the originator by means of transfer of funds received as a result of the bond issuance secured by underlying receivables.

In view of the fact that the law does not establish express restrictions, it appears that an SPE can issue different series of notes over time but backed by a specific pool of receivables.

i. Existence and identification

42) What assets can be securitised (existing, future)? What are the rules for asset identification?

Article 9 of the Securitization Bill provides for securitization of existing and future claims. Under Article 1.3 of the Securitization Bill, claims are included in the definition of the term "segregated assets," which is defined as: "claims, obtained by a special financial company, and proceeds on the claims, as well as additional security and other rights and financial assets, arising as a result of investing proceeds on segregated assets."

As already stated above, Article 7 of the Securitization Bill specifies that segregated assets must be separated from any other assets of a special financial company on each securitization transaction. In addition, as already stated above, Article 8.1 requires a special financial company to maintain separate accounting records and financial reports with respect to segregated assets. The procedure for maintaining the accounting for segregated assets should be established by the National Bank of the Republic of Kazakhstan as required by Article 8.2 of the Securitization Bill and Article 3.4 and 3.6.2-1 of the law of the Republic of Kazakhstan "On Accounting and Financial Reports," as provided in items 15 and 16 of the Proposed Amendments.

In relation to a transfer of future claims, please note that as a general matter of Kazakhstan law, a claim is deemed to be valid if such claim of an assigning creditor is based on legal grounds at the time of assignment. As such, Kazakhstan law only allows assignments to be made in respect of available (i.e., existing at the time of assignment) rights. The future rights would be deemed available at the time of assignment to the extent that they arise in the future from a contract which is in effect at the time of the assignment. Such contract should have all of the terms and conditions that would allow the parties to determine the assigned rights, both existing and future.

43) Can receivables be assigned despite contractual prohibition in the agreement between the originator and underlying debtor? If so, what are the consequences of such an assignment? Absent contractual restrictions on assignment, are there any statutory or implied restrictions on the assignment of receivables?

The Securitization Bill does not address this issue specifically. However, Article 339.2 of the Civil Code establishes that an original contract between a debtor or the underlying debtor and a creditor / the originator may require the debtor's consent for an assignment. However, Article 733 of the Civil Code establishes that an assignment of receivables to a "financial agent" ("a factoring transaction" as defined by the Civil Code) is valid even if the assignment is prohibited by an agreement between a "debtor" and a "creditor." Please note that a "factoring transaction" is deemed to be a type of a banking operation and requires a banking license. As such, this statutory provision is relevant for financial institutions.

Under Article 5.1.6 of the Kazakhstan Law On Natural Monopolies (the "Natural Monopoly Law") the assignment of receivables is expressly prohibited for natural monopolies.

44) Do underlying obligors need to be notified of or consent to the sale of assets? What is the effect of failure to give such a notice or receive a consent?

Article 339 of the Civil Code provides that an assignment is enforceable without notification of the debtor or the underlying obligor. However, in such event an SPE bears the risk that an underlying obligor will continue performing its obligations to the originator and such performance will be recognized as the duly performed obligation of the originator. As for the debtor's prior consent and an assignment in violation of the consent requirements, please see the discussion in item 43.

45) What steps need to be taken to validate/perfect issued loans and security backing them (e.g. registration)?

Loans. Under Kazakhstan law, loans issued by a resident lender to a non-resident borrower, or by a non-resident lender to a resident borrower, are subject to a wide array of currency controls affecting payment and banking activities. The application of the currency regime depends largely on whether the entity is a resident or a non-resident. For the purposes of the Currency Law, Kazakhstan residents and non-residents are defined as follows:

Residents include (i) individuals with their permanent place of residence in Kazakhstan, (ii) Kazakhstan legal entities ("KLEs"), and (iii) branches and representative offices of KLEs (whether abroad or in Kazakhstan).

Non-residents include (i) foreign individuals, (ii) foreign legal entities ("FLEs"), and (iii) branches and representative offices of FLEs.

Transactions between non-residents and residents are subject to registration or licensing requirements depending on whether these involve inbound or outbound loans, and depending also on the terms of the loans. For example, the provision of outbound loans for a period of greater than 180 days requires licensing and the provision of inbound loans for a period greater than 180 days requires registration.

Kazakhstan law requires lenders domiciled in Kazakhstan to hold banking licenses as a legal prerequisite to the making of loans. Loans issued by authorized Kazakhstan lenders (holding banking licenses) to Kazakhstan legal entities or individuals are not subject to registration or licensing requirements.

Security. Where a security requires registration, the security is not enforceable unless and until registration has occurred. Security transactions under Kazakhstan law require registration where the security is in the form of immovables, as well in some circumstances where the security is in the form of movables. Under Article 117 of the Civil Code, movable property is defined as "property that is not immovable." (Immovable property is defined as "land plots, buildings, structures, perennial plantings and other property closely connected to the land.") Article 117 also states that movable property includes "money and securities." Where registration is required for a pledge, the security is perfected upon its registration, and the pledge attains first-in-time-first-in-right priority over subsequent pledgees (Article 8 of the Movable Property Registration Law). As noted, there is no explicit rule on the registration of movable property such as contractual repayment rights. Where registration is required, the Movable Property Registration Law requires that "the pledge agreement must be registered with the Ministry of Justice of the Republic of Kazakhstan … as well as other state bodies and legal entities authorized by legislative acts to register certain types of movable property."

46) Is consumer protection legislation applicable to consumer loans? If so, please explain. Can the SPE, if it purchases consumer loans, become liable to the debtors for breach of product warranty by the originator or failure of the product financed by the consumer loan?

Under current Kazakhstan law there is no specific regulation related to consumer loans. Kazakhstan Law "On Protection of Consumers Rights" (the "Consumer Law") applies only to goods, works and services. The Consumer Law does not specifically refer to consumer loans. However, granting of loans is deemed a service under Kazakhstan law. Since such service is arguably rendered to a consumer, the Consumer Law may apply.

Under current Kazakhstan law, product liability is based on a no-fault principle, which applies to defective goods acquired for consumer purposes. Western-style "product liability" claims can be asserted under Article 947 of the Civil Code against manufacturers and/or sellers of products found to be defective, regardless of the source of such defect and lack of contractual privity. No-fault products liability rules only apply in case of "acquisition of goods (work, services) for consumer purposes." Since an SPE is most likely not a manufacturer and/or seller of products, it should not be liable to the debtors for a breach of product warranty or failure of the product.

47) Are there limitations as to the rates that can be charged on loans to individuals (usury/predatory lending legislation)? If so, please explain.

Kazakhstan law does not contain explicit limitations as to the rates that can be charged on loans to individuals. In particular, Article 71.1 of the Civil Code establishes a general rule applicable to legal entities and individuals that: "…a borrower shall pay interest to a lender in the amount specified by an agreement." Similarly, Article 39 of the Banking Law provides that: "interest rates and fees, as well as tariffs for rendering banking services, shall be established by a bank independently."

k. Set-off

48) Do underlying obligors have the right to set-off unrelated claims in bankruptcy of the originator (e.g. claims under a loan against claims under a deposit agreement)?

Under the general rule established by Article 370 of the Civil Code, an obligation of one party can be extinguished in whole or in part by setting-off a counterclaim of a similar kind against the other party, provided, however, that the term of such counterclaim either has matured, was not specified or is payable on demand.

The Bankruptcy Law and other relevant laws do not explicitly provide for the statutory right to set-off unrelated claims in bankruptcy of the originator (e.g., claims under a loan against claims under a deposit agreement).

However, at the time of liquidation of Kramds Bank (which occurred almost a decade ago, when Kramds Bank was the fifth largest bank in Kazakhstan in terms of assets), NBK liquidators dealt with the bankruptcy estate by using a net balance of claims that was arrived at by setting off claims of the bankrupt against the claims of specific creditors.
However, in view of the broad discretionary powers of the bankruptcy administrator and the absence of sufficient precedents, it is difficult to predict with certainty how a bankruptcy administrator would treat such unrelated claims.

49) If so, would a contractual prohibition of such set-off be lawful?

Such contractual prohibition could potentially be viewed as the waiver of statutory rights under Article 8(2) of the Civil Code, consequently and held as unenforceable. Please see our discussion in items 19 and 20 above.

50) Following assignment, does the right of set-off continues to exist? How does notice of sale affect the right of set-off?

Following assignment in favor of a third person, the right of set-off will cease to exist against an assignee.

However, under Article 339 of the Civil Code, a creditor's claims under a debtor's obligation can be assigned to a third party by such creditor. Although the assignment of the creditor's claims in favor of a third party does not require the debtor's consent, the debtor must be notified in writing of the transfer of the creditor's rights. If the parties fail to notify the debtor, then the assignee (i.e., the new creditor) would bear certain risks of potential unfavorable consequences. Specifically, if in the absence of notification of the assignment the debtor continues to make payments to the original creditor in lieu of the new creditor, then the debtor would be deemed to have properly performed its obligations. Similarly, if the debtor was not duly notified of the assignment, he may still be deemed to have retained the right of set-off against the original creditor under the underlying obligation.

l. Transfer

51) Please discuss the possibility, and possible challenges to, a transfer of assets that would be enforceable against:

a. Seller. There may be several challenges related to transfer of assets by a seller, such as (i) corporate challenges, (ii) contractual challenges, and (iii) regulatory challenges.

Corporate. The constitutive documents of a seller may potentially contain restrictions as to certain transactions unless a prior shareholders' or board of directors' approval, is not obtained.

Contractual. Please see discussion in item 44 above.

(c) Regulatory Issues. Antimonopoly legislation also may be relevant if the originator is a natural monopoly entity or an entity deemed an entity occupying a dominant position. If a seller is a natural monopoly, by virtue of Kazakhstan law it is prohibited from transferring receivables to third parties. In addition, under the Antimonopoly Law certain regulatory consents may also be required. For instance, it would be necessary to obtain the preliminary consent of the antimonopoly body, if the sale exceeds 10% of the balance sheet value of the seller's assets. However, the antimonopoly body may refuse to give its consent under Article 17 of the Antimonopoly Law, if it believes that such sale may result in a decrease of competition.

The Law of the Republic of Kazakhstan On Banks and Banking Activity dated 13 May 2003 (the "**Banking Law**") also provides certain specific rules for bankruptcy or rehabilitation of banks as well as limitations on certain transactions.

b. *Regulator, third-party creditors, external manager, liquidator or bankruptcy administrator in bankruptcy of the seller.* Please see our discussion in items 5, 7, and 54.

c. *Underlying obligors.* There may be contractual challenges.

52) What steps need to be taken to make the sale enforceable against third parties?

There are certain corporate steps that must be completed to make the sale enforceable. The sale might be subject to the "major transaction" rules. The Company Law establishes certain procedural requirements for a "major transaction" as defined in Article 68 of the Company Law:

> "1) a transaction or a number of interrelated transactions which result in the company's acquiring or alienating property, the value of which amounts to twenty five (as for a public joint stock company – ten) or more percent of the total value of the company assets;… "

If the value of the sale amounts to twenty five percent (25%) or more of the total value of the seller's assets, then the sale would be recognized as a major transaction and would require certain corporate pre-sale procedures. The steps would include the taking of a decision of the Board of Directors of the seller, and, if a company's charter requires, the approval of the sale by a general meeting of the shareholders of a legal entity. However, please note that the provisions of the Company Law regarding a major transaction are not applicable to a limited liability partnership.

In addition, there are several antimonopoly issues that may arise. For instance, it would be necessary to obtain the preliminary consent of the antimonopoly body if the sale exceeds 10% of the balance sheet value of the seller's assets.

Also, in relation to creation of a security interest, the relevant pledges must be perfected by way of registration with the Ministry of Justice, as discussed above.

53) Under what circumstances can a sale of assets be re-characterized as a secured loan or another transaction that fails to remove the asset from the transferor's bankruptcy estate?

According to general principles of Kazakhstan contract law found in the Civil Code, the terms of a contract must be respected (i.e., if a contract characterizes something as a sale or transfer of assets it should be interpreted that way) unless they contradict Kazakhstan law or there is a specific reason to assert that the contract is, in fact, an attempt to disguise the true nature of the transaction.

Generally, however, due to limited experience with such contracts in Kazakhstan and the nature of Kazakhstan's courts there is a risk that the courts might recharacterize such sale as a secured loan.

54) Can a sale of receivables be challenged /voided (preference, undervalue, etc.) in bankruptcy of the seller and if so, under what circumstances?

Generally, under the existing wording of Article 6.1 of the Bankruptcy Law, certain transactions effectuated by a debtor prior to its being recognized bankrupt *must* be held invalid. Specifically, these include transactions effectuated by the debtor after the initiation of bankruptcy proceedings, which appear to prefer one creditor over another. However, pursuant to the Proposed Amendments (specifically related to this provision), securitization transactions are expressly exempted from application of this provision.

Under Article 6.2 of the Bankruptcy Law, creditors may also request the invalidation of transactions (and the return of transferred property) that occurred up to two years (suspect period) before the initiation of the bankruptcy proceedings which were either below fair market value or "without sufficient grounds in prejudice to the creditors' interests." Additionally, creditors may demand the return of a debtor's property that was transferred within two years prior to bankruptcy, where such transfer was made to satisfy an obligation prior to its maturity.

The term "initiation" as used above refers to the issuance by a court of its opening ruling in the bankruptcy proceedings. The court may set aside transactions at the request of the bankruptcy administrator or creditors. Please note that the two year period is a fixed period which is calculated from the date of the issuance by a court of its opening ruling in the bankruptcy proceedings.

There are no established formal or practical criteria for a court to follow when determining whether transactions are voidable preferences. Generally, it is determined on a case-by-case basis and remains a discretionary matter.

In terms of voidable preferences, generally, and determining whether of transaction has acquired "below market value," specifically, the burden of proof appears to lie with the bankruptcy administrator or the creditors (e.g. they may present evidence as to existing market prices, seek advice of professional appraisers/valuers, etc.). However, we are not aware of specific methods or criteria established or developed for determining below market value.

Please note that the "suspect period" generally applies to all transactions.

Under the Bankruptcy Law, the mere fact that a contract is a long term contract (i.e. with a term of more than one year) could be sufficient grounds for the contract to be voided (Article 7 of the Bankruptcy Law).

55) Do bank secrecy/privacy/data protection laws affect the transfer of assets (e.g. transfer of information on borrowers) from the seller to the SPE?

Current Kazakhstan law contains certain provisions regarding bank secrecy. Article 50.1 of the Banking Law provides that bank information that should be treated as secret includes the following information: (i) the names and account numbers of depositors, and the clients and correspondents of a bank; (ii), the account balance and transactions performed by the persons mentioned above; (iii) transactions of a bank (except information about the general terms and conditions for bank transactions); and (iv) information about clients' property in safes and elsewhere in the premises of a bank. These requirements are applicable only to banks and entities performing bank activities based on a license issued by the National Bank of Kazakhstan. Should the above information be disclosed by the banks at the sale, it may potentially be viewed as the violation of the statutory banking secrecy provisions.

Article 126 of the Civil Code refers to commercial secrecy, which may be protected by Kazakhstan law as well as by an agreement between parties to a relevant transaction. In order for information to be treated as a commercial secret, it must satisfy the following three conditions: (i) it has commercial value due to the fact that this information is unknown to third parties; (ii) there is no access of third parties to such commercial information on any legal grounds; and (iii) a holder of such information takes measures to ensure the protection of information from disclosure.

m. Tax

The Securitization Bill provides that a transfer of assets constitutes a transfer of receivables. Under this Section we consider tax issues pertaining to a transfer of receivables.

56) Are there stamp duties or similar taxes payable on transfer of assets?

No stamp duties or fees arise in connection with the creation or perfection of a transfer of assets. However, the subsequent monetary flows might be subject to taxation as discussed below.

57) ***Can transfer of assets trigger VAT?***

Transfer of assets triggers the imposition of a 15% VAT under the Tax Code.

58) an transfer of assets trigger profits tax for the seller?

Transfer of assets may trigger the application of a profit tax or withholding tax depending on the residency of a seller. Article 176.6 of the Tax Code establishes that for the purposes of Kazakhstan tax law a non-resident is a legal entity, which is not established in accordance with Kazakhstan law and/or a legal entity whose governing bodies are not located in Kazakhstan. All other legal entities are residents. In particular, if a seller is a Kazakhstan resident, then, under Article 80.1(7) of the Tax Code, income from sale of receivables is subject to inclusion into its annual aggregate income, which is subject to a tax rate of 30% minus allowable deductions.

If a seller is a non-resident, then its income received from the sale of receivables is deemed Kazakhstan source income under Article 178.4 of the Tax Code, which defines Kazakhstan source income in connection with the transfer of a right of claim on a debt. Article 178.4 of the Tax Code states:

> “The following types of income shall be considered nonresidents' income from sources in the Republic of Kazakhstan:
>
> … 4) income from concession of the right of claim on a debt to residents or nonresidents in connection with doing business in the Republic of Kazakhstan through a permanent establishment; … ”

This provision may be interpreted very broadly, so that any proceeds generated through the sale of receivables that emerge in connection with a permanent establishment in Kazakhstan could theoretically be treated as Kazakhstan source income.

The language of Article 178.4 is not clearly drafted. In our view the most reasonable interpretation of Article 178.4 would be that Kazakhstan source income rules would not apply if a non-resident does not have a permanent establishment in Kazakhstan. However, the local authorities could interpret Article 178.4 so that the receivables are sufficiently "in connection with doing business in Kazakhstan" so that they constitute Kazakhstan source income.

59) ***Would transfer pricing rules be applicable to transfer of assets in a securitisation transaction?***

Kazakhstan has an aggressive enforcement policy and regime with respect to transfer pricing. The securitization transaction may be subject to the transfer pricing control under Article 73 of the Tax Code, which provides the following general transfer pricing rule:

> "Tax service authorities shall monitor the proper application of prices in transactions following the procedure and in those cases provided for under legislative acts of the Republic of Kazakhstan governing issues of government monitoring of the application of transfer prices. When it is determined that a transaction price differs from a market price, tax authorities shall make adjustments in objects of taxation and tax obligations in accordance with the legislation of the Republic of Kazakhstan."

The key legislative act governing transfer pricing issues is the Transfer Pricing Law, which applies to international business transactions. International business transactions are defined under Article 2.2 of the Transfer Pricing Law as: "export or import transactions related to sale-purchase of goods (work, services)." If a transfer of assets constitutes an export or import sale transaction, then the Transfer Pricing Law may be applicable to a transfer of assets and draw the attention of the tax authorities.

60) ***Is the SPE liable to pay corporate income taxes like any other limited liability company? If yes, how can payment of taxes be accounted for in any given securitisation transaction?***

An SPE like any other Kazakhstan legal entity is liable to pay corporate income tax on its income as required by the Tax Code. Article 91.1.7-1 of the Tax Code, in the wording of the Proposed Amendments, would provide for exclusion from aggregate annual income "segregated assets of a special financial company, which are collateral for securities in accordance with legislation of the Republic of Kazakhstan on securitization."

61) Would the SPE be subject to, or required to make, any withholding tax on cash-flows received or paid by it (e.g. under the receivables, the securitisation notes, any derivative hedging agreement)?

<u>Taxation of cash flow received</u>. Income received by an SPE as a result of cash flow (under the receivables, the securitization notes and derivative hedging

agreement) will be subject to income tax at the 30% rate minus allowable deductions.

Taxation of cash flow paid. If an SPE pays income to a non-resident without a permanent establishment in Kazakhstan, then such income is subject to withholding tax at a rate of 15%. If an SPE pays income to a resident in Kazakhstan, or to a non-resident with a permanent establishment in Kazakhstan, no taxes are withheld by an SPE on the cash flow paid.

n. Commingling

62) Will funds collected by the servicer on behalf of SPE be included in servicer's bankruptcy estate? What needs to be done to avoid that?

Under Article 83.2.(2) of the Bankruptcy Law, property which is not owned by a debtor, including property which is held by a debtor under a trust management arrangement or in entrusted into its custody, is expressly excluded from the bankruptcy estate. Therefore, it appears that the funds collected by the servicer on behalf of an SPE would not be included in the servicer's bankruptcy estate. This should be reinforced by incorporating a relevant contractual provision.

o. Other matters

63) Is pledge of accounts possible under Kazakh laws?

The Civil Code expressly permits creation of a pledge in order to secure underlying obligations existing between a pledgor and a pledgeholder. Under paragraph 4 of Article 301 of the Civil Code, money may be pledged. Pledged money, however, must be deposited on accounts maintained with a bank. Paragraph 2 of Article 301 specifically provides that property that will come into the ownership of a pledgor in the future may be the subject of a pledge with the consent of the parties. Thus, pledges of money in bank accounts, existing or future, is permitted and recognized under Kazakhstan law.

64) Is contractual subordination possible under Kazakh law?

There is nothing under Kazakhstan law that would restrict contractual subordination.

65) Does the servicer need any regulatory authorization / licenses to service the assets?

We are not aware of any regulatory authorizations/licenses that would specifically require a servicer to obtain a license. However, certain functions of the servicer may involve activities subject to Kazakhstan licensing requirements, e.g., if the servicer undertakes a banking operation activity.

66) Would the collection monies and/or investment securities owned by the SPE be lost in an insolvency of the deposit account bank?

Please generally see our answer to item 62 (Commingling of assets).

Under the existing wording of Article 74-1 of the Banking Law, the bankruptcy estate of a custodian bank does not include securities owned by third persons transferred to such bank's custody. Clients of banks who deposit their monies on accounts maintained with a bank are deemed creditors of such bank and are specifically referred to in the statutory priority settlement list in the event of bankruptcy (please see our answer in item 37, above).

Furthermore, pursuant to the Proposed Amendments (i.e., Article 74-1(1 and 2) of the Banking Law) (i) the segregated assets which are used as collateral to secure obligations under the bonds issued under Kazakhstan securitization legislation are specifically not included in the bankruptcy estate; and (ii) securities and assets of an SPE held in custody by custodian banks expressly exempted from the bankruptcy estate. As such, monies and/or securities owned by an SPE would not be included into the bankruptcy estate of a bank. However, in practical terms, it would be a fairly difficult process for an SPE to repossess the monies in view of the priority order satisfaction rules, as discussed above. Please also generally see our answer to item 62 (Commingling of assets).

67) Can debtor payments to the SPE be challenged in a bankruptcy of the debtor (e.g. for rules on preference)? Would the challenge apply also to any prepayment made by a debtor?

A debtor's payments to an SPE, generally, should not be challenged in a bankruptcy of the debtor as a voidable preference, subject, however, to our answer in item 54, above. However, prepayment made by a debtor may potentially be viewed as a voidable preference if made within the suspect period, as discussed above (specifically in item 54).

68) <u>Specifically for lease receivables:</u> can a securitised lease be cancelled without the SPE's consent by the liquidator of the original lessor even after that lessor has sold the lease rentals to the SPE pursuant to a securitisation transaction? Can the SPE, in the case of a default by a securitised lessee, obtain the benefit of the leased equipment even after the insolvency of the lessor?

In the event an assignment of an underlying lease agreement from the original lessor in favor of an SPE takes place, such that an SPE would replace the original lessor as a party to such lease arrangement, the liquidator of the original lessor would not be able to cancel the lease agreement (subject, however, to voidable preference and suspect period provisions as described in item 54).

However, in the event of merely a sale of receivables without the assignment of the underlying lease agreement, there is a risk that the bankruptcy administrator/liquidator may attempt to cancel the securitized lease. The Bankruptcy Law generally, and in Article 7 specifically, gives broad powers and discretion to a bankruptcy administrator with respect to transactions concluded by the insolvent/debtor prior to the bankruptcy proceedings. Under Article 7 of the Bankruptcy Law, a bankruptcy administrator may refuse to perform contracts concluded prior to the bankruptcy proceedings if:

(1) the performance of a contract would cause losses to the insolvent party;

(2) the agreement contains terms which are onerous for the debtor compared to similar agreements concluded under comparable circumstances;

(3) the agreement is a long-term agreement (for more than one year), or the results/consideration are obtainable by the insolvent party in the long term; or

(4) there are other grounds to assume that performance of a contract by the debtor shall be unfavorable for other creditors.

It appears that an SPE can obtain the benefit of the leased equipment only if a lease agreement was duly assigned to the SPE by a lessor and the SPE replaced the lessor as a counterparty to such lease agreement.

69) Would any special rules apply for true sale or other purposes if a debtor is the State or any public entity?

Generally, a sale of receivables must comply with the relevant requirements of the Civil Code (i.e., provisions on transactions, the form of sale/purchase agreements, assignment of claims/receivables, etc.).

Furthermore, in the event sales transactions are undertaken by a state body (e.g., the Ministry of Finance), such transactions would only be legal, binding and valid if within the state body's authority and capacity. If such transactions are outside of its capacity, then they would be deemed null and void.

STANDARD & POOR'S

Igor Iassenovets
Assistant General Counsel
Credit Market Services

4/7 Vozdvizhenka Str., Bld. 2, 7th floor
125009 Moscow, Russia
7 095 783 40 20 Tel
7 095 783 40 01 Fax

Timur Dzhankobaev
Director, Corporate Finance
FSI/ The Pragma Corporation
USAID/ CAR

e-mail: timur@kazecon.kz

06 Dec. 2005

via e-mail

Dear Timur,

You have requested that Standard & Poor's reviews the draft securitisation law and supporting amendments to some legislative acts sponsored by USAID/Pragma ("Draft Securitisation Legislation") and provides its views as to whether such legislation would be sufficient to structure "rateable" domestic securitisation transactions. As we are not experts in Kazakh law, we have asked Chadbourne & Parke, our legal counsels in Kazakhstan, to review the Draft Securitisation Legislation and answer a number of questions based on S&P legal criteria for rating securitisation transactions. Following our review of the answers prepared by Chadbourne, we believe that upon enactment of the Draft Securitisation Legislation, certain issues may still need to be addressed:

Bankruptcy remoteness of the SPV:

1. Enforceability of limited recourse and non-petition language. In order to make sure that the SPV will not be filed into bankruptcy by one of its creditors, we expect all creditors to be bound by limited recourse and non-petition provisions. Limitation of recourse language usually provides that creditors' claims will be limited to assets backing the rated debt. Besides, such language may subordinate such creditors' claims to the claims of holders of the rated notes. Non-petition language provides that creditors (including noteholders and other transaction parties) will not file the SPV into bankruptcy and will not join in any bankruptcy filing prior to the end of a specific period after all of the rated debt is paid in full. Such language must be binding and enforceable also in case of bankruptcy of SPV's bankruptcy. We understand that there's no certainty whether limited recourse and non-petition provisions will constitute legal, valid, binding and enforceable obligations of the SPV.
2. Employees of SPV. According to S&P's legal criteria for securitisation transactions of an SPV must not have employees because claims based on employment law are usually difficult to predict and cannot be covered by limited recourse/non-petition. Hence presence of employees may jeopardize bankruptcy remoteness of the SPV. We understand that in accordance with the Draft Securitisation Legislation the SPV needs to have a managing body that would include at least one independent director. We also

understand that such director may be viewed as an employee even in the absence of a labor contract. This may pose an obstacle to achieving bankruptcy remoteness.

3. Comfort on tax liabilities of SPV. Usually tax authorities cannot be made a party to the inter-creditor arrangements and hence cannot be bound by limited recourse and non-petition language. For this reason we usually expect to receive comfort that tax authorities will not have a valid claim against the SPV while rated notes are outstanding. In many jurisdictions we receive a tax ruling to that effect. We understand that this issue has not been addressed in the Draft Securitisation Legislation.
4. Security over assets of SPV. In accordance with S&P bankruptcy remoteness criteria, SPV must grant holders of the rated notes a perfected security interest over its assets. Such a security interest reduces incentives of the parent or any other creditor of the SPV to file the SPV into bankruptcy. To achieve the same effect, the Draft Securitisation Legislation introduces the notion of segregated assets. However, provisions covering segregation of assets in the draft law stipulate that segregated assets will be available not only to the noteholders, but also to entities providing services for the securitisation (clause 7 (2)).

Transfer of assets:

1. Need for corporate approval of the transfer of assets. We understand that the sale of securitised assets may require an approval as a major transaction and as a transaction. This may be an obstacle to efficient transfer of assets for securitisation.
2. Executory contracts. We also understand that in accordance with the bankruptcy laws a bankruptcy administrator may set aside an agreement merely because it's entered into for a period of more than a year. This may pose a threat to various future flow deals (e.g. leasing receivables securitisations).
3. Bank secrecy legislation. We understand that transfer of information on borrowers to the SPV may result in violation of bank secrecy laws. While this violation may not necessarily lead to invalidation of an asset sale, it may be an obstacle to effective structuring of securitisation transactions.

The full version of Chadbourne's answers to our questions is attached hereto. Please note that our analysis was limited to review of certain general legal issues and did not address risks associated with specific asset classes. Even if the aforementioned risks are mitigated, we do not and cannot guarantee that following enactment of the Draft Securitisation Legislation particular structures will be rateable.

Please do not hesitate to contact me should you have any questions.

Kind regards,

Igor Iassenovets

Legal Counsel
Standard & Poor's (Moscow)

БТА ИПОТЕКА

ИПОТЕЧНЫЕ ОБЛИГАЦИИ СЕКЬЮРИТИЗАЦИЯ И REITS

USAID
FROM THE AMERICAN PEOPLE

PRAGMA

РАЗВИТИЕ МИРОВЫХ ФИНАНСОВЫХ РЫНКОВ

	GDP	Reserves less gold	Stock Market Capitalization	All Debt Securities	Bank Assets	Bonds, Equities, Bank Assets	As Percent of GDP
World	40,890.5	3,856.3	37,168.4	57,962.1	49,577.9	144,708.5	353.9
United States	11,734.3	75.9	16,323.5	22,540.3	7,808.9	46,672.7	397.7
Euro Zone	9,550.1	174.5	5,873.0	15,816.3	16,127.5	37,978.8	397.7
European EM	**1,778.5**	**251.5**	**208.2**	**551.4**	**482.6**	**1,242.2**	**69.8**
Kazakhstan	**43.5**	**7.8**	**7.1**	**11.0**	**25.9**	**44.0**	**101.1**

Source: IMF, Pragma Corporation

ИПОТЕЧНЫЕ ОБЛИГАЦИИ В ОБРАЩЕНИИ KZT 42,964 МИЛЛИАРДА

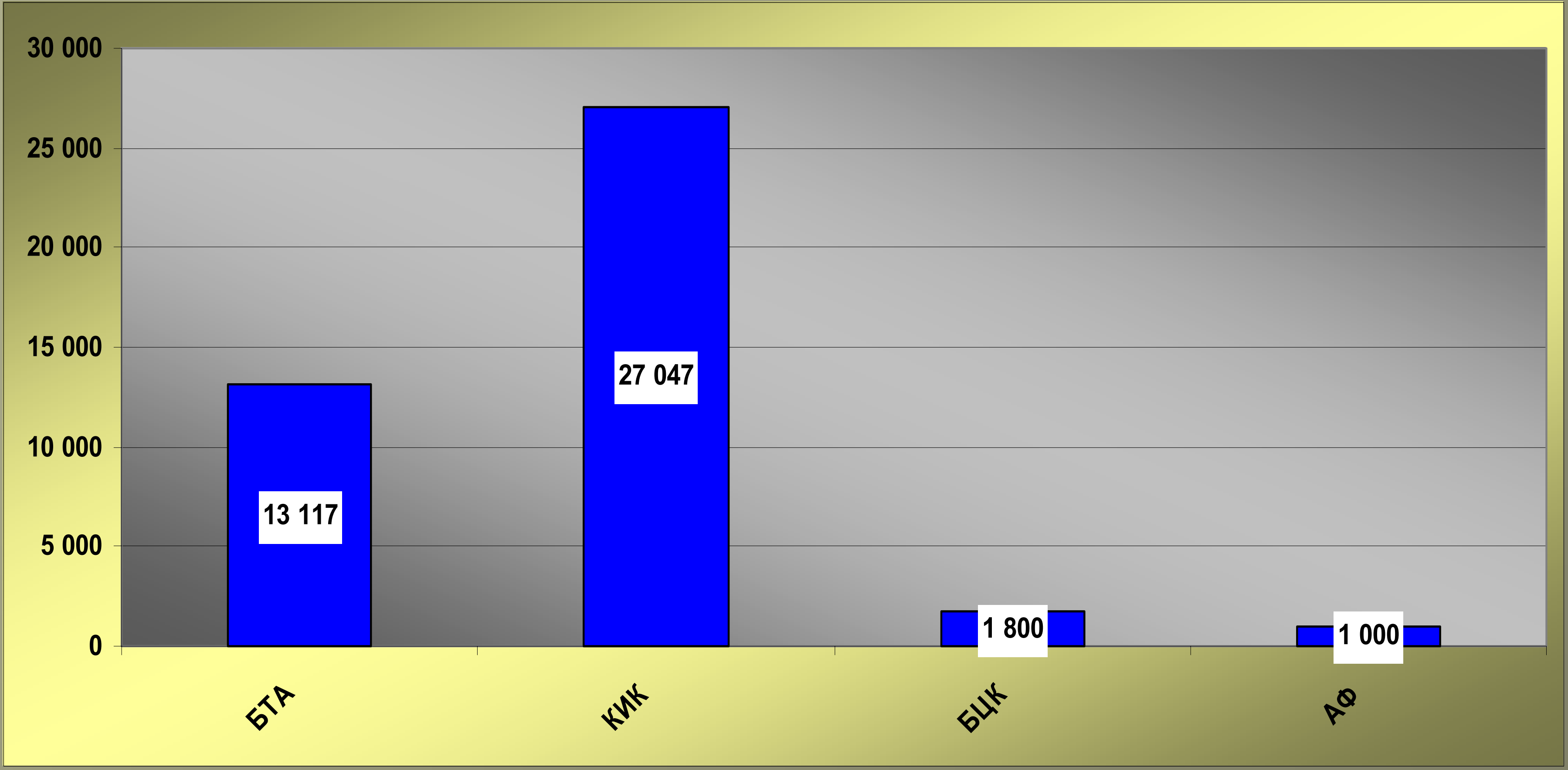


Схема ипотечной облигации КИК

актив остается на балансе эмитента

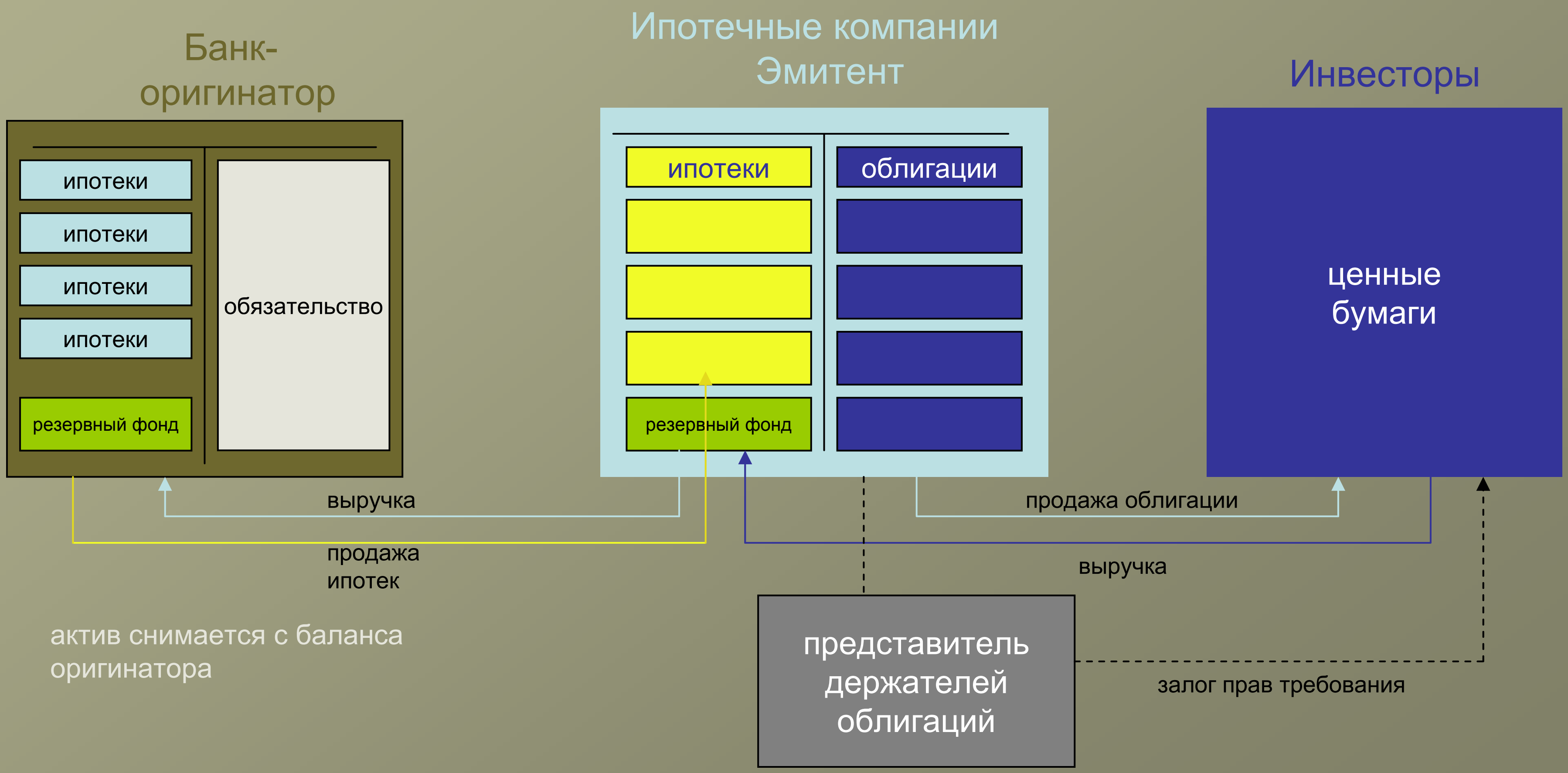
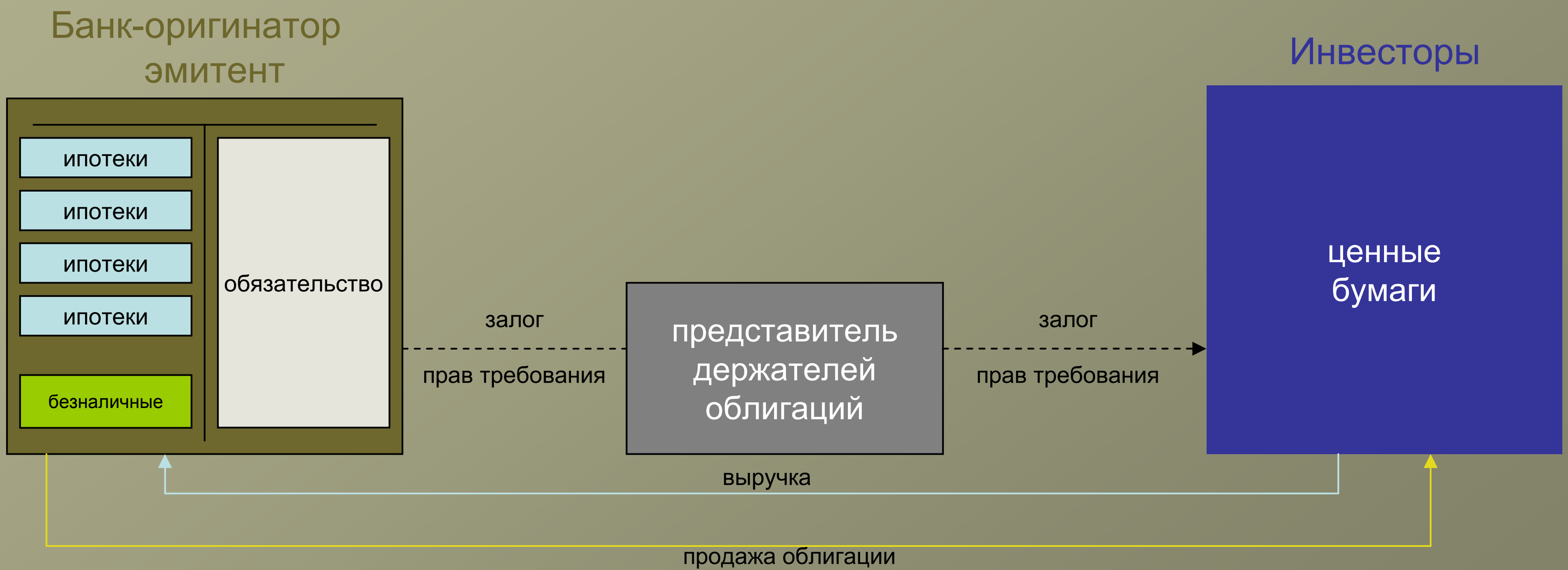


Схема ипотечной облигации оригинатора

“covered bonds”



актив остается на балансе оригинатора

Схема ипотечной облигации КИК

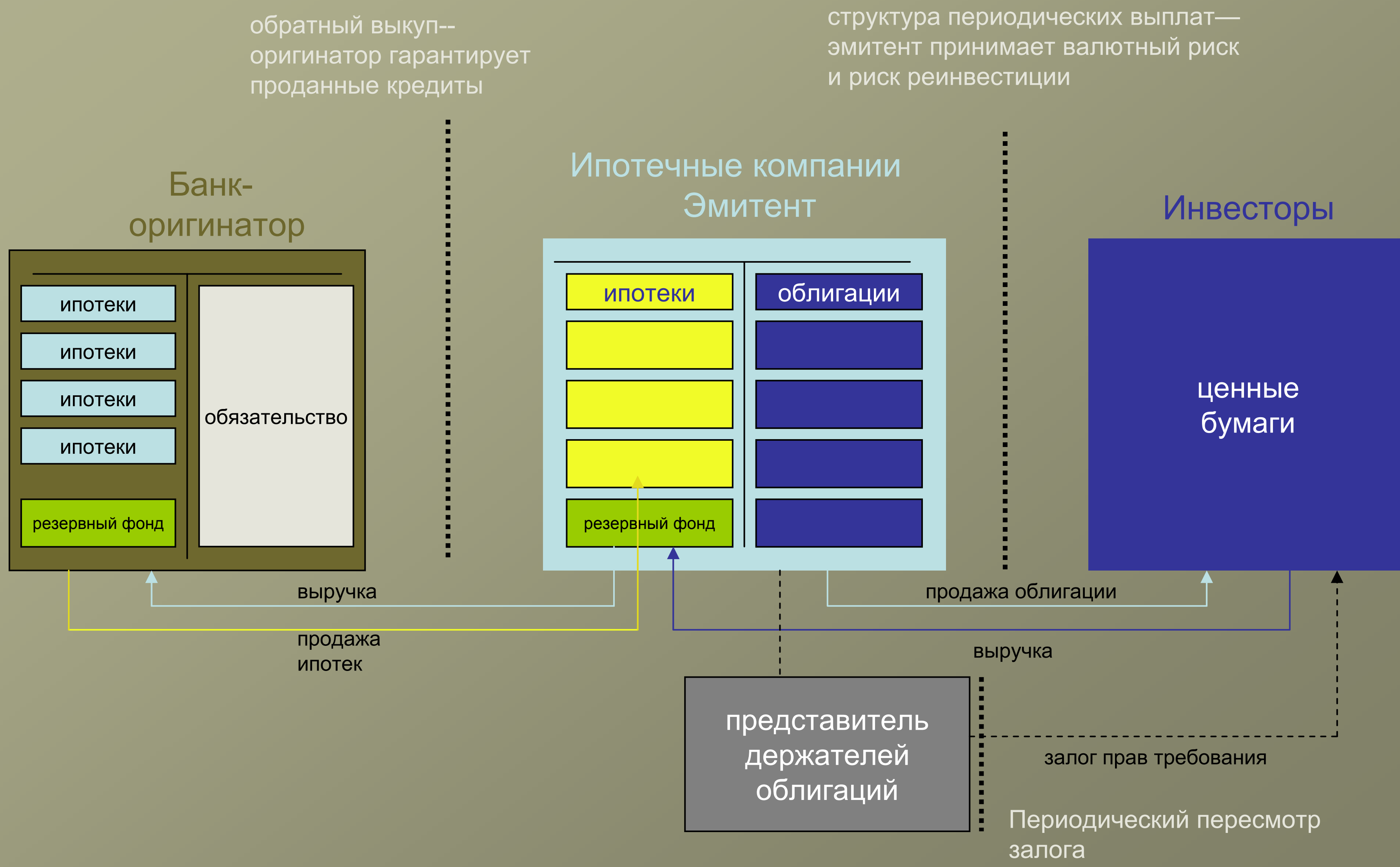


Схема ипотечной облигации оригинатора

“covered bonds”

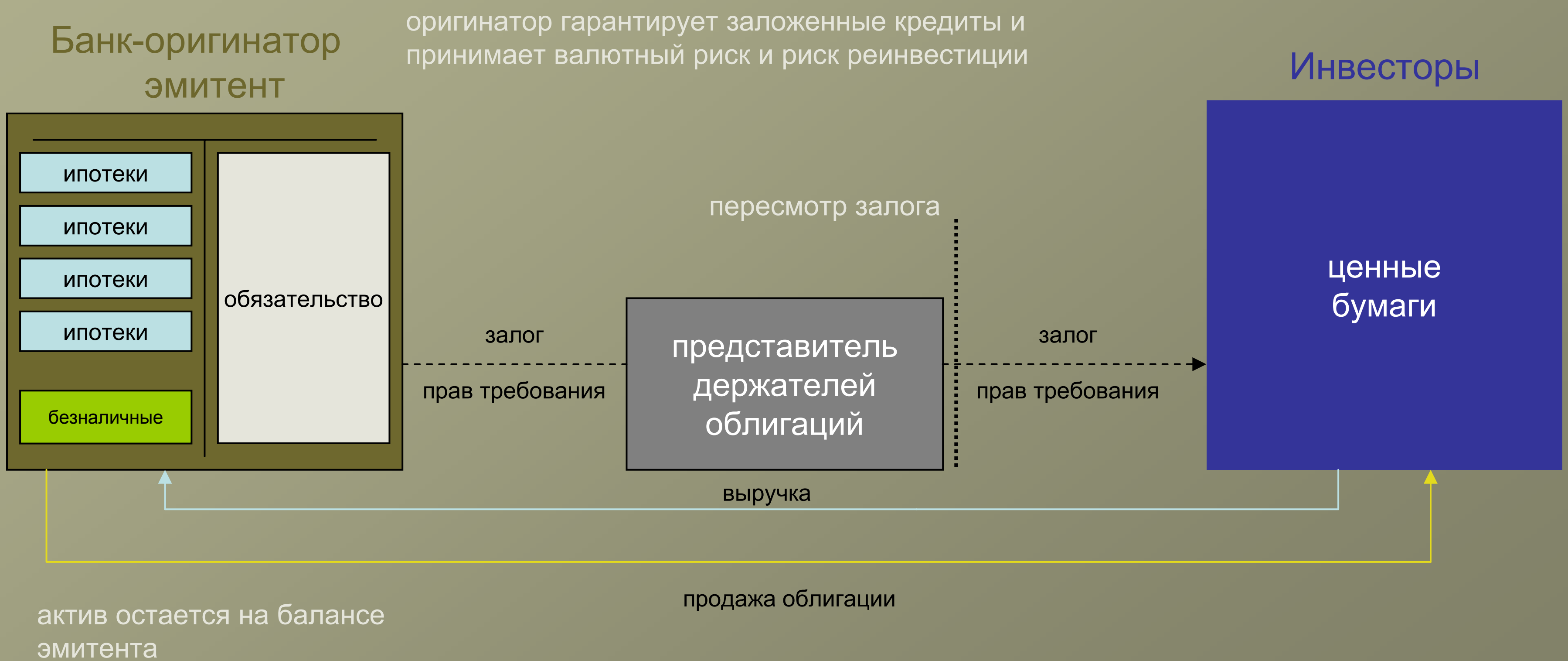
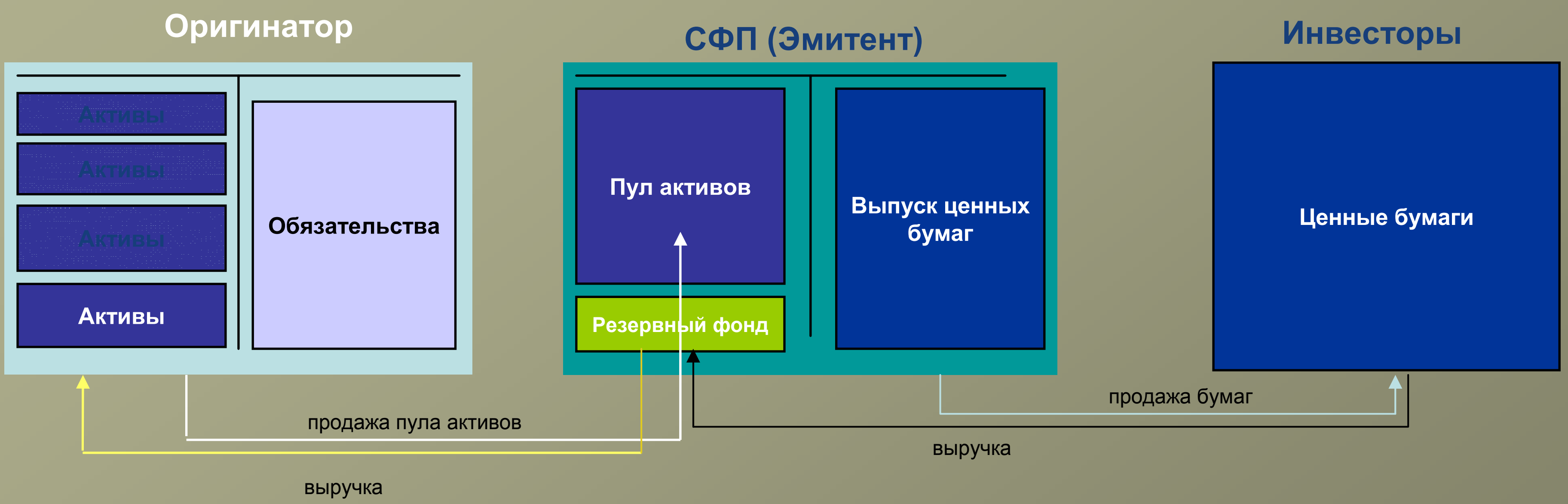
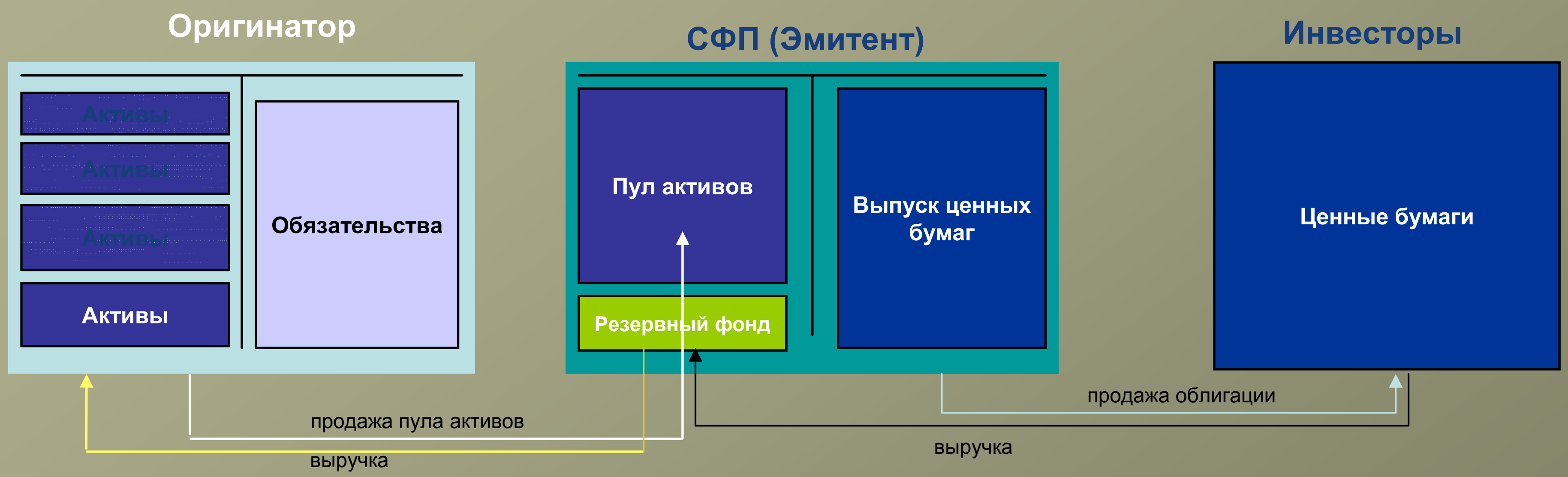


Схема секьюритизации



- Диверсификация источников финансирования
- Привлечение долгосрочного финансирования
- Снижение рисков
- Снижение стоимости финансирования
- Снижение уровня достаточности капитала

Схема секьюритизации



актив снимается с баланса оригинатора

обратный выкуп противоречит принципу «купли-продажи»

эмитент принимает все риски возникающие из разницы между притоками от оригинатора и выплатами инвесторам

Схема секьюритизации

переводной структурой

“pass-through”

При использовании амортизируемой срочной структуры денежные потоки по базовым активам переводятся напрямую инвесторам

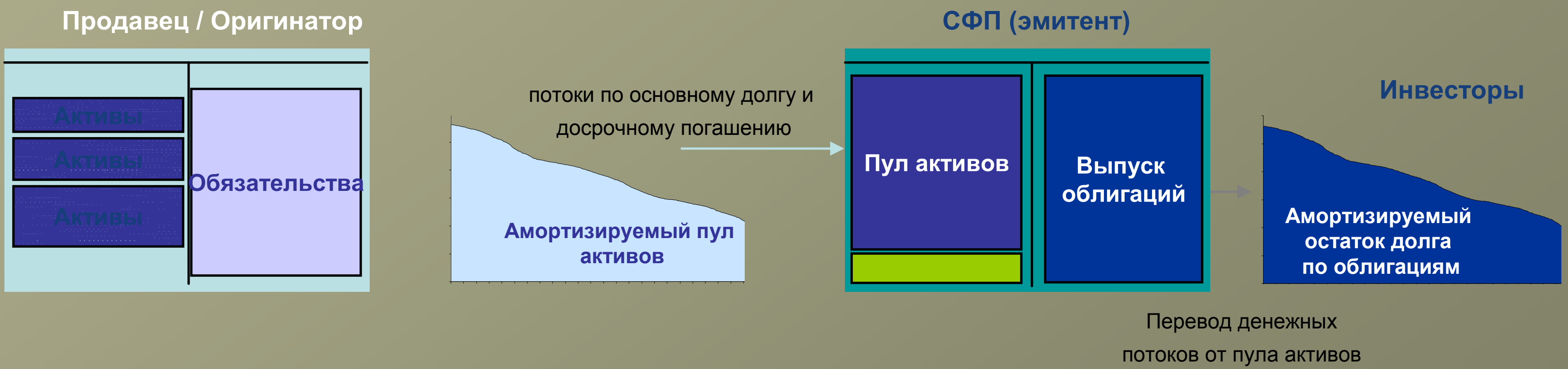


Схема секьюритизации

Револьверная срочная структура

При револьверной срочной структуре денежные поступления по базовым активам используются для приобретения новых активов у оригинатора

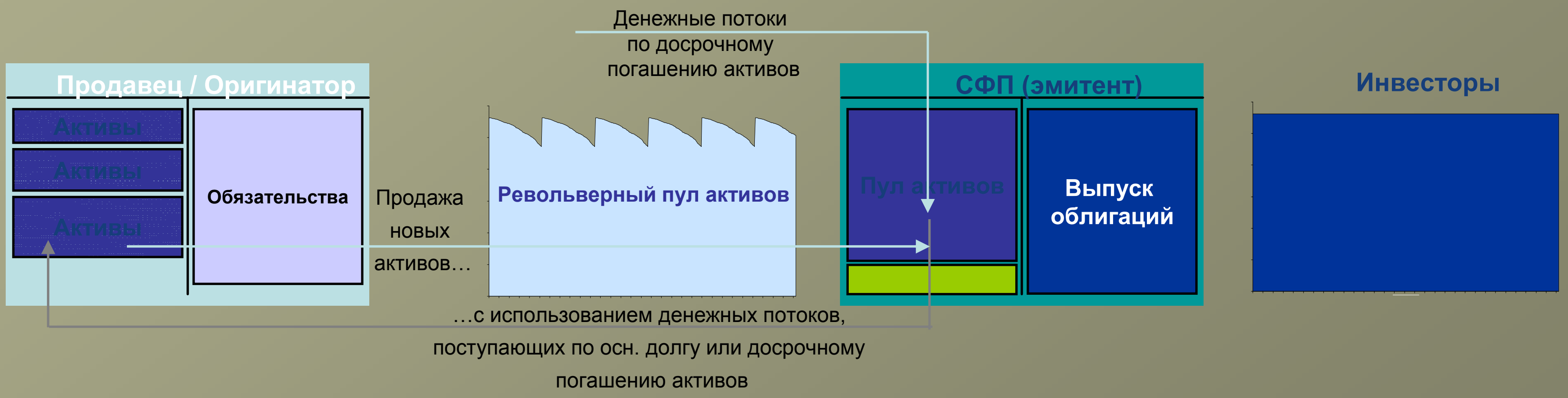
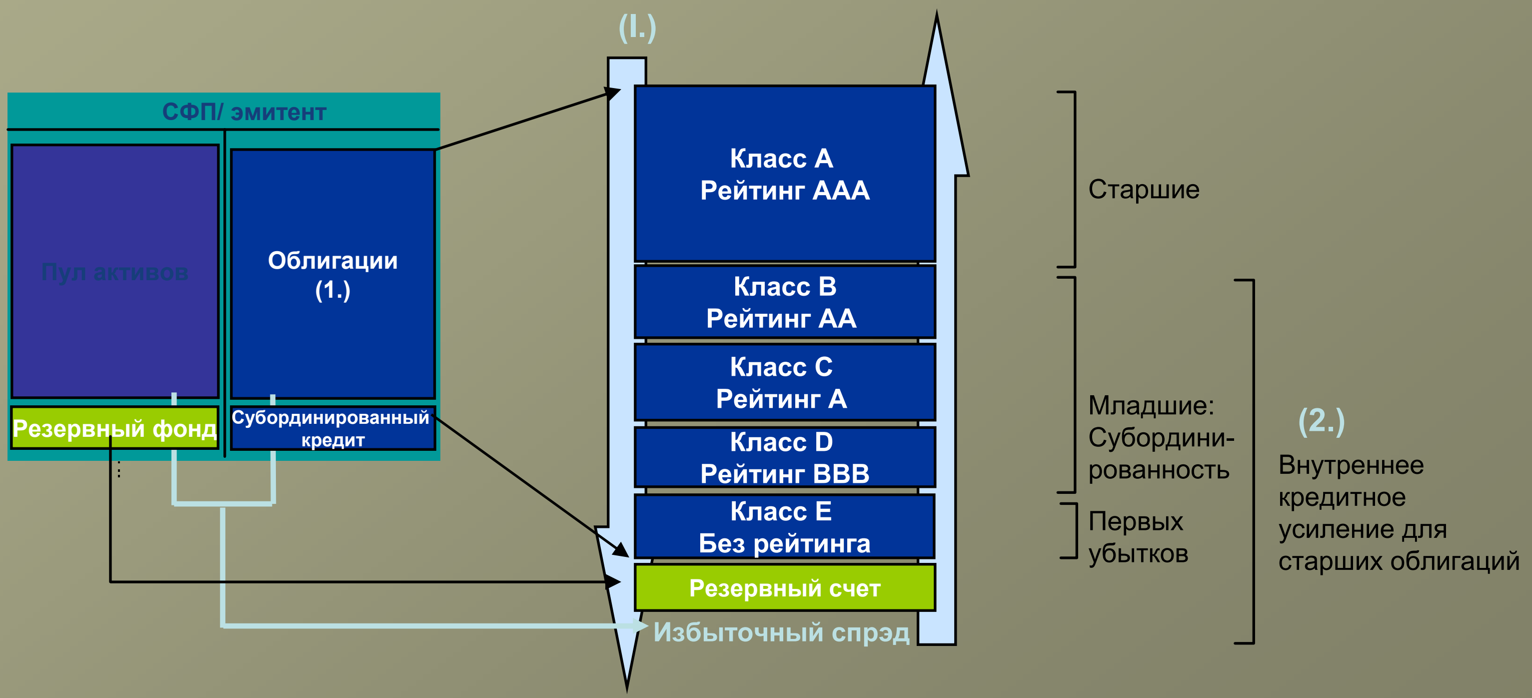


Схема секьюритизации

«дефолтный транш»

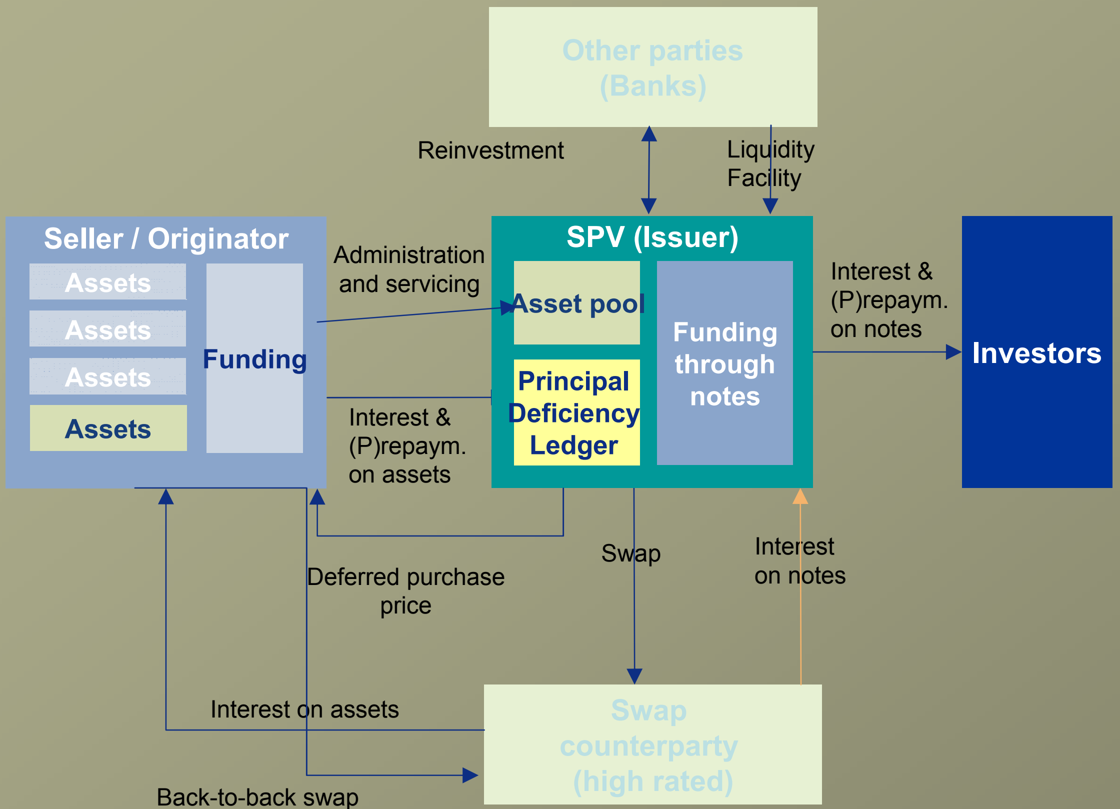
Пул активов – основа для структурного кредитного усиления и распределения облигаций по траншам



транш «первых убытков» остается
У оригинатора

Схема секьюритизации

финансовый инжиниринг



развивался ряд финансовых и юридических механизмов, инструментов и структур, которые снижают риски СФП и стабилизируют выплаты инвесторам

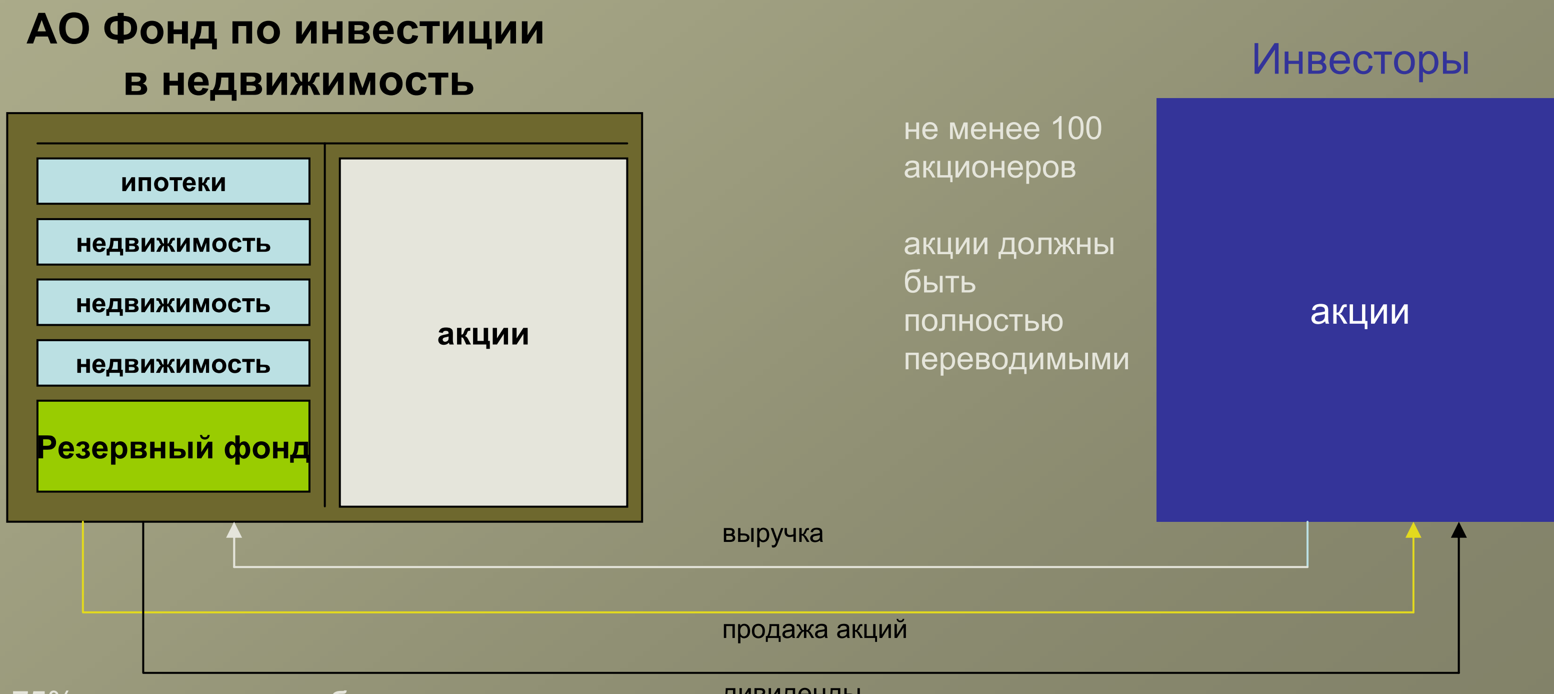
REITS

ФОНД ПО ИНВЕСТИЦИИ В НЕДВИЖИМОСТЬ

"equity securitization"

REITS

ФОНД ПО ИНВЕСТИЦИИ В НЕДВИЖИМОСТЬ



не менее 100 акционеров

акции должны быть полностью переводимыми

75% активов должно быть недвижимостью, в т.ч. ипотеки

дивиденды—не менее 90% годового налогооблигаемого дохода ФИН

REITS

ФОНД ПО ИНВЕСТИЦИИ В НЕДВИЖИМОСТЬ

Во что инвестируют REITS?

Отдельные помещения 20.1%
Жилая недвижимость 21.0%
Промышленная/офисы 33.1%
Специальная 2.3%
Медицинская 3.8%
Помещения для хранения 3.6%
Диверсифицированная 8.5%
Ипотечные облигации 1.5%
Гостиничная/курортная недвижимость 6.0%

193 REITS котируются
на фондовых биржах США

Капитализация—
US$ 500 миллиардов

PENSION & INSURANCE ATTACHMENTS

RECOMMENDATIONS

FOR THE

STATE ANNUITY COMPANY

AND THE

KAZAKHSTAN LIFE INSURANCE AND ANNUITY MARKET

November 2005
Almaty Kazakhstan

Table of Contents

I. INTRODUCTION

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

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

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

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

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

---

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

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

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

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

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

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

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

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

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

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

Solidarity Pension System

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

Table 1 **PAYGO Pension Calculations**

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

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

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

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

Pension Fund Accumulations

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

TABLE 2 **KAZAKHSTAN ACCUMULATION PENSION FUNDS** ASSETS AND CONTRIBUTIONS IN MILLION KZT				
	Assets *(million KZT)*	New Contributions *(million KZT)*	Change in asset value *(million KZT)*	Pension Accounts
2005 Aug	583.7	79.7	20.10	7,299,393
2004	483.9	95.3	20.20	6,974,437
2003	368.4	83.0	15.70	6,164,316
2002	269.7	65.3	22.00	5,399,313
2001	182.4	43.7		4,630,205

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

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

Demogrant

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

Total Retirement Income

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

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

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

Outliving Scheduled Withdrawals

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

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

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

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

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

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

Uncertain Mortality

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

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

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

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

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

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

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

Unfunded Longevity

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

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

It merits mentioning here that it is highly unlikely current annuitant mortality tables overestimate mortality; they were developed with a conservative bias using demographic techniques widely tested on western populations. It is much more likely that random variability arising from small samples sizes will cause real mortality to vary, sometimes significantly, from the rates in the tables. The variation can, of course, be in favor of the insurance company—that is, higher mortality than calculated; the fact is, however, small sample sizes simply render mortality unpredictable. As a result, there is a high risk of insurance company losses from under-funded or unfunded longevity. If retirement age life expectancy used in calculations proves too high, then standard life annuitants are hurt.

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

Potential Market Size

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

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

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

	Potential Premium Income

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

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

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

Longevity vs. Survivorship

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

The survivorship, or inheritance, feature of pension fund withdrawals may represent an obstacle to selling whole-life annuities; retirees may prefer leaving a legacy to funding their own longevity. The notion that the insurance company keeps money that rightfully belongs to a deceased annuitant's heirs is compounded by the natural cultural bias against insurance companies generally which, for years after economic reforms began, routinely defrauded clients or refused to pay claims. It does not help that over the past five years some 35 insurance companies have gone into receivership. In any event, the inclination to prefer legacy over longevity will no doubt reduce the number of retirees interested in whole-life annuities. It will also introduce selectivity bias due to **adverse selection** that is those interested in whole-life annuities will be in better health than those who are not.

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

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

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

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

Pricing Annuity Products

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

Annuitant Mortality

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

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

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

Investment Income

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

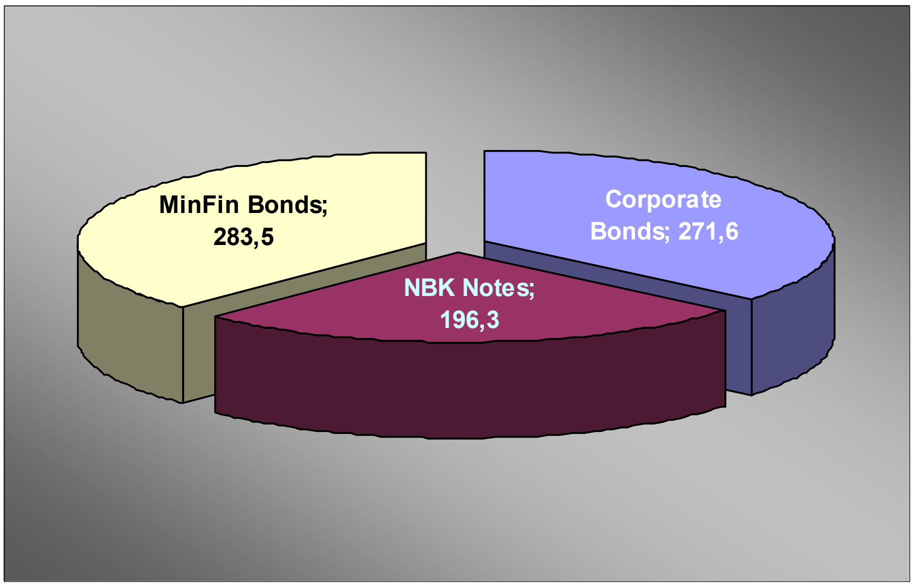
The shortage of investment opportunity for insurance companies in Kazakhstan is made worse by the rules governing insurance company investment and by separate taxation of insurance company investment income. Rules governing annuity investments should be liberalized to approximate those of pension funds,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

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

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

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

Figure 1



Source: KASE, NBK, Pragma Corporation

Allowable Operating Expenses

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

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

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

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

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

Disability Annuities for Worker Compensation Insurance System

Legal Basis

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

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

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

Period-certain Disability Annuities

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

Survivorship

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

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

Disability Mortality

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

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

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

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

SECTION II: THE STATE ANNUITY COMPANY

Objectives

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

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

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

Structure

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

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

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

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

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

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

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

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

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

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

Financial Viability of the State Annuity Company

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

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

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

Table 9	**STATE ANNUITY COMPANY**				
Scenario 1: Annuity Sales. Some Disability, No Pension					
(KZT millions)					
	Year 1	Year 2	Year 3	Year 4	Year 5
Income	361	459	626	742	860
Expenses	387	467	642	765	890
Net Gain (Loss)	**-26**	**-8**	**-16**	**-23**	**-30**
End-year Assets	1,225	1,520	1,914	2,359	2,856
End-year Liabilities	251	555	965	1,433	1,960
End-year Capital	974	965	949	926	896
Liabilities and Capital	**1,225**	**1,520**	**1,914**	**2,359**	**2,856**

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

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

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

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

Alternatives to the State Annuity Company

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

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

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

<u>Separate Guarantee Fund</u>

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

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

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

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

<u>State Annuity Company as Guarantor</u>

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

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

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

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

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

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

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

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

SECTION III: SUMMARY OF RECOMMENDATIONS

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

Compulsory Annuities for Accumulations over 1.5 million KZT

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

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

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

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

Scheduled payouts, however, are not whole life annuities; there is a risk, albeit small, that retirees will outlive their scheduled payouts. Further, since pension funds continue to earn commissions and fees on scheduled payout accounts, *a standard annuity could actually pay the retiree as much as 22.0 percent more than do scheduled payouts* as currently calculated over the course of a twenty-year retirement. (See Table 5.)

Recommendations

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

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

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

   a. A whole-life annuity with no survivorship provisions

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

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

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

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

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

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

Equalizing Retirement Ages for Men and Women

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

Recommendation:

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

Expense Recovery

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

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

Recommendation:

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

Prohibit Transfers

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

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

Recommendation:

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

Guarantee Annuity Payments

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

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

Recommendation:

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

Emerging Mortality Experience

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

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

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

Low benefit payments are not inevitable, however. Knowing that they can from time to time adapt benefit payments to emerging mortality experience, life insurance companies will be less inclined to establish conservative pricing strategies initially or to correct overly conservative initial estimates. Less rigid regulation will also automatically create a funded constituency for more accurate and reliable annuitant mortality tables. And more flexible regulation encourages greater competition among life insurance companies which should in the long run result in a bias toward higher benefit payments.

Recommendation:

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

Improve Investment Environment for Life Insurance Companies

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

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

Recommendation:

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

Parity between Pension Funds and Life Insurance Companies

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

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

Recommendation:

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

Improve Education and Understanding of Annuities in Kazakhstan

<u>Government</u>

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

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

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

Recommendations:

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

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

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

Insurance Industry

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

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

Recommendation:

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

General Public

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

Impact of Problem: Despite new decrees mandating the purchase of lifetime guaranteed annuity products, the general public may not understand annuities and the advantages of more complex features such as joint and survivor benefits, period-certain options, and benefit payments indexed to inflation.

Recommendation:

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

Improve Annuity Products: Disability Annuities

Link Employer Premiums to Disability Annuity Benefits

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

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

Recommendation:

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

Lack of Reliable Mortality Data for Disabled Lives

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

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

Recommendation:

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

Realign the Laws and Regulations

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

Recommendation:

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

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

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

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

SECTION IV: ANNEXES

Financial Analysis of the State Annuity Company

Assumptions

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

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

Disability Annuities and Pension Annuities

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

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

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

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

Scenario 1: No Pension Annuity Sales

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

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

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

assumed that SAC concentrates on selling Disability Annuities.

Scenario 2: Growing Pension Annuity Sales

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

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

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

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

Scenario 3: Stronger Disability Annuity Sales

Disability Annuities

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

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

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

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

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

Income Statements

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

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

Scenario 2 Growing Pension Annuity Sales

State Annuity Company

Proforma Income Statement

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

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

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

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

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

Balance Sheets

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

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

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

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

Legal Appendices by Law

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

Pension Law

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

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

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

Primary Recommendations:

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

Add new Article 23, paragraph 3, to read:

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

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

Amend Article 31-1, paragraph 1 to read:

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

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

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

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

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

Delete definition 7

Amend Article 6, paragraph 13, to read:

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

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

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

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

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

Delete Article 31-2, paragraph 6

Delete Article 31-3, paragraph 2, subparagraph 2

Delete Article 31-3, paragraph 4, subparagraph 3

II Legal Recommendations: References are to the Pension Law

Article 1 Definitions

14) Individual pension account

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

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

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

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

This definition should include the deduction of fees and expenses.

Amend Article 1, definition 14 to read:

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

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

III Additional Recommendations

<u>Pension Law</u>

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

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

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

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

Annuity Law

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

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

<u>DISABILITY ANNUITIES</u>

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

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

Primary Recommendations:

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

Amend Article 16 to read:

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

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

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

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

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

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

<u>Insurance Law</u>

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

Primary Recommendations:

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

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

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

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

Amend Resolution 941, paragraph 72 to read:

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

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

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

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

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

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

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

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

Add a new Article 17 to read:

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

Secondary Recommendations: References are to this Insurance Law

Article 3 Definitions:

The definitions should be numbered for easier reference.

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

APPENDIX

The Tax Code

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

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

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

Primary Recommendation:

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

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

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

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

TABLE OF CONTENTS

I. INTRODUCTION & SUMMARY

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

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

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

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

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

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

* per annum
^ insurance coverage also sought

II. THE KAZAK BANKING SECTOR AND SMALL & MEDIUM ENTERPRISES

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

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

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

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

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

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

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

III. THE FUND'S HISTORICAL ACTIVITY & PRESENT STRATEGY

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

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

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

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

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

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

IV. COMMENTARY ON DESIGN FEATURES

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

A. PROGRAM

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

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

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

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

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

B. GUARANTEE

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

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

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

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

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

C. LOAN STRUCTURE

<u>New Loans:</u> only

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

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

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

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

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

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

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

D. COLLATERAL & SECURITY

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

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

E. MONITORING

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

F. INSURANCE

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

V. RISK MANAGEMENT TRAINING

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

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

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

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

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

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

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

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

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

Richard L. Smith
Chappaqua, NY
November 8, 2005

MORTGAGE ATTACHMENTS

Implementation of a

CREDIT SCORING CENTRE

Prepared for:

Kazakhstan Mortgage Company

Prepared By: Norm Masters

Senior Consultant

The Pragma Corporation

Financial Sector Initiative

Date: October 2005

TABLE OF CONTENTS

1 Executive Summary

The JSC "Kazakhstan Mortgage Company" was established in 2000 (hereinafter, the "KMC"). KMC is a well run, well set up and well organized company with excellent leadership. The goals and vision of the company have been researched, documented and implemented with a great deal of professionalism.

KMC should be very proud of achievements to date. The current operation is not one of problems requiring attention before proceeding to the next level. As such, KMC is in a position to move forward now. All existing automation is sufficient to handle current volumes. The company has enjoyed excellent financial performance in the area of growth. The volume projections for KMC indicate explosive growth in the number of applications, and new mortgages purchased, KMC intends to manage over the next three years.

KMC leadership has identified the need to implement changes now in order to meet future growth objectives. A new *Credit Scoring Centre* has been identified as the most cost effective way to meet the increasing demands. The implementation of credit scoring software in order to automate the processing, workflow and decision functions is required.

The purpose of this study was to examine the existing processing functions in order to see how best to introduce credit scoring and workflow automation at KMC. The following is a summary of the findings within this report:

- Existing processing methodologies are thorough and sound
- Existing application parameters are adequate for decision making
- Workflow automation will deliver the most benefit immediately
- Credit ***risk*** scoring will deliver some benefit, but it is not mature enough in Kazakhstan to support the decision making process alone
- A combination of sounding lending policies and practices – combined with the proper mix of technological tools (software) is mandatory to success
- KMC should move forward immediately with a project to evaluate workflow automation (loans origination) and credit scoring software vendors

The report addresses the future vision, the current situation, the proposed solution and recommendations for implementation of a credit scoring software application at the KMC *Credit Scoring Centre*.

2 Scope of Work

In accordance with the SCOPE of WORK for, copy attached as Annex 4, I am pleased to submit the following report.

During the period from September 19, 2005 to October 7, 2005, most of the time was spent at the JSC "Kazakhstan Mortgage Company" office. Numerous meetings were held with senior management of the company including the Chairwoman, Deputy Chairmen, Deputy Directors, Director of Centre of Processing and various underwriting staff. Much of the time was spent with the Chief of Information Technology. Meetings were also held with the two primary partner banks, CentreCredit and BTA. Lastly, a meeting with KMC and the First Credit Bureau took on October 4, 2005.

In addition to work performed under the scope of work, the Kazakhstan Mortgage Company provided a document titled ***Questions for the Advisor which Need to be Addressed in the Final Report.*** Refer to Annex 5 for both the questions posed as well as the responses.

A further report was provided to KMC on October 7, 2005. This report addressed each of the following sub headings:

- The Company KMC and general observations and findings:
- The KMC processes and underwriting
- Recommendations for the software KMC requires
- The Information technology department

The Request For Proposal (RFP) will follow this report under a different heading. The RFP will be in draft format and KMC will be required to confirm that the proposal meets all legislative requirements for procurement.

3 JSC "Kazakhstan Mortgage Company" Strategic Vision

3.1 General Overview

To ensure practical implementation of the tasks assigned by the National Bank of the Republic of Kazakhstan, the JSC "Kazakhstan Mortgage Company" was established in 2000 (hereinafter, the "KMC"). This company refinances partner banks by purchasing demand rights on residential mortgage loans. The KMC commenced its operations in 2001 and as of now is one of the largest non-bank financial institutions of the country.

Since commencement of their operations, the KMC' scope of lending exceeded 31 billion KZT, KZT-denominated interest rates on loans fell from 24% to 13%, and down-payment – from 30% to 10%. This resulted in 16,000 households' raising of mortgage loans for home improvements and home acquisition. Out of the entire volume of mortgage securities issued in Kazakhstan, 91% falls on the KMC's bonds.

The significance of the KMC's operation is mainly associated with social designation of mortgages:

- To provide wide-scale access for the population to mortgage loans;
- To speed up the activity aimed at supplying such national wealth as residential real estate to the overwhelming portion of the population;
- To facilitate the establishment and development of middle class in the Republic.

On the background of development of market approaches, the KMC has embarked on implementing the State Housing Construction Development Program for 2005-2007. The main goal of this Program is commissioning of 12 million square meters of affordable housing and creating conditions for home acquisition and construction by households, using advanced lending forms. According to experts' evaluations, the mortgage lending market may grow in 4,5 times over the period of 2005-2007. Putting this in a different way, the development of mortgage resources will grow from 127 billion to 600 billion KZT.

3.2 The KMC's Developmental Strategy for 2005-2007

Determining the Main Goals and Principles of the KMC's Development

The KMC's main goals are refinancing of second-tier banks by acquisition of demand rights on mortgage loans, creating incentives for the origination of affordable mortgage loans by putting down interest rates and reaching acceptable lending conditions in the country for households making earnings at a medium level and at a level lower than medium.

To ensure further evolution of the mortgage lending market and to make mortgage loans available for wide masses of the Kazakhstani population, the KMC has scheduled the following arrangements for a period 2005-2007:

- Extending the terms of lending up to 30 years on mortgage loans provided in the framework of the KMC's market program;
- Increasing the "specific weight" of mortgage loans with down-payment in the amount of 10% in the KMC's loan portfolio (provided that such loans are supported by a guarantee of a special Fund);
- Further reduction of the ultimate interest rate on mortgage loans originated in the framework of the KMC's Market Program.

The KMC intends to achieve the aforesaid parameters provided that a favorable market environment prevails, and to fulfil the following conditions that include:

- Decreasing the inflation level;
- Funding of the purchase of loans for the account of raising of borrowings with adequate repayment terms at acceptable market rates;
- Reducing bank margin for the account of minimization of credit risks and the cost of servicing of the loans;
- Expanding the range of offered mortgage loans;
- Improvement of the legislative framework.

In the framework of this Strategy, the KMC intends to introduce new mortgage products and to differentiate the existing mortgage loans by targeting them at different segments of the consumer market. This will enhance the sales performance by creating a line of mortgage loans that do not compete with each other. Besides, the work aimed at expediting of the credit scoring process (determining the borrower's creditworthiness) due to establishing concise criteria of borrower's creditworthiness with respect to each product under design (the application of the scoring models).

Moreover, the Company is going to activate the work with specialized credit companies originating residential mortgage loans that will become serious competitors to banks due to their mobility, because the expansion of competitive environment or introduction of commercial market companies to the mortgage market is an additional measure aimed at reducing the margin of partner banks.

3.3 The KMC's Development Trends

Implementing the Program for Housing Construction Development in the Republic of Kazakhstan for 2005-2007

So far, only people that have adequate earnings can use the mortgage lending facility. However, the housing constraints remain to be vital for all layers of the population. This conditioned the design of a State Program with the main objective of comprehensive resolution of the issues relevant to housing construction development to make the housing available to the wide masses of the population.

Pursuant to the State Program for Housing Construction Development in the Republic of Kazakhstan for the years 2005-2007:

- In 2005, the scheduled commissioning of the housing amounted to 3 million square meters;
- In 2006 – to over 4 million square meters;
- In 2007 – to over 5 million square meters.

It is expected that about 195,000 households will be covered with the housing over the years of implementing the housing program.

In addition to this, the KMC plans to issue mortgage bonds:

- In 2005 – for the amount of 34,9 billion KZT;
- In 2006-2007 – for the amount of 111,2 billion KZT.

According to the KMC's special program developed in compliance with the State Program, 47 thousand mortgage loans will be originated and extended for acquisition of the housing with the total area of 3 million square meters (25 % of the commissioned housing).

As the practice demonstrates, citizens willing to purchase an affordable home today are lacking comprehensive information on the procedures, schemes and the principles of mortgage lending on the whole.

The overwhelming portion of loan applications is submitted by the workers of educational and medical institutions, and state establishments, for whom mortgage lending is a new and unknown financial product. Thus, it is necessary to undertake the following measures for successful implementation of the set tasks:

- Efficient clarification and educational work including holding of presentations, "round tables" and seminars;
- Dissemination of information material in mass media sources;
- Building up the quantity of partner banks;
- Expanding the regional network;
- Developing a uniform scheme for all stakeholders involved in the implementation of the 2005-2007 State Housing Construction Development Program and informing the population of this scheme.

3.4 New Products and Services

A) The possibility for the change in basic lending parameters

The classical model that provides for loan repayment throughout the entire term of a loan agreement in equal installments is not convenient for everyone. Repayment installments on a mortgage loan may be very burdensome for young couples during the first several years of a loan term. However, as they get promoted on their jobs, their earnings climb up and debt repayment ceases to be a problem. In such situation happen to be those whose earnings are not very high, while there is a realistic opportunity to build them up.

- *The mortgage with periodic increase of installment amounts*. In this scheme, the size of an installment is increased for a certain amount based on a schedule that has been previously agreed upon (for example, once every three years).
- *The loan with the growth of payments*. In this scheme, the size of payments is increased each month for a certain amount during several years and then remains fixed until expiry.
- *The loan with deferred payments*. In this scheme, the amount due may be deferred for a period of several months to several years.
- *5-year loan with an extension option*. This scheme gives an opportunity to repay debt beginning from the first year of mortgage or to refinance the loan in 5 years for a longer term.

B) Expanding the market of mortgage products with additional segments due to redesign of the existing mortgage products.

- Using the basic lending parameters under the KMC's Program:
- Loan amount – from 600 thousand to 50 million KZT
- Loan Currency - KZT
- Maximum size of a loan – up to 90% of the cost of the housing being purchased
- The interest rate - floating
- Loan term – up to 20 years
- It is intended to differentiate the mortgage products by targeting them at various segments of the consumer market.

The "Elite" Loan. This product is designed for people of rich fortune. Entering more than 40% of the value of the housing, the borrower will be entitled to raise a residential mortgage loan amount in excess of standard restrictions.

The "Youth" Loan. This product is designed for young people at the age 21 - 29 years. If a potential borrower can prove that he/she has a stable income but is lacking adequate savings, he/she will be provided with an opportunity to purchase the housing by paying only 5% of its value.

3.5 Improving the Organizational Structure

The KMC's Organizational Structure Improvement Strategy is aimed at ensuring stable activities in the conditions of the growing market of mortgage lending and increasing availability of mortgage loans for the population. To implement the 2005-2007 State Housing Construction Program, the KMC is planning to expand the activities almost 3-times as much.

The main objectives for the improvement of the KMC's organizational structure are:

- Determining the direction of the work of the KMC's subdivisions to develop the qualitative and quantitative structure of the personnel;
- Planning the requirements for labor resources, and formation of the structure;
- Further development of the organizational structure in compliance with the growing requirements of the KMC.

To reach the goals and objectives for the improvement of organizational structure, it is supposed to:

- Determine the volume of operation of newly instituted subdivisions and their demand for qualified staff;
- Develop the structure and staffing table of the Company jointly with the managers of subdivisions;
- Review and forecast on staff development for improvement of the Company's organizational structure.

To support the KMC activities, the chart of the Organizational Structure for 2005-2007 has been recently developed, with due regard to the volume of work and establishment of regional rep offices in the cities of Kazakhstan.

The system of the KMC's organizational structure has been formed in such a way as to provide for the best possible performance.

3.5.1 Expansion of the Regional Network

Due to increasing the scope of acquisition of demand rights on mortgage loans, as well as implementation of the State Program for Housing Construction Development for 2005-2007 in the Republic of Kazakhstan, it has been scheduled to establish regional rep offices of the KMC. In 2005, the plan is to open rep offices in all regional centres of the Republic. As of September 2005, there are 16 regional offices.

3.6 Risk Management System Formation

The purpose of the KMC's Risk Management Strategy is not avoiding risks (except those that are unacceptable or detrimental to the company), but establishing effective risk management system providing for active risk management to mitigate negative implications.

The main goal of an integrated risk management system is to find the best correlation between the risk and profitability at full scale of the KMC.

The directions of the Risk Management System development for 2005 – 07:

- Establishing the data system to support middle and top manager decision-making process and to enable evaluation of a progress and performance results;

- Introducing the system to evaluate performance of responsible persons that would generate effective incentives for resignation of unacceptable and detrimental risk;
- Risk management at different levels of KMC's operations;
- Improving the internal controls system;
- Adequacy and distribution of capital among different risk categories;
- Establishing an efficient organizational structure for risk management that will enable to maintain the existing net profit margin.

To reach the set goals and to continue developing the risk management system, the plan is to:

- Determine a short-term, medium-term and long-term policy and main trends of the KMC's activities;
- Identify the proneness to risks and select a risk profile for the KMC based on activity lines and geographic regions;
- Further improvement of the risk management methodology with the nature of the KMC's operations and prospective development taken into account;
- Develop methods and models for quantitative assessment of KMC's total risks and for separate risk categories;
- Establish and maintain databases required for the purposes of risk management;
- Develop and introduce the methodology for setting limits, breaking down of net worth into different risk categories;
- Design risk assessment models used to price financial instruments and products of the KMC;
- Develop the risk hedge method.

3.6.1 Internal Control System Improvement

The Internal Control System is called to secure the safety of the KMC's assets and to prevent the likely risks of bursting out of a conflict of interests.

In order to improve the internal control system, the controls should be identified and introduced at each level:

- Enhancing control over corresponding distribution of responsibilities so that duties allowing for the conflict of interest are not entrusted to the staff. Revealing the areas of potential conflict of interests, their minimization and exercise of diligent monitoring;
- Enhancing control over the safety of assets (appropriate authorization and control over made payments, daily account verification, periodic verifications to ascertain the fact of availability of inventories (tangible assets), etc.);

- Enhancing control over the KMC's all subdivisions' compliance with the internal regulations, policy and the requirements of the Republic of Kazakhstan legislation;
- Determining and introduction of appropriate methods of control of activities of the KMC's structural subdivisions;
- Analysis at the highest level – the KMC's on-going monitoring of general effectiveness of the internal control mechanisms.

To ensure data security, the informational systems encompassing all KMC's activities and expected to be implemented and their dependability will be ensured. The data systems storing and using information in electronic format needs to be periodically tested.

Improve the documented organizational procedures to identify a complete range of restrictions and functional responsibilities of departments, and a plan of action in a non-typical situation.

Ensure regular inspections by the actuaries of the Internal Audit Service of the KMC's structural subdivisions, evaluation of a follow-up control of all sectors that were identified as problematic.

The KMC's management requires regular evaluation of the internal control system performance based on the reports of internal audit department, evaluation of performance of the Management Information System and performance of the organizational structure.

3.7 The IT Development

The KMC's strategic goal in the area of computerization for 2005-2007 is establishing and developing Integrated Computerized Information System (hereinafter, "the ICIS") that will be applied in all its subdivisions.

The main mission of the ICIS designed is to improve the performance and enhance the effectiveness in reaching the tasks the KMC has been faced with, due to automation of functions and assignments and enhancement of analytical processes needed to make decisions at all managerial levels. The major ways to provide for accomplishment of the set task are:

- Introduction of up-to-date information technologies ensuring integration of newly designed and implemented systems (subsystems) into a uniform integrated automated data system of the KMC;
- The ICIS' exposure to external links and the potential for expanding these links provided that the established data security requirements are met;
- The maximum relief from reliance on a human factor, or possibility to receive information notwithstanding whether a certain officer of the KMC is available at the work place or is not;
- Enhancing the quality and efficiency of the KMC's subdivisions' accomplishing of the functions and tasks that they are charged with;
- Establishing common data space for partner banks of the KMC;

- Maximum reduction of hardcopy circulation and the use of e-documents;
- Increasing accuracy and precision in reflecting the KMC's operations in the books;
- Improving investment management to keep low risk level;
- Automation of the internal operations and business functions;
- Providing for ICIS secure and dependable operation.

To support the KMC's activities in terms of prompt data processing the Automated Informational System of the KMC has been presently designed (hereinafter, the "AIS") that needs to be improved for further reduction of hardcopy document flow between partner banks and the KMC. The AIS current status in the conditions of rapid growth of loan acquisition rates fails to meet the KMC's requirements due to additional manual input of the data from paper carriers (hardcopies) submitted by partner banks, the lack of automated generation and linking of accounts to a loan "ticket", the lack of uniform enumeration of contracts at the KMC and STBs (second-tier banks), the lack of exchange of e-documents with the partner banks, the lack of archiving system and multi-language support. Therefore, in developing and upgrading the KMC's AIS all the above requirements must be taken into consideration.

Establishing the Data Processing Centre at the KMC (hereinafter, the "DPC") to be equipped with the up-to-date technical facilities with operating automated data system should allow for creating prerequisites for active development of such modern settlement devices as internet-banking and card system. Payments made as repayment of mortgage loans via payment cards may be introduced through the payment card systems of second-tier banks.

Owing to the fact that the overwhelming portion of partner banks lack their own software for the servicing of mortgage loans, the Centre's services in implementing of unified software products will also enhance the quality of service for the borrowers and to minimize the corresponding costs of the banking sector and to expand the circle of the partner banks.

Besides, assumption of a portion of the functions of the partner banks that are related to the servicing of their clients and processing of payments will also demand software upgrading and regulation on behalf of the authorized agencies.

Due to the requirement to obtain a license for transfer operations for the DPC, in order to avoid the conflict of interests that emerge in the event of combination of lending operations with transfer operations, the DPC must be detached from the composition of the KMC and granted a status of a separate legal entity.

Designing an electronic archive system for payment documents and electronic copies of the documents (scanned credit files), as well as the management of their corporate content is another important aspect in using up-to-date information technologies for the KMC.

The e-archive system should enable to integrate various data from unstructured documents into a data repository and provide for their efficient use for resolution of the set tasks.

3.7.1 Ensuring Information Security

There is a need for institution of a Backup Centre to mitigate the data loss exposures. To computerize the process of delivery of account statements to their clients, there is a need for establishing their internal printing shop with a facility for printing and packing into envelopes of account statements, printing of standard contract and other document forms.

Credit risk review (credit scoring) or assessment of creditworthiness of loan applicants is one of the most critical components in the process of mortgage loan origination and extension.

Introduction of the modern credit scoring system in the KMC' DPC is a strategic solution opening opportunities for:

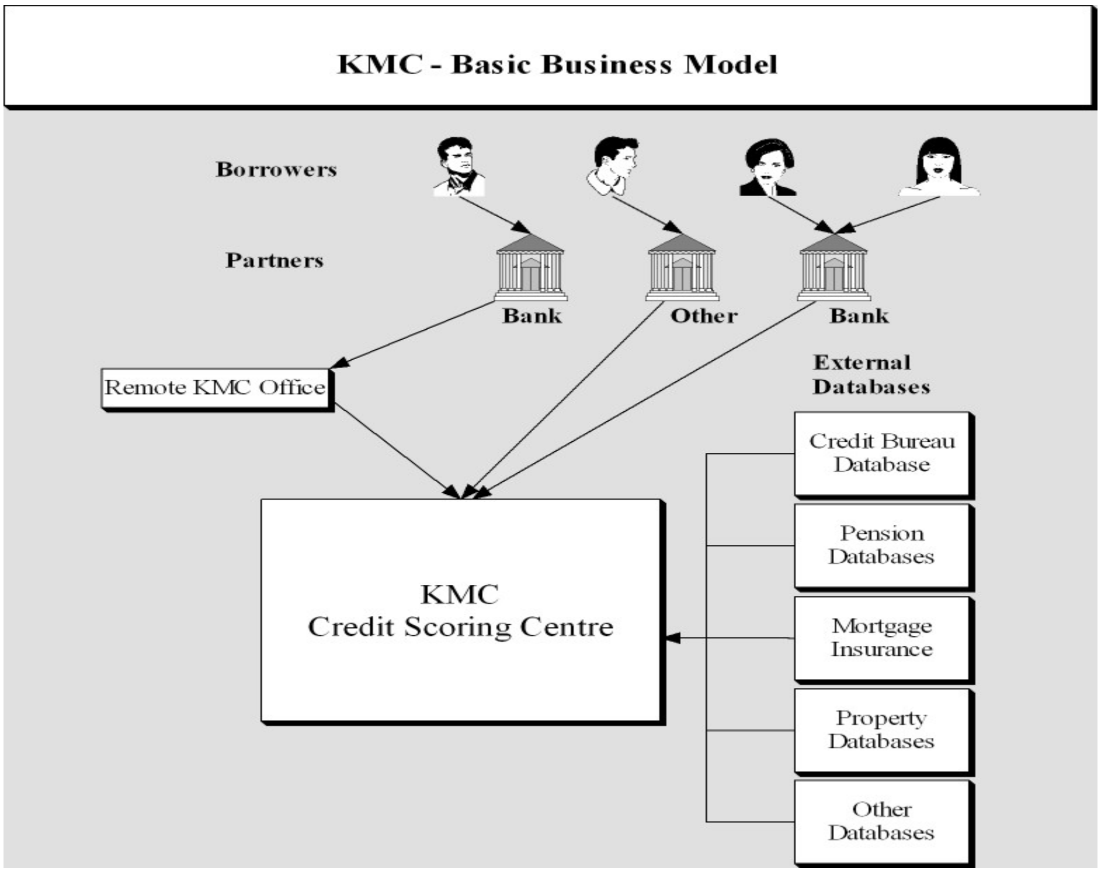
- Large-scale consumer lending,
- Efficient monitoring of the level and quality of demand for consumer credit services,
- Timely and adequate management of credit risks in retail lending,
- Reduction of operating costs to be incurred through the credit scoring process,
- Diversifying the range of credit products.

To provide for data security of operated subsystems of the KMC ICIS, taking of the following measures within a period of 2005-2007 must be provided for:

- Preparation and approval at KMC's Board meetings of appropriate Regulations concerning data security provision;
- Analyzing and selecting a system of centralized administration of antivirus protection facility or application that is installed on the users' work stations;
- Upgrading Internet security system (software and hardware platform), expanding Internet access channels;
- Creating one common center for generation and distribution of the keys of cryptoprotection to exchange the ICIS subsystems' data;
- Establishing in the IT subdivision a sector that will provide for the operation of the means of cryptographic protection of data in a corporate network;
- Building a cryptographic module into the functioning subsystems of the ICIS based on the one common center of distribution of the "PKI" keys;
- Preparation and distribution of a plan for ensuring a non-stop operation of the KMC AIS in the event of emergency situations.

3.8 Analysis and Recommendations to Support Strategic Direction

As identified in the KMC strategy and vision, the establishment of a modern credit scoring system as part of KMC's total Data Processing Centre has been identified. This project has been named the *CREDIT SCORING CENTRE.* The following diagram illustrates the basic business model.



3.8.1 Primary functions of the KMC Credit Scoring Centre:

- Access the creditworthiness of loan applicants
- Manage the status of all new applications
- Manage and control the collection of all documentation required
- Screen and quality applications according to specific products
- Apply pricing methodologies based on risk
- Deliver on-line, real time, decisions to remote offices and partner banks
- Expedite and automate the purchase and acquisition of approved mortgages

The business case for acquiring a Credit Scoring System has been fully evaluated by KMC management. Credit Risk Scores (often referred to as the FICO credit score) are used to make billions of credit decisions each year, including more than 75 percent of mortgage loan originations in the USA. In addition, more than 40 of America's 50 largest financial institutions rely on the FICO score to help them determine an individual's credit risk.

Credit Risk Scoring is an instrument widely used by companies for the internal processes of portfolio risk measurement and management. It indicates the probability of future insolvency of a person requesting credit (or a client already in the portfolio) based on their past history.

Credit scoring, in addition to being a tool to evaluate levels of risk, has also been effectively applied in other operational areas, such as:

- Streamlining the decision-making process, that is, higher-risk and borderline applications being given to more experienced staff for more scrutiny, while low-risk applications are assigned to junior staff. This can be done in KMC remote branches, credit adjudication centers such as the KMC Credit Scoring Centre, and collections departments.
- Reducing turnaround time for processing applications through automated decision making
- Apply consistency by creating a centralized underwriting environment applying institution polices
- Evaluating quality of portfolios intended for acquisition
- Setting economic and regulatory capital allocation
- Setting pricing for securitization of receivables portfolios
- Comparing the quality of business from different channels/regions/partner banks
- Lower delinquency and default
- Pricing - lower risk borrowers can be attracted by lower rates and higher risk borrowers will pay a premium rate to offset the higher risk
- Automated origination, full integration and document management

4 Implementation of Credit Scoring at KMC

4.1 Overview

Based on an evaluation of the main requirements of the JSC KMC applied in the acquisition of the rights of demand on mortgage loans, the current processes for both the acquisition and the maintenance meets international best practices. A thorough review of KMC's operating procedure named *Instructions On Verification of the Credit File of the Borrower by Specialist of the IPC Credit Support Department* as approved by S. Sarzhanova, Director of Information Processing Centre (IPC) as well as numerous meetings with KMC staff clearly indicates an excellent level of understanding the basic requirements. A copy of the current procedure is included as Annex 2.

However, all purchases to date have been with recourse to the partner bank who assume the responsibility for screening the credit risk as they are ultimately responsible in the event of a loss. In order to KMC to move to a model of "non recourse" and assume the credit risk, there is a need for additional Credit Risk Management policies and procedures.

KMC intends to use the Credit Scoring Centre in order to thoroughly access and analyze all factors of the borrowers risk in order to provide credit decisions. Implementation of a credit scoring software system in order to make credit decisions will be a challenge at KMC based on the lack of adequate past credit histories, especially as it pertains to mortgage lending. There is much more to decisioning and underwriting than just a credit score.

In general there are different interpretations of credit scoring and what credit scoring will accomplish. This has been partially brought about by the number of terms and various meanings of credit scores used by the software vendors – Application scoring, behavioral scoring, risk scoring, analytical scoring, expansion scoring, judgmental scoring and statistical scoring to name a few.

The same applies to Scorecards – what they are, where they come from and how they are used? These have numerous types – custom scorecards, generic scorecards, industry specific and pooled scorecards to name a few.

4.2 Terms Used

In order to bring about clarity and complete agreement, there is a need to clearly define each of the terms implied when discussing the overall concept of credit scoring and it's components. By having a total understanding, KMC will be in a much better position to provide specific business requirements to potential respondents to their Request for Proposal (RFP). Definitions may vary from vendor to vendor. The following describes exactly what is implied to when discussing each term in this report:

Credit Scoring - This is a process. It is a statistical means of providing a quantifiable risk factor for a given borrower. When referring to generic term credit scoring, we are really talking about application scoring. For the purpose of this document, credit scoring and application scoring can be interchanged.

Credit Risk Scoring - This is a product. It is a numerical value that ranks individuals according to their credit history at a given point in time. Credit risk scores are based on past payment history, the amount of credit outstanding, the amount of credit available, and other factors. Often referred to as a FICO score[1,] a *credit risk score is a computation of the odds (probability) that a borrower will repay a debt in the future based on their history of dealing with credit in the past.* It is important that we understand the differences between overall credit scores (or application scores) and credit RISK scores (or FICO scores). A credit risk score is only ONE of the scores that contributes to an overall credit score (or application score).

Behavioral Scoring - This is a process. It is used to determine a credit risk score - if generates the odds of a borrower repaying based on previous history as outlined in the credit risk score above.

Application Scoring - This is both a product as well as a process. This is the product that KMC requires in order to meet the needs of the scoring centre. This is the focus. The process of application scoring works by taking all the relevant details of an application and giving each piece of information a value (or 'score'). When all the individual scores have been added together, the total score gives the level of risk associated with the application.

1 All references to FICO SCORE (developed by Fair Isaac) are illustrative only as different providers of different risk scores use different names. FICO is the mostly widely used term and referred to within as an example only.

4.3 Application Scoring – Scorecards

The application score (application SCORECARD) should consist of at least the following scores:

- The Product Score
- The Credit Risk Score
- Financial Score
- Character Score
- Collateral Score

4.3.1 Sample Characteristics (parameters) of an Application Scorecard

The Product Score (Product Business Rules)

- Purpose of loan
- Deposit / Down Payment
- Product Rules for loan type and amount requested
- Term and ammortization, Loan to Value (LTV), interest rate, insurance

The Credit Risk Score

- See notes below regarding credit risk score

Financial Score (Solvency)

- Assets
- Liabilities
- Monthly Repayment
- Total Monthly Income

Character Score (Solvency)

- Time at current employment
- Time at current residence
- Position held
- Residential status

- Educational status

Collateral Score (Security)

- Documentation regarding property
- Type of property
- Construction of property
- Location of property
- Condition of property

Credit Risk Score

In order to properly build reliable credit risk scores, a large database of history is required. The implementation of the new entity – First Credit Bureau of Kazakhstan (FCB), will provide valuable information mandatory to the establishment of credit risk scores. However, it will take time for the credit bureau database to grow to a level of maturity which will enable it to properly apply the mathematical calculations for determination of a credit risk scores. At this time, there will not be a credit risk score available from the FCB. Many of the larger financial institutions have taken this task “in house” and built their own internal custom credit risk scores based on data provided by the credit bureau as well as their own internal data.

The best source for building risk scores is a large database of defaulted loans. By reviewing the characteristics of defaulted loans, key parameters and common attributes can often be identified and built into risk score models. Companies who specialize in building risk scores validate the accuracy of their models on a regular basis by reviewing tens of thousands of files. KMC will need to analyze their defaults on a regular basis in order to make adjustments to their scoring models.

While a credit risk score normally comes directly from the various Credit Bureau reporting agencies who represent the best source and largest quantity of data, credit risk scores can also be calculated in house. When the bank uses only a sub set of the credit bureau data, the behavioral patterns are not as sophisticated as credit bureau credit risk scores which rely heavily upon the complete behavioral analysis. In such cases, the bank will normally weight the score differently to reflect the behavioral pattern of the borrower based primarily on the banks past history with the same borrower.

Companies such as Fair Isaac Inc., out of California, developed the models used by the three major bureaus in North America. They have tested millions of consumers. The model has been validated and re-validated every other year. The three most recognized credit reporting agencies include Equifax, Experian and TransUnion. Known as a BEACON® score at Equifax, EMPIRICA® score at TransUnion and the Experian/Fair Isaac Risk Score at Experian, all use formulas developed by Fair Isaac & Co. Experian-Scorex has recently developed Scorex PLUS to provide a high-performance scoring alternative.

How are Credit RISK Scores established??

It is important to have a complete understanding of a overall Credit Score (application score) and a Credit Risk Score (such as a FICO score). The following information addresses the where and how credit risk are scores derived and the complexity of applying behavioral scoring to calculate risk scores. The credit risk score is normally a number between 300 to a perfect 850.

There are approximately 50 characteristics (parameters) of credit risk scoring models. The credit bureaus will not tell you all of the characteristics they use as they are a trade secret. In general terms, the FICO® score evaluates five main categories of information:

- Payment history (35% of the overall score)
- Amounts owed (30% of the overall score)
- Length of credit history (15% of the overall score)
- New credit (10% of the overall score)
- Type of credit used (10% of the overall score)

Payment history (35% of the overall credit risk score)

- Account payment information on specific types of accounts (credit cards, retail accounts, installment loans, finance company accounts, mortgage, etc.).
- Presence of adverse public records (bankruptcy, judgments, suits, liens, wage attachments, etc.), collection items, and/or delinquency (past due items).
- Severity of delinquency (how long past due).
- Amount past due on delinquent accounts or collection items.
- Time since (recency of) past due items (delinquency), adverse public records (if any), or collection items (if any).
- Number of past due items on file.
- Number of accounts paid as agreed.

Amounts owed (30% of the overall credit risk score)

- Amount owing on accounts.

- Amount owing on specific types of accounts.
- Lack of a specific type of balance, in some cases.
- Number of accounts with balances.
- Proportion of credit lines used (proportion of balances to total credit limits on certain types of revolving accounts).
- Proportion of installment loan amounts still owing (proportion of balance to original loan amount on certain types of installment loans).
- Escalating Debt/Rapid Spending – Consumers who take on a lot of debt in a short period of time will have lower scores

Length of credit history (15% of the overall credit risk score)

- Time since accounts opened.
- Time since accounts opened, by specific type of account.
- Time since account activity.

New credit (10% of the overall credit risk score)

- Number of recently opened accounts, and proportion of accounts that are recently opened, by type of account.
- Number of recent credit inquiries.
- Time since recent account opening(s), by type of account.
- Time since credit inquiry(s).
- Re-establishment of positive credit history following past payment problems.

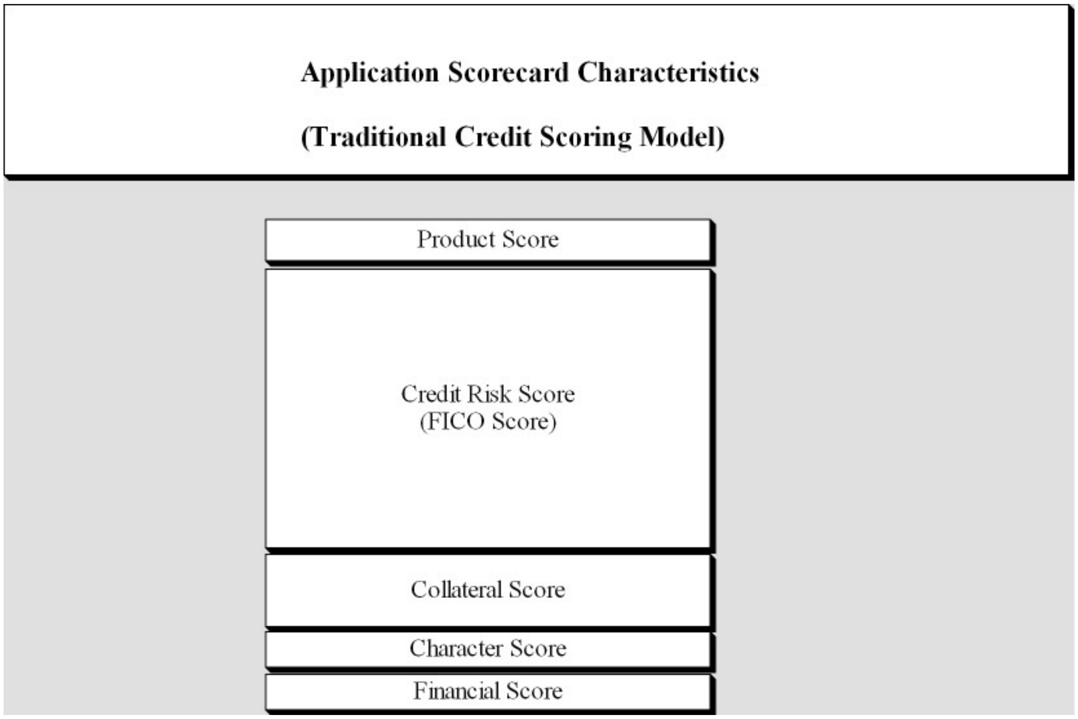
Type of credit used (10% of the overall credit risk score)

- Number of (presence, prevalence, and recent information on) various types of accounts (credit cards, retail accounts, installment loans, mortgage, consumer finance accounts, etc.).

Refer to Annex 1 for an example of an ODDS SUMMARY TABLE.

4.3.2 Application Scorecard Characteristics

In a traditional scoring model, the following diagram is an example of weighting that many lenders adopt. As the illustration clearly identifies, the model is heavily weighted toward credit risk scoring (FICO Score).



In the traditional model above, the best single indicator of the overall application score (credit score) will be the credit RISK score. A well established risk score, built from large quantities of data over an extended period of time, will normally place the borrower in the risk category most applicable to their individual circumstances. If a borrower has a good to excellent FICO score (credit risk score), they will normally have good income, good job stability, good net worth and generally have good character. Normally the character score and financial score are direct reflections of the credit risk score. As such, they play a lesser role in the overall decisioning process and the credit risk score is the one most heavily weighted score used.

In Kazakhstan the availability of reliable credit risk scores is a challenge for the following reasons:

- There is limited access to the large quantities of data required to establish a history of past repayment.
- Access to a single database of default loans (the best source for risk scores) is limited.
- Mortgage lending (and defaults) has not been in place for a long time and data is not available
- Credit card use, a major contributor to risk scores, are not yet widely used in Kazakhstan

- Many of the population of Kazakhstan have not yet discovered the value of credit and have no credit history or credit experience
- The First Credit Bureau of Kazakhstan is new and does not have a credit score product available at this time. It is estimated they will have one in 18 months.

How does this impact the introduction of credit (application) scoring at KMC?

It is critical the KMC recognizes most credit decisioning software is heavily weighted toward CREDIT RISK (FICO) SCORES. Most scorecards depend on the risk score (FICO) score.

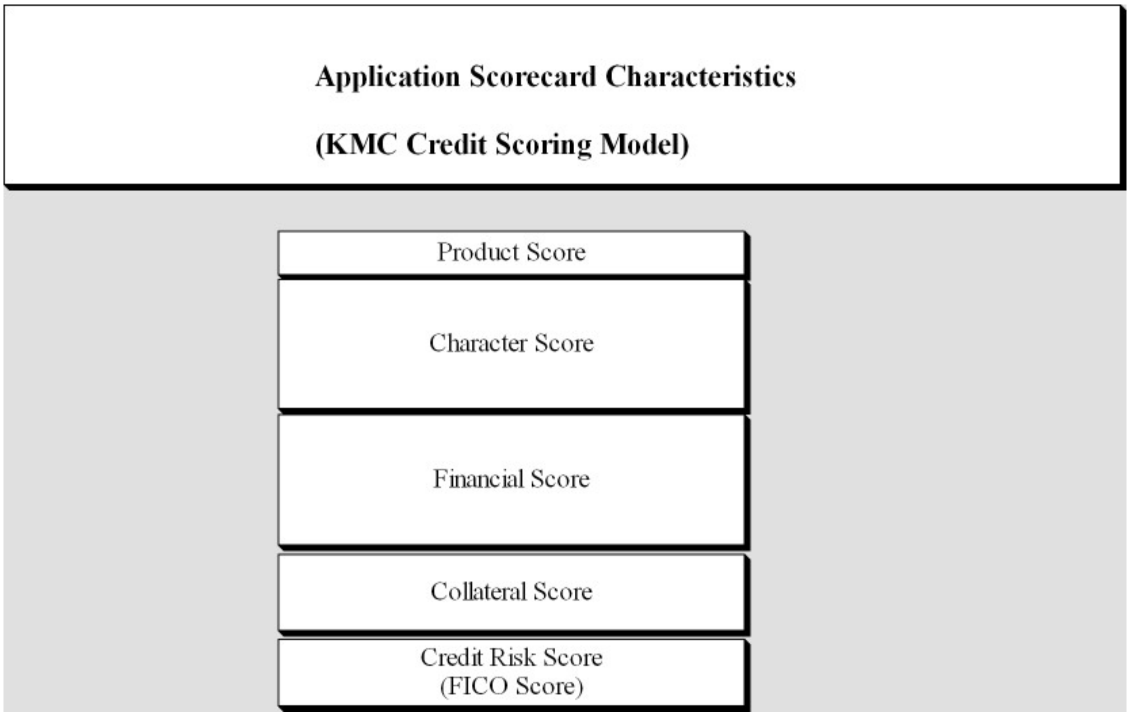
As a result KMC will need to modify the weighting applied to credit risk scoring until such time as credit risk scores are more widely available AND have proven record of their dependability. In the meantime, weighting needs to be stronger on the remaining application scores such as the character and financial scores (solvency) as well as the collateral scores.

In addition, KMC should take the establishment of credit risk scores “in house” and calculate their own credit risk score whenever there exists sufficient data to do so. As databases grow, both at the credit bureau as well as KMC, the quality of the credit risk scores will improve. KMC should challenge any provider who suggests they have the ability to provide credit risk scores without data.

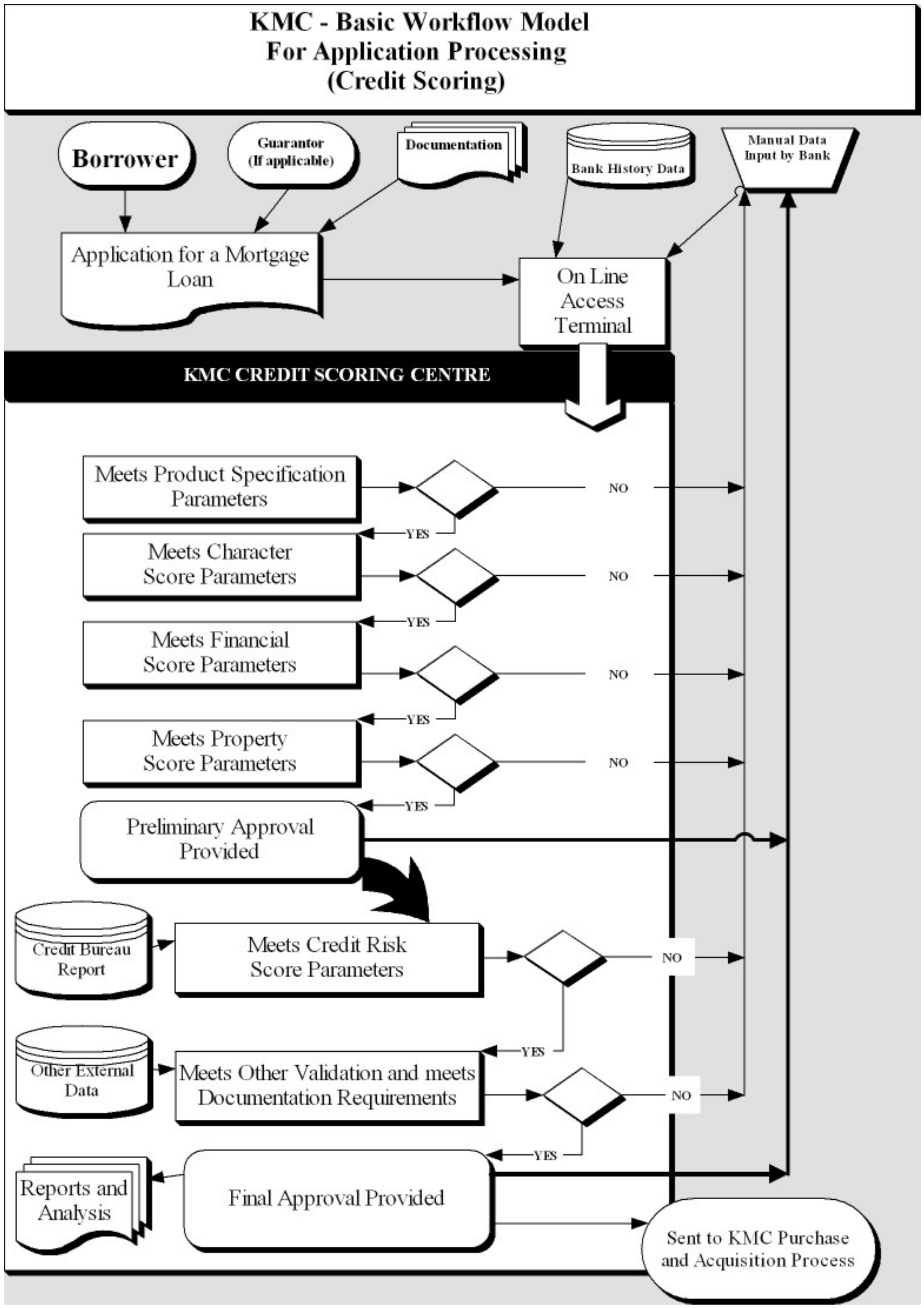
KMC should seek out a business partner who has access to large quantities of data, in similar markets, for similar mortgage products. A software partner with this information should be able to provide basic scorecards which identify the characteristics of borrowers with the highest risks based on experience in the similar markets. This single added value of the best partner selected will bring the most benefit to KMC if they are in fact able to provide such scorecards as KMC’s starting point.

Lastly, but most importantly, KMC must find the right combination of non-technical resources (experienced mortgage lending personnel) and technical resources (scoring software) in order to operate a successful Credit Scoring Centre.

The following diagram illustrates an example of the weighting KMC needs to apply to their overall credit scoring (application scoring) model in the Credit Scoring Centre. The model needs to be reviewed on a regular basis (by the experienced mortgage lending personnel) and on going modifications to the weighting, based on experience as it is acquired, is critical to the success of scoring.



4.4 The proposed KMC Work Flow Model



As illustrated in the proposed model, all applications would be sent into the Credit Scoring Centre for processing. Both internal and external data sources are used to validate information provided on the application. At every step a further evaluation is performed before proceeding to the next evaluation stage. These evaluations would be performed by the credit scoring (application scoring) software. When an attribute, characteristic or parameter fails to meet a minimum threshold the software application will provide one of two steps – refer the application for manual handling or to automatically reject the application based on all evaluations at that point.

During the implementation stage close review of all applications will be required to confirm the software has properly categorized the application as a reject versus a referral. It is recommended that all applications be referred, not rejected, during the implementation phase of the project.

<u>Data sources used during the processing of applications</u>

The primary source of electronic data is the *First Kazakhstan Credit Bureau. (FCB).*

As the credit bureau becomes more mature, it will have additional data and the value of the credit reports will improve. In the meantime, KMC will require the detailed credit report in order to calculate an internal credit risk score. As the FCB introduces it's own risk score product, KMC should monitor closely for comparisons and validity of FCB scores with the intent of eventually replacing in house risk scores with credit bureau risk scores. That evaluation is a minimum of two years away.

While Pension databases have been listed below as a possible source, there question of access will need to be addressed first. There is currently no access to Pension data. Pension data is a valuable source for determining borrower income as the pension contribution is 10% of income in all cases.

Other government and public record databases are not listed below as it must be assumed that the FCB will collect any data available from any source who is willing to provide it (assuming it is related to either credit or public records).

Employer databases (internal to KMC) are discussed in more detail under the risk mitigation section following. The same applies to property databases.

Potential Data Sources used in Application Processing:.

The Product Score

- Data supplied on application for mortgage loan
- Business Rules of KMC
- Mortgage Insurance Databases

The Credit Risk Score

- Credit Bureau Data

- Existing KMC databases
- Partner Bank Databases
- Scorecard Databases

Financial Score

- Pension Databases
- Credit Bureau data
- Certificates provided by borrower

Character Score

- Certificates provided by borrower
- Credit bureau data
- Pension databases
- Employer databases (internal)

Collateral Score

- Appraisal reports
- Property databases

Note: List of potential sources of data is subject to their availability.

4.5 Roles and users of the workflow/scoring system

The following highlights the users and their roles of the workflow / scoring system:

Partner Banks

- Assist KMC IT staff with interfaces to bank systems where required
- Assist KMC IT staff with all communications and security requirements
- Setup and install client workstations to access the KMC credit score software application
- Train users, with KMC support, on the use of the software
- Collect data from borrowers and input ALL data required into software
- Monitor status of application and acquire additional information / documentation as requested by KMC
- Validate borrowers identity and confirm accuracy of information provided
- Ensure accuracy of information provided from bank internal systems
- Maintain first line of all borrower contact and keep borrower informed

- Enter all manual data required to meet the specifications for each application
- Collect and forward documentation when requested
- Handle all other requests from KMC underwriting staff as needed

Remote KMC Staff

- Act as first line of communication between the KMC Credit Score Centre and the partner banks (or insurance company)
- Encourage additional participation from existing partner(s)
- Establish business relationships with new partner(s)
- Monitor economic conditions of local area and inform KMC Senior Management of adverse conditions (employers, properties)

Underwriting Staff

- Refer to ANNEX 2 - "*On Verification of the Credit File of the Borrower by Specialist of the IPC Credit Support Department*". This document outlines the existing processes and documentation validation currently required by KMC underwriting staff. There should be NO changes to the minimum verifications and cross checks.
- In addition to the visual inspection and validation of documentation described above, the underwriting staff will utilize the credit scoring software system as a tool.
- Review queues for new applications requiring attention (referrals)
- Monitor approved applications and follow for documentation
- Monitor and review all new applications where the decision has been "referred" for additional manual handling
- Follow partner banks (or remote office staff) for additional information / documentation as required
- Approve / Reject decisions, within pre-assigned approval limits, for the above
- Monitor system generated decisions for faulty scorecards and/ or system errors
- Other duties and responsibilities as they are in place at KMC now

Managers of Underwriting & Managers of Risk Management

- Establish and monitor all business rules in order to support business strategies
- Communicate to IT staff the logic required to convert the business rule into a logical statement that can be converted into code or parameters for scoring software
- Monitor all reports, daily, weekly, monthly and look for adverse trends and items requiring action
- Propose changes to the scorecard process where required
- Review and validate new scorecard models prior to implementation
- Monitor number of referrals and review lending "judgement" of underwriting staff
- Adjust approval limits of underwriting staff as needed
- Train and monitor underwriting staff
- Approve all external appraisers
- Other supervisory duties as are already in place at KMC

Financial and Accounting Staff

- Monitor operational reports (lending) as provided and as they apply to financial operations
- Ensure all regulatory compliance is met
- Provide regulatory reporting where required
- Contribute to scorecard analysis

Technology Staff

- Implement and monitor all access security requirements
- Set up users - add / edit / delete individual users with assigned rights
- Set up new partner banks with all access rights and data required
- Ensure system availability
- Monitor system for performance
- Backup procedures as well as a disaster recovery plan
- Setup and monitor all external links (credit bureau)

- Setup and monitor all communication needs (FASTI , email messages & other)
- Add and update any internal databases as required (employer, property)
- Test all new program releases prior to implementation
- Test any parameter or scorecard changes before implementation
- Run all regular reports on daily, monthly, annual bases (approval reports, statistics reports, portfolio analysis reports, and other operational reports as defined)
- Run ad-hoc reports as requested
- Run Management Information Reports (MIS) as requested
- Other functions required to ensure system availability, security & performance

Senior Management

- Establish the business strategy for acquisition of mortgages
- Set or approve policy and parameters for new products
- Monitor implementation of business rules by staff (as identified above)
- Monitor economic, market, regulatory and competition conditions for changes requiring new or altered business strategies
- Review operational, ad-hoc or MIS reports and react as appropriate

4.5.1 Recommendations Related to Roles

As indicated above, there are many roles for many players in the Credit Scoring / Workflow system. Purchasing mortgages is by it's very nature a very highly administrative task. While the decision process will be supported by the credit score (application scoring), the visual confirmation of document accuracy will not go away. As the technology improves, the registration of mortgages may become an electronic process as it is in some western regions now.

The key to streamlining is twofold:

1. Populate the input screens with all available data
2. Enter new data at source and only once

There is no replacement for good judgement. The responsibility for the overall mortgage portfolio quality needs to be owned by a single individual. That individual must play a key role, with the support of all underwriting and risk management supervisors, in monitoring and controlling the volumes and quality of new mortgage purchases.

It is strongly recommended that that individual identified above play a leading role in the credit scoring software system evaluation and selection. If they are to be held accountable for the overall quality of the portfolio, profitability of the portfolio and losses incurred from within the portfolio, then they need to be a part of the decision process now.

The individual responsible for the portfolio quality will also need to establish a collection centre as well introduce as collection policies and procedures for collection of defaulted mortgages, including litigation specialists. Alternatively, the collection task can be outsourced. A strong and effective collection centre will play a critical role in managing risk and minimizing potential losses. The need to act quickly on mortgage defaults is supported by a common expression in the collection world - *your first loss is your least loss*. The implication there is to act quickly and not procrastinate before the equity deteriorates. Establishment of a collection centre is no mundane task.

4.6 Data evaluation criteria in order to determine risk levels

"Mortgage lending is rules-driven at every stage of the lending process and in every system"

As described in the workflow process map, there are a number of stages at which each application is evaluated against the rules before proceeding to the next step. Mortgage processing normally has a very high rate of approval - between 85% and 90% of mortgages are approved. The biggest reason for slowing the process is the lack or documentation or accurate documentation requiring follow up.

The best strategy for approval processing is to follow a methodology that every application is approved - until it fails to meet a specific rule at one of the evaluation stages. At that stage the application is referred for manual handling. Depending on the circumstances, there may be alternatives or changes from the original request that can be made while still meeting the needs of the borrower. For example a smaller mortgage amount or a longer term of mortgage may be enough to reduce monthly payments (PTI or LTI ratios) which will then meet the criteria. The application is then resubmitted.

When evaluating the data, we are really evaluating two specific areas:

1. The strength of the borrower
2. The strength of the collateral (the property)

In addition to individual application evaluation criteria, corporately KMC needs to have a policy in place that provides an overall guideline for the mix of assets. By spreading the risk, the company will hedge itself against a negative issues in specific areas. For example, a guideline for the types of property KMC will mortgage. Currently, in order to avoid a well documented high risk category, KMC has a policy that they will only mortgage owner occupied property. At this time, that policy is sound. However changes to the market and / or competition may require a re-evaluation of that policy. In that case, KMC may be willing to hold up to 10% of the total mortgage portfolio in non owner occupied property. The same applies to mortgaging commercial property, low value property and other categories of property.

The most important guideline at this time is the mix of rural property KMC will hold which is normally a higher risk mortgage. Even at much lower loan to value ratios, this is still a much higher risk than urban properties. A good mix and variety will mitigate the overall portfolio risk.

Evaluation of the borrower

Referred to as SOLVENCY, the strength of the borrower(s) is the primary basis on which all mortgages are evaluated. The solvency of the borrower is determined by adding the financial score, the character score and the credit risk score.

In order to provide additional data for determination of financial score, it is recommended that individual assets and liabilities be added as new parameters to the application for loan. The difference between the assets and liabilities is a net worth calculation. Borrowers with a high net worth represent very low risks and as such can be categorized into the elite group. Character scores are determined by employment data as well as personal data and demographic data.

In order for the credit scoring software to purge high risk borrowers, we must first identify those classifications of borrowers who historically represent high risk. In a rules based application scoring system, following the strategy every application is approved until it fails an evaluation test, KMC will focus on segregating high risk as opposed to segregating low risk (the 85% to 90% approval rate). As KMC acquires more data, including defaulted mortgages, the identification of higher risks will surface. These changes must then be immediately reflected in revised scorecards.

Traditionally the credit risk score is used. If the borrower scores low, there is a high risk they will not pay. Many lending institutions use a bar of 640 as the credit score. If the applicant scores below the bar, they fail to meet the first rule and are immediately rejected or refereed for manual handling. Remember, manual handling might identify an alternative to mitigate the risk. Some lenders will offset a poor risk score with a guarantor. While that may mitigate the risk of loss, it seldom mitigates the risk that the borrower will require significant collection efforts. To offset this risk, the rate is normally higher.

The KMC credit scoring system needs to have a long range plan to weight the credit risk score as the heaviest overall determining factor. For reasons discussed earlier, the risk scores are not a dependable source at this time as the database of positive data is not large enough to calculate a reliable risk score. However, the risk score that is calculated can be heavily weighted toward negative information. It is recommended that any negative information on payment habits result in an automatic referral (not an automatic rejection) of the application.

Demographics are easiest done by age bands. The lower the age, the higher the risk. This has been proven in many scorecard models in the past. However, the State Program is targeting this group for home ownership and there is no doubt that the mix of young borrowers should be expected to be high. They normally have very little positive, or negative, information on which to make a decision. Length of time of the job is usually short, incomes are modest to low, and payment habits have not been established. Many lenders will automatically insist on a guarantor for this group. Following that strategy represents the lowest risk to KMC and it is recommended.

However, if it creates a problem with the State Program, consideration will be required to waive the condition. In those cases, the education and the type of position (or the career path) the young borrower has chosen will need to be weighted. What KMC will be doing is taking a risk on the future earnings of the borrower.

The amount, and the source, of the down payment can also offset the risk to young borrowers. Those who have saved a significant amount for a deposit represent a lower risk category. In most cases, these mortgages will need to be insured with MI insurance at a premium price to borrowers.

As a word of caution, education is of a lesser importance on any other demographic category than young borrowers. Often older borrowers lack education, as do some self employed borrowers, but those are usually very hard working and honest individuals that KMC will not want to discriminate against.

After handling of young borrowers separately, the most important evaluation criteria is the capacity (income or earnings) of the borrower to pay. Both the amount of the income as well as the security (probability of keeping the job) are critical. When evaluating an application, it does not matter how strong the character of the borrower is, it does not matter how good the credit is and it does not matter how good the collateral is (how low the loan to value is) IF the borrower lacks the capacity to pay. They would be theoretically entering into the agreement without the resources to make the first payment. There are lenders who will take this type of risk - called equity lenders. They charge a premium rate and normally have strong arm collection tactics. It is not recommended that KMC be an equity lender. Equity lenders usually build negative reputations as their number of legal actions is high.

In order to evaluate income, complex scorecards will be required. The first level of evaluation criteria should be the type of employment of the borrower. The following categories are recommended:

- Public Sector
- Ministry
- Non Government Employers
- Own enterprise
- Sole Proprietorship

- SME

Each of the above has a different risk category with sole proprietorship representing the highest risk. These should require special attention and a more detailed analysis of income. In Kazakhstan, there are groups that earn income and do not report it. This group will not have substantiating income verification methods. It is strongly recommended that any applicant who can not confirm income by any source be referred and be required to obtain a strong guarantor who is willing to pledge their own property as additional collateral. History has proven this group represents the highest risk in lending.

On the opposite side are borrowers who can confirm high levels of income with a good length of time on the job. This group represents the lowest risk category and should be approved with much less verification of data (after providing income verification). This group can be labelled elite borrowers and will normally be looking for lower than market interest rates as they represent a lower risk.

Collecting information and categorizing employer groups is difficult. In order to manage the task it is recommended that a database (internal to KMC) be created. This database should have the name of every employer that has an employee with a loan at KMC. For each individual employer, there may be a need to build specific classifications of job types. For example, management or labor etc. For each job type, the maximum amount of income as verified by the documentation should be entered. At that point subsequent borrowers working at the same employer, with similar job types, can have their declared income validated against the database. Each category can be assigned a specific “risk” weighting that should be incorporated into the KMC internal risk scoring program. For example, some types of employers represent higher risks than others. The larger the employer is, the lower the risk is.

In addition to assisting with the evaluation of individual borrowers as above, KMC would also have the data available to measure the risk of the overall portfolio. For example, if an employer comes upon hard times and requires either downsizing or closing, KMC could immediately identify their exposure by isolating the number of mortgages with employees at the specific employer. This type of information supports collection efforts as well - given that KMC would likely allow some tolerance in payment delinquency to this specific group.

It is not possible to write a good lending practices manual within the scope of work of this document. The above examples represent only a sample of the considerations required. When building the scorecards, it is recommended that emphasis, and weighting, be placed upon the borrowers capacity (income / probability of keeping the job) as the key criteria in evaluating the overall solvency of the borrower. The development of a KMC internal employer database should is recommended.

Lastly, KMC will need to ensure that it does not use parameters that are discriminatory in the eyes of the regulators in the credit scoring application.

Evaluation of the property

While less important than the strength of the borrower, the amounts of loans dictate that good security be taken to support the overall risk. Property (collateral) needs to be scored the same way the borrower is scored.

In the KMC credit scoring system, the preliminary approval must be "subject to appraisal" and confirmation of all other data and documentation as provided. Failure to meet appraisal standards will result in either a referral or a rejection of the application.

The key to good property evaluation is the strength of the appraiser. While the appraiser must hold a licence and be properly recognized by the regulators, it is recommended that KMC take additional steps to validate and screen appraisers. There are good appraisers and there are bad appraisers. Nothing will increase the level of risk as much as using a bad appraiser. KMC should approve each appraiser and should black list any appraiser who demonstrates poor judgement in evaluating property. Loan to value should always be calculated on the lesser of the appraised value or the purchase price. Appraisals should be conducted for mortgage purposes. The implication is that the value might be less than the market value. Foreclosures and distress sales will not normally attract purchasers willing to pay market value as most lenders desire a quick sale over holding onto property for longer periods in order to attract the right buyer willing to pay the right market price.

The first step in the collection process should be a re-evaluation of the property. Only in that way can the actual exposure be properly calculated. The extent of the exposure will often dictate the strategies used in collection. For example it may be more advantageous to permit the owner to stay longer while making token or partial payments as opposed to taking possession of the property and selling it.

When evaluating the property risk, a good quality appraisal will take all items requiring attention into consideration. For example the amount of time for a resale will reflect in the total price. Properties that take longer, should have lower values. If the property requires significant repairs, that also should be reflected in the appraised value. The most important part of a good evaluation is to locate similar properties in similar locations that sold recently. They are the best indicator of value. The final appraised price is the most important number required for the purpose of calculating loan to value. Going beyond the value into specifics of the individual properties is normally not required. The only other criteria recommended is that the property does not have any features that fail to meet the business rules. For example KMC has a policy of not mortgaging property constructed from certain building materials. By simply putting a YES / NO indicator on the mortgage application, these properties can be screen before they even hit the credit scoring application.

In addition to providing an opinion as to the value, it is recommended that appraisers make notes of living conditions directly on the appraisal. A neat and well kept home is normally as indication of a stronger character than a home requiring significant repairs that appears to be poorly maintained. Of coarse loans for the purpose of repairs will need to take this into consideration.

In Kazakhstan, there is access to a database of property information. This database provides information regarding the original construction of the property as well as other key data. it is recommended to use this resource of information. (BTA can supply the details from the provider)

One concern identified during the information gathering stage of this report is the right of ownership to a property as it relates to disabled persons and children. Without question, KMC MUST have the first right of possession to a property and that needs confirmation. Examples of other persons claiming a right to a property in front of KMC were provided and in one case a daughter living in North America for over eight years had a claim to the property ahead of the mortgage company. Complete investigation and analysis to mitigate this risk is mandatory.

The existing limit of a 70% loan to value ratio is good and no change is recommended for mortgages not covered by insurance. It is consistent with best practices for variable rate mortgages. Advances up to 75% are considered by most lenders for fixed rate mortgages. The credit scoring software should take into consideration a worst case scenario (interest rate spike to maximum levels) when evaluating PTI and LTI ratios as the higher payments may put the borrower into ranges exceeding the limits.

Rural properties require closer evaluation as they are normally not as saleable as urban properties at mortgage value or market value. Properties that are difficult to appraise because of a lack of comparable sales should have a lower loan to value limit when purchasing a new mortgage.

Evaluation of Guarantors

This is a special category requiring attention.

A guarantor needs to meet the same qualifications as the primary borrower. Taking a weak guarantor to support a credit decision to a weak borrower is a high risk and history has proven them to be very problematic. Often parents are persuaded by children to guarantee, and to pledge security. It is recommended that guarantors seek independent legal advise in order to be made fully aware by an independent third party of the risk they are taking. In cases where the parents have equity, but low or disability types of income, it is recommended that these guarantors be declined. Throwing a disabled person out onto the street because of a loan a sibling defaulted on can result in nothing but poor image of the company. As responsible lenders, KMC should look at all guarantors very closely before agreeing to accept them based on the image that will be portrayed in the event of a default.

A guarantor can support a credit decision where the credit is weak, the character is weak or the collateral is weak. Weak implies that it meets a minimum threshold, it does not imply that it mitigates the risk where the falls below the minimum. However, a guarantor does not support a borrower with a weak capacity to repay. These are historically high risks. This excludes applications where the guarantor is a contributor to the payments and their total income has been included in the PTI or LTI ratio calculation. Where the guarantor is not a participant in the property and the income will not support the payments, PTI and LTI calculations should be based on the borrower(s) income only.

Summary of Evaluation Criteria

Aside from comments made above, there is no data available for KMC that would enable them to categorise groupings of borrowers into high risk categories. It is expected that a supplier of credit scoring software has access to large databases of information in similar areas for similar products.

The income (capacity) is the most important criteria. Traditionally a good credit risk score has been the best indication that the borrower lives within their means and does not over extend themselves. KMC needs to focus on income as it is the number one cause of mortgage delinquency. Loss of income or reduced income.

4.7 Existing and developed credit products

Volume Projections (Number of new Mortgage Purchases Required)

Based on the growth expectations, as provided by KMC, the following chart represents the number of new mortgages (** Volume Requirements) KMC will need to approve on an annual basis. The company has grown from 30 to approx. 120 employees over the past few years and in 2005, it is expected to purchase approx. 23,000 new mortgages or just under 2,000 per month. Within two years, that figure will triple to approx. 67,000 mortgages or 5,600 per month and by 2008, KMC will need to process 84,000 purchases. While the new volume (new mortgages purchased) figure includes an allowance for mortgages pre-paid - it does not include the number of mortgages that will be rejected. As a general rule, one of every ten applications will be rejected. The biggest impact will be the number of new mortgages from the State Program in 2007 as the State Program ends it's third and final year.

The demands upon the staff and the credit score system will be a challenge.

	KMC Projections For # Mortgages outstanding:				
			Total	Volume	% Increase
	Market Program	State Program	# Outstanding	Requirements	
2004	10,569	-	10,569	12,140	
2005	18,646	1,061	19,707	22,707	87%
2006	24,108	4,160	28,268	32,768	44%
2007	34,988	25,709	60,697	66,697	104%
2008	50,228	25,709	75,937	83,937	26%

** Note: above figures exclude applications that are rejected. (While the percent of declines will vary for a wide variety of reasons, generally it is estimated at 1 reject for 9 approvals)

4.7.1 Mortgage Loans - General Terms and Conditions:

There are three basic types of MARKET products currently offered. They are defined by purpose. While the State Program mortgages are for property acquisition, they will be tracked and monitored in a separate sub ledger.

Products currently offered:

- Property Acquisition
- Property Repairs and Improvements
- New Construction

The following applies to all products:

- Currency of the loan – tenge;
- Term of the loan – 3 - 20 years;
- Interest rate - floating
- Availability of insurance: life, property, 15%GPO (if necessary) or KMGF(MI)
- Co-borrowers may be spouses and close akin of the borrower, i.e. son, daughter, mother, father, brothers and sisters
- Guarantor may be both a physical or a legal person
- Form of payment – annuities

Property Acquisition:

- The amount should not exceed 50 million tenge
- The minimal amount should be 600 thousand tenge
- LTV – 70% and the maximal LTV should not exceed 90% of the property's estimated market value
- Any property including the property under repairs can be pledged as security

Repairs & Improvements:

- The amount should not exceed 3 million tenge
- The minimal amount is 300 thousand tenge
- The maximal LTV should not exceed 50% of the estimated market value
- Any property including the property under repairs can be pledged as security
- The property is re-evaluated twice: prior and after the repairs

New Construction and Shared Participation in Construction

- The amount should not exceed 50 million tenge
- The minimal amount should be 450 thousand tenge
- The LTV should not be higher than 70% of the property' s estimated market value
- Any other property may be provided as security with the potential to be replaced by the property under construction when it is commissioned

The State Program (The Mortgage Lending System)

The main objectives of the mortgage lending system development shall be:

- taking measures to lower the inflation levels, which will enable to decrease the mortgage lending rates;
- issuance of long-term governmental securities in order to support the benchmark;
- development of the mortgage guarantee system. For these purposes, it is possible that the capital of KMGF will be increased.

In order to increase the access to mortgage credit, the State shall take action to improve the mortgage credit parameters. During the Program implementation period, the following targets of mortgage lending shall be achieved:

- interest rate - 9–10 %;
- downpayment - 10 %;
- mortgage loan term - 20 years.

In the market, currently, some banks offer mortgage loans, which have only one of the above mentioned criteria. No bank has yet offered loans with all the three parameters. The objective of the State shall consist in focusing the market on the compliance with the said criteria.

This objective shall be realized by means of existing financial development institutions' involvement, such as Kazakhstan Mortgage Company.

To achieve the posed objectives, it is necessary that within the period of 2005 – 2007 the following activities need to be implemented:

1. Planned disinflation, which, in the long run, will lead to the planned lowering of the mortgage loan basic terms and conditions, and, in particular, the interest rate. When calculating the mortgage loan rate, the dominant factor shall be the rate of inflation, which currently amounts to 6.4%. In accordance with the National Bank's forecasts it is anticipated that in 2005 – 2007 the inflation rate will amount to 4–6 % annually. In accordance with the National Bank's long-range predictions it is anticipated that the inflation rate will decrease to 3.5 % by 2015.
2. Development of the Special affordable housing mortgage program within the framework of the current KMC mortgage lending program approved in 2000 (hereinafter – the Special KMC's program), which envisages the mortgage loan refinancing according to the above said targets. The annual inflation rate will not be used as the basis index in the Special KMC's program, but the KMC's weighted-average rate. It will be envisaged that the KMC's spread will diminish from 3.1 % to 0.5–1.0 % and the partner banks' maximal margin will reduce from 4.0 % to 3.0 %. Also, in the Special program the maximal mortgage loan size will be determined of 5 million tenge. The KMC quotation rate must not exceed 6 – 7 %.
3. The KMC's capitalization of 26.8 billion tenge. With due account of the leverage applied to the second-tier banks, the KMC will be able to increase the lending volumes in the capital market from year to year. The KMC's capitalization shall assure the increase in the volume of the rights of demand acquired, which will ultimately lead to the decrease of the KMC's quotation rate and will enable the second-tier banks to lower their mortgage interest rates to 10 %. At the same time these mortgage loans should be extended only for the affordable housing acquisition within the KMC's framework.

The above activities shall be implemented in two stages.

1. The initial stage – 2005;

2. The second stage – 2006-2007.

During the initial stage (2005):

Taking measures towards further lowering the inflation level that will enable the reduction of the mortgage loan rate;

- KMC's capitalization of 6.4 billion tenge for the purposes of ensuring the Company's financial soundness;
- KMC's mortgage-backed security issuance for 34.9 billion tenge with the term of up to twenty years for the affordable housing demand financing;
- KMGF' capitalization of 1.5 billion tenge in order to decrease the downpayment to 10 %;
- Issuance of long-term (up to twenty years) governmental securities by the Ministry of Finance for the purposes of supporting benchmark prior to KMC mortgage-backed securities issuance.
- Incorporating amendments into the Republic of Kazakhstan's current legislation concerning setting the provision on banning the prepayment of the mortgage loans during the initial three years.

During the second stage (2006 – 2007):

- KMC's capitalization of 20.4 billion for the purposes of ensuring the Company's financial soundness along with the significant expansion of mortgage lending;
- Issuance of mortgage-backed securities totaling to 111.2 billion tenge for the term of up to 20 years for the purposes of financing the demand for the affordable housing to be built in 2006 - 2007;
- KMGF's capitalization of 2.3 billion tenge with the aim to reduce the downpayment to 10% of the housing value;

At the same time, prior to the Program's enforcement the following preparatory measures shall be taken:

- drafting of KMC's Special Program;
- transfer of the right of possession and usage of the State block of shares in KMC from the National Bank to the Ministry of Finance of the Republic of Kazakhstan;
- Issuance of the long-term (up to twenty years) government securities by the Ministry of Finance for the purposes of supporting the "benchmark" prior to KMC's mortgage-backed securities issuance.

Results

During the Program implementation period, the entire newly-built affordable housing offer will be covered by the effective demand of the citizens, participating in the mortgage lending system. In accordance with the estimates, forty-nine thousand families will be able to benefit from the mortgage lending system.

4.8 Matrix, based on the evaluation criteria to separate risk

International best practices has been following the basic four C's of mitigating credit risks for many years and the most experienced credit underwriters have been trained to identify and analyze the:

C*haracter* (Solvency of the borrower)

C*ollateral* (the security being pledged for the loan)

C*apacity* (the ability and stability of the income to repay(Solvency))

C*redit* (the past history of payment)

In order to provide a matrix only the sub groupings above have been used in the example. Each of the primary four criteria above have many individual parameters to examine in order to determine the overall strength of the characteristic. For example, when analysing Character, the borrower's demographics (age, marital status etc) and the employer, (employer type, position held, income and length of employment) ALL contribute to the determination of the strength of the character. For the purposes of the example below, weak implies that the attribute exceeds minimum thresholds, it does not imply that it fails the evaluation in which case the application is referred or rejected.

The following matrix examines the level of risk based on the strength of each of the above four attributes. There are four individual matrix, each using ONE of the four characteristics. The first four lines deal with a weak characteristic and the next four deal with a strong characteristic. Within each of the four matrix, the strength of the individual characteristic is matched with every combination of the remaining three characteristics.

The end result is an evaluation of the overall risk where L = Low risk, M = Medium risk and H = High risk.

Every loan is a risk. High risk loans as identified in the matrix should be referred or rejected. Referrals should require a guarantor, with or without pledging additional security depending on individual circumstances. In most cases, a low risk requires at least three of the four characteristics to be strong. When building scorecards, weighting for each characteristic requires consideration. It will not be appropriate to add scores for each of the four characteristics, and average them to determine a final score. Each characteristic should have minimum requirements or thresholds.

Noteworthy in the risk matrix is the impact of the capacity characteristic. It is really the only one that does not follow a pattern. As documented earlier, a weak capacity implies a high risk (or at best a medium risk), regardless of the strength of other characteristics. This again supports the primary scoring requirement to focus on a borrowers ability to repay based on current situation as well as the odds of continuous employment.

Unless the KMC business strategy adopts a position of equity lending, the criteria applies to all products, across all customer segments. Equity lending implies that if the equity is exceptionally strong, the other characteristics are not relevant. The impact of equity lending is normally seen in the high collection efforts. The risk of loss is low, but the risk of investment in staff time for collections is high.

4.8.1 Risk Matrix Based on Evaluation Criteria

Attributes of Application

Weak	Collateral	X	x	x	x	x	x	x							
Weak	Character		x				x	x		x				x	x
Weak	Credit			x	x		x	x			x	x		x	x
Weak	Capacity			x		x		x			x		x		x
Strong	Collateral								x	x	x	x	x	x	x
Strong	Character	X		x	x	x			x		x	x	x		
Strong	Credit	X	x			x			x	x			x		
Strong	Capacity	X	x		x		x		x	x		x		x	
	RISK	L	M	H	M	M	H	H	L	L	M	L	L	M	H

Weak	Character	X	x	x	x	x	x	x							
Weak	Collateral		x				x	x		x				x	x
Weak	Credit			x	x		x	x			x	x		x	x
Weak	Capacity			x		x		x			x		x		x
Strong	Character								x	x	x	x	x	x	x
Strong	Collateral	x		x	x	x			x		x	x	x		
Strong	Credit	x	x			x			x	x			x		
Strong	Capacity	x	x		x		x		x	x		x		x	
	RISK	M	M	H	M	M	H	H	L	L	M	L	L	M	H

Weak	Credit	x	x	x	x	x	x	x							
Weak	Character		x				x	x		x				x	x
Weak	Collateral			x	x		x	x			x	x		x	x
Weak	Capacity			x		x		x			x		x		x
Strong	Credit								x	x	x	x	x	x	x
Strong	Character	x		x	x	x			x		x	x	x		
Strong	Collateral	x	x			x			x	x			x		
Strong	Capacity	x	x		x		x		x	x		x		x	
	RISK	M	M	H	M	M	H	H	L	L	M	L	L	M	H

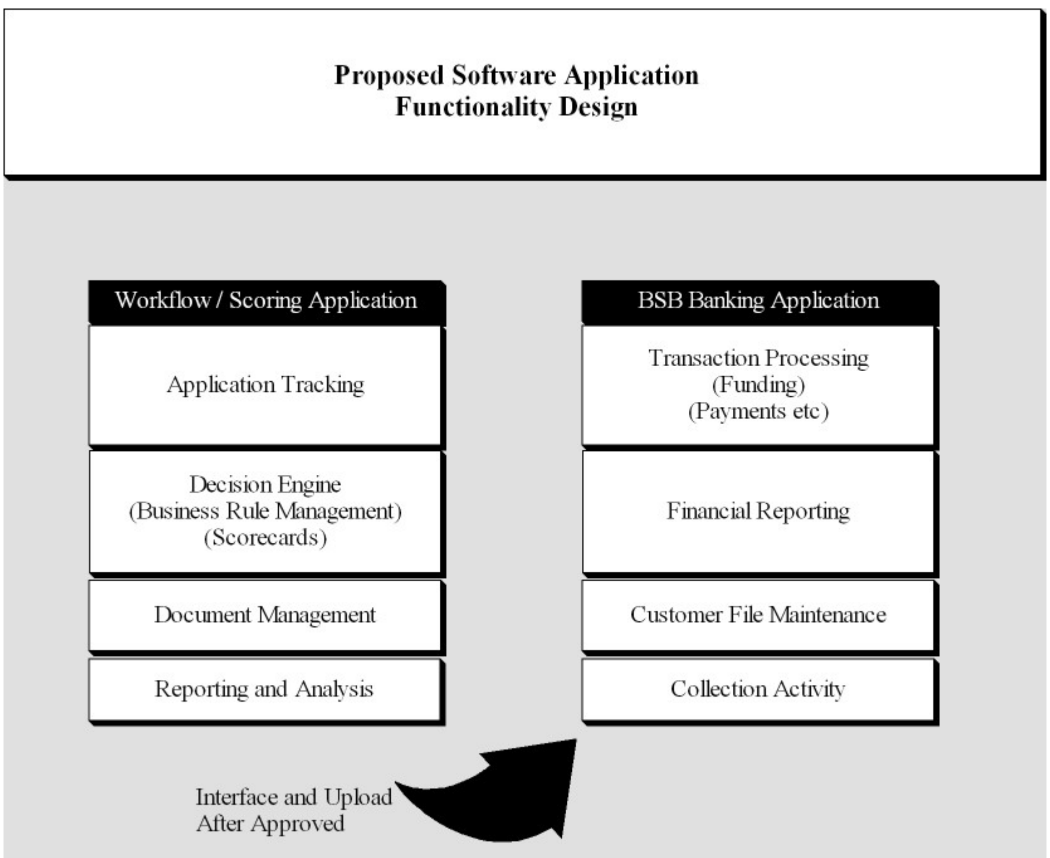
Weak	Capacity	x	x	x	x	x	x	x							
Weak	Credit		x				x	x		x				x	x
Weak	Character			x	x		x	x			x	x		x	x
Weak	Collateral			x		x		x			x		x		x
Strong	Capacity								x	x	x	x	x	x	x
Strong	Credit	x		x	x	x			x		x	x	x		
Strong	Character	x	x			x			x	x			x		
Strong	Collateral	x	x		x		x		x	x		x		x	
	RISK	M	H	H	H	H	H	H	L	L	M	L	L	M	H

5 Final Recommendations and Next Steps

The first issue that will require complete agreement is the scope and magnitude of the Credit Scoring Software System.

It is recommended that KMC look towards implementing a new stand alone software application for a complete and total management of mortgage processing.

It can be referred to as Loans Origination Software or Workflow Software. In both cases, the credit scoring software and decisioning engine needs to be tightly embedded into the application as a module. Interfaces at both ends, input and output, will be required. The database layer and the communications layer should both capitalize on KMC's existing systems – Oracle (database) and FASTI (communications) and be fully integrated wherever possible.



5.1 The functionality required in the workflow / scoring system :

Architectural Requirements

- Ability to install multi company implementations each with independent database and set-ups
- Ability to use Oracle database
- Ability to co-exist with existing FASTI communication layer
- Ability to interface to electronic messaging systems

Interface Requirements

- Credit Bureau
- Partner Banks (as well as Insurance or other partners)
- KMC Regional Offices
- Other external sources
- Other internal sources
- Ability to interface to KMC existing financial system - BSB

Client (User) Requirements

- User-friendly interface
- Automatic assignment of all new applications to designated underwriting staff
- Immediate notification of new application in the queue to the underwriter
- Tracking of the status of each application in the queue with dates and name of underwriting staff assigned
- Prioritized application regime
- Tracking of all activity during the underwriting process with capability to add free form notes
- Ability to recall an existing application from achieved data
- On line real time access
- Batch or off line access and processing
- Interface to existing bank databases for data entry of new applications
- Drop down boxes for data input where possible
- Preliminary approval functionality
- Final approval after document verification and appraisal
- Automatic communication (messages) of above approval status to partner banks or remote KMC office

- Investigation and underwriting on the basis of the predefined product requirements
- Investigation and underwriting on the basis of the preliminary score

Credit Decisioning Requirements

- Decisioning and analytical software to calculate CREDIT RISK values based on data supplied by the Credit Bureau as well as apply specific scorecards for determining BORROWER total overall risk (Application Scoring).
- An eligibility screening application to ensure the loan being requested meets KMC corporate PRODUCT rules and specifications
- Standard scorecard templates (for similar products in similar geographical areas)
- Application of the score algorithms, rules, filters, segmentation for the automated decision making
- Functional set up of modules (score cards, rules, filters, and environment) by means of manual and system parameters
- Ability to add and edit existing scorecards without impacting approved business
- Ability to add, edit and delete parameters to the database
- Ability add and edit new screens to incorporate above changes

Volume and Capacity Requirements

- Processing of 500 new applications per day
- Up to 1,000 users with capacity to scale beyond if required
- Ability to manage 25,000 applications in queue
- Ability to archive unlimited number of approved applications either off line or with extended response times
- Response time of screen painting in less than 30 seconds
- Response time to decision of less than two minutes, ideally shorter response time

Security Requirements

- Limitations of the access of users into the system with specified rights for each user
- Easy administration of the users and the system (user-friendly)
- Back up (archiving) of data
- Complete audit trails for all changes made to new and pending applications

- No changes to processed applications or data after purchase and funding has occurred (unless authorized at highest level of security)
- Assurance of information security (safety)

Reporting Requirements

- Standard set of activity based reports
- Ability to add, edit and delete standard reports
- Ability for ad-hoc and custom reports
- Statistical monitoring of the score card, potential of introducing changes into the score card;
- Setting up of the score card levels in points (Level “Yes”, Level “No” and the Referral level).
- Monitoring and reporting
- Release of the data for monitoring of the score card and reports
- Availability of the generator of reports for the formation of exceptional requests

The above requirements represent the outline of the Request for Proposal for a Workflow / Scoring Software application.

Next Steps

- Confirm concurrence with the preliminary report
- Prepare DRAFT Request for Proposal (RFP)
- KMC will be required to edit the draft RFP to ensure conformity with legislative and mandatory requirements for procurement.
- KMC will need to evaluate their organization structure to support the introduction of a Credit Scoring Centre - (addition of collection centre)
- KMC will need to review current lending policies and procedures to ensure all rules support the business strategies for the level of risk they are prepared to assume

5.2 BSB Automated Information System

KMC uses the BSB Automated Information System for the management of the mortgage portfolio. At this time they are the only users of the exact release of the software system. The BSB application is supported by a subsidiary of the National Bank who originally developed the application.

The existing automated information system appears to be meeting the current needs. However, based on the anticipated increases in volume, it is recommended that the system be thoroughly tested to confirm the ability to handle increased volume. Stress tests should be conducted with three to five times the number of accounts and three to five times the number of users.

The primary purpose of the stress tests should be to confirm that the response times are acceptable. (Acceptable implies determining a benchmark in advance).

Equally important will be the results of the batch cycles - open, close and monthly batch processes to ensure system availability within the fixed amount of time (over night). Based on the amount of time required at existing volumes, there is a high risk that these processes will not be able to complete within the fixed amount of time allotted.

It is highly recommended that this type of testing should be completed as soon as possible and that it is completed in future on an regular basis in order to identify capacity problems in advance.

Based on the analysis of the existing Information Technology infrastructure, consideration should be given to taking the support of the BSB application in house for the following reasons:

- KMC will have more control over the response time for addressing bugs and fixes
- KMC will be better positioned to prioritize new system enhancements
- KMC is currently in a better position to address interface requirements including new requirements to the Workflow / Scoring application
- KMC will be able to monitor and manage system capacity
- KMC has the skillsets and leadership needed to be able to assume responsibility of supporting the BSB system

Prior to proceeding, a thorough business case is required. The total cost of support needs to be compared to the projected cost of support. Additional resources, staff, will be required as well as additional hardware in order to build a complete duplicate testing environment. In addition, the following items need review:

- Proper training of new programming staff. It is recommended that an extended transition take place
- Availability of contract resources (National Bank) if required
- Availability of documentation for the existing system
- Implementation of certified software development and deployment methodologies
- Documentation of new software releases and implementation

6 ANNEX 1 - Credit Risk ODDS Summary Table - Example

Once the model has evaluated all the characteristics, the total credit risk score is then computed. Ranges are then determined for the overall score. As an example, the Empirica model then tells us, based on the range, the following information:

- The number of records in each range which, when totalled, tells us the size of the total test.
- What percentage of the number of records are represented in each range.
- How many records in each range that had negative performance
- The percentages of negative records of the total base
- The odds value, or simply put, what are the odds the consumer will or will not default.

The higher the score, the greater the consumer will not default

The lower the score, the greater probability the consumer will default

Refer to the following ODDS Summary Table. (the probability that the borrower will repay on time) for a testing of almost 1,000,000 borrowers as was completed by Trans Union.

The odds of repayment for a borrower with a credit risk score of 800 are 57.2 to 1 in favour.

The odds of repayment for a borrower with a credit risk score of 640 are 2 to 1 in favour.

Many lenders use the 640 credit risk score as the bench mark and the cut off point where they will normally not take a risk below this score unless the risk is mitigated with other security and/or a guarantor.

CREDIT RISK SCORE ODDS SUMMARY TABLE

Paper	Empirica Score Range From:	To:	Base Category # of Records	%	Cumm	Negative Records	%	**Odds (Value to 1)**
A	800 +		96,728	9.88%	9.88%	1,662	0.99%	**57.2**
	780 -	799	117,797	12.03%	21.91%	2,945	1.76%	**30.0**
	760 -	779	123,403	12.60%	34.51%	4,886	2.92%	**24.3**
	740 -	759	114,841	11.73%	46.24%	6,480	3.88%	**16.7**
	720 -	739	100,064	10.22%	56.46%	8,307	4.97%	**11.0**
	700 -	719	89,899	9.18%	65.65%	10,337	6.19%	**7.7**
A	680 -	699	80,829	8.26%	73.90%	13,695	8.20%	**4.9**
B	660 -	679	69,185	7.07%	80.97%	16,186	9.69%	**3.3**
	640 -	**659**	**47,970**	**4.90%**	**85.87%**	**15,501**	**9.28%**	**2.1**
C	620 -	639	35,551	3.63%	89.50%	15,148	9.07%	**1.3**
	600 -	619	25,831	2.64%	92.14%	13,682	8.19%	**0.9**
D	550 -	599	45,914	4.69%	96.82%	31,374	18.78%	**0.5**
E	549 or less		31,088	3.18%	100.00%	26,883	16.09%	**0.2**
Total			979,100	100.00%		167,086	100.00%	**4.9**

7 ANNEX 2 - KMC Existing Underwriting Requirements

Instructions

On Verification of the Credit File of the Borrower

by Specialist of the IPC Credit Support Department

1. IPC Specialist shall accept the Credit files of the Borrowers submitted by the Banks-Partners pursuant to the delivery-acceptance certificate envisaged for Credit Files.
2. Each Credit File shall be verified with a view of compliance with the "Main requirements to the mortgage loans provided that the right in action shall be acquired by the JSC "Kazakhstan Mortgage Company".
3. **Title page** shall state the name of the bank, extending the mortgage loan; full name of the Borrower (shall be verified with that of ID/ Passport); the name of the town where the loan is extended, the year of the extension of the loan).
4. Credit file shall be enumerated and contain the following documents:
    a. ID/ Passport/ Birth certificate of the Borrower/co-Borrower(s), and pledger (s) (copy shall be verified by the Bank Specialist);
    b. Taxpayer's certificate of the Borrower/co-Borrower(s), pledger (s) (copy shall be verified by the Bank Specialist);
    c. Certificate of the preliminary qualification of the Borrower (original copy signed by the Bank specialist);
    d. Labor contract/employment records book (shall be submitted by the bank, if the amount of the loan exceeds 5, 000, 000 tenge) (copy shall be verified by the Bank Specialist);
    e. Abstract on income (shall be submitted by the bank, if the amount of the loan exceeds 5, 000, 000 tenge) (original);
    f. Report on appraisal of the mortgage property (original copy);
    g. Ownership documents on the mortgage property (original);
    h. Abbreviate from the Bank's credit commission minutes (verified by the Bank specialist);
    i. Loan agreement with the Bank with all the necessary supplements attached (original);
    j. Mortgage contract (original);
    k. Insurance contract (insurance policy) ;
    l. Mortgage certificate or Deed of assignment (Cession contract) (original);

m. Delivery - acceptance certificate (original).

5. **ID/ passport** shall be valid as at the date of extension of the mortgage credit (the relevant documents shall be renewed on attaining of age of 25 years, 45 years, 90 years).

6. **Certificate of preliminary qualification of the Borrower** shall be completed in full:

   a. General data on the Borrower and co-Borrower (s);

   b. Info on the monthly expenditures of the family;

   c. Assets of the Borrower;

   d. Info in the premises to be acquired or refurbished ;

   e. Terms and conditions of the mortgage loan requested by the Borrower;

   f. Purpose for which the premises are purchased;

   g. Additional securing;

   h. Loan parameters;

   i. Info on monthly income;

   j. Factor L/A –is ratio of the amount of the mortgage loan to the market price of the premises pursuant to the appraisal of the mortgage loan, and when the L/A is lower than 70%, the life and property insurance contract is required, for factor from 71% through 85% there civil-legal liability insurance is additionally required, and when the security from the JSC “Kazakhstan Fund for Guaranteeing Mortgage Credits” is available the value of the factor can reach 90%;

   k. Factor P/I –is ratio of the monthly payment under the mortgage loan and the amount of monthly net aggregate income. Factor P/I shall not exceed 35%; P/I can be adjusted up to 45% provided there is sufficiency of the residual income per each family member of the Borrower and the co-Borrower; 55% is permitted when the Borrower submits two or more units of the mortgage property;

   l. Factor O/I – ratio of the total amount of obligatory monthly payments and the amount of monthly net aggregate income. Factor O/I shall not exceed 40%; O/I is adjusted up to 50% provided that there is sufficiency of residual income per head of the Borrower’s and Borrower’s families, and factor of 60% is acceptable for the case when the Borrower submits two or more mortgage properties;

   m. Date of completion and signature of the executor.

7. If the loan amount exceeds 5,000,000 tenge, the Credit file shall contain the copy of the **employment history book/ employment contract/ labor contract** and the original copy of the **abstract on income**. A copy of the employment history book shall be certified by the HR specialist of the relevant company the Borrower works for. The copy of the labor contract shall be verified with the original copy by the Bank specialist, and contract shall be valid as at the date of approval of extension of the mortgage loan by the Credit commission of the Bank. The abstract on income shall state the name of the company, first, full name of the Borrower/Co-Borrower, his/her position, the amount of income accrued, amount of pension deductions, amount of social deductions, net income, and shall be signed by the chief accountant, signed and sealed by the top manager.

8. **Mortgage property appraisal report shall state :**

   a. Date of appraisal (shall not be earlier than 30 days prior the date of approval of extension of the mortgage loan);

   b. Full mail address of the mortgage property;

   c. Description of the plot surrounding the mortgage property;

   d. Full description of the condition of the mortgage property;

   e. Year of construction (operation life shall not exceed 50 years);

   f. Total and living space/net room area;

   g. Plottage;

   h. Construction material of walls (light constructions, such as unit-built houses, adobe, clay, clay-hay and cane-fiber-frame houses and others of the type shall not be qualified);

   i. Construction material of the foundation;

   j. Availability of separate kitchen and bathroom (multifamily units shall not be qualified for pledge);

   k. Availability of utilities network (heating; hot/cold water supply, sewerage, electric power supply);

   l. All buildings shall have a permit for construction issued by an authorized agency, a permit for alteration of the flat's plan, as well as a permit for re-planning;

   m. Market value of the mortgage property.

9. **Ownership documents are**:

   a. Purchase and sale contract;

   b. Deed of gift;

   c. Privatization agreement;

   d. Covenant on succession to property (inheritance);

e. Barter contract;

f. Registration taxpayer's document ;

g. Certificate of acceptance (into operation);

h. Patent-right for private property on the plot (in case the real estate has a plot)

All legal documents shall be notarized and registered with RSE "Real Estate Center" under the Registration Commission of the Ministry of Justice at the place of location of the property and shall have official seal. Ownership documents shall be accompanied by the technical passport which shall be officially sealed by the RSE "Real Estate Center".

Name of the pledger (s) in the ownership documents shall be reconciled with that in the ID/ passport/ Birth certificate;

mail address of the Real Estate, number of rooms, total and living rooms area envisaged in the ownership documents shall match those in the technical passport of the Real Estate;

designated purpose of the land plot stated in the patent-right for private property on plot shall be worded as "for operation and maintenance of the living premises".

10. The abstract from the minutes of the **Credit commission** shall contain:

a. decision on approval of mortgage credit extension (shall state the full name of the Borrower);

b. amount of the mortgage loan;

c. term of the mortgage loan;

d. interests rate;

e. mail address of the pledged premises stated as security.

11. **Banking Loan agreement** shall comply with the approved format. There are 8 types of Contracts: A) one borrower, designated purpose : acquisition of the living premises, initial installment: not less than 30%, B) there is a co-Borrower (s) available, designated purpose: acquisition of the living premises, initial installment not less than 30%, C) one Borrower, designated purpose – acquisition of the living premises, initial installment – from 15% up to 30%, D) there is a co-Borrower (s) available , designated purpose – acquisition of the living premises , initial installment – from 15% to 30%, E) designated purpose – refurbishment of the premises, F) designated purpose – acquisition of the living premises , the amount of the mortgage loan equals to 100% of the premises to be acquired, G) designated purpose – construction of premises, provided that the ratio L/A shall not exceed 70%, H) designated purpose – acquisition of the living premises, and liabilities of the Borrower are secured by the JSC "Kazakhstan Fund for Guaranteeing Mortgage Credits". Depending on the initial installment

and availability of the co-Borrower the formats A, B, C, D can be used for the purpose of– acquisition of the living premises and refurbishment thereof.

While verifying the Contract one should pay a close attention on the following:

a. Such data stated in Preamble and Details of Parties to the Contract as full name, ID/Passport data, Taxpayer's certificate number of the Borrower and co-Borrower (s) shall match those in the copies of the documents (ID/passport, certificate of the taxpayer;

b. Amount, terms, interest rate shall match those in the abstract from the Credit commission minutes;

c. Info on the mortgage property/premises shall be reconciled with that stated in the abstract from the Credit commission minutes and ownership documents;

d. Inflation rate and the spread of Bank shall match as at the date of the decision of the Credit commission;

e. Amount of the mortgage loan as a share of the value of the mortgage property shall be calculated as follows: ratio of the amount of the mortgage loan to the market value of the immovable property pursuant the Report on appraisal of the pledge property;

f. The Banking loan agreement shall be attached with the following documents Supplement N 1 (Schedule of repayment), Supplement N 2, Supplement N 3, Supplement N 4/3 ("Co-Borrower's checklist" if any co-Borrower(s) available);

g. Banking loan agreement and Supplement N 1 shall be signed by the authorized specialist of the Bank, as well as Borrower and co-Borrower (if any), and Supplement N2, Supplement N3, Supplement N 4/3 shall be signed by the Borrower and co-Borrower (s) (if any).

12. **Mortgage contract** shall comply with the approved format. There are 2 types of a contract: one person is a borrower and a pledger at the same time; collateral guarantor (other person) called as a Pledger. Mortgage contract is registered at the Republican State Enterprise "Real Estate Center" at a place the mortgage property is located. During the examination of a contract the following points shall be paid special attention:

a. In a preamble and the details' section: full name (family name, first name and patronymic name), ID/Passport/Birth certificate data, Tax Registration Number of a borrower(s) and a pledger(s) must coincide with the submitted copies of documents (ID/Passport/Birth certificate, tax payer certificate);

b. Reference to a number and a date of a bank loan contract must correspond to the data of the current effective contract;

c. The date of a mortgage contract must not be earlier than the date of a bank loan contract;

d. The amount and the term of a mortgage residential loan shall be verified with an extract from the minutes of the Credit Committee and bank loan contract;

e. The data of all title documents, attesting to ownership's right to real estate must be complete and authentic;

f. The information on mortgage property must be consistent with the data specified in title documents: address of the mortgage property, usable (total) and living areas, number of the rooms, availability of a land lot ;

g. The mortgage contract shall be signed and sealed by an authorized person of a bank , as well as by a borrower(s) and a pledger(s);

h. If the rights of demand are assigned by virtue of a Mortgage certificate, then the following handwritten inscription "Me, full name, the pledger has issued this Mortgage certificate", as well as the signature of a pledger(s) shall be included in the mortgage contract.

13. The borrower must purchase life and property insurance. In case, the down payment is 15% - 30% then liability insurance will be required against a failure to make down payment. In case the borrower insures his/her liabilities with the JSC "Kazakhstan Mortgage Guarantee Fund", the civil liability insurance will not be obligatory.

14. The bank may assign the rights of demand by registering the **Mortgage Certificate** or **Contract on assignment of rights of demand** (**Assignment agreement**) in the Republican State Enterprise "Real Estate Center". Mortgage certificate must be completely filled out and signed by a pledger(s). There must be an endorsement for a specified cost, the signature and the seal of a person who makes the endorsement, as well as the marks that the borrower met obligations as of the date of assignment of rights of demand. It's not permissible to make corrections in Mortgage certificate. When carrying out an examination of Contract on assignment of rights of demand (assignment agreement) the following points deserve special attention:

a. Number and date of a bank loan contract;

b. Number and date of the Mortgage contract;

c. Address of the mortgaged property;

d. The cost of the assignment of rights of demand;

e. The contract shall be signed by the authorized persons of a partner-bank and the KMC, and signatures shall be certified by seals of the organization.

15. The act of transfer and acceptance must be in approved format. The act must include: by which partner- bank, to which organization and which documents are being assigned, title and number of documents; originals and copies of documents; name of a company, departments, the employees' full names and signatures, who have transferred and received a credit file with the borrower and pledger documents.

Shabanov A.Zh.

Deputy Director of

Mortgage Data Processing Center

Chief of Loan Servicing Department

8 ANNEX 3 - KMC Existing Parameter Requirements

Parameters Required on all mortgage applications

Partner bank	1	Bank Identification Code (BIC) of a partner bank
	2	Unique loan code of a partner bank
	3	Type of a lending program
	4	Priority
The data on a borrower	5	The borrower's surname
	6	The borrower's name
	7	The borrower's patronymic
	8	The borrower's date of birth
	9	The borrower's sex
	10	The borrower's tax payer number
	11	Identification document
	12	The number of an id doc
	13	The date of issuance of an id doc
	14	The authority that has issued the id doc
The data on a co-borrower	15	The co-borrower's surname
	16	The co-borrower's first name
	17	The co-borrower's patronymic
	18	The co-borrower's date of birth
	19	The co-borrower's sex
	20	The co-borrower's tax payer registration number
	21	Identification document
	22	Number of identification document
	23	Date of issuance of identification document
	24	The authority that has issued the id doc
The data on a pledger	25	The pledgor's surname
	26	The pledgor's first name
	27	The pledgor's patronymic
	28	The pledgor's date of birth

	29	The pledgor's sex	
	30	The pledgor's tax payer registration number	
	31	An id doc	
	32	The number of an id doc	
	33	The date of issue of an id doc	
	34	The body that has issued the id doc	
Income and expenses	35	Type of income	
	36	The amount of income	
	37	Type of expenses	
	38	The amount of expenses	
Insurance	39	Type of insurance	
	40	The amount of insurance policy	
	41	The date of issue of insurance policy	
	42	The date of expiry of insurance policy	
The data on a housing	43	The number of the housing in the register (list)	
	44	The status of the housing	
	45	The housing's address	
	46	The quantity of rooms	
	47	The total area of the housing	
	48	The living area	
	49	The date of purchase and sale contract	
	50	The organization that has registered the housing	
	51	The cadastre number of the housing	
	52	The data on appraisal of the housing	The price of the housing under purchase and sale contract
	53		The price of the housing according to an appraisal act
	54	Mortgage Contract	The number of a mortgage contract
	55		The date of a mortgage contract
	56	Mortgage Certificate	The number of mortgage certificate
	57		The date of mortgage certificate
The data on a loan	58	The number of master agreement	
	59	The number of contract on trust management (beneficial ownership)	

	60	The code of loan use goal (from the directory)		
	61	The loan amount on the bank loan contract		
	62	The amount of the rights of demand to be ceded (assigned)		
	63	Loan period		The date of decision of a credit commission on origination of a loan
	64			The date the loan is extended
	65			The date of expiry of the loan
	66			The date of first instalment on a loan
	67			The date of a month a monthly payment on a loan is to be effected
	68	Loan rates		The interest rate as of the date the loan is extended
	69			The company's spread
	70			Partner bank's margin
	71			The inflation rate as of the date the credit commission adopts a decision to extend a loan
	72			Prepayment fee
	73	Loan documents	Bank loan contract	The number of a bank loan agreement
	74			The date of bank loan agreement
	75		Contract on cession (assignment of rights)	The number of a cession contract
	76			The date of a cession contract

The above requirements are sufficient for meeting the needs on the credit scoring application.

It is recommended that additional data related to the employment be obtained to include the name and address of employer, position held, length of time employed. Where employment is less than two years, the names of previous employers should be obtained.

It is recommended that a balance sheet type of application be used - one that collects a borrowers assets (vehicles, other property, other assets) in detail as well as a list of all liabilities (name of creditor, balance, payment) in detail in order to establish the NET WORTH of a borrower.

It is recommended that guarantor's provide the same amount of information as borrowers need to provide. All guarantors must be treated as the principal borrower during the qualification and approval phase.

9 ANNEX 4 - SCOPE OF WORK:

1. In close consultation with the KMC, the consultant would complete the following tasks:

- Analyse and understand the Mortgage Company's strategic vision and short term objectives as well as workflow/scoring system requirements and outputs. The consultant will:
- Describe data sources which will be used during the processing of applications coming from banks and insurance companies
- Determine different roles and users of the workflow/scoring system
- Lay out data evaluation criteria in order to determine risk levels and lending tolerances.
- Describe existing and developed credit products as well as potential segments of mortgage customers
- Develop a matrix, based on the evaluation criteria, which would segregate potential borrowers into separate "risk buckets" based on internal risk criteria.
- Criteria would be tied to different products and customer segments.

2. The consultant will prepare a Request for Proposal (RFP) for distribution to data processing "solution" providers with expertise in mortgage lending.

- In addition to the material outlined in point 1 above, the RFP would include expected times lines and delivery dates.
- RFP will specify clearly the content of the proposals and conditions, which any provider has to fulfil by his proposal.
- RFP will specify the structure of the prices and business conditions in order to make further proposals comparable.
- Together with RFP the consultant will prepare the list of potential providers, to whom the RFP document will be addressed
- Prepare for the KMC a memo, based on the RFP, with additional recommendations, observations, and work flows that go beyond the information contained in the RFP. The memo would be for the KMC's internal use.
- The consultant will participate in final negotiations and evaluation of collected proposals. The KMC will make all final decisions.

10 ANNEX 5 - Scope of Work as provided by KMC

Questions for the Advisor which Need to be Addressed in the Final Report

1. Business processes associated with the purchase and maintenance of mortgage loans in JSC Kazakhstan Mortgage Company (JSC KMC)

1. ***Questions Regarding the Process of Acquisition of the Right of Demand on Mortgage Loans***

1.1 Evaluation of the main requirements of the JSC KMC applied in the acquisition of the rights of demand on mortgage loans. – existing underwriting requirements are very good.

1.2 To which extend they provide for the credit scoring and whether additional parameters are necessary? – they provide 95% of the basic parameters.

1.3 What is the significance of the parameters required in making decision on the loan extension? – they are all important and are all required

2. ***Questions Regarding Credit Maintenance***.

2.1. In case of data processing in a computerized manner what will be the part, which is still necessary to be processed manually by analysts and at which stage the analytical work will be necessary. – the amount of manual processing can be reduced but not significantly. Instead of performing manual calculations, the AIS will perform them. However, there will still be a need to confirm all documentation has been provided as well as the need to cross check the accuracy and completeness of the information in the document as it compares to the scoring application.

2.2. Your assessment of JSC KMC concerning the following: IT, information processing rate; a two stage division of the transaction approval; transaction reversal process. – information processing rate appears to be slow. Two stage division of transaction approval is required and in line with international best practices. Transaction reversal process appears satisfactory with no suggestions for changes.

2.3. Is it possible that the credit officer will work at a distance, how does this method work in practice, the efficiency of this method? – yes, with software the credit officer will be able to review and approve transactions based on the scoring system. There will still be a need to handle some applications manually and refer them to higher authorities for approval.

2.4. To which extend the existing PTI and LTI ratios describe the borrower's solvency? – they are adequate based on information available. With the deployment of credit scorecards, the ratios will vary for different sub groups as the ability to create and monitor sub groups is established.

2.5. The optimal limit of LTV? – same response as 2.4.

2.6. Is there a need to introduce other ratios? One additional suggestion is the calculation of NET WORTH – the amount of assets a borrower has in excess of their liabilities.

2.7. To which degree the existing insurance programs diminish credit risks? Insurance diminishes risk. However the lender must NOT depend upon insurance to mitigate risk as an unacceptable level of losses from insurance companies will drive up the premiums.

2.8. Which frequency should be used in the revaluations of the pledged property? – this will depend largely upon the collection process. If the mortgage is not in default, and the total economy of the area does not change drastically, then no real need for frequent revaluations. However, in the case of a default, it should be one of the first steps to collection and measurement of current exposure.

2.9. Decrease/increase of the main requirements to the pledged property – existing requirements are satisfactory. Suggest a very strict and rigid process for approving those who are authorized to perform appraisal reports. The appraisers need to be monitored for accuracy in their evaluations. There are some very good bench marks currently available to test reasonableness of appraisal reports.

3. ***Questions Regarding the Methodology of the Credit Scoring***.

3.1 What credit scoring methods exist? – basically there are two - credit RISK scoring and credit SCORECARDS. Many different variations and terms used to describe the types of each of these two.

3.2. The quantity/quality of parameters of the score card? – the existing parameters meet basic requirements. The lack of a CREDIT RISK score in any scorecard diminishes the value of the scorecard. There are additional parameters such as age demographics, employment types, income, and net worth that will assist with the evolution of industry specific scorecards until KMC has collected enough data to more to a CUSTOM scorecard exclusively for KMC. A "custom" scorecard is the ultimate goal.

3.3. What additional parameters we have to use in conjunction with our legislation based on the local specific properties. – was not able to identify additional parameters.

3.4. Division of the approved parameters into 3 stages of the scoring program – there are different definitions of the three stages of the scoring program. This section is the single biggest part of the final report and will address all stages needed during the underwriting and decision processes. Please refer to the final report for a more detailed analysis of this section.

3.5. Underwriting criteria used in JSC KMC, their assessment and comparison with the world practices. – KMC has excellent underwriting processes and is definitely well within the scope of any international mortgage lending institution. While their approach can be described as somewhat conservative, I fully support the conservative methodology until such time as data is available to empower KMC to depend on credit risk scoring in their underwriting process.

4.0. Findings and Proposals.

2. IT Technologies on the Computerized Processing of the Mortgage Loan Data in JSC KMC

2.1. Analysis of the technical requirements regarding the establishment of the automated information system (AIS) of JSC KMC. Findings and proposals**.** – findings indicate a well thought out framework. Proposals to be included in the final report.

2.2. Analysis of JSC KMC's AIS performance. Analysis of the existing level of automation of business processes compared to international practices. – there is a lack of automation in the existing levels of automation. Opportunities exist for additional automation.

- Level of the equipment and software used; - client server environment used and has met the need to date. There is a concern that existing software will not be capable of keeping pace with the KMC growth requirements
- Capacity of the server equipment; - no analysis other than a brief conversation of server requirements was performed. Based on the leadership and the management of the IT Department, there is no question that the current management has an outstanding grasp of hardware requirements.
- Velocity of the information processing in AIS of JSC KMC; - a concern that the existing infrastructure will not meet future requirements
- Software support and maintenance practices compared to the international practices; - all are within best practices of international software providers.
- Other; - additional comments will be included in the final report.

2.3 Analysis and the evaluation of the electronic information exchange system (FASTY) between JSC KMC and the partner banks. Conclusions based on the evaluation. – existing FASTI handles the communication and security layers of the existing infrastructure adequately. In the longer term, there is a need to move to a web based application only after the security requirements and risks can be addressed.

2.4 Proposals on the improvement of the computerized processing of the information in the JSC KMC. – numerous suggestions and proposals. To be detailed in the final report but will include:

1. Business Rules Managements Systems to address specific KMC business rules
2. A complete Automated Underwriting System to manage and monitor the mortgage lending process from application to final purchase.
3. Introduction of Industry Specific Scorecards to mitigate credit risk
4. Implementation of a Decision Engine to make credit decisions.
5. A document management system.
6. A Management Information System for portfolio analysis and on going scorecard modification

7. Lastly, a clearly defined roles and responsibilities of those ultimately responsible for the overall portfolio quality.

3. Establishment of the Scoring Center in JSC KMC

3.1 The main provisions and requirements associated with the establishment of the JSC KMC Scoring Center.- refer to responses above, including but not limited to 2.4

3.2 Analysis of the operational scheme between the JSC KMC Scoring Center and the partner banks. –adequate but there is a need for clear definitions of roles and responsibilities for data collection as well as credit investigation. Evaluation of the proposed scheme. – appears sound, more detail to follow in final report.

3.3 Requirements on the cooperation between the credit scoring system and the automated systems of the Credit Bureau and other sources of information (the Pension Funds, Tax authorities and others – required, the better the data, the better the decision.

3.4 Review of the existing the mortgage loan automated scoring systems in significant international companies, their analysis and comparison. – there is currently lots of variation. The new KMC AIS will be a world class leading application.

3.5 Steps in the selection and introduction of the scoring system in JSC KMC.- collect business requirements, prepare business case and tender, and send to prospective providers.

3.6 Technical requirements to the selection of the credit scoring system for JSC KMC.- will depend upon platforms of suppliers.

3.7 Selection criteria regarding the credit scoring system.- refer to RFP (tender) for detail as this will be a complete and a comprehensive requirements document

3.8 Practical application of the credit scoring system for the mitigation of the JSC KMC's credit risk.-will be mandatory if KMC is going to be able to meet volume expectations.

3.9 Evaluation of offers of SAS, EXPERIAN, SNOUCACTUS. Findings and proposals. – too soon, need to go through the complete RFP (tender) process. Review of Experian indicates a complete and total system but have concerns related to the complexity of the system. Will be in better position to evaluate at a later date.

3.10 Findings and conclusions regarding the establishment of the Scoring Center in JSC KMC.- A good way to go. Well thought out by senior management. Has tremendous opportunities in a variety of ways.