

**The Pragma Corporation
Financial Sector Initiative
Twentieth Quarterly Report
For the Period
May 22, 2005 – August 21, 2005**

**For the
U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT**

GENERAL INFORMATION

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ALMATY, KAZAKHSTAN

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A. PROJECT OVERVIEW

I. PROJECT DESCRIPTION

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

In September 2001, Mr. Rick Gurley, the CTO for the USAID/CAR Mission, approved the Work Plan that set forth the priorities of the Project *through its completion date*. In August, 2002 Dr. Lewis Tatem became the new CTO of FSI. During the eighth quarterly review, Dr. Tatem approved FSI's work plan through the remainder of the first option exercise, August 2003. In July, 2003 FSI reviewed its activities and received notification that USAID would exercise its option to have FSI continue. In late August, FSI and USAID mutually agreed on revised expected results. 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"
- START OF THE ANALYSIS FOR THE DEVELOPMENT A STATE ANNUITY COMPANY PROJECT REQUESTED BY THE FSA
- PROJECT FOR IMPROVING THE REGULATORY FRAMEWORK AND INVESTMENT CLIMATE FOR ACCUMULATION PENSION FUNDS WAS COMPLETED
- ACCELERATION OF ACTUARIAL TRAINING PROGRAM TO PROVIDE GREATER SUPPORT FOR A SELF SUSTAINING ACTUARIAL TRAINING OF LOCAL EXPERTS WAS DELIVERED
- A PROJECT WAS UNDERTAKEN FOR THE SMALL ENTREPRENEURSHIP DEVELOPMENT FUND TO DEVELOP A SUSTAINABILITY ANALYSIS AND TO DELIVER CREDIT TRAINING FOR THE STAFF OF THE FUND
- PRAGMA/FSI FACILITATES SECOND MONETARY POLICY ROUNDTABLE AT NATIONAL BANK OF KAZAKHSTAN

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- PRAGMA/FSI ASSISTS IN SECOND CERTIFICATION COURSE FOR TRAINING OF TRAINERS FOR THE REAL ESTATE INDUSTRY THROUGH THE ASSOCIATION OF REALTORS OF KAZAKHSTAN (ARK)
- DOUG WHITELEY BEGINS A TRAINING ASSESSMENT FOR THE KMGF
- 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

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 May-Aug. 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 (the Council of Issuers under the Association of Financiers of Kazakhstan – AFK) on May 26th as recommendations to the Parliament.

The Second Monetary Roundtable was held June 3rd at the Hyatt Regency. The roundtable was sponsored by USAID with the assistance of the Pragma Corporation's Financial Sector Initiative project. Hosting the roundtable was Anvar Saidenov Governor of the National Bank of Kazakhstan. Representing USAID was Mary Norris Regional Director, Office of Enterprise and Finance USAID/Central Asia. There were three presenters, Mr. Mohamedi is currently Chief Economist and Senior Director, of The Petroleum Finance Company (PFC Energy). Dr. Patrick Conroy a professor Conway teaching Economics at the University of North Carolina at Chapel Hill and Dr. Harvey Rosenblum, Dr. Rosenblum is currently a Senior Vice President and Director of Research, Federal Reserve Bank of Dallas.

Insurance/Pension

During the quarter under review, foreign consultants aided by local staff began a comprehensive study of the potential annuity markets which may arise as a result of recent legislation, including legislation establishing the State Annuity Company. Two types of annuities are at issue: (1) pension annuities, or whole life annuities purchased by pensioner upon retirement, and (2) disability annuities, or period certain annuities purchased by an employer for employees disabled by a workplace accident.

The primary complicating factor in both cases is the lack of reliable mortality data. Annuitant mortality tables for Kazakhstan exist, but they were introduced only this year and have yet to be tested against actual mortality rates. Disabled mortality tables have yet to be developed; it is questionable if the necessary data is even being collected in the proper format. In any event, potential annuitant pools will remain for the foreseeable future too small to constitute valid statistical samples, meaning that true mortality rates, which are absolutely critical to the pricing of whole-life annuities, will only be available in the distant future.

A second complicating factor for annuity development is the lack of long-term investment instruments. Also critical to the proper pricing of any kind of annuity is the ability to invest at the yields and terms implicit in the benefit payment to the annuitant. The current investment climate in Kazakhstan is not conducive to annuity product development.

It will be the objective of the study begun during this quarter to quantify the risks of starting an annuities market in Kazakhstan under current conditions.

Also during the quarter under review, Pragma/FSI continued its work with FSA and the asset managers (KUPA) of the private accumulation pension fund system with a view to strengthen current regulation regarding investments and benchmarking. Of primary concern in this regard is the management of risks associated with foreign investments—specifically, hedging the currency risks which arise from holding foreign currency-denominated assets against tenge-denominated liabilities. Unable to hedge currency risk, asset managers are likely to avoid foreign investments, exacerbating the shortage of tenge-denominated investments of terms comparable to those of pension fund liabilities.

Pragma/FSI with the assistance of foreign consultants focused specifically on the possibility of developing either a tenge-dollar futures market or a tenge-dollar swap market.

Actuarial Training Program to Provide Greater Support for a Self Sustaining Actuarial Training by Local Experts began with courses being given by annuity experts Mike Sze and Mo Chambers. The first training course 6B began on August 8th for 6 days of training. Course 6A was taught from August 8th for 12 days.

The actuarial training program of Kazakhstan funded by the USAID during the last 5 years has been very successful. An actuarial profession has been established and local actuaries

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have participated in the development of insurance, pension, and other market economy activities in Kazakhstan. In accordance to USAID/FSI plan, the local actuaries are gradually taking over the actuarial training program. Our target is to produce 20 fully qualified actuaries who have passed all six actuarial examinations by the end of 2008. However, based on discussions in June with Kanat Dosmukametov, Vice Chairman of the Financial Supervisory Agency of Kazakhstan (FSA), there is a strong need to accelerate the actuarial training program for the following reasons:

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.

Mortgage

The Association of Realtors of Kazakhstan (ARK) completed the Student's Manual for a pilot pre-certification course. Each section was reviewed by expert trainers and approved. Once complete, the book was sent to Galina Nikolskaya, Deputy Director for the National Training Center, Russian Guild of Realtors (RGR) Moscow, Russia. Ms. Nikolskaya gave positive feedback on the workbook. Development of the Final Exam to be used for certification was developed. Each section of the test was reviewed by the experts who would teach that section and interim quizzes were developed to help the students know if they understood the material.

The consultant Doug Whiteley arrived in June to begin a needs assessment for the KMGF. He was specifically asked to review the following:

- Identify the current strengths and weaknesses of the KMC staff and make recommendations to what areas of training are needed.
- Identify and make specific recommendations on the type of international experts that are required for training in the area of mortgage guarantees.
- Identify institutions and make recommendations on potential candidates to be trained at leading international mortgage guarantee institutions.
- Identify institutions and make recommendations on delivery of seminars and courses on the subject of risk management, underwriting and the methodology of extending mortgage guarantees.
- Identify and make recommendations on the appropriate countries that can be used for developing training literature.

Credit Bureau

Work to bring the server room into compliance with the FSA's requirements has started. Companies engaged in construction and electrical works, as well as suppliers of air conditioning systems, anti-fire alarm systems and video monitoring systems have been selected. The FCB has signed services contracts work has begun.

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FCB orders equipment for server room and back-office. Purchases of furniture, office appliances, telephone sets, etc. was begun and is ongoing.

The CB Initiated actions to obtain the software certificate from Kazakhstan's Agency for Informatising and Communications. Office premise upgrade ongoing. FCB continues to hire staff.

IV. PROJECT STAFFING

The following personnel were engaged in project activities this quarter:

- John K. Pascal, Chief of Party (from January 20, 2005)
- Stephen S. Moody, Resident Senior Advisor, Financial Instruments, Mortgage, Pension/Insurance
- Javier Piedra, Resident Senior Advisor, Credit Bureau
- Michael Sze, Consultant, Actuarial
- Patrick Conway, Professor, University of North Carolina at Chapel Hill
- Rosenblum Harvey, Senior Vice President and Director of Research, Federal Reserve Bank of Dallas
- Mohamedi Fareed, Professor, University of North Carolina at Chapel Hill
- Douglas Whiteley, Consultant, Mortgage Insurance
- Martha Kelly, Consultant, State Annuity Company
- Morris Chambers, Consultant, Actuarial
- Paul Carlson, Senior Consultant
- Charles Rubin, Senior Consultant

V. ADMINISTRATIVE

None.

LIST OF ATTACHMENTS

1. Final Periodic Review of FSI.

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 May 22, 2005 through August 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. Secondly, the Financial Instruments Component is intended to extend the yield curve of the Kazakhstani corporate bond market by facilitating the issuance of longer maturities, and to upgrade the quality of new issues by introducing credit enhancement techniques, and by improving both bond indentures and investment memoranda.

II. SIGNIFICANT EVENTS

- PRAGMA/FSI FACILITATES SECOND MONETARY POLICY ROUNDTABLE FOR THE NATIONAL BANK OF KAZAKHSTAN
- PRAGMA/FSI CONTINUES TO WORK TO AMEND THE MINFIN VERSION OF THE LAW “ON SECURITIZATION”
- DEVELOPING FUTURES OR SWAP MARKETS FOR PENSION FUNDS

III. EXECUTIVE SUMMARY

Second Monetary Roundtable

The Second Monetary Roundtable was held June 3rd at the Hyatt Regency. The roundtable was sponsored by USAID with the assistance of the Pragma Corporation’s Financial Sector Initiative project. Hosting the roundtable was Anvar Saidenov Governor of the National Bank of Kazakhstan. Representing USAID was Mary Norris Regional Director, Office of Enterprise and Finance USAID/Central Asia.

The roundtable began with welcoming remarks and presentations by Governor Saidenov and E&F Regional Director Mary Norris.

The first speaker was **Fareed Mohamedi** his topic was “Kazakhstan the Implication of Oil on Monetary Policy the next 10 years”. Mr. Mohamedi is an international economist with over 20 years experience in consulting firms, credit rating agency, research institutes, multilateral organizations, and finance ministry. He has advised a wide variety of corporate and government clients on global economic developments, structural adjustment policy issues, and external debt/investment challenges facing Asia, Latin America, Middle East, Former Soviet States, and Africa He is a recognized expert on the Persian Gulf, OPEC dynamics, and global oil markets

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Mr. Mohamedi is currently Chief Economist and Senior Director, of The Petroleum Finance Company (PFC Energy).

Mr. Mohamedi was chosen to speak first as oil reserves and the price of oil remains key to the direction of the economy of Kazakhstan and National Bank monetary policy operations.

Some highlights of his presentation

Mr. Mohamedi's presentation was divided into four sections

- Short term oil markets
- Are we in a world of "peaking oil"?
- What are other oil producers doing?
- Some suggestions for Kazakhstan

The biggest contributors to the rise of oil to over 50 dollar per barrel are

- Stretched infrastructure, refinery and tanker bottlenecks
- Low Supply Growth
- Shrinking OPEC Spare Capacity
- Supply Anxiety
- Political Risks
- Speculative dollar flow

Oil demand growth remains tightly correlated to economic growth. The rise of Asian economies in the 1990's has helped re-establish this relationship.

- China's soaring growth impacts all regions of the world
- US product demand also stays strong gasoline and diesel underpin growth
- Refiner utilization is stretched
- FSU is the only region with significant spare capacity

Can Supply Keep Up With Demand in 2005?

- Supply growth outside of OPEC quota in 2005 will fall 825,000 b/d short of demand growth.
- OPEC will work to fill the gap by increasing output nearly 800,000 b/d and by pushing output in the second half to new highs.
- However, the organization's spare capacity will remain tight and its marginal barrel will still not be the light sweet crude the market most needs.
- Non-OPEC supply will step firmly into a new era this year:
 - Russian supply growth will slow.
 - The next big wave of mega-projects (from deepwater and Central Asia) will start to come online in earnest.
 - Mature Non-OPEC regions will see an accelerating pace of declines.

Why Is OPEC Not Able To Respond?

- Wrong type of crude. Total crude supply is increasing but sweet crude production is flat

Price of crude is increasing somewhat due hedge fund speculation

- Sliding dollar and low interest rates
- The recent rallies of the last three months are related to pouring money into the oil futures market by all types of investors.
- Investment in commodities is a great opportunity to cash in Asian growth, but a growing problem for the stability of oil prices

Key Messages

- The world is not in imminent danger of running out of oil, but certain countries/regions are depleting much faster than others. This will cause a shift in the geographic dominance of production sources.
- In spite of high oil prices, Non-OPEC production has been stagnant with the notable exception of the FSU. This trend is likely to continue through this decade.
- Exploration results in the last 10 years (with a few exceptions like Angola, Sudan, Mauritania) have been much less significant than in previous decades. Without a significant reversal of this trend, Non-OPEC production is likely to peak just after 2010 and begin a long term decline.
- Every year, in every region (including OPEC), the world produces more oil than it finds. It is only logical to conclude that inevitably this will lead to dwindling supplies.

Kazakhstan Oil Production Forecast

- Oil production should peak in 2021

How long can OPEC production be able to fill the growing gap between demand and non-OPEC production capacity.

- In a low demand growth scenario, OPEC production will likely meet global demand through the end of the next decade but not beyond 2025.
- In a base case demand growth scenario, OPEC production will likely not be able to meet global demand in the latter part of the next decade.
- In a high demand growth scenario, OPEC production will likely not be able to meet global demand as early as the middle part of the next decade.

Some Suggestions for Kazakhstan

- Understand and monitor oil markets:
 - Expect volatility in oil markets:
 - Understand the impact of Kazakhstan production on oil markets
 - Understand the behavior of other oil producers
 - Get a real understanding of the capabilities of your own oil and gas sector:
 - What is the long term production profile of your sector? Don't take it for granted
 - What do you want from the oil and gas sector?
 - You can do a lot more than extract rents
- Building a oil and gas sector to promote development:
 - Backward linkages:
 - Gas as an engine of growth
 - Oil services and engineering

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- The Norwegian model
- Oil/gas sector policies are any important signal for FDI promotion
- Build a national oil company with a long term vision:
 - Devise a strategy to make it a viable private company
 - Use it to develop indigenous skills
 - Do not give ita all the assets – have some competition
 - It should not make policy – but give it a stable planning horizon
- Fiscal policy (and exchange/monetary policy) should take into account your oil/gas sector developments:
 - Understand your long term revenue potential
 - Integrate longer term saving plans with oil/gas sector revenue and investment potential

The second speaker **Professor Patrick Conway** who spoke on Exchange Rates and the Alternatives to Exchange Rate Policy

Professor Conway is currently teaching Economics at the University of North Carolina at Chapel Hill. His teaching responsibilities include courses on both the graduate and undergraduate level in macroeconomics, economic development and international economics. Recent academic research has focused on the problems of developing and transition countries in adapting to the international environment.

Professor Conway has Ph.D. in Economics, Princeton University, Master in Public and International Affairs, from the Woodrow Wilson School, Princeton University and an undergraduate degree from the Georgetown University School of Foreign Service

The Export Boom in Hydrocarbons

- Blessing:
 - Windfall gains in export receipts.
 - Surplus on the government budget due to taxes and royalties on hydrocarbon production.
- Curse?
 - Inflation is rising.
 - Excess liquidity.
 - Non-renewable, exhaustible, resource.

What are the three Challenges?

- Creating a transparent and effective exchange-rate regime for Kazakhstan.
- Making the exchange-rate regime consistent with inflation targeting.
- Providing for future generations through contributions to the National Fund.

Recommendation 1: Accept that the real exchange rate will appreciate on average

- Increased export receipts become an increased demand to purchase tenge. In a flexible regime, this will lead to nominal appreciation.
- The increased income from the windfall leads to increased expenditure and Dutch disease effects, including real appreciation.

Looking at real rates of exchange of the tenge versus the Dollar and Euro

- The biggest increase in real rates of exchange has been against the dollar
- But the weighted real rate of return has been fairly consistent, which would indicate that much of the appreciation of the tenge against the dollar is not been because of oil revenues, but more associate with the weakness in the dollar against over all.

Recommendation 2: Managed exchange rate regime, plus.

The current methods used by the NBK have been working and are the best way to go. Most importantly is set a strategy for exchange rates, currently the exchange rate regime is reactive.

- Why not a flexible regime?
 - Desirable properties if it works.
 - “Fear of floating”
- Why not a fixed regime?
 - Desirable if credibility is a problem, and if there is one dominant trading/financing partner.
 - These don’t seem to be the case in Kazakhstan.
- Managed: already evidence that NBK does it well.
- To do: Careful attention to desired parity.
 - Simple rules (fix currency value with price of oil). The professors from Harvard have suggested that the exchange rate be fixed to oil, this is not a good idea since it will reintroduce volatility
 - Elaborate modeling exercises (monetary CGE models).
 - Periodic revisions

Recommendation 4: Integrate exchange-rate policy with other macro policies

- Dutch Disease outcomes are inevitable with this real appreciation considered in isolation.

Some sign’s of the Dutch Disease as there has been some reduction in the manufacturing sector

- Sectoral development policies can be combined with these to mitigate effects.

The NB needs to include other sectors of the government such as the Minter of Economy in the exchange rate dialogue to explain their exchange rate policy.

Recommendation 5: Recognize and exploit the inflation-targeting benefits of the National Fund

- National Fund has two explicit roles: stabilization from year to year and saving for future generations.
- The National fund has an implicit role in reducing the real appreciation necessary in the current generation – this also limits the inflationary potential of the oil windfall.
- A new way to achieve this: lower the “trigger price” of oil in the Republican Budget Law.

- Needed: more thought and transparency on the policy for disbursements from the saving component of Fund.

How Can We Integrate Policies and Remain an Independent Central Bank?

- Transparency is the key.
 1. NBK Sets Policy and Analyzes Impact
 2. NBK alerts rest of government to consequences and possible mitigating steps
 3. Government debates, implements mitigating steps

The final speaker was **Dr. Harvey Rosenblum** whose topic was Instruments for Monetary Policy in Kazakhstan

Dr. Rosenblum is currently a Senior Vice President and Director of Research, Federal Reserve Bank of Dallas. He has served as Chief Economist and Economic Policy Advisor to the Bank's president for Federal Open Market Committee and other matters related to monetary policy and related regulatory issues. His responsibilities included providing monthly economic briefings to the Bank's Board of Directors. He has served as a member of the Bank's Senior Management Committee and the Discount Committee. He has also worked at the Federal Reserve Bank of Chicago as a Vice President, Director of Research

Dr. Rosenblum has a Ph.D in Economics, University of California and a B.A. in Economics, University of Connecticut.

His presentation focused on three main topics: 1) the appropriate goals for monetary policy in Kazakhstan; 2) the choice of instruments for achieving these goals; and 3) special considerations like the impact of changes in energy prices and bank safety and soundness issues.

The National Bank's current monetary policy settings seem appropriate for the present-day situation. Fiscal policy is somewhat restrictive in that the government is running surpluses, given the contributions to the National Fund. Monetary policy, as suggested by low and negative real rates of interest, is somewhat expansionary. But the thrust of overall economic policy is the sum of fiscal and monetary policy, and this combined impact of the two policies is supportive of continued economic growth.

Kazakhstan has had exceptional economic growth over the last few years and I urge caution in changing your current economic policy just because it is a popular new trend in other economies.

A change to formal inflation targeting would require a more restrictive monetary policy, now is not the best time to make such a change because it would remove much of the growth momentum in the economy and would slow the rate of economic development.

At the present time, one important role for the monetary policy of the National Bank is to build the public's confidence in the financial future of the economy and its financial system. Strong economic growth is helpful to achieving this end. Current rates of inflation of around 7 percent the government needs to provide an incentive for people to earn a rate of interest on their spare cash balances by keeping their money in the banking system. This will continue as long as the economic future looks good and people believe the banking system is honest

and sound and that deposit insurance is real and dependable. Without a deposit system, the ability to create a viable credit system would be diminished.

Over the last decade, two trends have emerged around the world that are changing the nature of central banking. The first is the practice of inflation targeting, and the second is the separation of monetary policy from the supervision and regulation of the financial system. Central banking is a man-made invention designed to mitigate and hopefully prevent financial instability. In order to do so, central banks must be able to influence both the economy's credit expansion and the financial sector firms that are an integral part of the credit creation process. Unfortunately, we do not live in a world in which these issues can be isolated from one another. Monetary policy settings have an important impact on financial intermediaries. A healthy banking sector is critical for the transmission of monetary policy.

Inflation Targeting: Many central banks have, by law or by choice, begun to practice explicit or implicit inflation targeting. Generally this involves setting an upper bound for inflation and tightening policy whenever inflation threatens to move above the upper tolerance limit. Some central banks also set a tolerance limit for the lower bound of inflation they are willing to live with. This latter practice has become more widespread in recent years as the potential for deflation has become a concern in a few countries. As mentioned above, some central banks have an implicit inflation target or band that gets communicated to the public and financial markets in an informal manner. The important issue is central bank behavior/action as inflation moves toward the upper or lower band.

His impression from visiting with some members of the staff of the National Bank of Kazakhstan ("NBK") is that NBK targets inflation in an implicit way because there is a professed goal of "price stability," but no explicit statement of an upper or lower bound for inflation that would necessitate a predictable tightening or easing of monetary policy. An inflation forecast or projection (as contained in the NBK's *Inflation Report for First Quarter 2005*) is not the same as an inflation target because the monetary policy response remains unclear.

NBK should be commended for analyzing a range of inflation measures in its Q1 2005 *Inflation Report*, including several measures of "base" or trend inflation that paint a more benign picture of inflationary pressures in the Kazakhstan economy. When he first looked at the Q1 report it appeared that inflation was in the 7-7.5 % range, but by removing the more volatile components of inflation, trend inflation, as shown by the "trimmed mean" and CPI median measures, is likely in the 3.0-5.5 percent range. These measures have proven quite useful for interpreting inflation trends in the United States and may also be helpful for Kazakhstan. Every country has its own group of volatile inflation components and he recommends that NBK analyze which inflation measures correlate best with future movements of overall inflation. The Dallas Fed has been experimenting with a trimmed mean indicator and it appears to be quite successful in

He also recommends that NBK work closely with the Kazakhstan Statistical Agency to develop some unique inflation measures that more meaningfully represent the inflation impact on the median citizen of Kazakhstan. GDP has grown extremely rapidly in recent years, the availability of and demand for higher quality (and thereby more expensive) goods and services may be upwardly biasing the measures of inflation if careful quality adjustments are not being made. He also suggested that, in addition to analyzing price inflation the NBK should use measures of wage inflation. It may very well be the case that if "properly measured," overall inflation may be running at half, or even less than half, of the 7 percent rate that is thought to prevail. In short, if NBK is considering a move toward inflation

targeting, it is critical that careful analysis take place first on the best inflation measure or measures to be targeted.

Another consideration to consider if the NBK is going to full inflation targeting is the impact on banks and other financial intermediaries. A bank's asset mix that makes sense in an environment of inflation rates of 7-10 percent may not make sense in an environment of inflation in the range of 1-3 percent, especially if the move to the lower inflation range were unanticipated and occurred abruptly. For example, a borrower may be able to cover loan payments easily if his wages and cash flow grow at a 7 percent annual rate, but could experience difficulty if wage growth slows to 2 percent.

He cautioned the NBK about some reservations he has with inflation targeting. First, inflation targeting should be done only if a central bank is truly serious and absolutely committed to such a strategy. A halfway commitment or backtracking is simply not an option. The credibility, reputation, and integrity of the institution are at stake. Second, inflation targeting requires the explicit political support of the rest of the government and at least the implicit support and understanding of the general public and the banking system. It is the central bank's job to educate and persuade these constituencies on the cost-benefit tradeoffs of inflation targeting. Third, the central bank must be willing and committed to seriously restrain the growth of credit and raise the cost of credit whenever the rate of inflation threatens to move above the upper tolerance level that has been established. On this point, the central bank has virtually **no choice**. Proponents of inflation targeting find this to be a desirable feature. Opponents of inflation targeting, such as Chairman Alan Greenspan of the U.S. Federal Reserve System, sometimes find this to be an undesirable feature of inflation targeting if they would be forced to tighten monetary policy just as their economy is headed into a recession.

One of the key rules in the practice of medicine and central banking is "do no harm." Until a few years ago, it was my view that countries that adopted inflation targeting did not need inflation targets to reduce inflation in their economy. The same results could have been achieved by carrying out the same policy settings without inflation targets. But inflation targets did no harm. Many central banks achieved similar disinflation results without inflation targeting. The differences were not statistically significant. However, over the last couple of years I have begun to wonder whether inflation targeting has locked some central banks into inflexible policy settings that may be restraining the ability of their economies to reach their full, long-term growth potential.

In this regard, the main issue is the banking system's "excess liquidity" discussed by Oldrich Dedek and Steve Moody at the April Roundtable. If NBK desires to reduce the rate of inflation, it is necessary to restrain the rate of credit growth in the economy by absorbing the banking system's excess liquidity. To do this, the first step involves constraining the liability choices of the banks and their rate of growth.

Currently, banks hold reserve balances at NBK of 6 percent on liabilities maturing in less than two months. He suggested extending reserve requirements to a wider range of liabilities, irrespective of maturity.

NBK may wish to consider having a higher reserve requirement ratio on liabilities raised outside Kazakhstan. This broader, and possibly higher "reserve requirement tax" on banks, would reduce excess reserves and would reduce the costs of operating NBK. This would put upward pressure on interest rates and likely reduce the asset size of the banking system. This could also reduce the profitability of banks, and therefore should be phased in gradually and carefully.

He concurred with Mr. Dedek's recommendation that NBK needs to select a single, highly visible policy instrument that communicates clearly any change in NBK's policy stance.

Because the discount rate applies only to the lender of last resort facility which is rarely used, the discount rate cannot serve this purpose. Consideration should be given to establishing a ending facility sometimes called a “Lombard facility” from which banks can borrow from NBK on a regular basis with the proper collateral at a pre-announced interest rate established, say, weekly. The rate should be set just above the open market rates for short-term funds.

If NBK wishes to stick with its current mix of policy instruments, the repo facility can be used instead of a Lombard facility. The only difference is that the repo rate is primarily market driven (but influenced by the central bank’s use of other policy instruments). The Lombard rate is set administratively with guidance from the market. The Lombard rate is a publicly announced rate set by a conscious, periodic decision of the central bank, and thereby conveys important information about the changing stance of monetary policy. If excess reserves are absorbed through higher reserve requirements, it is likely that NBK can narrow the band on the repo rate and keep the reserve situation sufficiently “tight” to keep the repo rate within the repo band, unlike the situation that currently prevails where the repo rate typically falls below the lower repo band.

NBK has all the instruments it needs at its disposal. The objective should be to convert the banking system from one which is virtually unconstrained in its potential credit expansion to one that is constrained in its ability to grow its aggregate balance sheet by the reserves provided by NBK. This is called a “reserves constrained banking system.” At the margin, the banking system cannot grow unless the central

Other Considerations

The recalibration of the instrument settings needs to occur gradually with a “learn-by-doing” approach, both for NBK and the banks. Banks have become accustomed to having little or no limits imposed by NBK on their credit expansion activities. In a reserve-constrained banking system, binding limits on bank credit and balance sheet expansion will become the norm. The pricing power of bank borrowers in a lower inflation environment will also be curtailed. This impacts the ability of borrowers to repay their loans in full and on time. In this environment, banks must be even more careful in their credit risk analysis. As mentioned earlier, loans that are easily repaid when inflation averages 7 percent may be more difficult to repay when inflation is 1 or 2 percent. In this environment, NBK must co-ordinate and communicate on a regular basis with FSA, and vice versa.

He has lived in Texas since the 1980’s and he have seen the effects on an oil based economy as prices fall and rise. If there is an adverse shock to the economy, say, from a sharp decline in oil prices, many borrowers could default on their bank loans. The loan losses will result in shrinkage of bank capital. The write-down of bank capital could force banks to stop new lending entirely to meet capital-asset ratio standards, or worse, to shrink the volume of loans on the books. This would be a “capital-constrained” banking system.

In these circumstances, even if the central bank provided excess reserves to the banking system, prudential capital ratio standards would prevent banks from expanding credit, and monetary policy instruments would be ineffective in stimulating economic growth. As long as there exists a separation between NBK and FSA, there is not an effective way for both organizations to work together to internalize the tradeoffs in a way that would stimulate the economy so economic growth could resume.

Growth would be stalled until the weak banks could be recapitalized. Monetary policy is ineffective in such a situation. Such events are not theoretical. 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 event of an adverse shock, some consideration should be given to how the

Fund might be used to help recapitalize the banking system 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”

Work on the draft Law “On Securitization”. May 22 - Aug. 21, 2005

1. In the course of May-Aug. 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 (the Council of Issuers under the Association of Financiers of Kazakhstan – AFK) on May 26th as recommendations to the Parliament.
2. In Pragma/FSI’s opinion, the official draft remained below the minimum required by the rating agencies. To address this, we contacted one of the rating agencies, Standard & Poor’s (S&P), and asked them to review the draft. Pragma/FSI traveled to S&P (Moscow) to discuss both the official and our recommended drafts and the overall concept with S&P key securitization expert & legal counsel (Mr. Igor Iassenovets).
3. S&P proposed to hire their preferred international legal firm with an office in Almaty, Chadbourne & Parke (CP), to conduct due diligence on the recommended draft in the context of Kazakhstan’s Civil Code legislation
4. In August 2005, Timur Dzhankobaev was appointed to the Parliament’s (Mazhilis, the Lower House) working group on the draft law “On Securitization” to start work on Sept. 6, 2005 and to submit its final recommendations to the Mazhilis Committee on Budget and Finance on Oct. 26, 2005, in accordance with the Committee’s Resolution. The plan was to defend the recommended draft in the Mazhilis working group while waiting for the results of S&P/ CP due diligence/ formal review process from the standpoint of S&P legal criteria for structured finance.

Developing Currency Futures or Swap Markets

Recent amendments to Pension Fund prudential norms now allow private accumulation pension funds to use derivative instruments to manage specific investment risks. There are currently two risks facing pension funds which might be managed using derivatives: (1) the currency risk arising from holding foreign currency-denominated assets and (2) the risk of accumulating exclusively floating rate investments. The use of currency futures or currency swaps helps control the first risk; the use of interest rate swaps addresses the second.

The currency risk problem is particularly acute among Kazakhstan’s pension funds. Without some means of hedging currency risk, asset managers would be ill-advised to invest heavily in foreign currency-denominated instruments. And yet, investing exclusively in tenge-denominated instruments has proven costly over the past two-and-a-half years: the yields on most National Bank notes and MinFin bonds are almost all net negative—that is, below the rates of annual inflation. Thus, currently, avoiding currency risk comes at the cost of net negative yields.

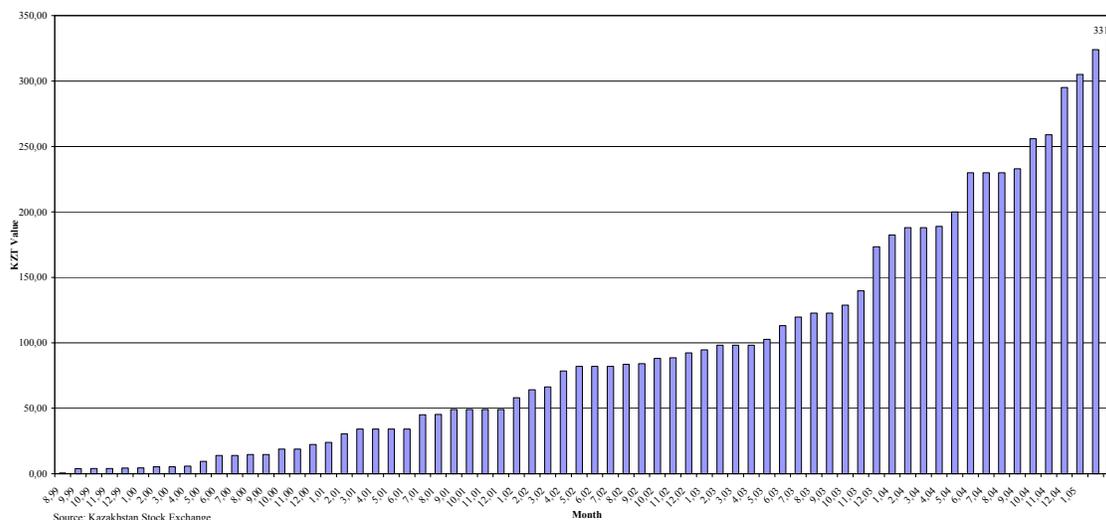
Solutions are not easy, however. The primary problem of developing an active tenge-dollar futures market is that the tenge is a marginal (as opposed to reserve) currency. While there might be as much as a billion dollars of demand for a tenge-dollar futures contract today, it is simply not enough to 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 derivative 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 considerable to the volume of trades included in the VaR calculation. Currency swaps, on the other hand, are non-linear derivatives.

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.

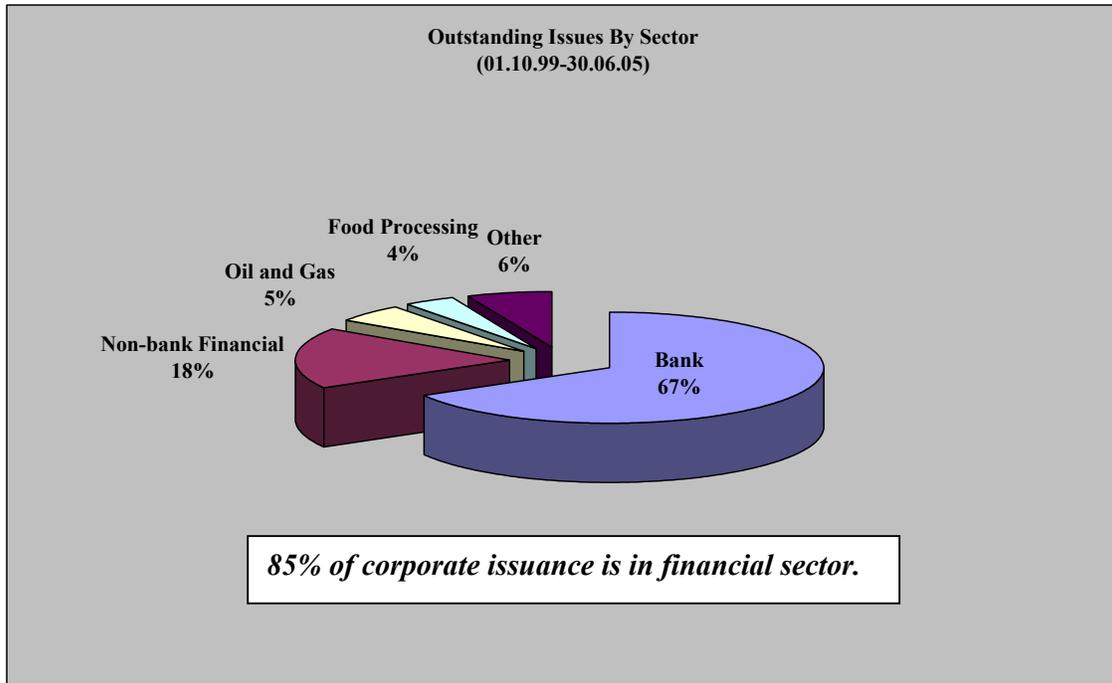
**Figure 2. Cumulative Corporate Issuance
(09.99-06.05, monthly)**

Cumulative Growth in Corporate Bond Issuance, KZT billions: August 1999 - March 2005



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)



IV. ADMINISTRATIVE ISSUES

None

V. DESCRIPTION AND STATUS OF TASKS

Task 1. Development of Financial Instruments

Defined Activity	Progress Made During Quarter/ Proposed Future Actions
<ul style="list-style-type: none"> • Mortgage-Backed Security 	<ul style="list-style-type: none"> • 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
<ul style="list-style-type: none"> • Social Obligations Bond 	<ul style="list-style-type: none"> • 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
<ul style="list-style-type: none"> • Microlending Project 	<ul style="list-style-type: none"> • 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
<ul style="list-style-type: none"> • Warehouse Receipts Project 	<ul style="list-style-type: none"> • 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

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

Task 2. Legal Reform

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

<ul style="list-style-type: none"> • Securitization 	<ul style="list-style-type: none"> ▪ 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
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3. Un-tasked Activities/Accomplishments

Defined Activity	Progress Made During Quarter/Proposed Future Actions
<ul style="list-style-type: none"> • Bond Index 	<ul style="list-style-type: none"> • DEVELOPED CLEAN PRICE BOND INDEX AND PORTFOLIO PERFORMANCE INDICATOR • INDEX AND INDICATOR MADE AVAILABLE TO PUBLIC BY REUTERS NEW SERVICE • PUBLICATION OF PRAGMA/FSI INDEX METHODOLOGY IN <i>RYNOK TSENNYKH BUMAG</i>
<ul style="list-style-type: none"> • Atyrau Mortgage Lending Project 	<ul style="list-style-type: none"> • PROVIDED LEGAL AND FINANCIAL ANALYSIS ASSISTANCE TO ATYRAU OBLAST FOR LOCAL MORTGAGE LENDING PROGRAM

LIST OF ATTACHMENTS

1. Pragma/FSI comments on the draft law “On Securitization”
2. Review of Monetary Round Table II
3. Newspaper article NB Review “Kazakh Bond Stronger than a Dollar”
4. Article “Investors are Looking at the West” from “Expert Kazakhstan” magazine. The article on Bond Congress of CIS Countries in Almaty.
5. NBK Presentation

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

- START OF THE ANALYSIS FOR THE DEVELOPMENT A STATE ANNUITY COMPANY PROJECT REQUESTED BY THE FSA
- PROJECT FOR IMPROVING THE REGULATORY FRAMEWORK AND INVESTMENT CLIMATE FOR ACCUMULATION PENSION FUNDS BEGAN
- ACCELERATION OF ACTUARIAL TRAINING PROGRAM TO PROVIDE GREATER SUPPORT FOR A SELF SUSTAINING ACTUARIAL TRAINING OF LOCAL EXPERTS
- A PROJECT WAS UNDERTAKEN FOR THE SMALL ENTREPRENEURSHIP DEVELOPMENT FUND TO DEVELOP A SUSTAINABILITY ANALYSIS AND TO DELIVER CREDIT TRAINING FOR THE STAFF OF THE FUND

III. EXECUTIVE SUMMARY

1. 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.

Specific duties of the consultants

Annuities Consultant

The primary objective of the study is to determine if viable annuity products can be developed in Kazakhstan given the current retirement and disabilities demographics and the current structure of domestic fixed-income instruments. The Annuities Consultant will:

1. Estimate the sizes of both retirement and disabilities annuitant pools for ten years beginning in 2006. The retirement annuitant pool must be calculated in accordance with current regulations governing minimum pension pay-outs.
2. Analyze and comment on the suitability of Kazakhstan's existing annuitant mortality tables.
3. Identify the volume, term and yields of domestic financial instruments suitable for annuity investment.

Based on the result of the foregoing analysis, the Annuities Consultant will design two distinct annuity products: (1) a whole life pension annuity and (2) and a term life disability annuity. For each product, the consultant will:

1. Estimate the costs associated with marketing and maintaining the product (taxes, commissions, administration costs, asset management costs, risk weighting, et al.)
2. Determine the viability of each product.
3. If either or both products are not viable, identify specific reasons (demographics, mortality, and investment legal or regulatory) why the product is not viable.
4. Estimate when, at reasonable rates of economic growth, conditions might be suitable for annuity product development in Kazakhstan.

Demographics and Mortality Consultant

The demographic and mortality consultant will assist the Annuities Consultant in:

1. Analyzing and commenting on the suitability of Kazakhstan's existing annuitant mortality tables
2. Designing two distinct annuity products: a whole life pension annuity and a term life disability annuity
3. Determining the viability of designed products
4. Identify reasons for non-viability, if any
5. Determining when annuity development might be feasible

Actuarial Consultant

The actuarial consultant will assist the Annuities Consultant in:

1. Analyzing and commenting on the suitability of Kazakhstan's existing annuitant mortality tables
2. Designing two distinct annuity products: a whole life pension annuity and a term life disability annuity
3. Determining the viability of designed products
4. Identify reasons for non-viability, if any
5. Determine when annuity development might be feasible

Insurance Expert

There are numerous variations that need to be evaluated in establishing a Government Annuity Company or the alternatives, they may include:

- A government subsidized annuity company
- A private annuity company, domestic in origin.
- A private annuity company, developed by a foreign partner.
- A private annuity company with a combination of domestic and foreign partners.

- A private, domestic annuity company which contracts with a foreign strategic partner to organize and manage the company.

But whatever variant is selected what in essence is being developed is an insurance company.

The insurance consultant will;

- Review the economic situation as it relates to the insurance industry.
- Meet with and develop relevant information from the domestic insurance industry, the Insurance Regulator and the Insurance Committee of the Kazakhstan parliament.
- Define, in general terms, the target market.
- Project anticipated market size and composition for the annuity product.
- A key element to annuities is the product distribution system that is, the agents and agencies that sell the product to the public. In the insurance industry, annuities are generally considered a “sophisticated sale. In a population that is not familiar with insurance or investment products generally, the problem of delivering annuities becomes even more critical. The consultant will make recommendations on marketing and delivery of the annuity product.

Legal and Regulatory Expert

The consultant will review all current legislation and regulations for annuities including investments, general insurance, annuities for pension payments and annuities for obligatory employer’s liability insurance. The consultant will make recommendations on the legal framework as it applies to annuities.

The consult will make recommendations on the legal structure of the government annuity company or an alternative company.

2. ACCELERATION OF THE ACTUARIAL TRAINING PROGRAM TO PROVIDE GREATER SUPPORT FOR A SELF SUSTAINING ACTUARIAL TRAINING BY LOCAL EXPERTS

The Second Monetary Roundtable was held June 3rd at the Hyatt Regency. The roundtable was sponsored by USAID with the assistance of the Pragma Corporation’s Financial Sector Initiative project. Hosting the roundtable was Anvar Saidenov Governor of the National Bank of Kazakhstan. Representing USAID was Mary Norris Regional Director, Office of Enterprise and Finance USAID/Central Asia.

Acceleration of the Actuarial Training Program to Provide Greater Support for a Self Sustaining Actuarial Training by Local Experts began with courses being given by annuity experts Mike Sze and Mo Chambers. The first training course 6B began on August 8th for 6 days of training. Course 6A was taught from August 8th for 12 days.

The actuarial training program of Kazakhstan funded by the USAID during the last 5 years has been very successful. An actuarial profession has been established and local actuaries have participated in the development of insurance, pension, and other market economy activities in Kazakhstan. In accordance to USAID/FSI plan, the local actuaries are gradually taking over the actuarial training program. Our target is to produce 20 fully qualified actuaries who have passed all six actuarial examinations by the end of 2008. However, based on discussions in June with Kanat Dosmukametov, Vice Chairman of the Financial Supervisory Agency of Kazakhstan (FSA), there is a strong need to accelerate the actuarial training program for the following reasons:

- The FSA intends to enforce the requirement for continued actuarial licensing of passing all six actuarial examinations by the end of 2007. Due to the pace of development of the market economy in Kazakhstan, the country will need more than 20 fully qualified actuaries by that date. An accelerated training program is essential.
- International Accounting Standards (IAS) for insurance companies has changed substantially in recent years. Auditors have required actuarial reports for actuarial insurance companies in Kazakhstan to fully comply with the new IAS. To this date, many auditors have required Kazakhstan actuarial reports to be certified by external international actuaries. Until Kazakhstan's actuaries are fully cognizant of the new IAS, this situation will persist.
- Kazakhstan is promoting many new insurance products, such as life insurance, annuity insurance, disability insurance, and health insurance. Much experience is needed to produce profitable business plans for these new lines of insurance. While local actuaries have the technical skill for conducting actuarial calculations, they lack the experience required for the overall plan.

Course 6B, was taught by two international experts Mike Sze and Mo Chambers.

The inclusion of Mr. Chambers in this training is needed to cover the areas of solvency and risk control for insurance companies, and the proposed changes in EU insurance regulations. He is the former president of the International Actuary Association and is very familiar with insurance international regulations, accounting principles and is an expert on the new developments of Solvency Rules. This was a very intensive course offered during the week of August 8 to 13, with a comprehensive examination on August 15. The course covered many important topics on financial reporting and solvency protection of insurance companies:

- Overview of financial accounting for insurance companies
- New International Accounting Standards on insurance, and International Financial Reporting Standards 4
- Standard of practice of the International Association of Actuaries
- New solvency rules of the International Association of Actuaries
- Solvency standards of the International Association of Insurance Supervisors
- Solvency standards of the European Union
- Principles of Risk Based Capital
- International Risk Based Capital Systems
- Insurance Regulatory Information System

35 students attended the course, including over 10 officers of the Financial Supervisory Agency of Kazakhstan who audited the course. 17 students took the comprehensive final examination. 8 students passed. This represents 47% of students taking the examination, which is higher than expected, considering the breadth and depth of the subject material covered. A survey of the students showed very positive feedback from the students.

Course 6A was taught by Mike Sze which immediately followed Course 6B. It was on investment as outlined in the insurance regulations issued by the FSA. This knowledge is critically needed for the development of the market economy in Kazakhstan. This was an intensive two weeks course offered during the weeks of August 15 – 27. The course covered:

- Ethics
- Quantitative methods
- Accounting
- Corporate finance
- Portfolio management

- Equity investment
- Fixed income investment
- Derivatives
- Alternative investments

There were two lectures each morning, followed by a test and tutorial each afternoon. The lectures were given in English with translation by the tutors. 20 students took the course. 17 students took the final examination, with questions provided in both English and Russian. Only four students passed. This represents 24% of students taking the examination. The results showed that students with strong English skill have clear advantage over the non-English speaking students. While the results are slightly disappointing, it is comforting to know that two of the students passing this examination have completed all six examinations, bring the total number of fully qualified actuaries to 16.

3. IMPROVING THE REGULATORY FRAMEWORK AND INVESTMENT CLIMATE FOR ACCUMULATION PENSION FUNDS

Responding to requests from the Financial Supervisory Agency (FSA) for technical assistance in improving the regulatory framework and investment climate for the accumulation pension fund system Pragma/FSI fielded a team. The scope of work included two distinct tasks: (1) assisting FSA in developing regulations (“prudential norms”) and pension fund reporting requirements governing the use of derivatives and recommending realistic benchmarks (or alternatives to benchmarks) for measuring the performance of individual pension funds and asset management companies (AMC); and (2) delivering to FSA staff a series of seminars on pension fund asset allocation and the use of derivatives in risk management and performance enhancement.

Pragma/FSI fielded a team of two consultants to do facilitate the project. Paul Carlson and Charles Rubin

Paul Carlson was tasked with assisting the FSA in developing regulations (“prudential norms”) and pension fund reporting requirements. Charles Rubin delivered to FSA staff and pension fund managers a series of seminars on pension fund asset allocation and the use of derivatives in risk management and performance enhancement.

Paul Carlson review of pension fund benchmarking.

Total assets now stand at well over 570 billion KZT and are increasing by 10 billion KZT per month. However, this success is also creating the need for more sophisticated oversight of the funds’ investment performance.

Clients, regulators and supervisors measuring the investment results of these funds must have strong standards for determining how well asset managers are handling the funds entrusted to them. The normal practice is to compare fund results to benchmarks - indices that measure returns available in the investment markets during the measurement period from the universe of acceptable investments. Examples of benchmarks are:

1. a well recognized price or total return index using the actual returns on market assets,
2. a tailored composite of assets or indices, or
3. an index calculated using the average returns of a peer group of similar funds.

Each of the above types of benchmarks is widely used in the investment management industry.

The choice of the benchmark is usually a matter discussion between the fund client and the fund manager. In Kazakhstan, the Financial Supervision Agency (FSA) represents the pension participants in setting investment guidelines and parameters. Thus, the agency needs to work with the fund managers to design benchmarks that reflect the needs of the fund participants and that reflect the investment opportunities for the fund managers. His report reviewed performance measurement, benchmark methodology and usage and specific recommendations for adaptation by the Kazakhstan pension regulator and industry.

Examples of Index Benchmarks

Indices of unmanaged assets are the preferred benchmark. They reflect all the assets available to the fund and to other funds with similar objectives. Furthermore, the advent of low cost index funds gave fund sponsors a realistic alternative to fund managers who could not earn the index return. Index publishers have now created indices to reflect investment performance specific to:

- growth and value shares called style indices,
- large, medium and small market capitalization shares,
- conservative and aggressive bonds and shares,
- different countries and regions for shares and bonds,
- hedged and GDP weighted strategies, and
- different economic and market sectors for shares and bonds.

In each case above, the index publisher chooses assets that meet the criteria and uses the returns on those assets to calculate the index. For example, the publisher would use the shares that meet “value” criteria (low price to earnings or price to book value)

Peer Group Benchmarks

Nevertheless, in some cases available capital market indices do not match the investment situations of funds. There may be an unusual set of constraints on the investment managers that are not captured by commercially published indices. For these managers, such indices are simply not investable or appropriate for the funds. A popular solution is the use of peer group universe of managed assets. In developed markets, indices of venture capital, private equity and real estate are actually peer groups of managed assets. There is no trading market in these assets that can be used to create a market index.

The Kazakhstan pension program has adopted a peer group benchmark. Each fund’s investment returns are measured against the weighted average returns of all the pension funds in the program. When a fund does considerably worse than the average, the fund manager must contribute enough money to the fund to bring the performance up to the average. While strong performance will lead to large inflow of funds, poor performance can lead to assets flowing out of the funds and a large capital contribution. The cost of negative relative performance is probably greater than the benefit of positive performance except for small funds (with small loss potential) managed by wealthy management companies willing to assume the risks.

Mr. Carlson agreed that the present peer group benchmarking is appropriate for Kazakhstan. The most important area to look at in the future is benching foreign investment for the asset managers. Kazakhstan pension funds are now getting large enough to hire investment managers to replicate specific indices for them at very low cost.

On balance, he strongly recommended that managers of Kazakhstan pension funds adopt indexing for their foreign investment programs.

Page #	Recommendation			
6	The FSA should continue to use the peer group method for benchmarking domestic holdings given the limited opportunities available.			
8	We recommend that the FSA continue to develop and monitor risk measurement systems that will help asset managers and fund participants understand the nature of the investment returns.			
9	For the purpose of benchmarking foreign investment, alternatives #2, 3 & 4 on page 7 are all appropriate for the funds. The FSA and the industry should agree on one of them and implement it.			
9	The recent change to performing a monthly review of the investment results for the past three years is a highly positive step and we recommend that the agency continue this practice.			
9	We recommend that all published fund comparisons should feature three and five year returns when available.			
9	All fund and benchmark returns should be translated into the same currency, preferably the KZT.			
9	We recommend that the relative performance calculation be: <table border="1" style="margin-left: auto; margin-right: auto;"> <tr> <td style="text-align: center;">1 + fund return</td> </tr> <tr> <td style="text-align: center;">1 + benchmark return</td> </tr> <tr> <td style="text-align: center;"> </td> </tr> </table>	1 + fund return	1 + benchmark return	
1 + fund return				
1 + benchmark return				
10	We recommend that the FSA adopt a graduated schedule of sanctions for poor performance.			
10	The regulator should carefully review the assets and pricing of any fund that has a relative performance index over 1.25.			
11	We strongly recommend that managers of Kazakhstan pension funds adopt indexing for their foreign investment programs.			

4. SUSTAINABILITY ANALYSIS AND CREDIT TRAINING FOR THE STAFF OF THE SMALL ENTREPRENEURSHIP DEVELOPMENT FUND

Gulnar Khassenova Deputy Chairman of the Board of the Small Entrepreneurship Development Fund asked for USAID/FSI’s assistance in a broad range of assistance for the Fund.

The first area of assistance is a sustainability analysis of the Fund. Doug Whiteley the consultant was mandated with;

Sustainability analysis for the Fund which included

- Performing a sustainability analysis for the Fund and make recommendations as to how the Fund should operate under prudent norms given the mandated 1% cap on loan guarantees.
- To advise on the viability of fund using insurance company guarantees to protect the fund.
- Review investment instruments available to the fund in determining its sustainability
- Review the default history in other countries that have similar funds for estimating the default risk to the Small Enterprise Development Fund.

Doug Whitley successfully completed the assignment his report and the sustainability model are included in the Quarterly report.

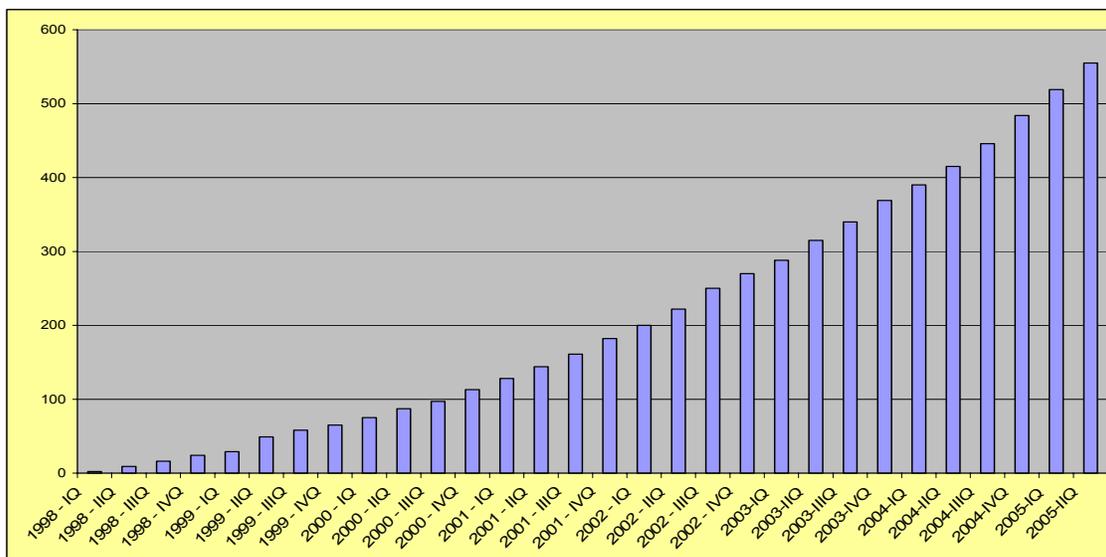
The second area of assistance was undertaken by Rick Smith to develop and deliver a credit training program for the staff of the SEDF on loan guarantee underwriting standards. The consultant was also tasked with reviewing current standards and advising them on internationally credit underwriting procedures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

Rick began this assignment in the end of August and his report it will be covered in the 21st Quarterly report.

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.

V. DESCRIPTION AND STATUS OF TASKS

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

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

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

Defined Activity	PROGRESS MADE DURING QUARTER/PROPOSED FUTURE ACTIONS
<ul style="list-style-type: none"> • Prepare a plan for eliminating the State Accumulation Pension Fund as a dominant market force (within 45 days of the start of the activity) 	<ul style="list-style-type: none"> • PRAGMA/FSI'S INVOLVEMENT IN THIS AREA HAS BEEN DOWNGRADED FROM A PROACTIVE ROLE TO ONE OF ASSISTANCE (SEE ABOVE).
<ul style="list-style-type: none"> • Resolve technical issues related to the privatization of the SAPF <ul style="list-style-type: none"> • Clean up duplicate accounts • Prepare financial analysis • Prepare a preliminary design 	<ul style="list-style-type: none"> • PRAGMA/FSI'S INVOLVEMENT IN THIS AREA HAS BEEN DOWNGRADED FROM A PROACTIVE ROLE TO ONE OF ASSISTANCE (SEE ABOVE).
<ul style="list-style-type: none"> • Strengthen political support for the privatization of the SAPF • Build support from donors, international investors, etc. • Provide local counterparts with supporting analysis 	<ul style="list-style-type: none"> • 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
<ul style="list-style-type: none"> • Identify key threats to the pension system and develop a plan for monitoring them (within 30 calendar days of the start of the activity) 	<ul style="list-style-type: none"> • PRAGMA/FSI CONTINUES TO MAINTAIN A "WATCHING BRIEF" ON THREATS AND DEVELOPMENTS, USING MEDIA MONITORING AND PROFESSIONAL CONTACTS.
<ul style="list-style-type: none"> • Improve record keeping 	<ul style="list-style-type: none"> • PRAGMA/FSI'S INVOLVEMENT IN THIS AREA HAS BEEN DOWNGRADED FROM A PROACTIVE ROLE TO ONE OF ASSISTANCE (SEE ABOVE).
<ul style="list-style-type: none"> • Improve policies and supervision 	<ul style="list-style-type: none"> • SEE "ESTABLISHING STANDARDIZED (UNIFORM) REPORTS, METHODOLOGIES, NORMATIVE ACTS, AND SUPERVISION" PERFORMED PRELIMINARY LIQUIDITY ANALYSIS

Task 1 Insurance – Supervision / DIS Efficiency

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Defined Activity	Progress Made During Quarter/Proposed Future Actions
<ul style="list-style-type: none"> 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 	<ul style="list-style-type: none"> TASK WAS COMPLETED PRIOR TO QUARTER
<ul style="list-style-type: none"> Develop framework for upgrading supervisory procedures and practices within 60 days of start of contract 	<ul style="list-style-type: none"> INITIAL FRAMEWORK WAS DEVELOPED PRIOR TO QUARTER
<ul style="list-style-type: none"> Implement framework date for production of User Guide to be established within 30 days of start of contract 	<ul style="list-style-type: none"> TASK WAS COMPLETED PRIOR TO QUARTER
<ul style="list-style-type: none"> 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 	<ul style="list-style-type: none"> TASK WAS COMPLETED PRIOR TO QUARTER
<ul style="list-style-type: none"> Develop and implement certification exams for relevant industry participants 	<ul style="list-style-type: none"> 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
<ul style="list-style-type: none"> Develop and implement dispute resolution regime 	<ul style="list-style-type: none"> 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

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	<ul style="list-style-type: none"> • NO ACTION TAKEN DURING QUARTER
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Task 2 Insurance – Legal Reform

Defined Activity	Progress Made During Quarter/Proposed Future Actions
<ul style="list-style-type: none"> • Develop and pass legislation 	<ul style="list-style-type: none"> • 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
<ul style="list-style-type: none"> • Develop and promulgate regulations 	<ul style="list-style-type: none"> • 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
<ul style="list-style-type: none"> • Assess rules and regulations within 60 days of start of contract 	<ul style="list-style-type: none"> • DISCUSSIONS CONTINUED ON HOW TO IMPLEMENT CUSTOMS BONDING INSURANCE • FURTHER ASSESSMENT WILL FOLLOW THE PROMULGATION OF ALL NECESSARY REGULATIONS UNDER THE NEW INSURANCE LAW
<ul style="list-style-type: none"> • 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 	<ul style="list-style-type: none"> • THIS WILL FOLLOW COMPLETION OF THE ASSESSMENT OF THE RULES AND REGULATIONS (SEE PRECEDING BOX) • NO ACTION TAKEN DURING QUARTER
<ul style="list-style-type: none"> • Develop and implement consumer protection measures, including trade practices and consumer disclosure requirements 	<ul style="list-style-type: none"> • NO ACTION TAKEN DURING QUARTER
<ul style="list-style-type: none"> • Develop and implement rules for licensing: 	<ul style="list-style-type: none"> • THESE WILL BE SET OUT IN THE REGULATIONS CURRENTLY UNDER EXAMINATION BY THE NBK

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<ul style="list-style-type: none">• brokers• actuaries• auditors• companies• other relevant industry participants	<ul style="list-style-type: none">• ACTUARIAL LICENSING REQUIREMENTS IMPLEMENTED DURING PAST QUARTER
<p>Develop and issue other required regulatory documents:</p> <ul style="list-style-type: none">• guidelines• rulings• interpretation bulletins• best practices papers	<ul style="list-style-type: none">• 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. Paul Carlson review of pension fund benchmarking.
2. Review of Actuarial Training by Mike Sze
3. Sustainability Analysis for the Small Entrepreneurship Fund by Doug Whiteley

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

- DEVELOPMENT OF THE FIRST “TRAINING OF TRAINERS” COURSE WAS COMPLETED AND SELECTED TRAINERS GAVE A COURSE TO TWENTY TWO STUDENTS IN JULY
- DOUG WHITELEY BEGAN A TRAINING ASSESSMENT FOR THE KMGF

III. EXECUTIVE SUMMARY

1. ASSOCIATION OF REALTORS OF KAZAKHSTAN (ARK)

The Association of Realtors of Kazakhstan (ARK) completed the Student’s Manual for a pilot pre-certification course. Each section was reviewed by expert trainers and approved. Once complete, the book was sent to Galina Nikolskaya, Deputy Director for the National Training Center, Russian Guild of Realtors (RGR) Moscow, Russia. Ms. Nikolskaya gave positive feedback on the workbook.

Development of the Final Exam to be used for certification was developed. Each section of the test was reviewed by the experts who would teach that section and interim quizzes were developed to help the students know if they understood the material.

Lastly, in preparation for the pilot course offering presentation materials were prepared, lesson plans, handouts, and PowerPoint slides.

In addition to press releases announcing the pilot course offering, ARK announced future course offerings. A list of topics for seminars and courses is being evaluated by the ARK leadership to target issues of broad interest to appeal to the entire industry. The seminars were conducted by local experts as well as their professional cohorts in the Russian Guild of Realtors RGR

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In July, the training center received its equipment from Pragma--a computer, multi-media projector, screen, fax machine, copier and a printer.

In July US experts, Paul Lindsey of Coldwell Banker Success Southwest and Jim Hogan of the Hogan School of Real Estate, arrived to give the course. Both had been asked to conduct a session as part of the curriculum. Their primary objective for the week was to observe the course and provide feedback to the instructors on effective presentation techniques. An interpreter was assigned so they could follow along with course content as well. In this way they were able to assess the adequacy of the course itself. At the end of the course, they met with all the instructors and provided specific feedback so all could benefit from the lessons. Lindsey and Hogan, both highly regarded instructors themselves, identified Ms. Khassenova as by far the most natural instructor

There were some problems noted in the final exam. Several questions lacked definitive "correct answers" so they were thrown out from the final scores. Also, because the course was offered as an all-day class for the whole week, several business owners had to leave to attend to business and return later. This sporadic attendance led obviously to some missed material. The decision was made that future offerings would be held evenings and weekends, designed to accommodate the dynamic environment of the industry.

Please see the report provided by Lindsey and Hogan attached. In the end, 22 students received Certificates of Attestation--the first certified realtors of Kazakhstan.

The Association of Realtors focused on identifying the appropriate government agencies that would regulate the real estate industry and establish legislation to license sales practitioners. The Legislative Committee formed by ARK conducted their research and decided against inviting the government to regulate the industry at this time. Through their research however, they come to understand they could be formally recognized by the Committee on Technical Regulation and Metrology, Ministry on Industry and Trade, and have authority to enforce the ARK Code of Ethics and Standards of Practice. So this is the path the ARK is on--to petition this committee to accept the standards of practice and recognize ARK as the keeper of the standards. Thus, the letter was prepared by Pragma's to endorse of the work accomplished and to support approval of the standards.

In addition to work on the standards (with much assistance from Pragma's lawyer, Jamilya Kurmangaliyeva), the ARK developed rules for the certification of real estate companies, individual agents, and real estate brokers. They also developed rules for running the Kazakhstan School for Realtors (the official name of the training center); i.e., student qualifications, how training is offered, how the training center is operated, etc.

As a result of their growing relationship with Pragma, the ARK has begun work with the Association Development component of the Enterprise Development Project and is working on a strategic plan to carry their organizational development through the next year.

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Finally, as a fitting culmination of this year's efforts to develop the real estate sales industry, ARK is co-organizing the international "Real Estate Exposition 2005" to be held in October. ARK will have a booth and marketing materials to reach their target audience.

2. KAZAKHSTAN MORTGAGE GUARANTEE FUND

Dulat Alimzhanov, Chairman of the Kazakhstan Mortgage Guarantee Fund asked for technical assistance from USAID. The Chairman in a letter asked for a broad range of assistance.

Specifically the letter asked for assistance in:

- Retaining international experts in the area of mortgage guaranteeing.
- Obtaining regulatory and training literature.
- Carry out educational and explanatory campaigns in mass media sources.
- Introduction of the ISO 9001:2000 Quality Management System.
- Obtain a credit rating from one of the recognized international rating agencies.
- Opening regional offices in the Republic of Kazakhstan.
- Creating a uniform mortgage loan guarantee database for the Fund with potential hook-ups to regional representatives of the Fund.
- Introducing electronic document flow system.
- Have personnel trained at leading international mortgage guarantee institutions; participate in various training programs, delivery of seminars and courses on the subject of risk management, underwriting and the methodology of extension of guarantees of mortgage loans.
- Organization and delivery of training modules.

A Scope of Work was developed to assist the KMGF

The consultant Doug Whiteley arrived in June to begin a needs assessment. He was specifically asked to review the following:

- Identify the current strengths and weaknesses of the KMC staff and make recommendations to what areas of training are needed.
- Identify and make specific recommendations on the type of international experts that are required for training in the area of mortgage guarantees.
- Identify institutions and make recommendations on potential candidates to be trained at leading international mortgage guarantee institutions.
- Identify institutions and make recommendations on delivery of seminars and courses on the subject of risk management, underwriting and the methodology of extending mortgage guarantees.
- Identify and make recommendations on the appropriate countries that can be used for developing training literature.

Doug Whiteley's report was submitted in August the following recommendations were made:

Recommendations

FUND Management – Chairman and Deputy

1. Hire a translator experienced in English and preferably with experience in mortgage lending or banking. This position will enable the Funds management and

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staff to take advantage of the mortgage insurance, mortgage lending, statistical data and educational materials available from “English based” web sites. The majority of mortgage insurance information that is available is provided by US and Canadian mortgage insurers, including the their respective federal governments or English speaking service providers. This position could be used a resource by the functional areas of KMGF to locate specific types of training materials and information that the Funds manager are seeking.

2. Communication to Staff – the Funds underwriting staff interacts with the banks loan officers on a daily basis. It is important to keep underwriting personnel as well as any other customer contact staff up to date and well informed regarding any new or proposed legislation and current developments in the mortgage lending market. This will enable them to be viewed as an expert and a valuable resource to the Funds customers.

3. Establish IT as a separate department that serves the needs of all areas of KMGF in a prioritized and coordinated effort. The location of independent IT staff through out the functional areas will eventually lead to development of systems that meet only that functional areas requirements along with the development of “department definitions” for data and reporting formats. This is not happening today but it will evolve over time.

4. Create functional job descriptions for employees that will communicate to others what their responsibilities are from their position title. The position descriptions can be one of several tools used to develop a career growth path for the staff with in a specified discipline.

Training programs should be developed for several operational disciplines.

1. Formal Training Program for New Hires.

The new hire-training program should provide a new employee with basic knowledge of what each area of KMGF is responsible for doing and where a new employee should go to seek any additional clarification.

Areas that should have introductory training programs for new hires are:

Risk management – Underwriting, Quality Control, Loss Mitigation, Blanket Policy Holder Requirements and Monitoring.

Management Reports, their purpose and function.

Legal

IT Systems Training

Customer Service

Pricing Concepts

Marketing and sales

Hands on training

Corporate Goals and Objectives

The new hire should be provided with a binder / workbook that contains all the relevant training materials for their future reference.

2. Continuing Education and Training – Improvement of Skills

Longer-term employees need continuing education training programs to provide them with a sense of career development and a personal growth component. There appears to be a very strong self-improvement incentive amongst the KMGF staff. These courses should be made available after the employee has had a reasonable amount of experience and / or time on the job. There are some very good self-study courses

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available from the Mortgage Bankers Association, but they are in English. A variety of training resources are available to gain an insight into other countries practices and procedures particularly from the secondary market entities in the USA and Canada. Much of this information, particularly the mortgage insurance basics, is available for free by requesting it from either the private or government insurance companies and government-sponsored entities in the country where they operate and are licensed.

3. The Fund would be well served to obtain guidance from outside experts and / or topical Internet Web Sites when developing Training Programs for disciplines in the following areas of Risk Management.

Risk Management Committee – organization and Policy Role function

MI Business Reporting –

Management Reporting

Regulatory Reporting

Customer Performance

Portfolio Analysis

Product and Program Profitability Analysis

Analysis of Loan Characteristics relative to Pricing and Underwriting Policy

Exception Report

Risk Management Operational Areas:

Underwriting

Loss Mitigation / Claim Payments

Risk Analysis of customer proposed programs

Quality Control Programs

4. IT (Information Technology) –

Data base design and development of an integrated interactive transaction based operating systems. The IT systems for the respective areas must have data consistency and data integrity. This requires standard data definitions and standard report heading definitions. Much of this work has been done under the ANSI standards for mortgage lending, which is available at no cost. Licensing and certification training for the hardware and software should be made available from the vendors (such as Cisco, Oracle, Sun Micro Systems for the IT staff. Some of the certification courses are fee-based training but they are worth the expense to KMGF.

5. Marketing –

KMGF should provide marketing and sales materials to the banks and bank loan officers for their use when explaining the KMGF mortgage insurance benefits to their mortgage loan customers. Periodic invitations to bank loan officers to get together and hear an expert speak on a specific subject or to introduce and discuss the implications of a new mortgage lending law can be directed at the banks front line staff. The goal should be to build relationships and establish KMGF as the place to find out “what is happening” in the lending market in Kazakhstan.

6. Efficiency –

The current underwriting process needs to be reviewed and an expedited process should be established to speed up turnaround time. Response time, based on my years of doing independent customer surveys, is the number one criteria utilized by US mortgage lenders in determining which mortgage insurer or government program they will use. KMGF current IT system also needs to be addressed to allow underwriters the ability to make changes and corrections (but these need to be transaction based with parties and dates identified) to existing mortgage insurance records to improve customer service and turnaround time.

7. Financial –

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Investment Strategies – The current structure of the FUND, absent any change to the requirement that 100% of the premium received is allocated to the Loss Reserve, will necessitate an investment program that generates sufficient income for the Funds payment of all their expenses as well as allowing some cushion for cash flow shortages during down periods.

Reserves – The Fund will need to develop a case basis reserve and loss reserve methodology eventually. Since there are no losses or delinquent loans at this time it is not critical. It will in time become a critical component of the Funds profitability, cash flow management strategy and improve justification to regulatory agencies for premium rate adjustments. Proper reserve requirements will validate the Funds capital adequacy requirements. Additionally, if the current legislative requirements that provide for 100% of KPMG's premium income to be placed in the Loss Reserve are changed to a Contingency Reserve concept then this issue should become a very important regulatory concern.

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 *		
<u>Выдано за период:</u>	8,135.50	2,461.00
<u>Остаток на конец периода</u>	37,068.12	
БТА Ипотека		
<u>Выдано за период:</u>	4,420.04	1,317.00
<u>Остаток на конец периода</u>	20,493.64	7,547.00
Банк ТуранАлем		
<u>Выдано за период:</u>	5,068.98	1,771.00
<u>Остаток на конец периода</u>	17,209.93	7,090.00
Народный банк Казахстана		
<u>Выдано за период:</u>	14,146.78	3,218.00
<u>Остаток на конец периода</u>	51,843.06	18,462.00
АТФ Банк		
<u>Выдано за период:</u>	3,485.70	1,167.00
<u>Остаток на конец периода</u>	13,353.40	5,654.00
Банк ЦентрКредит		
<u>Выдано за период:</u>	5,848.00	1,924.00
<u>Остаток на конец периода</u>	12,652.00	7,102.00

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Астана-Финанс		
<u>Выдано за период:</u>	318.47	66.00
<u>Остаток на конец периода</u>	1,879.47	463.00
Техака Банк (данные первого квартала)		
<u>Выдано за период:</u>	175.70	19.00
<u>Остаток на конец периода</u>	681.02	74.00
Альянс Банк		
<u>Выдано за период:</u>	2,260.00	475.00
<u>Остаток на конец периода</u>	4,350.00	1,195.00
Темирбанк		
<u>Выдано за период:</u>	2,095.60	935.00
<u>Остаток на конец периода</u>	4,851.20	1,064.00
КИК		
<u>Выдано за период:</u>	4,548.51	1,284.00
<u>Остаток на конец периода</u>	28,711.82	12,305.00
Итого выдано за период	<u>50,503.28</u>	<u>14,637.00</u>
Итого остаток	<u>193,093.66</u>	<u>60,956.00</u>

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
<ul style="list-style-type: none"> ▪ Assessment of rules and regulations for the mortgage sector ▪ Work plan for reform of rules and regulations ▪ Work plan for development of mortgage default insurance ▪ Assessment of rules and regulations relevant to default insurance and recommendations for development of such a product, including relevant data collection ▪ Implementation of work plan for reform of mortgage lending rules and regulations, including development of needed legislation 	<ul style="list-style-type: none"> ▪ COMPLETED BY IUE ▪ COMPLETED BY IUE ▪ COMPLETED BY IUE ▪ COMPLETED BY IUE AND UI ▪ 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
<ul style="list-style-type: none"> ▪ Review of mortgage banking courses and materials developed by Housing Sector Reform Project ▪ Framework for mortgage banking training developed 	<ul style="list-style-type: none"> ▪ THIS WAS COMPLETED THROUGH CONSULTATION WITH PRAGMA/FSI’S COP AND IUE STAFF IN MOSCOW. ▪ 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 MORTGAGE LENDER (CML) DESIGNATION. CML TRAINING IS NOW OFFERED BY THE KMC WITH OVERSIGHT PROVIDED BY IUE.
<p>Development of strengthened modules for:</p> <ol style="list-style-type: none"> 1. Alternative mortgage instruments, including spreadsheet program for class use 2. Features of different mortgage securities - “mortgage bank model” use of guarantees 3. Adjust courses to Kazakh situation; develop local case studies 4. Development of loan servicing simulation software 	<ul style="list-style-type: none"> • THE CML CURRICULUM WAS CUSTOMIZED TAKING INTO ACCOUNT 1, 2 & 3 AND KAZAKHSTANI PRACTICES, AND INCORPORATED INTO THE THREE MODULES COMPLETED IN APRIL 2000 FOR USE BY THE TRAINERS OF THE ALMATY BANK TRAINING CENTER (ABTC). THE CURRENT CURRICULUM WAS FURTHER UPDATED TO EMPHASIZE THE BENEFITS OF SECURITIZATION SINCE KAZAKHSTANI BANKS AS WELL AS THE KMC ARE NOW ISSUING MORTGAGE-BACKED SECURITIES. IT IS ESSENTIAL THAT PRACTITIONERS UNDERSTAND THE RELATIONSHIP BETWEEN PRIMARY ORIGINATION AND SECONDARY MARKET ISSUANCE ESPECIALLY AS IT RELATES TO UNDERWRITING STANDARDS FOR CONFORMING LOANS. ▪ TWO TRAINERS FROM THE ABTC ATTENDED AND COMPLETED COURSES I, II AND III, AND RECEIVED THE DESIGNATION OF ‘CERTIFIED MORTGAGE LENDER’. SINCE THEN, MORTGAGE EXPERTS FROM IUE HAVE PROVIDED ONGOING TECHNICAL ASSISTANCE TO THE ABTC IN TEACHING, COURSE DEVELOPMENT AND CONTENT. DURING A FEBRUARY VISIT AND REVIEW OF MATERIALS AND INSTRUCTOR CONTENT KNOWLEDGE , IUE CONSULTANTS DELAYED DELIVERY OF ABTC’S CML MORTGAGE TRAINING COURSE IN ORDER TO REFINE THE CURRICULUM AND TEACHING METHODS. THE COURSES WERE DELIVERED IN MARCH AND APRIL 2002. HOWEVER, IUE CONSULTANTS DO NOT

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	<p>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.</p> <p>THE LOAN SIMULATION SOFTWARE CURRENTLY AVAILABLE HAS NOT BEEN UPDATED DUE TO THE EXPENSE INVOLVED AND USE BY BANKS OF MORE MODERN SYSTEMS. CONSEQUENTLY, THIS EFFORT HAS BEEN CURTAILED. RECOMMENDATIONS FOR SOFTWARE SPECIFICALLY DESIGNED FOR LOAN SERVICING AND CURRENTLY AVAILABLE IS CONTAINED IN THE FANNIE MAE REPORT TO THE KMC.</p>
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Task 3 – Develop Action Plans for Mortgage Lending Infrastructure and Implement Selected Plans

Defined Activity	Progress Made During Quarter/Proposed Future Actions
<ul style="list-style-type: none"> • Formation of independent appraisal association • Formation of professional real estate brokers association. • Devise or adjust methodology for appraisal of property that is being mortgaged • Establish methods and terms of mortgage risk insurance 	<ul style="list-style-type: none"> • 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. • 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 POTENTIAL COUNTERPARTS A PLAN FOR CERTIFICATION AND LICENSING OF REAL ESTATE SALES PERSONS. • FSI IN COOPERATION WITH THE KMC AND THE BANKS HELD A ROUND TABLE ON HOW TO IMPROVE COORDINATION. DURING DISCUSSION, MANY PARTICIPANTS HIGHLIGHTED THEIR LACK OF CONFIDENCE IN THE EMPLOYMENT OF A STANDARDIZED APPRAISAL METHODOLOGY. CONSEQUENTLY, FSI ORGANIZED A SEPARATE MEETING WITH THE CHAMBER OF APPRAISERS AND A REPRESENTATIVE OF THE BANKING COMMUNITY, BTA MORTGAGE. AS A RESULT, A MEMO OUTLINING OUTSTANDING ISSUES DISCUSSED WAS PREPARED BY FSI AND DISTRIBUTED TO EACH FOR COMMENT. A FOLLOW-UP MEETING IS PLANNED ON HOW BEST TO ADDRESS THESE DEFICIENCIES. THE LACK OF A UNIFORM METHODOLOGY 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. • FSI/UI CONSULTANTS ALSO ANALYZED NBK CAPITAL RESERVE REQUIREMENTS FOR MORTGAGE LENDING AND PREPARED A DRAFT

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	MEMORANDUM FOR NBK CHAIRMAN GOVDERNOR MARCHENKO WITH SUGGESTIONS FOR LOWERING THESE REQUIREMENTS ON MORTGAGES HAVING KMGF GUARANTEES. THESE RECOMMENDATIONS WERE GIVEN TO THE NEW KMGF CHAIRMAN PRIOR TO SUBMISSION TO GOVERNOR MARCHENKO. WITH THE ESTABLISHMENT OF THE NEW AGENCY FOR REGULATION, FSI MET WITH ITS NEW CHAIRMAN, MR. ZHAMISHEV TO BRIEF HIM ON THE MATTER.
<ul style="list-style-type: none"> ▪ System of registration of real estate rights and transactions 	<ul style="list-style-type: none"> ▪ 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
<p>Assessment of:</p> <ul style="list-style-type: none"> ▪ Bank internal rules and procedures for retail mortgage banking ▪ External rules and regulations for retail banking 	<ul style="list-style-type: none"> ▪ COMPLETED AS PART OF THE IUE ASSESSMENT. ▪ COMPLETED AS PART OF THE IUE ASSESSMENT.
<ul style="list-style-type: none"> ▪ Work plan to establish rules and procedures for retail mortgage lending 	<ul style="list-style-type: none"> ▪ COMPLETED AS PART OF THE IUE ASSESSMENT. RESULTS WERE REFLECTED IN UPDATED CML COURSEWORK.
<ul style="list-style-type: none"> ▪ Standards for mortgage underwriting, loan documentation rules, mortgage contracts 	<ul style="list-style-type: none"> ▪ 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. KMGF Training Assessment by Douglas E. Whiteley

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

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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

- 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.
- SIGNIFICANT GAINS IN MARKETING CREDIT BUREAU TO NON-FINANCIAL SECTOR

III. EXECUTIVE SUMMARY

From May 22, 2005 through August 21, 2005, FSI continued to initiate actions to develop a credit reporting system that would meet the needs of Kazakhstan. As reported in the 18th quarterly report, FSI focused on a) finalizing the First Credit Bureau of Kazakhstan's (FCB) shareholder structure and starting joint implementation with Creditinfo, the credit bureau operator and shareholder, b) determining the "data structure" of data capture, upload, and transfer to the FCB, c) finalizing the insurance industry's participation in a unified credit reporting system, d) advancing discussions on regulatory matters related to data security, and data management and access rights, and e) initiating discussions with public record holders (automobile, traffic and pension). In all these areas, FSI made major significant progress.

During the quarter, JSC «Alliance Bank», JSC «Bank TuranAlem», JSC «Bank CenterCredit», JSC «Kazkommertsbank», and Creditinfo Group (Iceland) each agreed to increase their respective shareholdings to 18.2% each. JSC «ATF Bank», JSC «Narodny Bank of Kazakhstan» and JSC «TsesnaBank» maintained their existing capital while Astana Finance joined the shareholder group with a minority stake. Once funds are transferred to the FCB, equity will reach US\$ 1.5 million. The company will have no debt and does not plan to take on any debt in the immediate future.

The Association of Insurance Companies signed a Letter of Intent agreeing to establish a unified database with the FCB for insurance companies. This is a major accomplishment given that insurance companies around the world tend not to share

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data with the banking sector. It must be noted that Pragma in earlier discussions with the FSA had recommended that insurance data be included in the FCB database. The FSA, at the time Pragma made the recommendation, did not agree. It took nearly 1 year to convince the market that data sharing of insurance information in the same data base would be not only good for the industry but for Kazakhstan's financial sector. In order to reach agreement, Pragma with the assistance of the FCB and the Bankers' Association organized multiple meetings with the insurance industry and government regulators in order to sign the above mentioned Letter of Intent. Work continues with respect to data structure analysis, access rights, upload and down load protocols, and the entire gamut of issues that are required to collect, manage and distribute insurance related data to FCB customers. Any of these activities require by law a) consumer consent, a) there must be a permissible purpose for access to data, and c) the credit bureau and an individual insurance company must sign a contract outlining the rights and obligations of each party.

Progress with respect to the CB's physical plant and equipment requirements continue on track. In order to issue a credit report before the end of the year, it is critical, by law, to ensure that the premises and data security systems and procedures are in place. Essential hardware and software must also be studied, ordered, installed, customized and tested. The most critical element is software customisation.

A partial list of activities follows during the period follow:

- Work to bring the server room into compliance with the FSA's requirements has started. Companies engaged in construction and electrical works, as well as suppliers of air conditioning systems, anti-fire alarm systems and video monitoring systems have been selected. The FCB has signed services contracts work has begun.
- FCB orders equipment for server room and back-office. Purchases of furniture, office appliances, telephone sets, etc. was begun and is ongoing.
- Initiated actions to obtain the software certificate from Kazakhstan's Agency for Informatization and Communications.
- Office premise upgrade ongoing.
- FCB continues to hire staff.

The FCB continues to require assistance with respect to CB workflow, office procedures, customer relations, potential dispute resolution and data security concerns. In this connection, FSI plans to provide assistance with respect to the preparation of an operating manual. Moreover, it appears that the shareholders with install direct "sealed" communication (data transfer) lines between the credit bureau and the main data suppliers.

Finalization of a "common" data structure remains a top priority, as it is absolutely necessary when constructing the CB database. Meeting with banking specialists from each of the shareholders continue. As per the Credit Bureau Law, the requirement to transfer data to the CB is mandatory for the financial sector and also applies, upon signature of commercial contracts, to the Kazakhstan Real Estate Center and the Traffic Police.

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FSI, together with the FKC, continues to approach data providers in the non-banking sector. In this respect, our discussions with insurance have been extremely positive despite initial resistance to join as data suppliers to the credit bureau. Because of both the support of the FSA and the expected professional management of the FCB, additional data suppliers and, eventual users, should materialize. The next step will be to convince telephone companies and key retailers to cooperate with the FCB.

Discussions with Insurance companies continue to move forward and, as reported in the last quarterly, the FCB is discussing various product sets with the Association of Insurance companies:

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.
2. A central database that lists accident/theft claims, both past and present.
3. A similar database to #2 that would list claims for disability and life insurance.
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.

Analysis continues to see how best to develop these products and services.

A primary objective of USAID/Pragma has been to move the KCB forward in order to guarantee the long-term sustainability of the institution through capacity building, marketing, product/services development and public awareness. Capacity building was at the core of our activities during the quarter. In this connection, the KCB management requested that continued capacity building be a central component of FSI's activities under the Credit Bureau Component.

FSI continued discussions with relevant parties regarding the development of credit scoring products and other services, such as fraud detection for the banking. FSI underscored that a Credit bureau must offer its clients expert services and products to help detect potential fraud from new and existing clients.

Kazakhstan's new private Credit Bureau will strengthen the primary mortgage, auto, retail, and credit card markets. It will accelerate the securitization of consumer receivables. It will help empower the middle class with greater mobility, greater opportunity, and, in the long run, provide greater resiliency to economic shocks – conditions for the development of a stable democracy in a more secure economic environment.

In no other market anywhere in the world at no time in history, to the best of our knowledge, has a project, like this one, made such progress in such a short period of time under such favorable conditions.

Kazakhstan's Credit Bureau is expected to be 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.

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There was no change to FSI's report last quarter regarding the establishment of a rating agency in Kazakhstan.

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 <ul style="list-style-type: none">• Complete a feasibility study on the possibility of establishing a Credit Bureau in Kazakhstan• Analyse the legal environment for the creation of a Credit Bureau	<ul style="list-style-type: none">• COMPLETED - FOR DETAILS SEE 6TH QUARTERLY REPORT
PHASE II <ul style="list-style-type: none">• Develop a Credit Bureau in Kazakhstan• Develop and Distribute a business plan and a detailed operations/technical implementation plan• Design a marketing and PR campaign• Develop the legislative package and actively resolve any legal issues• Work toward drafting a Credit Bureau law.	COMPLETED <ul style="list-style-type: none">• 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 <ul style="list-style-type: none">• Establish a Credit Bureau in Kazakhstan• Develop a credit reporting system• Construct a data base• Ensure sustainability	COMPLETED OR UNDERWAY <ul style="list-style-type: none">• 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

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	<p>PENSION) TO TRANSFER DATA TO THE FCB.</p> <ul style="list-style-type: none">• 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
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Task 2 – Credit Rating Agency

Defined Activity	Progress Made During Quarter/Proposed Future Actions
<ul style="list-style-type: none">• Create conditions and interest favorable to establishing a credit rating agency in Kazakhstan by holding second credit ratings training.• Identify credit agency willing to establish office in Kazakhstan	<ul style="list-style-type: none">• NO SIGNIFICANT CHANGE SINCE THE 11TH QUARTERLY REPORT.

LIST OF ATTACHMENTS

None

OVERVIEW ATTACHMENTS



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ОТ АМЕРИКАНСКОГО НАРОДА

FSI

Final Periodic Review Financial Sector Initiative Kazakhstan

October 05, 2005

Presented by:
The Pragma Corporation

Implemented by The Pragma Corporation





FSI Built Investment Capacity:

- **Introduced new financial instruments for domestic Investment**
- **Developed the mortgage industry--both primary and secondary markets**
- **The insurance industry and pension funds**
- **Developed the Credit Bureau**



Helped Create Essential Financial Sector Components and Enabling Legislation.

- **Institutions**: KMC, KMGF, Insurance Indemnity Fund, National Actuarial Center, Credit Bureau
- **Associations**: Association of Realtors of Kazakhstan (ARK), Chamber of Appraisers, Society of Actuaries, Association of Insurers
- **Products**: Corporate bonds, mortgage-backed bonds, grain warehouse receipts, PPNs, structured instruments
- **Services**: Mortgage lending, Insurance (life and annuity), Actuaries
- **Processes**: Legal (security interest, bankruptcy, trust), regulatory training, financial engineering, pension reporting and benchmarking



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FSI

Activities: November 22, 2004- May 21, 2005

Financial Instruments

Principal Protected Notes (PPNs)

- The Credit Suisse First Boston presentation on PPNs
- European Central Bank assessment of Central Securities Depository



Financial Instruments (cont.)

Draft Law on Securitization

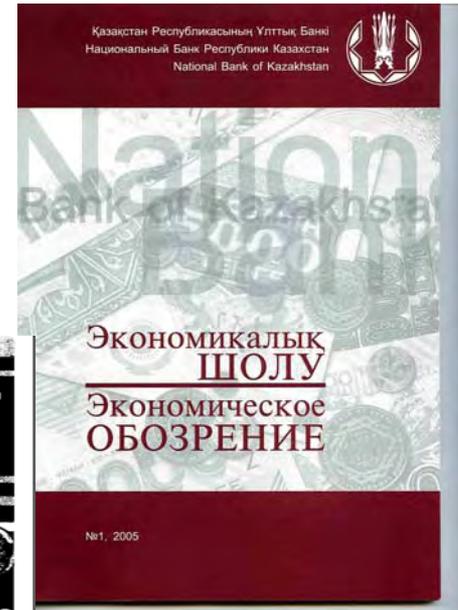
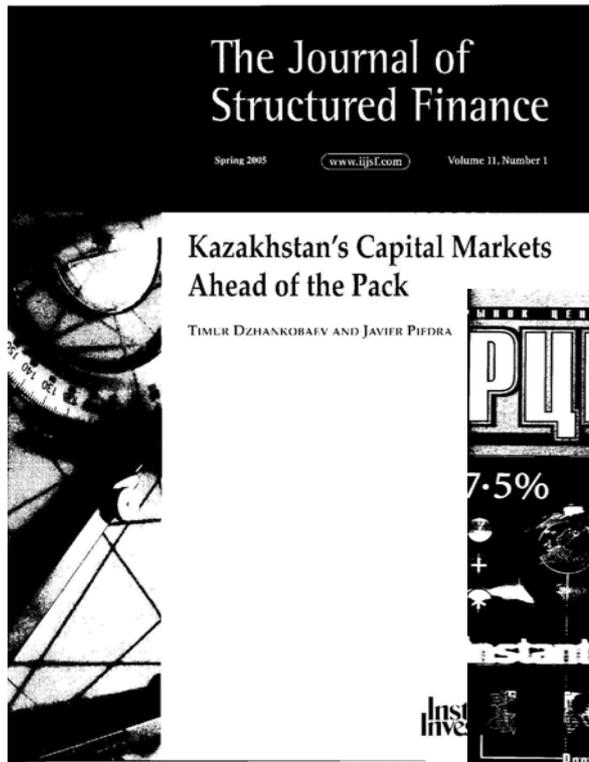
- Sponsorship of draft law shifted to Ministry of Finance
- Pragma alerts MOF/FSA on technical and conceptual discrepancies
- April MOF submits substandard version to Mazhilis
- Pragma works with Association of Financiers Committee of Issuers to draft modifications
- Pragma requests Standard and Poor's review the AFK draft
- AFK and FSA arrive at a compromise draft and submit the “consolidated version” to MOF



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FSI

Financial Instruments (cont.)





Financial Instruments (cont.)

Monetary Policy Roundtables

April

Mr. Oldrich Dedek, former Deputy Governor of the National Bank of the Czech Republic

- *Inflation Targeting and Instrumentalities*

June

Fareed Mohamedi

- *Kazakhstan the Implication of Oil on Monetary Policy the next 10 years*

Harvey Rosenblum

- *Instruments for Monetary Policy in Kazakhstan*

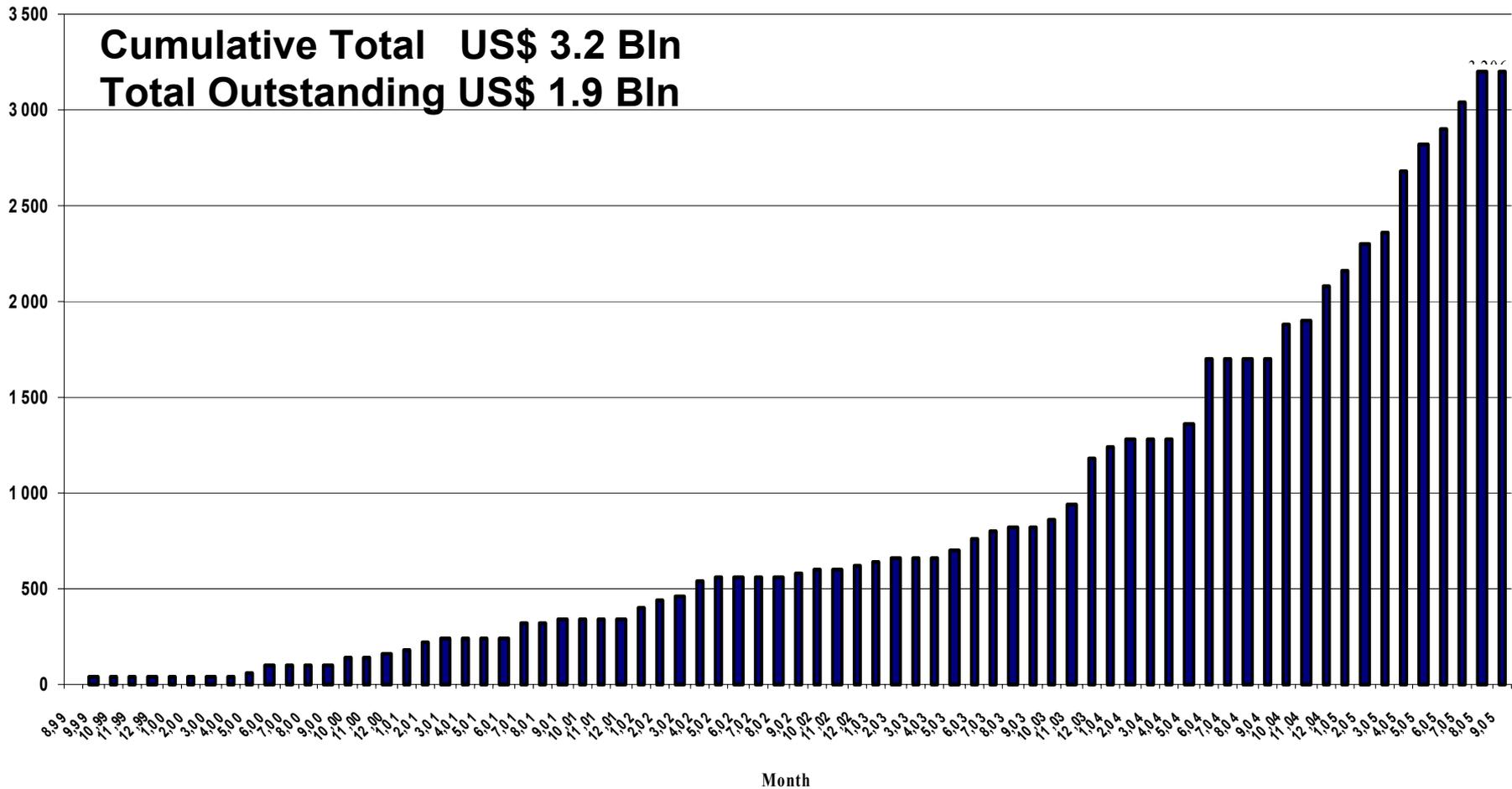
Professor Patrick Conway

- *Exchange Rates and the Alternatives to Exchange Rate Policy*



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CORPORATE BOND ISSUANCE (1999-2005, monthly in millions of USD)



Source: Kazakhstan Stock

Exchange



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FSI

Activities: November 22, 2004-May 21, 2005

Mortgage

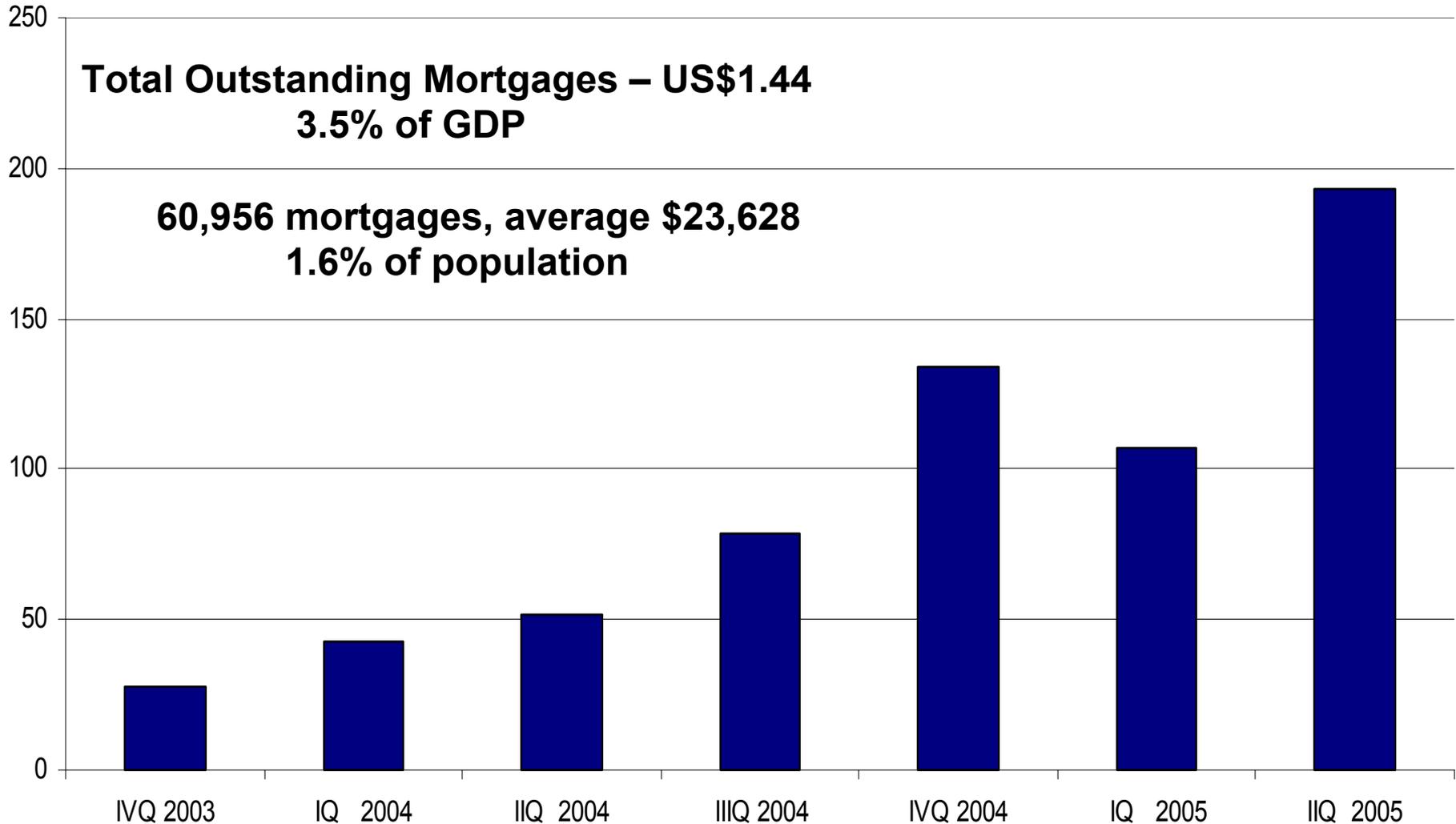
- Asset-liability management at KMC
- Profit/loss model for Kazakhstan Mortgage Company and Mortgage Guarantee Fund
- Association of Realtors of Kazakhstan (ARK) established
- Certification program for real estate professionals



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OUTSTANDING MORTGAGES

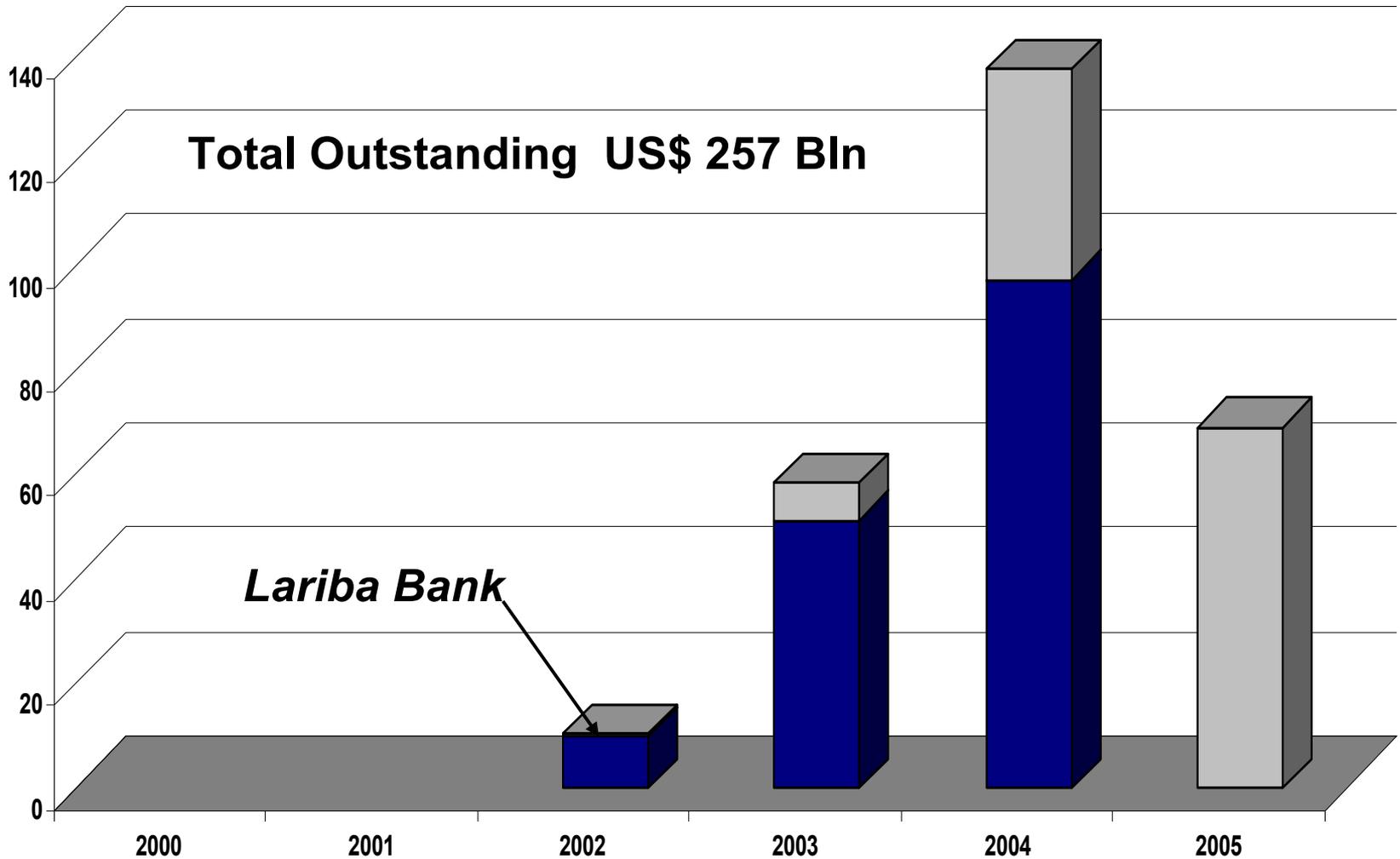
(QIV 03-QII 05, Quarterly, in Billions KZT)





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MORTGAGE BOND ISSUANCE (2002-2005, in millions US\$)





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FSI

Activities: November 22, 2004 - May 21, 2005

Insurance/Pension

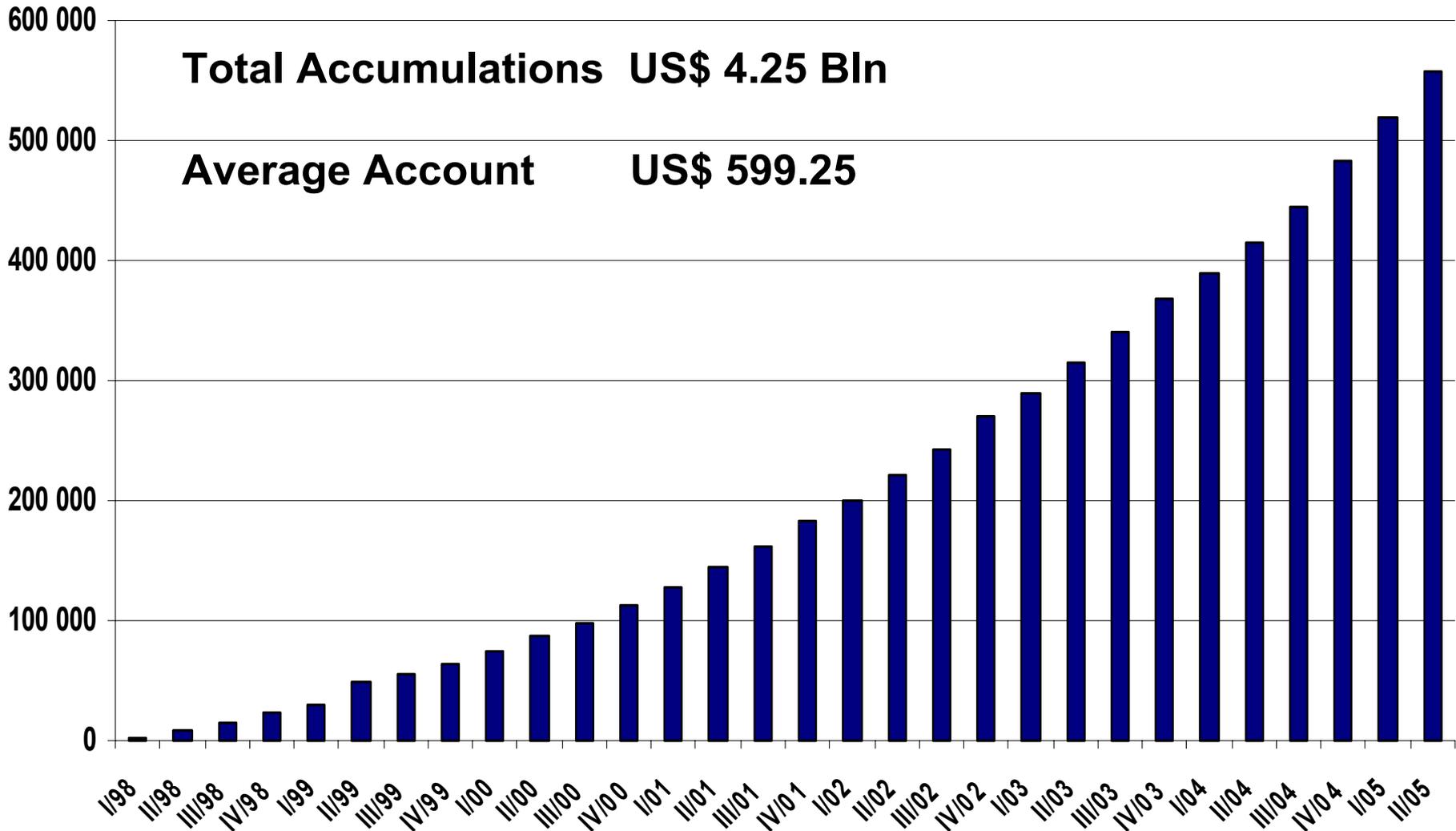
- Annuitant mortality tables.
- Life insurance review
- Society of Actuaries training program
- Draft law “On Insurance Activity”



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TOTAL PENSION ASSETS

(IQ 1998-IIQ 2005, quarterly in billion KZT)





Activities: November 22, 2004- May 21, 2005

Credit Bureau

- First Credit Bureau of Kazakhstan (FCBK) -- 7 commercial banks 1 finance company and Creditinfo Group
 - CreditInfo Group selected as the operator of the Credit Bureau
 - Data collection and testing started
 - Insurance related information to be included



No Cost Extension

Areas tasked under extension:

- 1. Annuity Product Development**
- 2. Assistance to the Small Enterprise Development Fund**
- 3. Actuarial Training**
- 4. Credit Bureau**



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No Cost Extension

Assistance to the Small Enterprise Development Fund

- Sustainability Analysis for the Fund
- Staff training program on loan guarantee underwriting for SMEs



No Cost Extension

Development of the State Annuity Company and its alternatives

- The use of annuities in Kazakhstan is mandated under Pension Law and Obligatory Employers Liability Insurance regulations.
- In eight years no insurance companies have developed annuity products



Deliverables / Accomplishments

PPNs	Benchmarking		Companies Offering Life/Annuity Products				Actuarial Center
Agencies			Industry Consolidation				Government Yield Curve
Non-Bank MBS	Privatize State Accumulation Fund	Train Personnel of the Unified Regulatory Body	Laws Adopted	IAIS Compliance		Mortgage-Backed Securities	Insurance Indemnity Fund
Bank MBS	Transparent Record-Keeping	Merge Existing Regulatory Bodies into a Single Unit	Licensing Brokers and Actuaries	Training	Database	Mortgage Origination	Mortgage Insurance Separate Class
Warehouse Receipts	Mark-to-Market	Encourage Government Decision to Unify Regulation	Consumer Protection	Implementation of Assessments Conclusions	Society of Actuaries	Training and Documentation	Credit Bureau
Corporate Bonds	Information Systems	Design Unified Pension Regulator	Assessment	Assessment	Trained Actuaries	Legal & Regulatory	KMGF

Formation of New Instrument Types

Pension System

Strengthen Pension Regulation

Insurance Legal Regulatory Framework

Effective, Efficient Insurance Supervision

Actuaries

Mortgage

Extraordinary Related Results



Capital Market Development

	GDP	Reserves less gold	Stock Market Capitalization	All Debt Securities Public Private Total	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



Capital Market Development

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Kazakhstan	43.5	7.8	7.1	7.8	24.0	38.9	89.4



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Finance in Kazakhstan
Small but elegant

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FSI

Areas Future Donor Organization Focus

- Actuarial Training
- Insurance Industry (Life insurance, annuities)
- NBK/FSA—Banking Supervision
- Judiciary



USAID
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FSI

USAID/FSI could not have achieved these accomplishments without the outstanding cooperation of:

National Bank of Kazakhstan

Financial Supervisory Agency

Association of Financiers

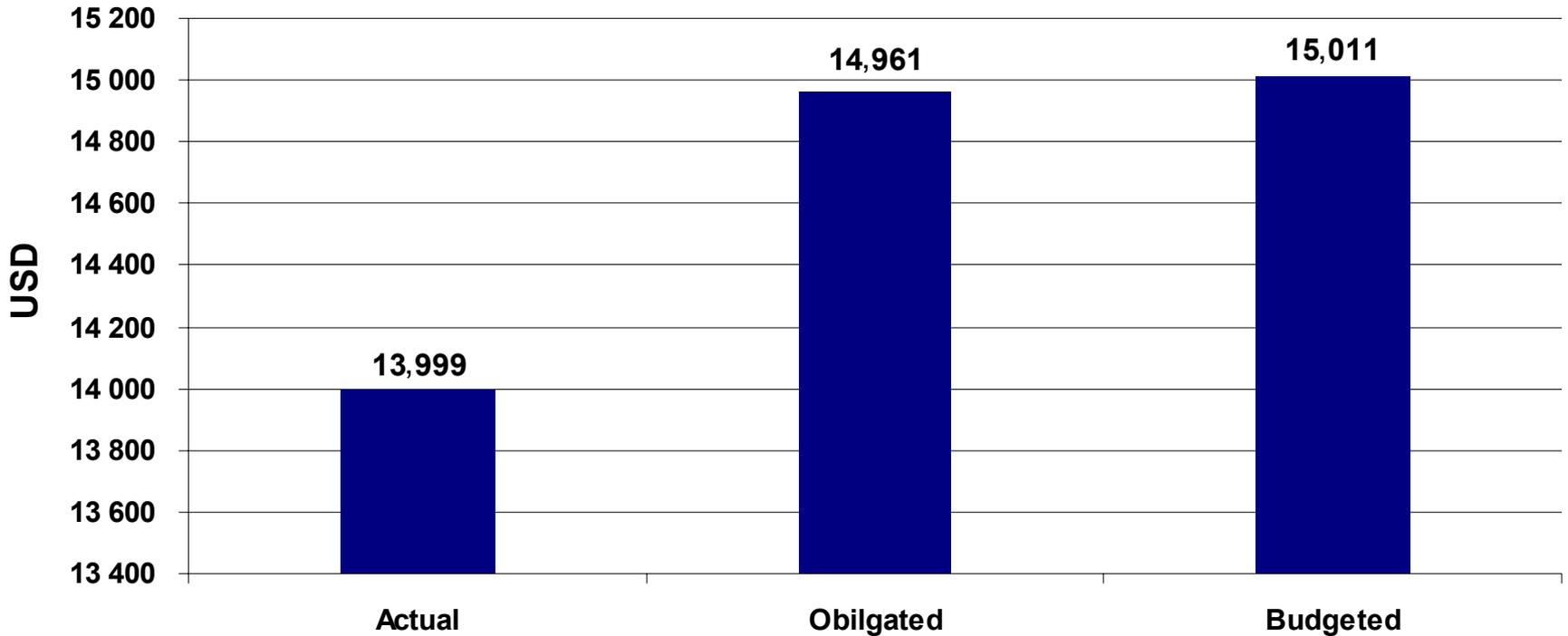
KMC

KMGF

And our local staff

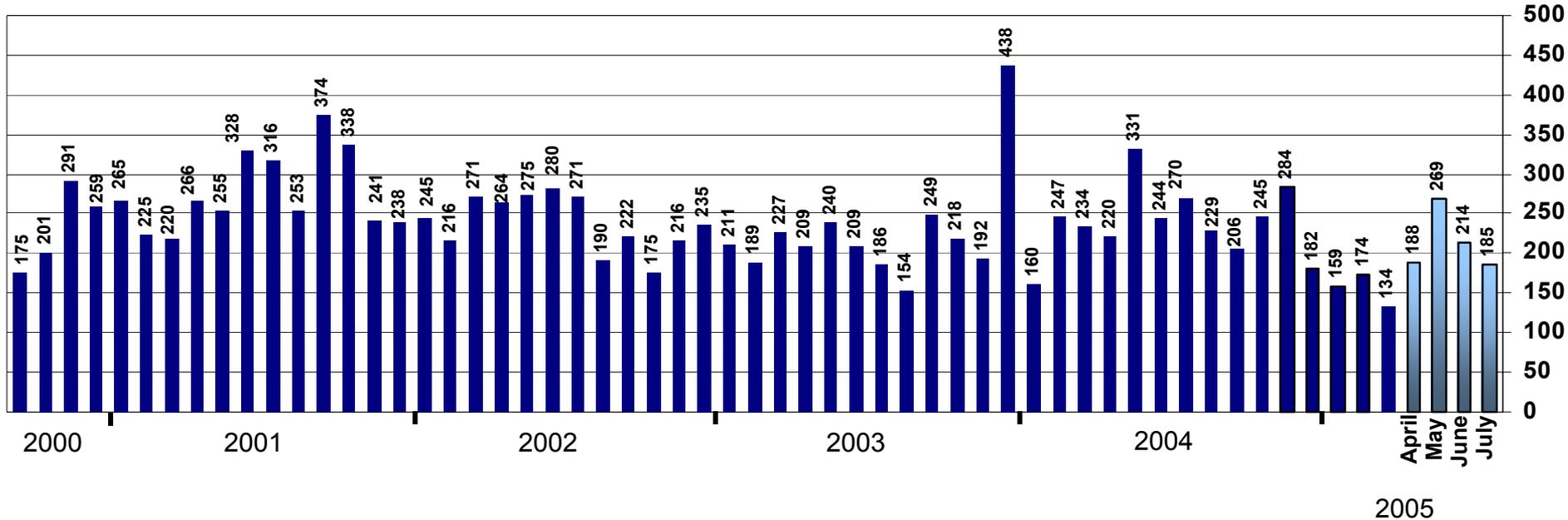


**FSI Budget
through July 31, 2005
(USD 1000)**





Cumulative Project Expenditure By Month through July 31, 2005 (USD 1000)



Total Expenditure: \$ 13,999,349

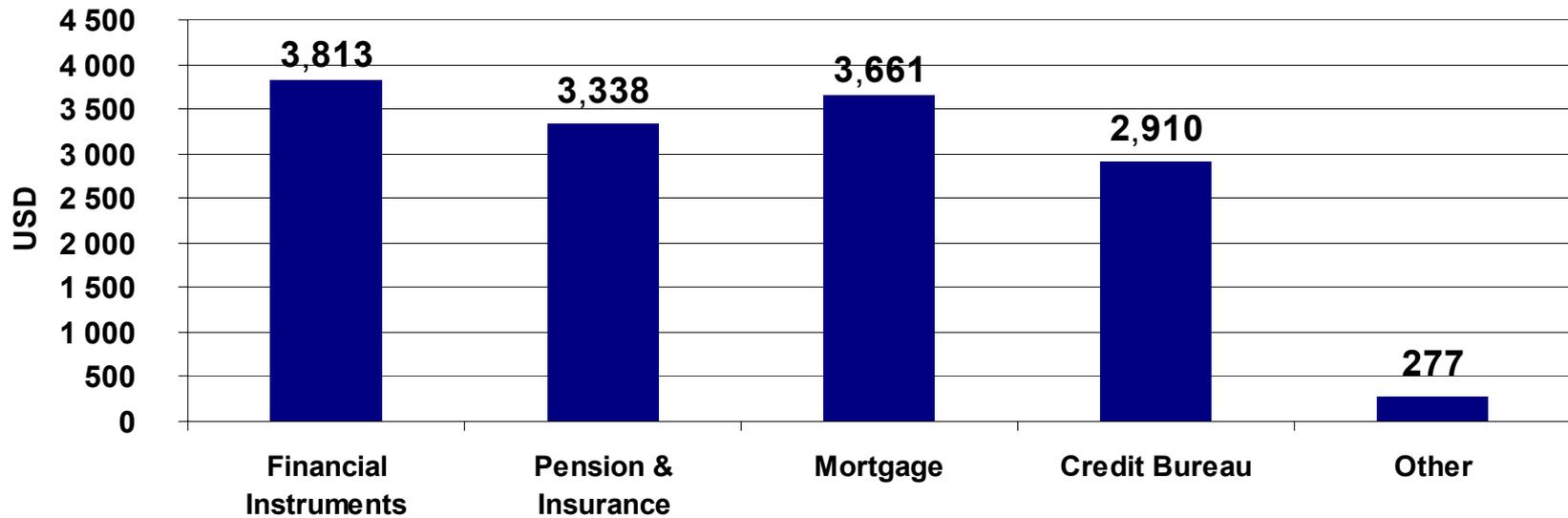
Average Monthly Expenditure: \$ 237,329

Average Monthly Expenditure last 6 months: \$ 193,844

Average Monthly Expenditure last 3 months: \$ 222,494



Cumulative Project Expenditure By Component through July 31, 2005 (USD 1000)



FINANCIAL INSTRUMENTS ATTACHMENTS

Облигационный конгресс СНГ констатировал привлекательность казахстанского рынка облигаций

Ценные бумаги

На заседании облигационного конгресса СНГ, прошедшего в Алматы в конце прошлой недели, обсуждалась ситуация на казахстанском рынке облигаций. Переживший очень стремительный рост начиная с 2000 года, наш первичный рынок облигаций стал, пожалуй, самым развитым в СНГ, и лишенные и достаточно дешевые деньги, которые могут быть заимствованы на нем, потенциально являются достаточно сильной проблемой даже для российских эмитентов, не говоря о компаниях с менее крупными и развитыми постсоветскими рынками. Желание видеть Алматы региональным финансовым центром и кризис пенсионных фондов, связанных с дефицитом инвесторов для инвестирования, и так или иначе происходящая на рынках СНГ экспансия казахстанских банков, где они принимают на себя существенные риски, вроде бы являются факторами, говорящими в пользу того, что «капитал» для инвестирования будет искать быть открыт шире. Пока не совсем ясно, как быстро может пойти этот процесс и насколько или для его активизации дополнительные политические решения и «концентрация политической воли», после которой начались поиски с выпуском инфраструктурных и промышленных облигаций и возможностью вывода на рынок производных бумаг национальных компаний или даже их акций. Согласно оценкам практически всех выступавших экспертов, ключевую роль в том, что состоялся и развивается казахстанский рынок облигаций, сыграло проведение пенсионной реформы и появление институциональных инвесторов в лице пенсионных фондов. Президент Казахстанской фондовой биржи Азамат ДЖОЛДАСБЕКОВ отмечает, однако, резантом успеха, помимо появления институциональных инвесторов в лице пенсионных фондов, которых не видел больше в СНГ, и принятые в свое время решения государственных структур, без которых рынок не смог бы развиваться. Принятые «на субфундаментальном уровне» решения, связанные с осуществлением облигационного налогообложения налогоплательщиков - резидентов ценных бумаг и решение, принятое тогда Наубайком о возможности для банков учитывать выпущенные облигации как часть капитала банка, стали основными факторами роста рынка.

Основным фактором роста рынка облигаций в Казахстане является, по мнению участников конгресса, возможность выпуска облигаций с государственным обеспечением. Пока барьеры, установленные для бумаг-резидентов на Казахстанской фондовой бирже, очень высоки. По словам президента Агентства финансового центра Алматы Ж.А. ЖАМШИЕВА, основным условием допуска иностранных госбумаг, например, является наличие инвестиционного рейтинга не ниже ВВВ+ в градации «Стандарт энд Пурс». Причем рейтинг должен быть обновлен или подтвержден в течение 18 месяцев после выпуска, а в случае изменения рейтинга между различными агентствами приоритет имеет последний рейтинг. Что касается корпоративных бумаг, то для листинга категории «А» биржи рейтинг должен быть не ниже «С» от «Стандарт энд Пурс», а для категории «В» - не ниже «В». Кроме того, компания, выпускающая в листинг «А», должна иметь собственный капитал не ниже \$100 млн и чистый аудированный доход за последние 3 года, для категории «В» - требования к собственному капиталу могут быть снижены до \$10 млн и чистый доход за последний финансовый год. Г-н Жамшиев в преддверии Наубайка Амар САЙДИЕВЫ говорит о намерении осуществить полную валютную либерализацию к 2007 году, а г-н Сайдинов отметил и наличие «национального государственного фонда» для обеспечения государственных облигаций, однако неясно, насколько серьезным будет влияние либерализации и какие категории инвесторов оно может затронуть. Не менее важным фактором в сложившейся ситуации остается и ревальвация тенге, дающая значительно меньшим интерес инвесторов к долларовой ценной бумаге. По словам г-на Джалдасбекова, 2-хлетняя еврооблигация Российской Федерации, допущенная на рынок, имеет практически нулевой спрос, хотя и успешно удерживается по цене выше 100% от номинала, были бы интересны казахстанским инвесторам. По словам руководителя агентства «ИРБИС» Андрея ЦАЛЮКА, хотя еврооблигация Казахстана эмитентов и листингована на нашей бирже, сами эмитенты довольно реалистично оценивают перспективы этих бумаг в условиях ревальвации тенге и практически не рассчитывают на продажи умов. Впрочем, когда иностранные покупатели ориентировались на спрос на наш валютный рынок и формировали свое отношение к тенге, ситуация, однако, может измениться под влиянием мировых рынков.

Спикеры конгресса стремились объяснить многочисленные страны, которые, несмотря на быстрое развитие, характерны для казахстанского рынка облигаций. Одна из них состоит в полном отсутствии вторичного рынка, то есть отсутствия ликвидных облигаций. Пенсионные фонды, являющиеся главными инвесторами, покупают бумаги и удерживают их до погашения, не торгуя ими. Главным инструментом для вторичного торгового остаются ноты Наубайка, которые выполняются для инвесторов роль своеобразных «бумаг ожидания», куда инвесторы вкладываются на некоторое время, до принятия крупных инвестиционных решений. Второй отмеченной практически всеми ос-

бенностью является доминирование банков и финансовых институтов среди эмитентов, их доля среди эмитируемых бумаг составляет около 80%. Отсутствие диверсификации означает определенные риски, и аналитик корпорации «Прагма» Стефан МОДИИ считает не сплоченным позитивным фактором то, что весь рынок корпоративных облигаций зависит от роста банков, который может быть критичен, например, в этом году. Если сравнить с российским рынком, то там лишь 17% эмиссии принадлежит банкам. По мнению аналитика, возможно, это связано с тем, что российский экономика все равно больше и не в такой степени зависит от мировых цен на нефть и слабого или, наоборот, сильного доллара. Г-н Цалюк считает, что то, что именно банки пользуются основным высочайшим кредитным рейтингом и кредитными историями, является отчасти ностальгией по дешевым деньгам на фондовом рынке и затем с выгодой кредитуют реальный сектор экономики, связанно с «силой привычки» самих компаний реального сектора, которые пока предпочитают кредиты, а не выпуск облигаций. Нисколько сплоченным барьером для компании не считается, а банк бы заимствованы на рынке дешевле кредитов, является спорным вопросом, поскольку это необходимо считать в каждом конкретном случае. Казахстанские инвесторы выигрывают по оценкам г-на Джалдасбекова, относительно низкокачественными на внутреннем фондом рынке, несмотря на доминантность, по мнению г-на Пана, однако, мог бы быть выведен на рынок еврооблигаций. Первоначально в выпуске облигаций, повливающих на рынок инвесторов, компаниям банков, но затем по мере снижения рисков стали выступать как отдельные инвесторы. Узбекские участники дискуссии признали преимущества существования институциональных инвесторов, которыми в Казахстане являются пенсионные фонды. Построение подобной модели выигрывает пока крайне маловероятно, хотя 2-е место после узбекских банков в качестве инвесторов занимают страховые компании, а также крупные корпоративные инвесторы, которые в Казахстане являются пенсионными фондами. Построение подобной модели выигрывает пока крайне маловероятно, хотя 2-е место после узбекских банков в качестве инвесторов занимают страховые компании, а также крупные корпоративные инвесторы, которые в Казахстане являются пенсионными фондами.

Участники облигационного конгресса пока не видят в Алматы регионального финансового центра

Второй день облигационного конгресса стран СНГ был посвящен обсуждению ситуации на рынках стран СНГ, каждой из которых была посвящена самостоятельная сессия.

Принимая участие в дискуссии, участники конгресса отметили, что рынок облигаций в Казахстане является достаточно привлекательным, несмотря на то, что речь во многих случаях шла о таких странах-антагонистах, как Узбекистан и Украина. Несмотря на крайнюю слабость «труда государства» в Узбекистане рынок облигаций занимает по объемам четвертое место в СНГ после России, Казахстана и Украины, хотя в абсолютном выражении общая сумма всех эмиссий составила и составила 100 млрд тенге, что является самым высоким показателем в СНГ. Среди участников конгресса были отмечены трудности Казахстана и тем более российских эмитентов, состоящая примерно в \$30 млн. Ставки привлечения медленно снижаются все несколько лет существования рынка и снизились в итоге с 30 или немногим более процентов до 24%, но которые размещаются в последние времена при низком уровне. Один из участников обсуждения Джамал ДЖУС, возглавляющий крупнейшего производителя сока в Узбекистане «Мервилл Джус», перечислил преимущества выхода на узбекский рынок облигаций, по сравнению с банковским финансированием. Более высокая стоимость финансирования и более длинные сроки заимствований, речь обычно идет о двухлетних бумагах, которые затем пролонгируются до 3 лет. Между тем банковские кредиты выдаются лишь на год, и пролонгация их банков даже для корпоративных клиентов обычно решается регулятором как нарушение. Рефинансирование кредитов в других банках выигрывает также очень сложной процедурой, и банковские кредиты выдают для клиентов для реального сектора. Как ни удивительно, но при этом выигрывают потенциальные кредиторы в плане существующих барьеров и требуют предоставления меньшего пакета документов. По словам голландского бизнесмена, в стране не так много компаний, которые способны эффективно заимствовать на облигационном рынке. 24%, «Мервилл Джус» является на местном рынке торговой маркой, которую знают все, и со своей рентабельностью в 45% и ежегодным ростом рынка на треть заинтересованы в таком финансировании. При этом основной проблемой является уровень инфляции в соседней стране составляет всего 2-2,5%. Гендиректор «Мервилл Джус», отвечая на вопросы, также постарался успокоить аудиторию относительно процедур, связанных с репатриацией валютной выручки, указав, правда, выигрывает компания относительно инвесторов, поскольку, по его словам, компания в последние годы никогда не получала отказа, связанного с конвертацией любых сумм, правда, после определенного временного срока, который может составлять и 6, и 7 месяцев. В любом случае, ситуация, по его словам, качественно изменилась в лучшую сторону по сравнению с 1990-ми, когда существовали квоты на конвертацию и компания, которая не попадала в эти квоты, была бессильна что-либо изменить. Общественный менеджер, занимающийся участием узбекской «панели» эксперта корпорации «ПРАГМА» Джамал ПАСКАЛЯ, сообщил к тому, что узбекский рынок облигаций является, безусловно, потенциалом оптимизма. По словам бизнесмена, который из Узбекистана сотворил операторов Советом Алексея ПАНА, одной из главных проблем для эмитентов остается отсутствие ликвидности для долгосрочного инвестирования, на которое не всегда приходится инвесторам, которые не всегда готовы вкладывать средства в облигации (что не удивительно, учитывая доходность размещаемых бумаг). Компания является единственным сотовым оператором, размещаемым в своем банке облигаций, несмотря на то, что одним из участников конгресса является один из крупнейших участников американского рынка мобильной связи (естественно, имеющий доступ к международным рынкам капитала), именно американцы настояли на первом

размещении на внутреннем фондом рынке, несмотря на доминантность, по мнению г-на Пана, однако, мог бы быть выведен на рынок еврооблигаций. Первоначально в выпуске облигаций, повливающих на рынок инвесторов, компаниям банков, но затем по мере снижения рисков стали выступать как отдельные инвесторы. Узбекские участники дискуссии признали преимущества существования институциональных инвесторов, которыми в Казахстане являются пенсионные фонды. Построение подобной модели выигрывает пока крайне маловероятно, хотя 2-е место после узбекских банков в качестве инвесторов занимают страховые компании, а также крупные корпоративные инвесторы, которые в Казахстане являются пенсионными фондами.

Вчера в алматинской гостинице «Казахстан» состоялась заседание Совета эмитентов, на котором были рассмотрены 2 вопроса: законодательство о секьюритизации и дальнейшее развитие норм, связанных с корпоративным управлением. По словам председателя Агентства финансового надзора Бюлета ЖАМШИЕВА, несмотря на то, что законопроект уже находится в парламенте, технические вопросы все же предстоит внести и внести изменения, которые стали бы компромиссом между участниками рабочей группы, созданной Ассоциацией финансистов, правительством и АФН.

Большинство противоречий по проекту закона о секьюритизации сняты

Консультации привели к снятию большинства противоречий. Руководитель рабочей группы ассоциации Юрия ЯХУШЕВА привел основные цифры, характеризующие развитие проектного финансирования в Европе и США, на рынках которых оно начал развиваться с 80-х годов.

(Окончание, пожалуйста, на 9-й стр.)

Presenters Monetary Roundtable II
Hyatt Hotel Almaty, Kazakhstan
June 3, 2005

The Second Monetary Roundtable was held June 3rd at the Hyatt Regency. The roundtable was sponsored by USAID with the assistance of the Pragma Corporation's Financial Sector Initiative project. Hosting the roundtable was Anvar Saidenov Governor of the National Bank of Kazakhstan. Representing USAID was Mary Norris Regional Director, Office of Enterprise and Finance USAID/Central Asia.

The roundtable began with welcoming remarks and presentations by Governor Saidenov and E&I Regional Director May Norris.

The first speaker was Fareed Mohamedi his topic was "Kazakhstan the Implication of Oil on Monetary Policy the next 10 years". Mr. Mohamedi was chosen to speak first as oil reserves and the price of oil is key to the direction of the economy of Kazakhstan and National Bank monetary policy operations.

Mr Mohamedi is an international economist with over 20 years experience in consulting firms, credit rating agency, research institutes, multilateral organizations, and finance ministry. He has advised a wide variety of corporate and government clients on global economic developments, structural adjustment policy issues, and external debt/investment challenges facing Asia, Latin America, Middle East, Former Soviet States, and Africa He is a recognized expert on the Persian Gulf, OPEC dynamics, and global oil markets

Mr. Mohamedi is currently Chief Economist and Senior Director, of The Petroleum Finance Company (PFC Energy), Washington DC. Prior to that he was a Vice President/Senior Analyst, Sovereign Risk Unit Moody's Investors Service, New York, where he was principal rating analyst for: Norway, Netherlands, Saudi Arabia, Iran, South Africa, Kuwait, UAE, Tunisia, Kazakhstan, Turkmenistan and Pakistan Mr. Mohamedi has an MA, Arab Studies (Economics concentration), School of Foreign Service, Georgetown University and a BS, Economics, Western Michigan University

Mr. Mohamedi's presentation was divided into four sections

- Short term oil markets
- Are we in a world of "peaking oil"?
- What are other oil producers doing?
- Some suggestions for Kazakhstan

The biggest contributors to the rise of oil to over 50 dollar per barrel are

- Stretched infrastructure, refinery and tanker bottlenecks
- Low Supply Growth
- Shrinking OPEC Spare Capacity
- Supply Anxiety
- Political Risks
- Speculative dollar flow

Oil demand growth remains tightly correlated to economic growth. The rise of Asian economies in the 1990's has helped re-establish this relationship.

China's soaring growth impacts all regions of the world

US product demand also stays strong gasoline and diesel underpin growth

Refiner utilization is stretched

FSU is the only region with significant spare capacity

Can Supply Keep Up With Demand in 2005?

- Supply growth outside of OPEC quota in 2005 will fall 825,000 b/d short of demand growth.
- OPEC will work to fill the gap by increasing output nearly 800,000 b/d and by pushing output in the second half to new highs.
- However, the organization's spare capacity will remain tight and its marginal barrel will still not be the light sweet crude the market most needs.
- Non-OPEC supply will step firmly into a new era this year:
 - Russian supply growth will slow.
 - The next big wave of mega-projects (from deepwater and Central Asia) will start to come online in earnest.
 - Mature Non-OPEC regions will see an accelerating pace of declines.

Iraqi crude production faces a number of severe challenges:

- Security: Insurgents have effectively shut down northern exports and severely curtailed the ability to refine crude domestically. The south is a less permissive environment for insurgents and has seen few attacks of late, but remains vulnerable to attack.
- Stagnation: The worst reservoir management practices of the past continue (overproduction to secure revenues, reinjecting degasified crude, etc.) and to date no sub-surface evaluation has been carried out. Kirkuk has lost 200,000 b/d of capacity from pre-war levels and faces the real threat of catastrophic collapse.
- With the security situation unlikely to improve substantially in 2005, production will remain very choppy but will continue to trend downwards, averaging a mere 1.9 million b/d.
- Mature oil-producers will head further down the road of declines in 2005: Non-OPEC crude production excluding the FSU and major deepwater projects will actually decline by 500,000 b/d.
- The North Sea will continue to lead declines, but the usual suspects in the Non-OPEC Middle East (Yemen, Oman and Syria) and Latin America (Colombia, Argentina) will also keep falling.
- Australia, which has seen 275,000 b/d of declines in the past four years, will manage to halt the slide thanks to the start of the Mutineer-Exeter field, but this will be only a temporary respite before declines resume.
- With increasingly depleted reserve bases, Non-OPEC declines are only expected to gather steam in the years to come.

Why Is OPEC Not Able To Respond?

- Wrong type of crude. Total crude supply is increasing but sweet crude production is flat

Price of crude is increasing somewhat due hedge fund speculation

- Sliding dollar and low interest rates
- The recent rallies of the last three months are related to pouring money into the oil futures market by all types of investors.
- Investment in commodities is a great opportunity to cash in in Asian growth, but a growing problem for the stability of oil prices

Key Messages

- The world is not in imminent danger of running out of oil, but certain countries/regions are depleting much faster than others. This will cause a shift in the geographic dominance of production sources.
- In spite of high oil prices, Non-OPEC production has been stagnant with the notable exception of the FSU. This trend is likely to continue through this decade.
- Exploration results in the last 10 years (with a few exceptions like Angola, Sudan, Mauritania) have been much less significant than in previous decades. Without a significant reversal of this trend, Non-OPEC production is likely to peak just after 2010 and begin a long term decline.
- Every year, in every region (including OPEC), the world produces more oil than it finds. It is only logical to conclude that inevitably this will lead to dwindling supplies.

Kazakhstan Oil Production Forecast

- Oil production should peak in 2021

How long can OPEC production be able to fill the growing gap between demand and non-OPEC production capacity.

- In a low demand growth scenario, OPEC production will likely meet global demand through the end of the next decade but not beyond 2025.
- In a base case demand growth scenario, OPEC production will likely not be able to meet global demand in the latter part of the next decade.
- In a high demand growth scenario, OPEC production will likely not be able to meet global demand as early as the middle part of the next decade.

Some Suggestions for Kazakhstan

- Understand and monitor oil markets:
 - Expect volatility in oil markets:
 - Understand the impact of Kazakhstan production on oil markets
 - Understand the behavior of other oil producers

- Get a real understanding of the capabilities of your own oil and gas sector:
 - What is the long term production profile of your sector? Don't take it for granted
 - What do you want from the oil and gas sector?
 - You can do a lot more than extract rents
- Building a oil and gas sector to promote development:
 - Backward linkages:
 - Gas as an engine of growth
 - Oil services and engineering
 - The Norwegian model
 - Oil/gas sector policies are any important signal for FDI promotion
 - Build a national oil company with a long term vision:
 - Devise a strategy to make it a viable private company
 - Use it to develop indigenous skills
 - Do not give ita all the assets – have some competition
 - It should not make policy – but give it a stable planning horizon
 - Fiscal policy (and exchange/monetary policy) should take into account your oil/gas sector developments:
 - Understand your long term revenue potential
 - Integrate longer term saving plans with oil/gas sector revenue and investment potential

Questions.....

Next Speaker

Professor Patrick Conway

Exchange Rates and the Alternatives to Exchange Rate Policy

Professor Conway is currently teaching Economics at the University of North Carolina at Chapel Hill. His teaching responsibilities include courses on both the graduate and undergraduate level in macroeconomics, economic development and international economics. Recent academic research has focused on the problems of developing and transition countries in adapting to the international environment.

Professor Conway has Ph.D. in Economics, Princeton University, Master in Public and International Affairs, from the Woodrow Wilson School, Princeton University and an undergraduate degree from the Georgetown University School of Foreign Service

The Export Boom in Hydrocarbons

- Blessing:
 - Windfall gains in export receipts.
 - Surplus on the government budget due to taxes and royalties on hydrocarbon production.
- Curse?
 - Inflation is rising.
 - Excess liquidity.
 - Non-renewable, exhaustible, resource.

What are the three Challenges?

- Creating a transparent and effective exchange-rate regime for Kazakhstan.
- Making the exchange-rate regime consistent with inflation targeting.
- Providing for future generations through contributions to the National Fund.

Recommendation 1: Accept that the real exchange rate will appreciate on average

- Increased export receipts become an increased demand to purchase tenge. In a flexible regime, this will lead to nominal appreciation.
- The increased income from the windfall leads to increased expenditure and Dutch disease effects, including real appreciation.

Looking at real rates of exchange of the tenge versus the Dollar and Euro

- The biggest increase in real rates of exchange has been against the dollar
- But the weighted real rate of return has been fairly consistent, which would indicate that much of the appreciation of the tenge against the dollar is not been because of oil revenues, but more associate with the weakness in the dollar against over all.

Recommendation 2: Managed exchange rate regime, plus.

The current methods used by the NBK have been working and are the best way to go. Most importantly is set a strategy for exchange rates, currently the exchange rate regime is reactive.

- Why not a flexible regime?
 - Desirable properties if it works.
 - “Fear of floating”
- Why not a fixed regime?
 - Desirable if credibility is a problem, and if there is one dominant trading/financing partner.
 - These don’t seem to be the case in Kazakhstan.
- Managed: already evidence that NBK does it well.
- To do: Careful attention to desired parity.
 - Simple rules (fix currency value with price of oil). The professors from Harvard have suggested that the exchange rate be fixed to oil, this is not a good idea since it will reintroduce volatility
 - Elaborate modeling exercises (monetary CGE models).
 - Periodic revisions

Recommendation 4: Integrate exchange-rate policy with other macro policies

- Dutch Disease outcomes are inevitable with this real appreciation considered in isolation.

Some sign's of the Dutch Disease as there has been some reduction in the manufacturing sector

- Sectoral development policies can be combined with these to mitigate effects.

The NB needs to include other sectors of the government such as the Minter of Economy in the exchange rate dialogue to explain their exchange rate policy.

Recommendation 5: Recognize and exploit the inflation-targeting benefits of the National Fund

- National Fund has two explicit roles: stabilization from year to year and saving for future generations.
- The National fund has an implicit role in reducing the real appreciation necessary in the current generation – this also limits the inflationary potential of the oil windfall.
- A new way to achieve this: lower the “trigger price” of oil in the Republican Budget Law.
- Needed: more thought and transparency on the policy for disbursements from the saving component of Fund.

How Can We Integrate Policies and Remain an Independent Central Bank?

- Transparency is the key.
 1. NBK Sets Policy and Analyzes Impact
 2. NBK alerts rest of government to consequences and possible mitigating steps
 3. Government debates, implements mitigating steps

Q. I would like to know your notion about the separation (task sharing) of exchange rate policy between the National Bank and the Government.

I was not suggesting that exchange rate policy be divided between the NBK and he government. The NBK is responsible for exchange rate policy, but it need to keep the government informed of what their policies are. The government needs to know exchange rate goal.

Q. You suggested the scheme of interaction between the NB and the Government. You said that on the first stage the NB analyzes the versions and combinations of exchange rates and inflation, after that NB announces to the Government some variations. Do you think there should be any discussion between the NBK and the Government about elaboration of the best combination of exchange rates and inflation at this stage?

The NBK's mandate comes from the legislature that has mandated no inflation. But a zero inflation rate will result in an appreciation of nominal exchange rate. The NBK needs to warn the government what the effects of a zero inflation rate target.

Q Do we need to change the way the NBK operates

A. No

Q. In your recommendations you told, that one of the functions of rates of exchange determination is "tying" it to oil prices. The question is : Don't you think that such a form of "tying" will be a form of hedging for oil exporters, because while decreasing oil prices, rates must be devalued and that is a subsidy for oil exporters and producers. Before 1999 Kazakhstan made a nominal rate devaluation that was an incentive for exporters. How do you think this policy can connect with the goals of industrialization and development of non-primary (not raw materials) market? (after answer) The 2 question. Do you think that increasing infrastructure cost will be conducive to reducing surplus.

A. The price of oil is key to targeting exchange rate policy. The people from Harvard have suggested with pegging the price of oil to the tenge. I believe this is quite problematic as it will create great currency volatility and be a problem to the non-oil manufacturing sector and discourage exports.

Dr. Harvey Rosenblum

Topic: Instruments for Monetary Policy in Kazakhstan

Dr. Rosenblum is currently a Senior Vice President and Director of Research, Federal Reserve Bank of Dallas. He has served as Chief Economist and Economic Policy Advisor to the Bank's president for Federal Open Market Committee and other matters related to monetary policy and related regulatory issues. His responsibilities included providing monthly economic briefings to the Bank's Board of Directors. He has served as a member of the Bank's Senior Management Committee and the Discount Committee. He has also worked at the Federal Reserve Bank of Chicago as a Vice President, Director of Research

Dr. Rosenblum has a Ph.D in Economics, University of California and a B.A. in Economics, University of Connecticut,

My presentation will focus on three main topics: 1) the appropriate goals for monetary policy in Kazakhstan; 2) the choice of instruments for achieving these goals; and 3) special considerations like the impact of changes in energy prices and bank safety and soundness issues.

The National Bank's current monetary policy settings seem appropriate for the present-day situation. Fiscal policy is somewhat restrictive in that the government is running surpluses, given the contributions to the National Fund. Monetary policy, as suggested by low and negative real rates of interest, is somewhat expansionary. But the thrust of overall economic policy is the sum of fiscal and monetary policy, and this combined impact of the two policies is supportive of continued economic growth.

Kazakhstan as had exceptional; economic growth over the last few years and I urge caution in changing your current economic policy just because it is a popular new trend in other economies.

A change to formal inflation targeting would require a more restrictive monetary policy, now is not the best time to make such a change because it would remove much of the growth momentum in the economy and would slow the rate of economic development.

At the present time, one important role for the monetary policy of the National Bank is to build the public's confidence in the financial future of the economy and its financial system. Strong economic growth is helpful to achieving this end. Current rates of inflation of around 7 percent the government needs to provide an incentive for people to earn a rate of interest on their spare cash balances by keeping their money in the banking system. This will continue as long as the economic future looks good and people believe the banking system is honest and sound and that deposit insurance is real and dependable. Without a deposit system, the ability to create a viable credit system would be diminished.

I would like to switch to monetary policy

Over the last decade, two trends have emerged around the world that are changing the nature of central banking. The first is the practice of inflation targeting, and the second is the separation of monetary policy from the supervision and regulation of the financial system. Central banking is a man-made invention designed to mitigate and hopefully prevent financial instability. In order to do so, central banks must be able to influence both the economy's credit expansion and the financial sector firms that are an integral part of the credit creation process. Unfortunately, we do not live in a world in which these issues can be isolated from one another. Monetary policy settings have an important impact on financial intermediaries. A healthy banking sector is critical for the transmission of monetary policy.

Inflation Targeting: Many central banks have, by law or by choice, begun to practice explicit or implicit inflation targeting. Generally this involves setting an upper bound for inflation and tightening policy whenever inflation threatens to move above the upper tolerance limit. Some central banks also set a tolerance limit for the lower bound of inflation they are willing to live with. This latter practice has become more widespread in recent years as the potential for **deflation** has become a concern in a few countries. As mentioned above, some central banks have an implicit inflation target or band that gets communicated to the public and financial markets in an informal manner. The important issue is central bank behavior/action as inflation moves toward the upper or lower band.

My impression from visiting with some members of the staff of the National Bank of Kazakhstan ("NBK") is that NBK targets inflation in an implicit way because there is a professed goal of "price stability," but no explicit statement of an upper or lower bound for inflation that would necessitate a predictable tightening or easing of monetary policy. An inflation forecast or projection (as contained in the NBK's *Inflation Report for First Quarter 2005*) is not the same as an inflation target because the monetary policy response remains unclear.

NBK should be commended for analyzing a range of inflation measures in its Q1 2005 *Inflation Report*, including several measures of "base" or trend inflation that paint a more benign picture of inflationary pressures in the Kazakhstan economy. When I first looked at the Q1 report it appeared that inflation was in the 7-7.5 % range, but by removing the more volatile components of inflation, trend inflation, as shown by the "trimmed mean" and CPI median measures, is likely in the 3.0-5.5 percent range. These measures have proven quite useful for interpreting inflation trends in the United States and may also be helpful for Kazakhstan. Every country has its own group of volatile inflation components and I recommend that NBK analyze which inflation

measures correlate best with future movements of overall inflation. The Dallas Fed has been experimenting with a trimmed mean indicator and it appears to be quite successful in

I also recommend that NBK work closely with the Kazakhstan Statistical Agency to develop some unique inflation measures that more meaningfully represent the inflation impact on the median citizen of Kazakhstan. GDP has grown extremely rapidly in recent years, the availability of and demand for higher quality (and thereby more expensive) goods and services may be upwardly biasing the measures of inflation if careful quality adjustments are not being made. I also suggest that, in addition to analyzing price inflation the NBK should use measures of wage inflation. It may very well be the case that if “properly measured,” overall inflation may be running at half, or even less than half, of the 7 percent rate that is thought to prevail. In short, if NBK is considering a move toward inflation targeting, it is critical that careful analysis take place first on the best inflation measure or measures to be targeted.

Another consideration to consider if the NBK is going to full inflation targeting is the impact on banks and other financial intermediaries. A bank’s asset mix that makes sense in an environment of inflation rates of 7-10 percent may not make sense in an environment of inflation in the range of 1-3 percent, especially if the move to the lower inflation range were unanticipated and occurred abruptly. For example, a borrower may be able to cover loan payments easily if his wages and cash flow grow at a 7 percent annual rate, but could experience difficulty if wage growth slows to 2 percent.

I need to caution NBK about some reservations I have with inflation targeting. First, inflation targeting should be done only if a central bank is truly serious and absolutely committed to such a strategy. A halfway commitment or backtracking is simply not an option. The credibility, reputation, and integrity of the institution are at stake. Second, inflation targeting requires the explicit political support of the rest of the government and at least the implicit support and understanding of the general public and the banking system. It is the central bank’s job to educate and persuade these constituencies on the cost-benefit tradeoffs of inflation targeting. Third, the central bank must be willing and committed to seriously restrain the growth of credit and raise the cost of credit whenever the rate of inflation threatens to move above the upper tolerance level that has been established. On this point, the central bank has virtually **no choice**. Proponents of inflation targeting find this to be a desirable feature. Opponents of inflation targeting, such as Chairman Alan Greenspan of the U.S. Federal Reserve System, sometimes find this to be an undesirable feature of inflation targeting if they would be forced to tighten monetary policy just as their economy is headed into a recession.

One of the key rules in the practice of medicine and central banking is “do no harm.” Until a few years ago, it was my view that countries that adopted inflation targeting did not need inflation targets to reduce inflation in their economy. The same results could have been achieved by carrying out the same policy settings without inflation targets. But inflation targets did no harm. Many central banks achieved similar disinflation results without inflation targeting. The differences were not statistically significant. However, over the last couple of years I have begun to wonder whether inflation targeting has locked some central banks into inflexible policy settings that may be restraining the ability of their economies to reach their full, long-term growth potential.

Monetary Policy Instruments

Does the NBK have the necessary instruments or tools? Yes they do.

In this regard, the main issue is the banking system's "excess liquidity" discussed by Oldrich Dedek and Steve Moody at the April Roundtable. If NBK desires to reduce the rate of inflation, it is necessary to restrain the rate of credit growth in the economy by absorbing the banking system's excess liquidity. To do this, the first step involves constraining the liability choices of the banks and their rate of growth.

Currently, banks hold reserve balances at NBK of 6 percent on liabilities maturing in less than two months. I suggest extending reserve requirements to a wider range of liabilities, irrespective of maturity.

NBK may wish to consider having a higher reserve requirement ratio on liabilities raised outside Kazakhstan. This broader, and possibly higher "reserve requirement tax" on banks, would reduce excess reserves and would reduce the costs of operating NBK. This would put upward pressure on interest rates and likely reduce the asset size of the banking system. This could also reduce the profitability of banks, and therefore should be phased in gradually and carefully.

I concur with Mr. Dedek's recommendation that NBK needs to select a single, highly visible policy instrument that communicates clearly any change in NBK's policy stance. Because the discount rate applies only to the lender of last resort facility which is rarely used, the discount rate cannot serve this purpose. Consideration should be given to establishing a ending facility sometimes called a "Lombard facility" from which banks can borrow from NBK on a regular basis with the proper collateral at a pre-announced interest rate established, say, weekly. The rate should be set just above the open market rates for short-term funds.

If NBK wishes to stick with its current mix of policy instruments, the repo facility can be used instead of a Lombard facility. The only difference is that the repo rate is primarily market driven (but influenced by the central bank's use of other policy instruments). The Lombard rate is set administratively with guidance from the market. The Lombard rate is a publicly announced rate set by a conscious, periodic decision of the central bank, and thereby conveys important information about the changing stance of monetary policy. If excess reserves are absorbed through higher reserve requirements, it is likely that NBK can narrow the band on the repo rate and keep the reserve situation sufficiently "tight" to keep the repo rate within the repo band, unlike the situation that currently prevails where the repo rate typically falls below the lower repo band.

NBK has all the instruments it needs at its disposal. The objective should be to convert the banking system from one which is virtually unconstrained in its potential credit expansion to one that is constrained in its ability to grow its aggregate balance sheet by the reserves provided by NBK. This is called a "reserves constrained banking system." At the margin, the banking system cannot grow unless the central

Other Considerations

The recalibration of the instrument settings needs to occur gradually with a "learn-by-doing" approach, both for NBK and the banks. Banks have become accustomed to having little or no limits imposed by NBK on their credit expansion activities. In a reserve-constrained banking system, binding limits on bank credit and balance sheet expansion will become the norm. The pricing power of bank borrowers in a lower inflation environment will also be curtailed. This impacts the ability of borrowers to repay their loans in full and on time. In this environment, banks must be even more careful in their credit risk analysis. As mentioned earlier, loans that are easily repaid when inflation averages 7 percent may be more difficult to repay when inflation

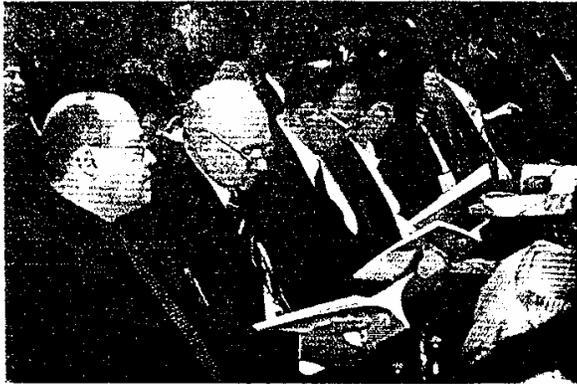
is 1 or 2 percent. In this environment, NBK must co-ordinate and communicate on a regular basis with FSA, and vice versa.

I have lived in Texas since the 1980's and I have seen the effects on an oil based economy as prices fall and rise. If there is an adverse shock to the economy, say, from a sharp decline in oil prices, many borrowers could default on their bank loans. The loan losses will result in shrinkage of bank capital. The write-down of bank capital could force banks to stop new lending entirely to meet capital-asset ratio standards, or worse, to shrink the volume of loans on the books. This would be a "capital-constrained" banking system.

In these circumstances, even if the central bank provided excess reserves to the banking system, prudential capital ratio standards would prevent banks from expanding credit, and monetary policy instruments would be ineffective in stimulating economic growth. As long as there exists a separation between NBK and FSA, there is not an effective way for both organizations to work together to internalize the tradeoffs in a way that would stimulate the economy so economic growth could resume.

Growth would be stalled until the weak banks could be recapitalized. Monetary policy is ineffective in such a situation. Such events are not theoretical. 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 event of an adverse shock, some consideration should be given to how the Fund might be used to help recapitalize the banking system so that, if necessary, stimulative monetary policy can more quickly assist in reviving economic growth.

#	Name	Organisation
1	Aldashov Mars	Financial Supervision Agency
2	Agambayeva Saida	National Bank
3	Kaliaskarova	National Bank
4	Tutushkin	National Bank
5	Dzharkinbayev	Ministry of Economy
6	Kaliyev	Presidential Administration
7	Umbetaliyev	Marketing Research Center
8	Akmambetaliyev	Financial Institution's Association of Kazakhstan
9	Moisov Ivan	National Bank
10	Seleznev Alexander	National Bank
11	Abylkasymov	Marketing Research Center
12	Pedro Rodriquez	World Bank
13	Sazanov	Marketing Research Center
14	Nusupova, Assem	Advisor to Prime Minister
15	Sartbayev Medet	Center of Marketing Research Center
16	Akishev	National Bank
17	Saidenov	Governor National Bank
18	Zhamishev	Governor Financial Supervision Agency
19	Shotayev Meiram	Presidential Administration
20	Aasim Husain	IMF
21	Lewis Tatem	USAID
22	Mary Norris	USAID
23	Gauhar Serikbayeva	USAID



«КАЗАХСКИЙ BOND КРЕПЧЕ ДОЛЛАРА»

19-20 мая в г. Алматы прошел облигационный конгресс стран СНГ, организованный Казахстанской фондовой биржей и информационным агентством CBONDS. В рамках Конгресса достаточно интересное объяснение нашли особенности казахстанского рынка облигаций.

Вопросы развития долговых инструментов являются наиболее актуальными для развития финансовых систем большинства стран СНГ и Балтии. Как правило, облигации являются следующим этапом, после ссуд кредитных организаций, в обеспечении финансирования большинства средних и крупных предприятий. Действительно, с учетом относительной неустойчивости института частной собственности на постсоветском пространстве, низкого уровня корпоративного управления и т.д., с одной стороны, и быстрого повышения стоимости активов на волне экономического роста, с другой, трудно ожидать бурного развития такого достаточно сложного способа финансирования предприятий, как выпуск акций. Кроме того, интерес к данному событию определялся и планами развития г. Алматы как регионального финансового центра, поскольку корпоративные облигации предполагаются в качестве ключевого инструмента, определяющим успех данного проекта.

Состав участников включал порядка 280 участников из разных стран СНГ. Спикеры

затрагивали широкий спектр вопросов развития как национальных рынков облигаций, в частности таких стран, как Казахстан, Россия, Украина, Узбекистан, Кыргызстан, Азербайджан, Беларусь, так и перспектив эмитентов стран СНГ в современных условиях на мировом рынке.

В то же время, по нашему мнению, наиболее актуальными для нас стали высказанные точки зрения о двух наиболее фундаментальных проблемах современного казахстанского рынка облигаций: низкой ликвидности и высокой концентрированности на финансовом секторе.

Действительно, в настоящее время казахстанский рынок облигаций является самым развитым на фоне рынков других стран СНГ (см. рис. 1). В то же время, как отметил президент KASE Азамат Джолдасбеков, наблюдается резкое доминирование эмитентов из финансового сектора (90,1% рынка), а также низкая ликвидность и ее быстрое снижение (рис. 2). Среди большинства казахстанских экспертов преобладает мнение о том, что низкая ликвидность объясняется спецификой ос-

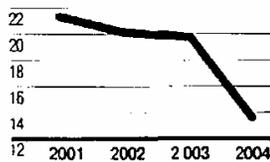
Рис. 1
Рынок корпоративных облигаций отдельных стран СНГ в 2004 г. (в % ВВП)



Источник: расчеты автора по данным доклада генерального директора CBONDS С. Лялина

новных институциональных инвесторов – пенсионных фондов, которые в условиях недостатка финансовых инструментов на рынке вынуждены шокувать облигации практически только до погашения. В подтверждение данной точки зрения приводит динамику роста объемов корпоративных облигаций и пенсионных активов, корреляция по которым близка к 100%.

Рис. 2
Удельный вес вторичных торгов корпоративными облигациями к их биржевой капитализации в 2001-2004 гг. (в %)



Источник: доклад президента KASE А. Джолдасбекова

На этом фоне интересную точку зрения высказал старший консультант Программы по развитию финансового сектора корпорации «Прагма-Стив Муди». По его мнению, прирост рынка корпоративных облигаций в Казахстане определяется не только и не столько увеличением активов пенсионных фондов, а ростом спроса на инвестиции. Так, в 2004 г. темп роста выпуска корпоративных облигаций практически удвоился, и объем выпуска превысил весь предыдущий выпуск корпоративных облигаций в Казахстане.

Кроме того, низкая ликвидность казахстанского рынка

облигаций также не совсем связана с активами пенсионных фондов. Дело в том, что, как отмечает г-н Муди, стоимость всех текущих эмиссий облигаций с фиксированным доходом, в том числе и государственных бумаг, превышает пенсионные активы на 65%. В этой связи основная причина избытка высоколиквидных финансовых ресурсов на казахстанском рынке в излишке больших внешних заимствований банковского сектора. Дело в том, что в условиях укрепления тенге к доллару эмитенты облигаций в иностранной валюте зарабатывают не только обычную банковскую маржу (около 4%), но и возможность получить всю девальвацию доллара (порядка 10%). В этих условиях казахстанские «банки проглотили», что и привело к избытку финансовых ресурсов в финансовом секторе и недостатку инструментов.

Таким образом, деньги иностранных инвесторов уже знакомы с казахстанским рынком облигаций. Как известно, именно возможность привлечения средств с международных рынков капитала позволила казахстанским банкам столь резко увеличить объемы кредитования. Вместе с тем, эволюционное развитие финансовой системы «от банковских кредитов к облигациям и далее к акциям» в Казахстане имеет возможность получить мощнейший стимул к выходу на новый этап своего развития.

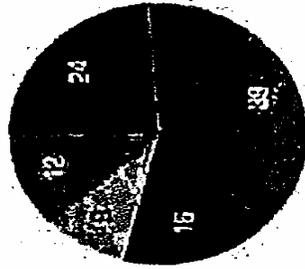
Марат Каирбеков,
к.э.н.

Инвесторы смотрят на Запад

Прошедший в Алматы Облигационный контракт стран СНГ продемонстрировал большой разрыв в развитии национальных рынков облигаций и ответственную роль поставленных перед ними задач.

Наиболее инфраструктурно-развитые и капитализированные рынки Казахстана и России ищут точки роста на международных рынках. При этом катальность рынков стран СНГ снижают малые объемы выпуска облигаций, низкая ликвидность и отсутствие вторичного рынка, юридические проблемы и непрозрачность амплитов. И хотя участники конференции были единодушны в вопросе более тесного сотрудничества, ясно, что практический интерес для казахстанцев представляют лишь Украина и Россия, в силу наличия эффективного банковского сектора и производственной базы. В плане перспектив — большие шансы у Азербайджана с его нефтяными проектами.

Казахстанские банки охотно инвестируют в реальный сектор экономики в странах СНГ, %

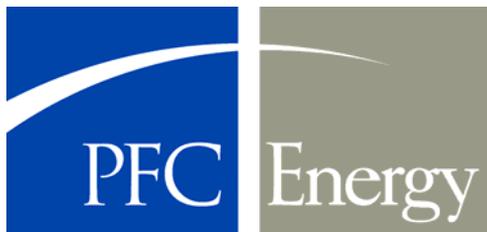


■ формальность
■ структура
■ торговля
■ сельское хозяйство
■ прочие

Источник: JSC «MIR Business»

Для Казахстана же актуальными проблемами низкой ликвидности и низкой диверсификации рынка облигаций, когда эмиссии сконцентрированы в финансовой сфере. Одна из причин — небольшой размер

экономики, который не позволяет активно развиваться финансовому сектору. По мнению представителя корпорации ПРАГМА Стива Мулли, доминирование банков-эмитентов говорит о том, что рынок ценных бумаг находится в большой зависимости от ситуации именно в этом секторе рынка. В случае возникновения в нем неблагоприятных изменений инвесторы откажутся в сложном положении. Ожидания отечественных инвесторов озвучил управляющий директор Tiscalalet Securities Руслан Егембаев, отметив узость домашнего рынка для казахстанских акционеров и переход к поиску зарубежных рынков с наибольшим потенциалом для роста и диверсификации.



Oil Markets and the Geopolitics of Oil

Perceptions of Shortage and their Consequences

Fareed Mohamedi

Senior Director, Country Strategies and Analysis

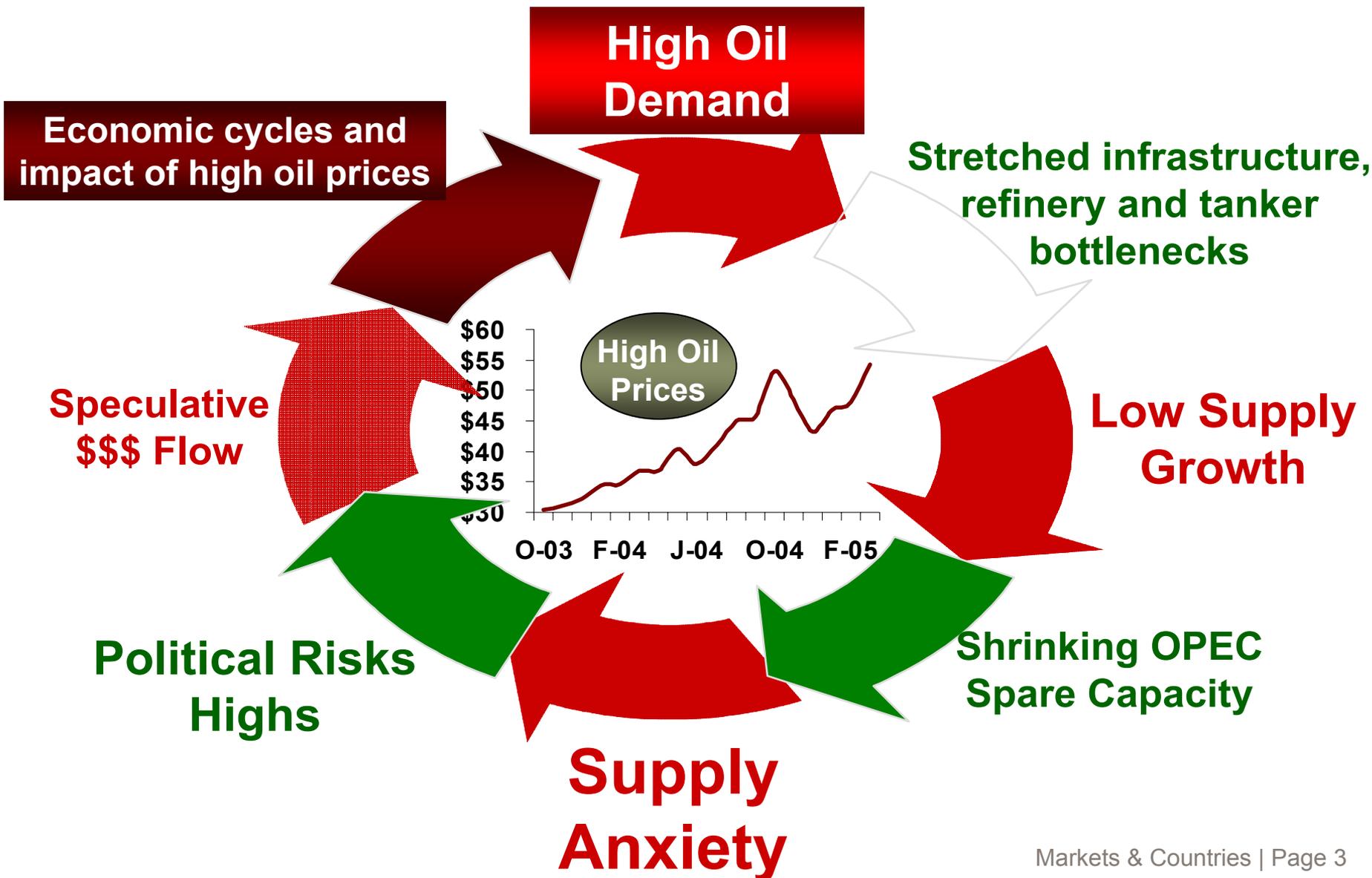
**Strategic Advisors
in Global Energy**



- Short term oil markets
- Are we in a world of “peaking oil”?
- What are other oil producers doing?
- Some suggestions for Kazakhstan

Why The World Has \$50 + Oil

Several Factors Feeding Each Other In This New Episode



Another Perfect Price Storm 2005

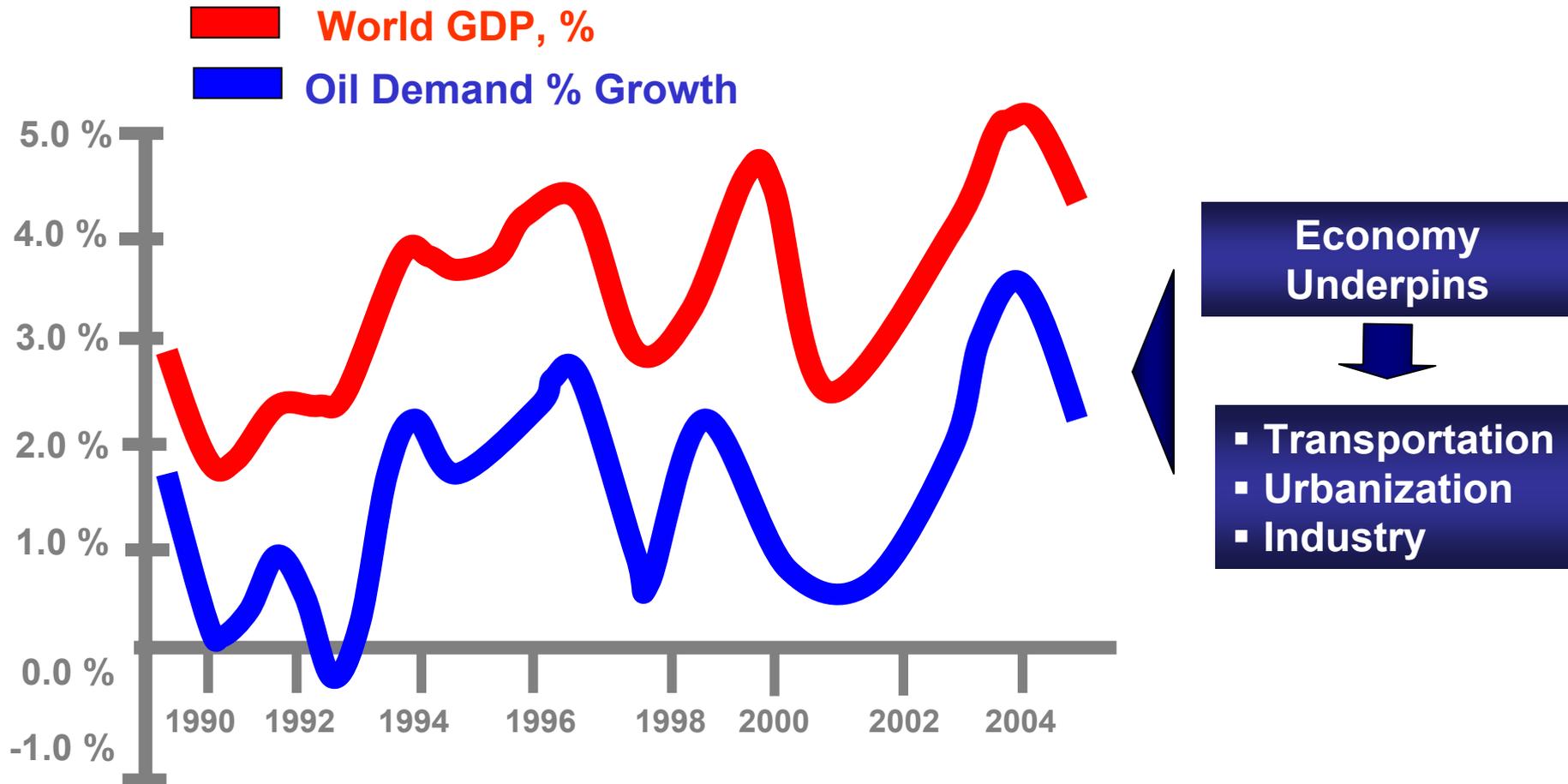
While some of the specific issues have changed from the last couple years, the fact remains that in 2005 a flood of bullish factors is again poised to outweigh a handful of bearish ones. The bullish elements will grow stronger as the year progresses.



Its Still The Economy....

The Key Cyclical Driver

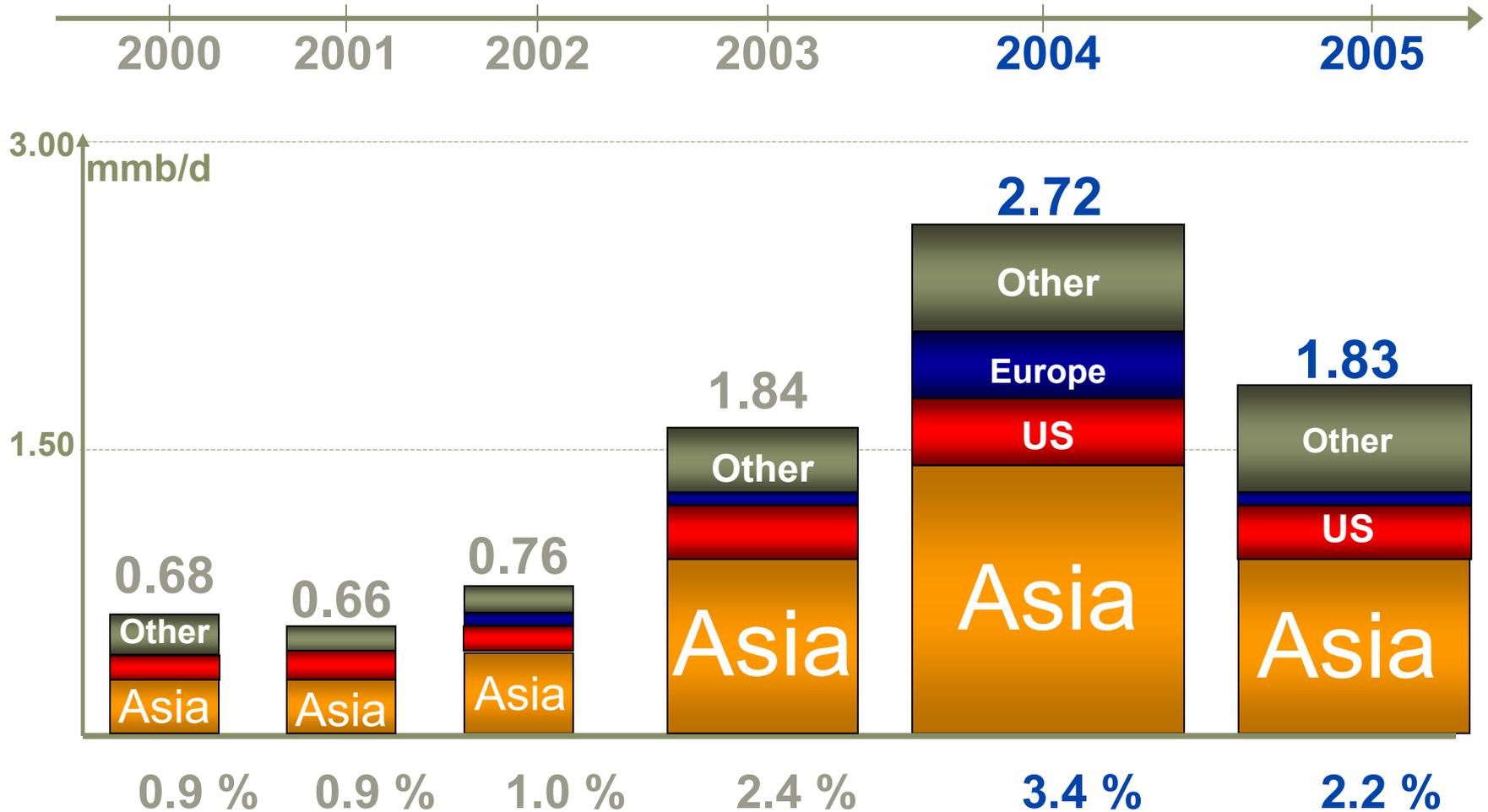
Global Economy Vs. Oil Demand



Oil demand growth remains tightly correlated to economic growth. The rise of Asian economies in the 1990's has helped re-establish this relationship.

Demand Strength Is The Source Of The Problem

Even Though 2005 Will Be Weaker Than 2004



How Can The World Cope With This Growth?

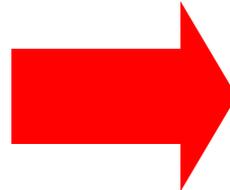


6.4 million b/d

China's Soaring Growth Impacts All Regions

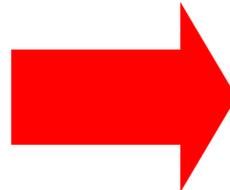


- **High Products And Crude Demand**
- **Power Crunch**



**Needs
Lights**

- **Has Roiled The Sweet Crude Market By Competing With The Atlantic Basin W. Africa Barrels. Contributing To Market And Price Dislocation**



**Needs
Diesel**

- **Exacerbating Product Market Imbalances In Asia, Pushing Refinery Runs Up Across The Region**



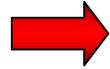
**Needs
Power**

- **Electricity Crunch Has Boosted Oil Demand, But For How Long?**

Drivers Of Chinese Growth

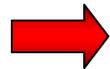
Several Sectors Underpinning Product Strength

Industry



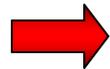
Industrial output is booming across the board

Urbanization



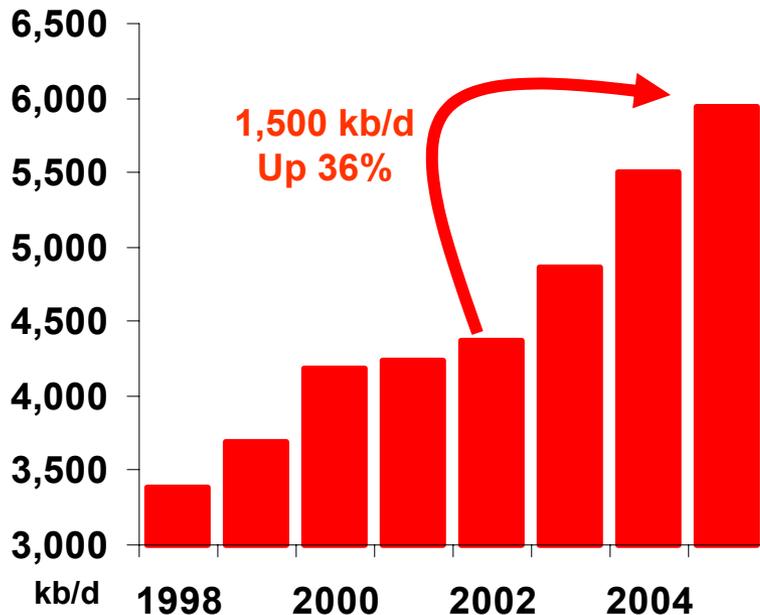
Increased household consumption

Transportation

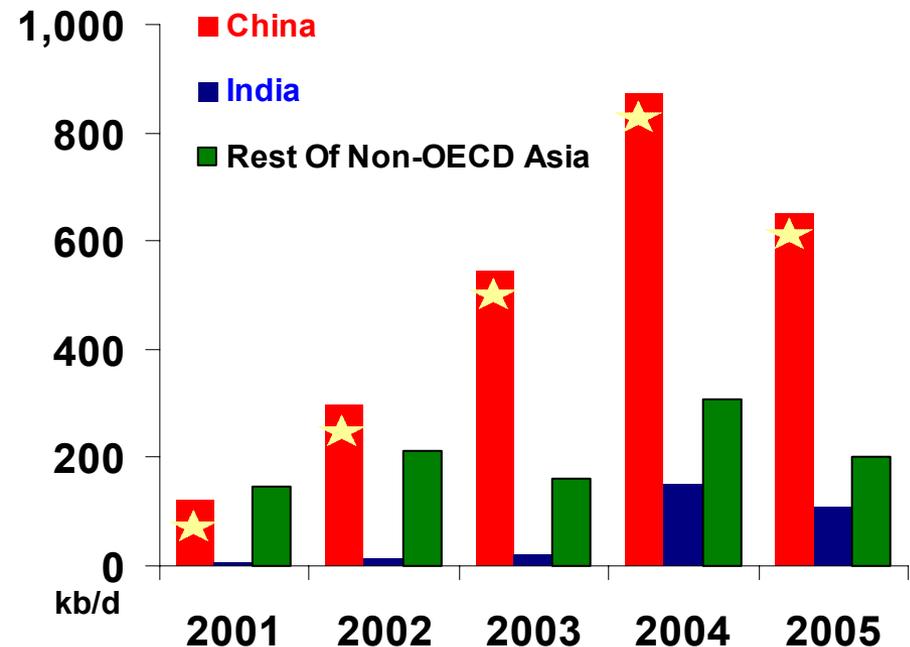


Increasing car fleet, trucks shifting to diesel

Chinese Refinery Runs



Asian Demand Growth



US Product Demand Also Stays Strong

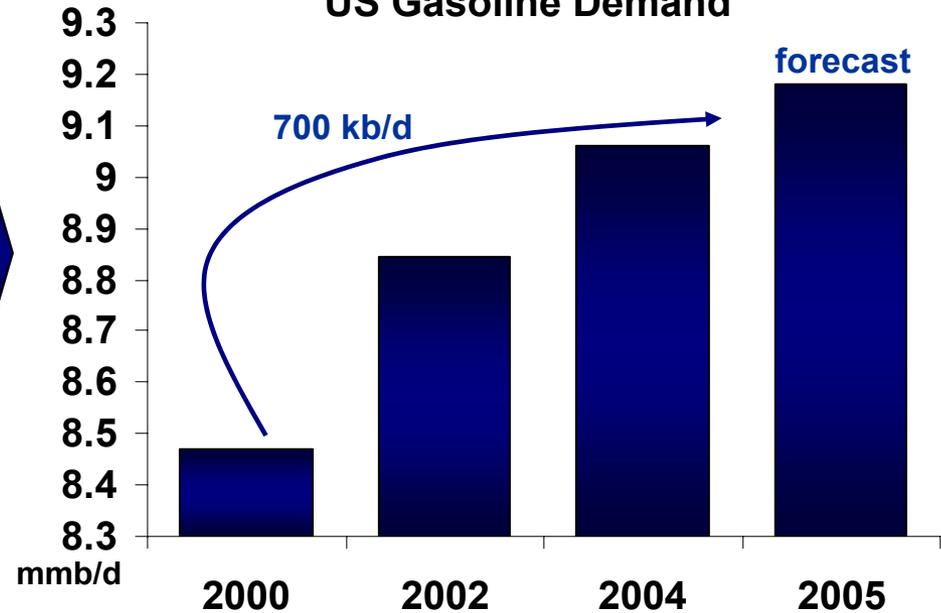
Gasoline And Diesel Underpin Growth

 **Gasoline demand increased 8% between 2000 and 2005**

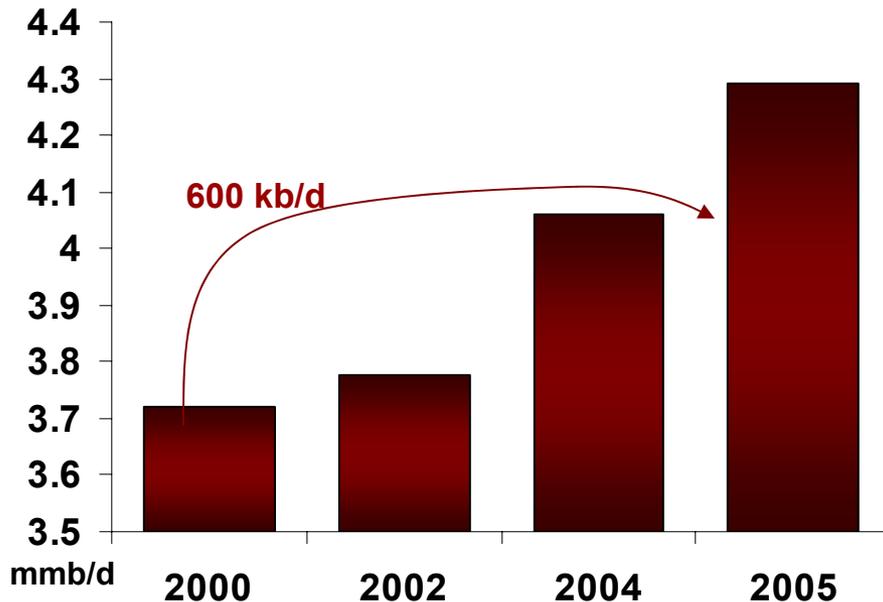
 **People live farther away and use bigger cars**



US Gasoline Demand



US Distillate Demand



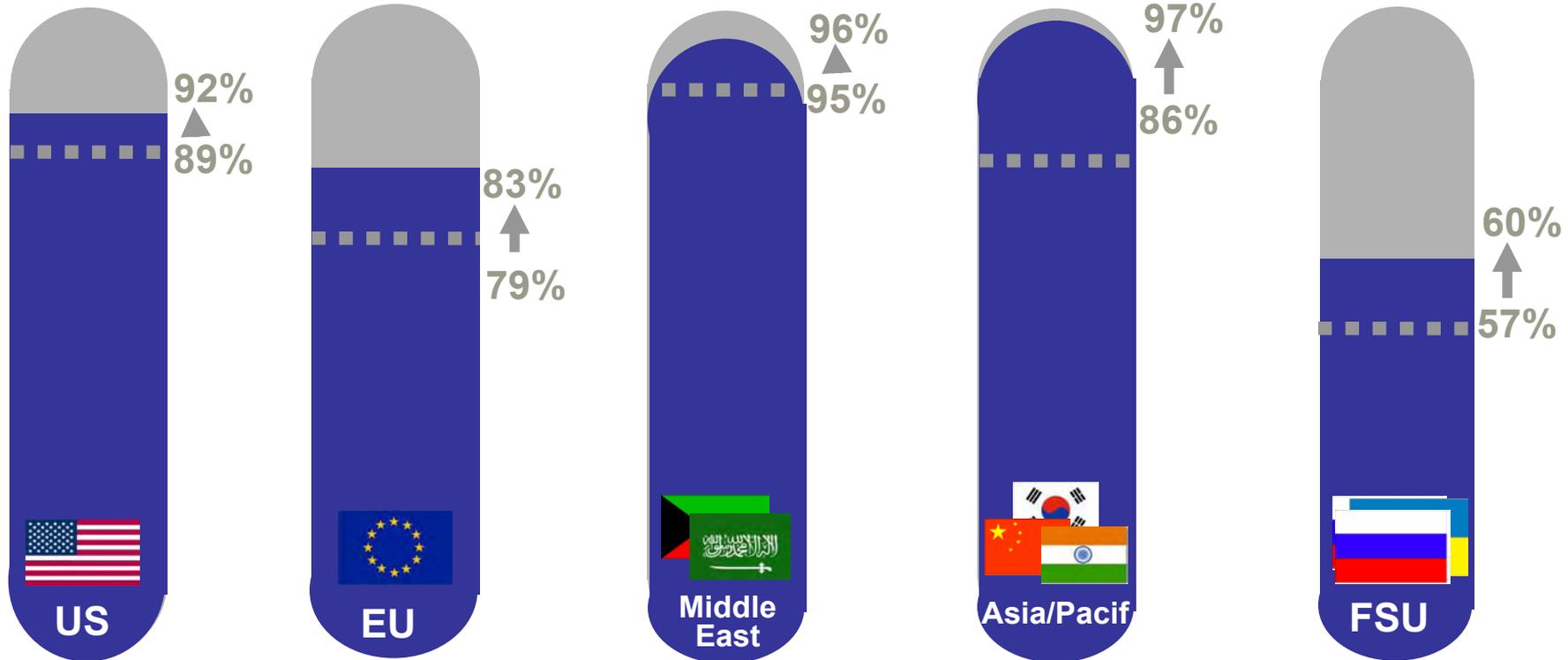
- **Between 2000 and 2005 distillate soared with a 15% growth.**
- **Transportation of imported goods throughout the country underpins diesel consumption.**

Refinery Utilization Is Stretched

FSU IS The Only Region With Significant Spare Capacity

Average Yearly Utilization Rates In Selected Regions

2002 And 2004

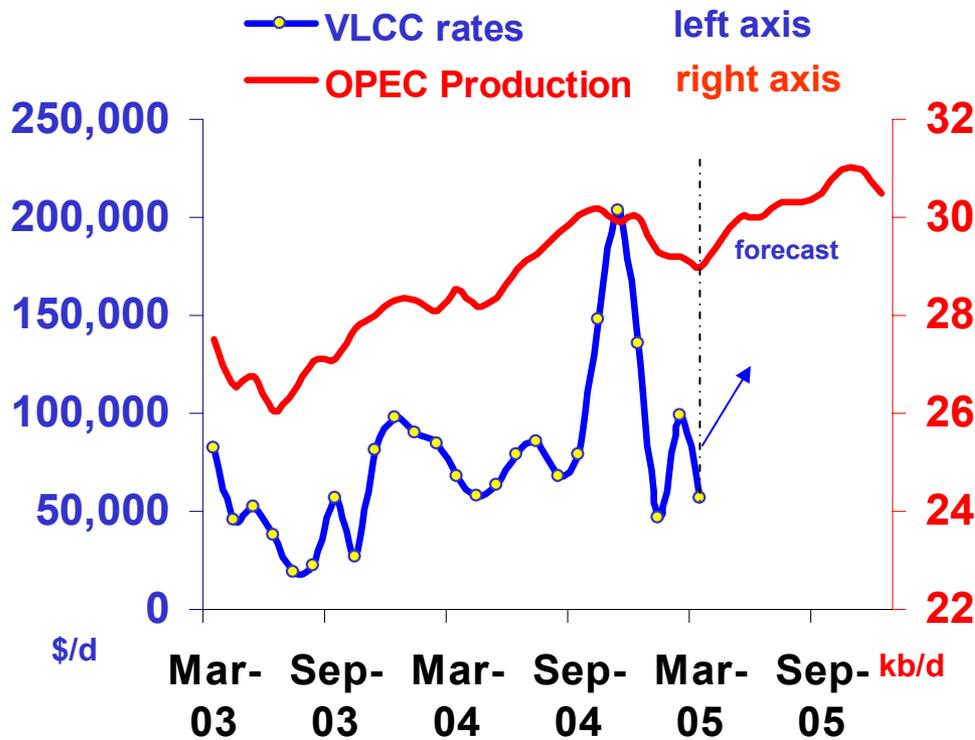


Does not include teapot capacity in China

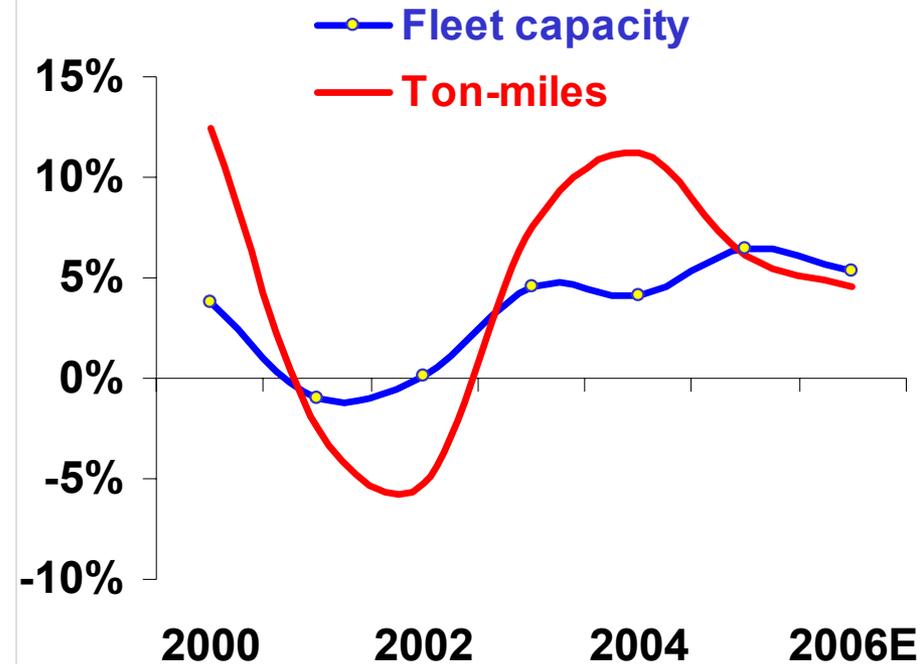
- Post-1997 the Asia/Pacific region had a lot of spare refining capacity, that is no longer the case. Soaring Chinese product demand has absorbed most of it.
- Next year will see the last round of significant specification changes for distillates in the US and Asia, and its impact on production should not be underestimated.

Tankers: Higher Volumes, But Higher Capacity

OPEC Production vs. Freight Rates



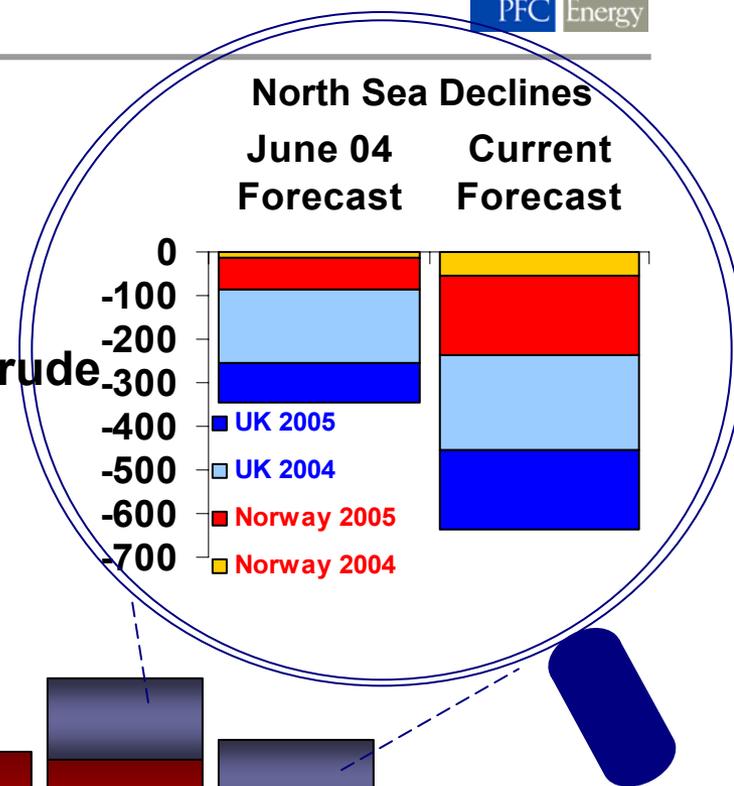
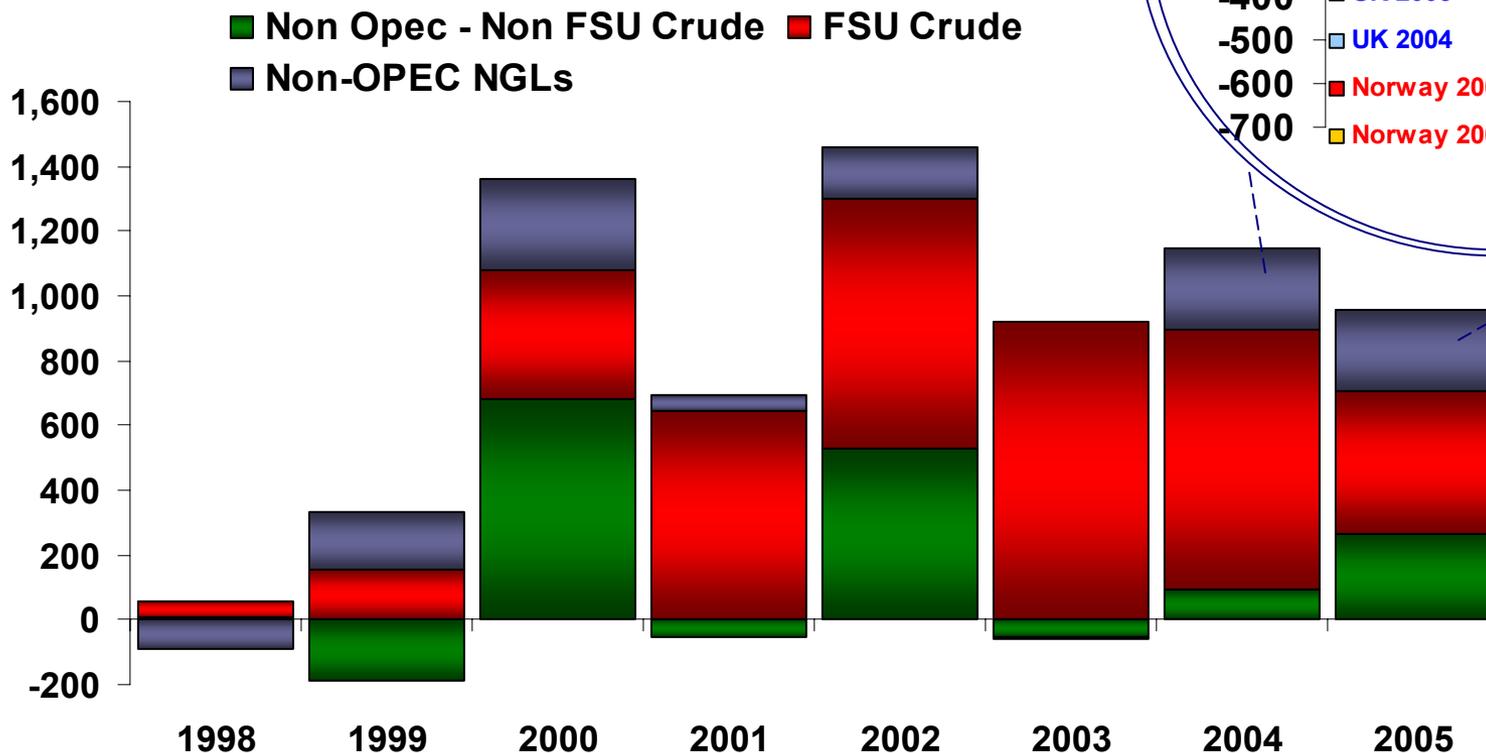
Change In Tanker Demand And Supply



Non OPEC Growth Sluggish

Decline Rates Hamper Growth

Year-on-Year Growth In Non-OPEC Crude



Can Supply Keep Up With Demand in 2005?

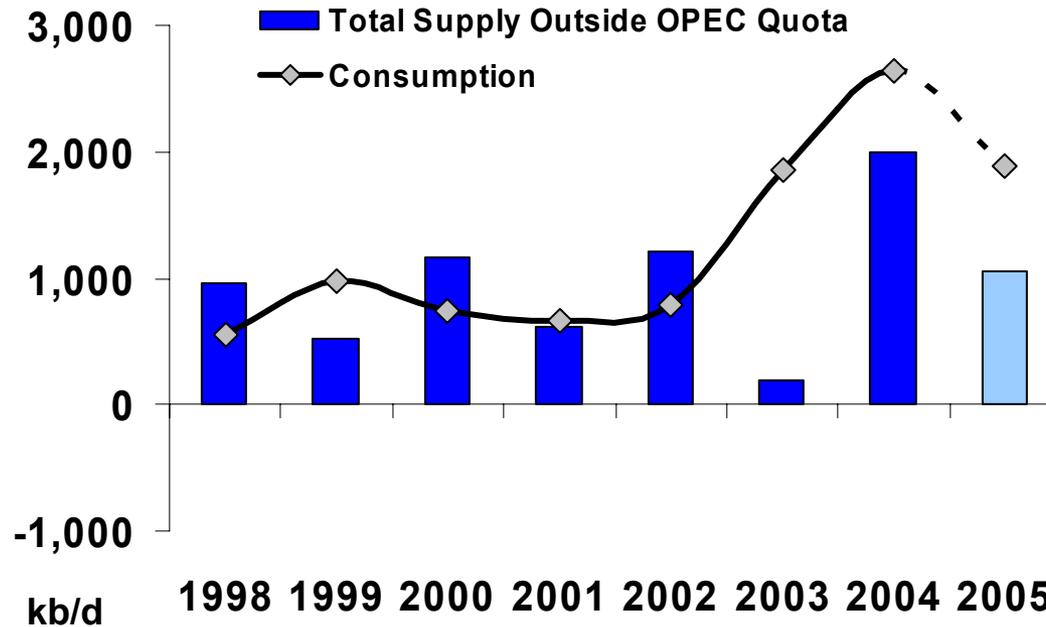
- **Supply growth outside of OPEC quota in 2005 will fall 825,000 b/d short of demand growth.**
- **OPEC will work to fill the gap by increasing output nearly 800,000 b/d and by pushing output in the second half to new highs.**
- **However, the organization's spare capacity will remain tight and its marginal barrel will still not be the light sweet crude the market most needs.**
- **Non-OPEC supply will step firmly into a new era this year:**
 - **Russian supply growth will slow.**
 - **The next big wave of mega-projects (from deepwater and Central Asia) will start to come online in earnest.**
 - **Mature Non-OPEC regions will see an accelerating pace of declines.**

2005 Demand Outstrips Non-OPEC Supply Again

Average Supply Not Enough For Extraordinary Demand



Year-on-Year Growth In Demand Versus Growth In Liquids Outside OPEC Quota



- **2005 demand growth will outstrip total supplies outside OPEC quota (Non-OPEC Liquids + OPEC NGLs + Iraq) by 825,000 b/d, even greater than the 640,000 b/d seen in 2004.**
- **The result will be a continuing tight supply system that will allow OPEC to maintain easy control of the market while still increasing output.**
- **The last time supply growth outside OPEC quota outstripped demand was 2002. With supply growth constrained, only a demand downturn seems capable of re-introducing slack into the system.**

Iraq On A Bumpy Ride Down

Bombs & Stagnation To Keep Production Choppy, Sliding

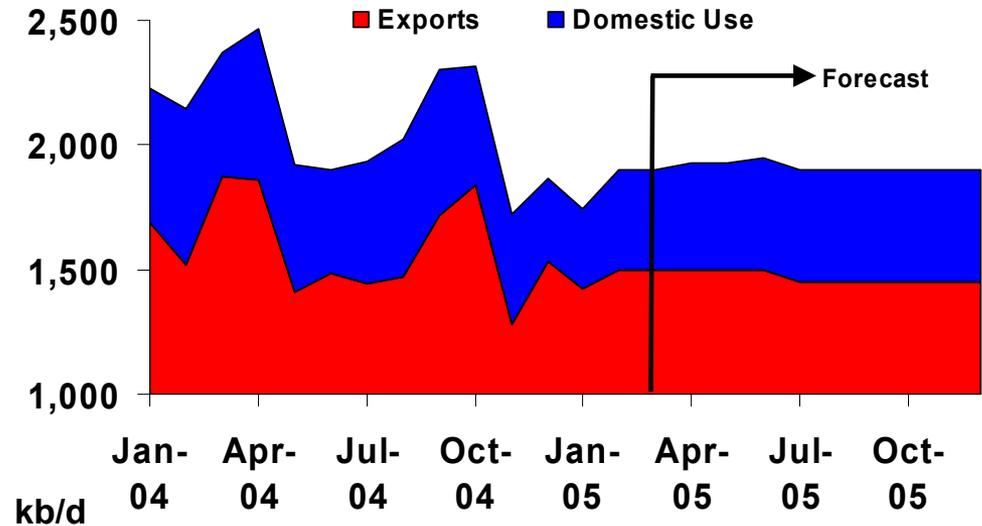


Iraqi Crude Production By Disposition

- Iraqi crude production faces a number of severe challenges:

- **Security:** Insurgents have effectively shut down northern exports and severely curtailed the ability to refine crude domestically. The south is a less permissive environment for insurgents and has seen few attacks of late, but remains vulnerable to attack.

- **Stagnation:** The worst reservoir management practices of the past continue (overproduction to secure revenues, reinjecting degasified crude, etc.) and to date no sub-surface evaluation has been carried out. Kirkuk has lost 200,000 b/d of capacity from pre-war levels and faces the real threat of catastrophic collapse. Problems in the south became more evident with SOMO's recent decision to reduce term contracts by 10% (160,000 b/d).



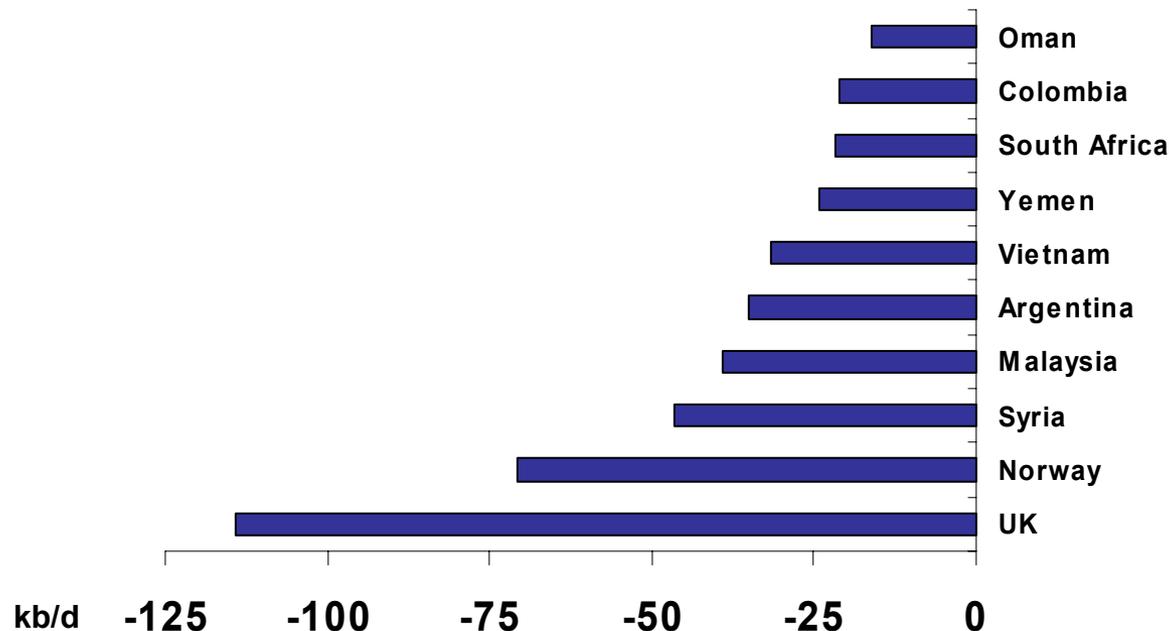
- With the security situation unlikely to improve substantially in 2005, production will remain very choppy but will continue to trend downwards, averaging a mere 1.9 million b/d.
- Long-term improvement in production will require first an end to the insurgency in the north of the country and then a political process which can allow investments to flow in a stable legal and political environment. When that day comes, huge production increases are possible, but it will not be in 2005.

More Mature Areas Going Over The Cliff

Declines Accelerating In Former “Baseload” Suppliers



2005 Top 10 Non-OPEC Crude Supply Decliners



- **Mature oil-producers will head further down the road of declines in 2005: Non-OPEC crude production excluding the FSU and major deepwater projects will actually decline by 500,000 b/d.**
- **The North Sea will continue to lead declines, but the usual suspects in the Non-OPEC Middle East (Yemen, Oman, Syria) and Latin America (Colombia, Argentina) will also keep falling.**
- **Australia, which has seen 275,000 b/d of declines in the past four years, will manage to halt the slide thanks to the start of the Mutineer-Exeter field, but this will be only a temporary respite before declines resume.**
- **With increasingly depleted reserve bases, Non-OPEC declines are only expected to gather steam in the years to come.**

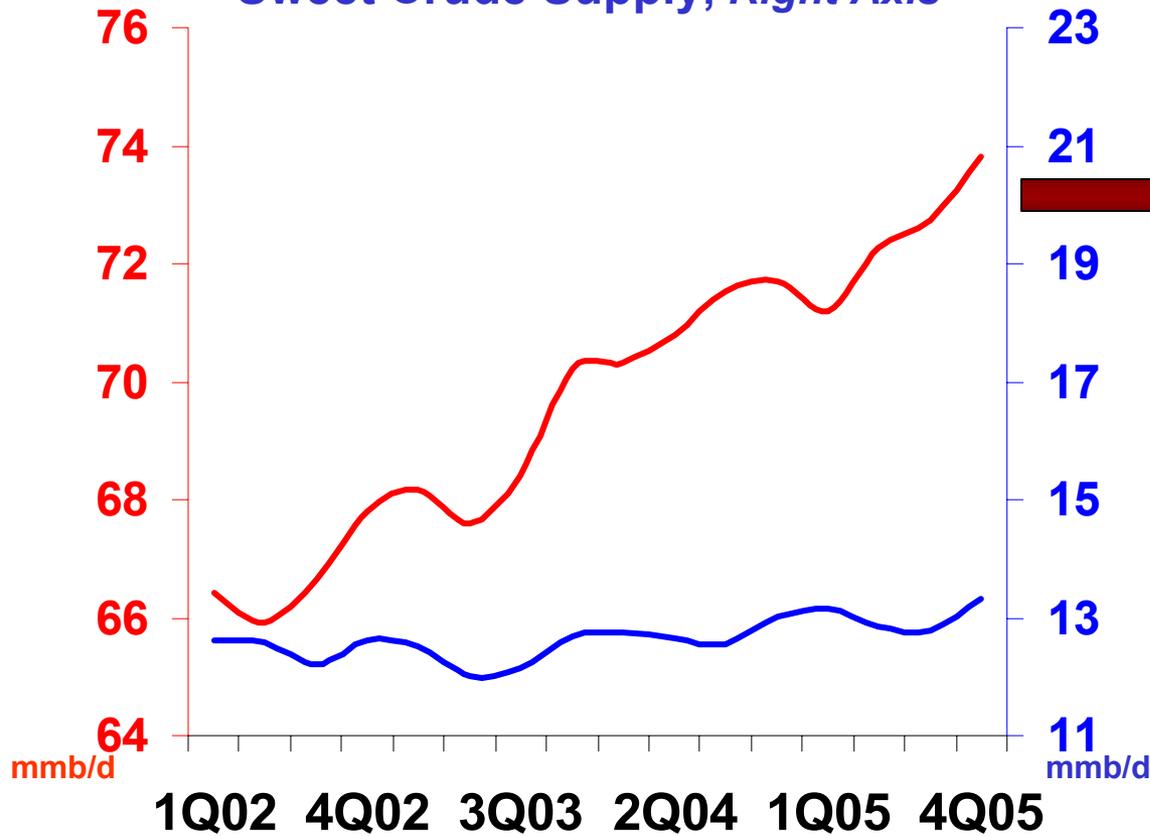
Why Is OPEC Not Able To Respond?

Not The Right Crude

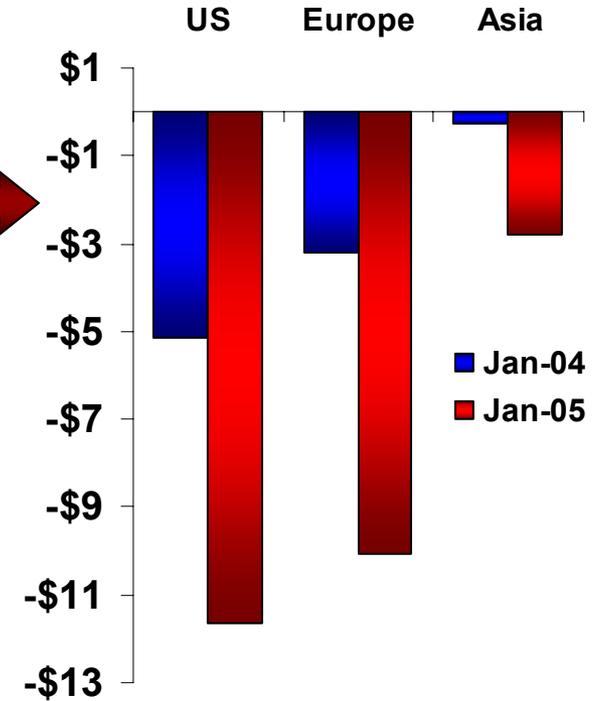
Total Crude Supply, Left Axis

vs.

Sweet Crude Supply, Right Axis



Discounts Of Arab Medium In Selected Markets



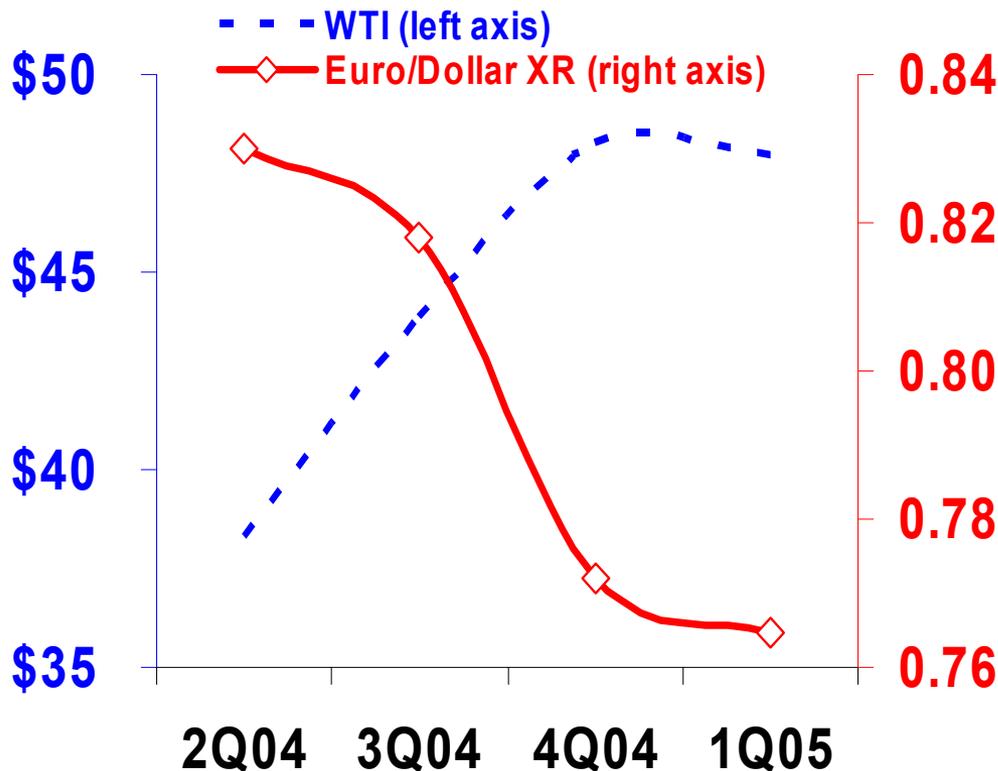
Wrong Quality Spurs Soaring Discounts

Why Hedge Funds Are Flocking In?

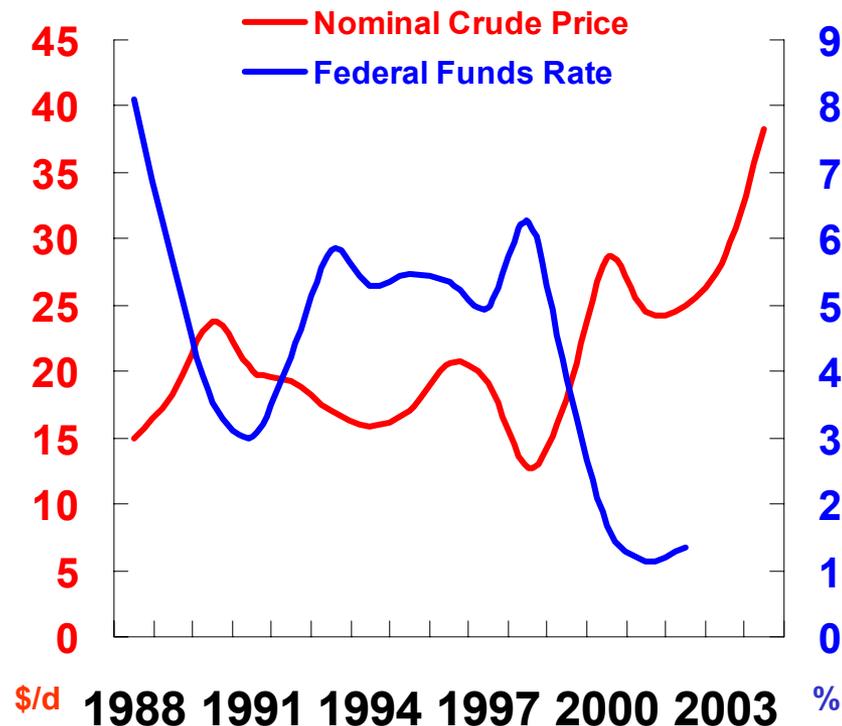
Sliding Dollar And Low Interest Rates



Falling Dollar And Rising WTI



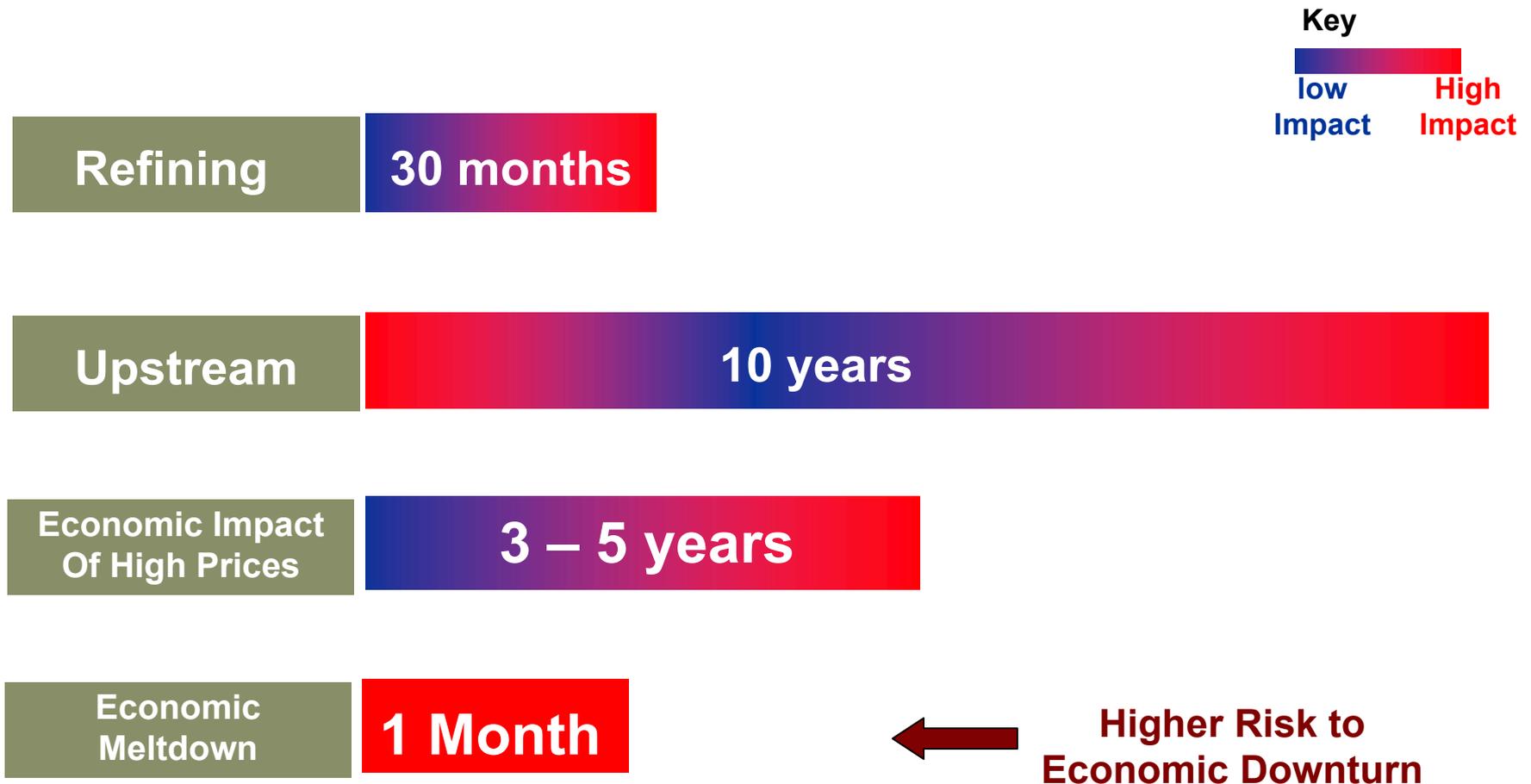
Interest Rates and WTI



- The recent rallies of the last three months are related to pouring money into the oil futures market by all types of investors.
- Investment in commodities is a great opportunity to cash in in Asian growth, but a growing problem for the stability of oil prices

How Long Does It Take To React To High Prices?

The Reaction Time Shows Asymmetric Risks



- Expensive oil may trigger investments in upstream or downstream, or may potentially affect demand in the long run.
- But the only short term element able to change the outlook is a potential economic meltdown.

The Economic Cycle Has Peaked

But The Timing Of The Downturn Is Difficult To Predict

Steroids Effects Waning

US Growth Is Slowing

- Inflation driving interest rates up
- trade deficit impacting \$ value

Growing By Borrowing Not Sustainable

Asian Banks Willing To Subsidize Forever?

Adjustment of Imbalances is Necessary

Managed adjustment

Crisis Triggered Adjustment

Slowdown

Meltdown

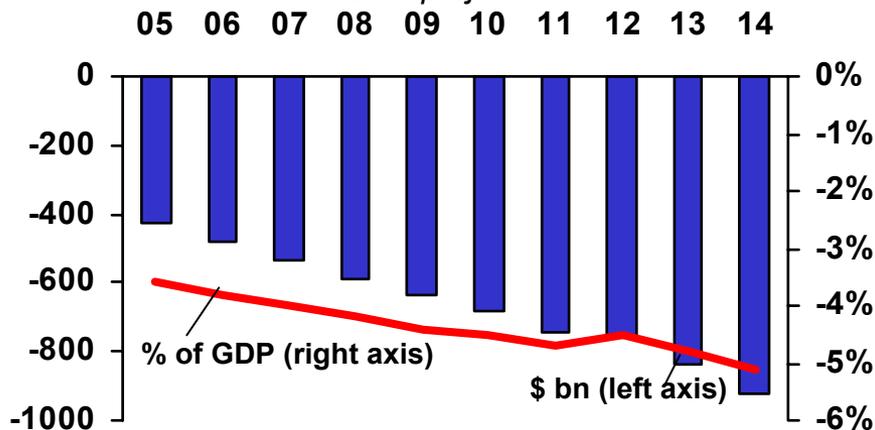
No country has managed to consume and invest 6% more than it produces for long.

Oil Demand Slowing

US Economy: Growth Now, Adjustment Later

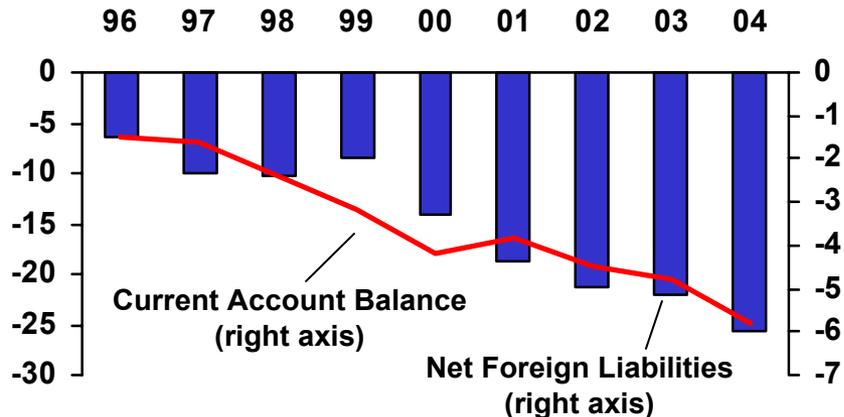
US Budget Deficit

CBO projections

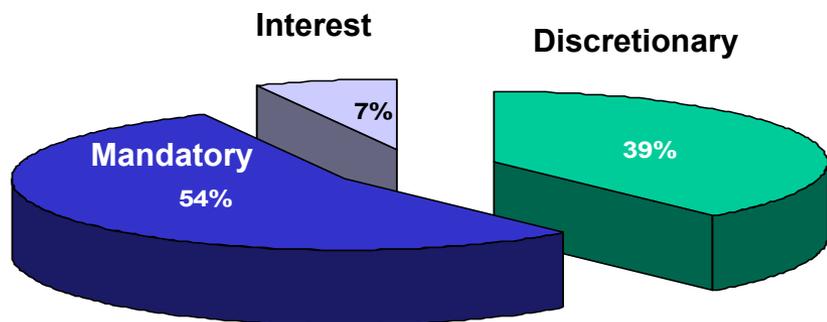


External Balance and Debt

% of GDP

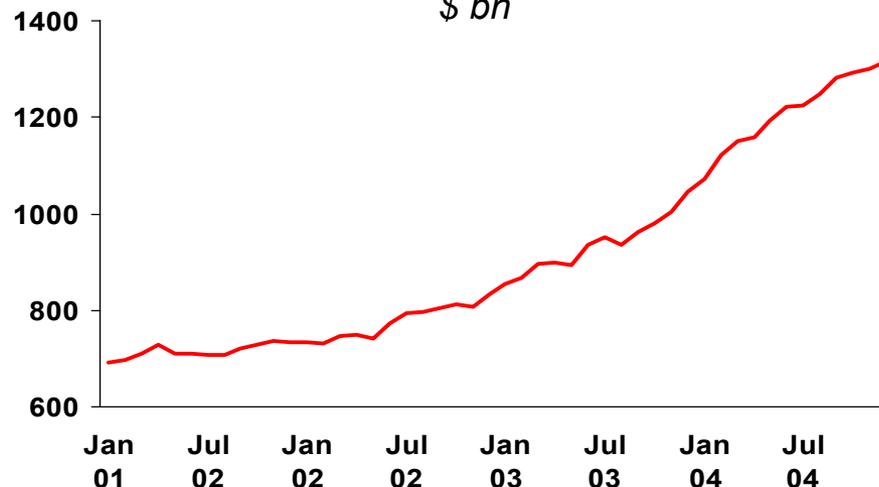


Expenditure By Category, 2004



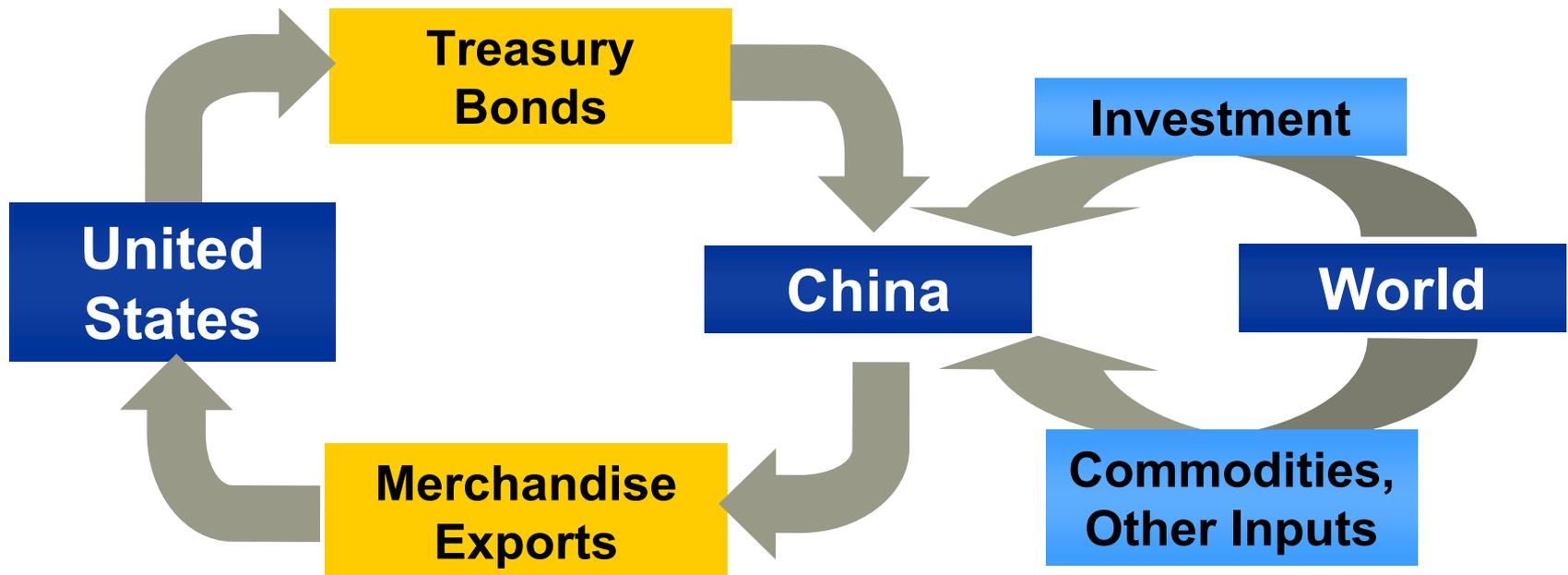
Foreign CB Holdings of US T-Bonds

\$ bn



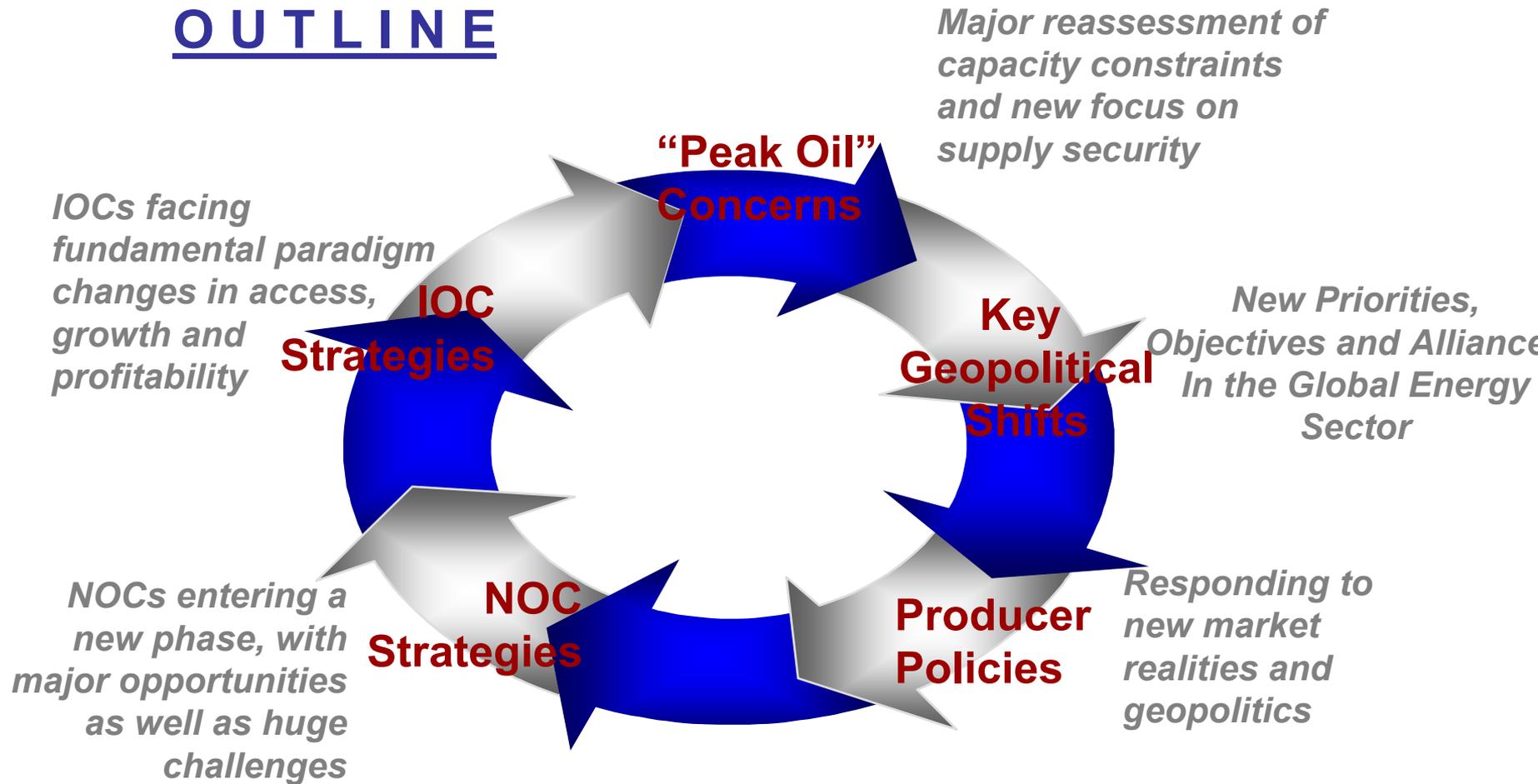
Global Economy: The US-China Growth Engine

- US demand growth remains key to the global economy
- The US/China axis boosts growth through other channels as well
- China provides a welcome “second pillar” of growth



The Investment Environment in Producing Countries: Geopolitical and Commercial Drivers

OUTLINE

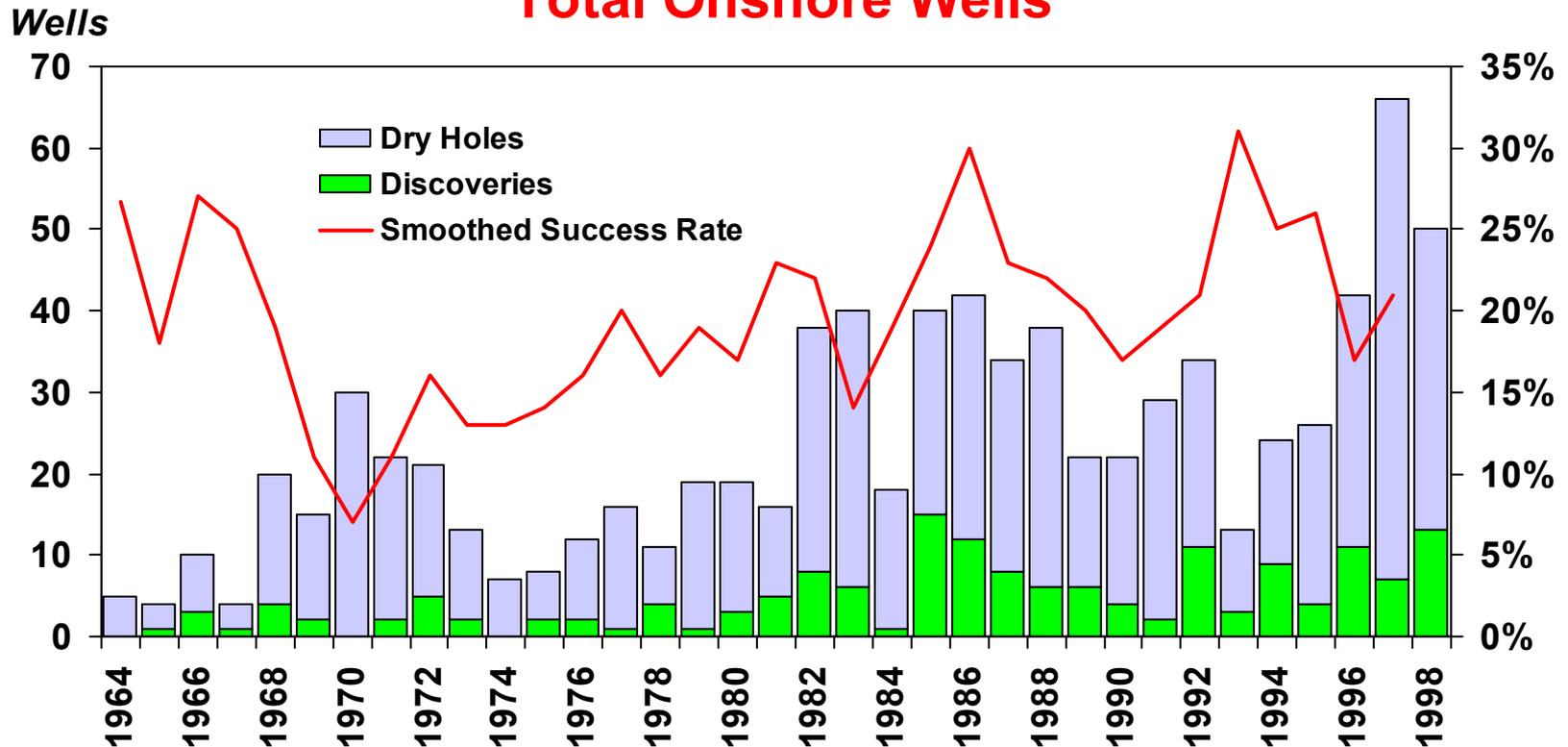


Key Messages

- 1. The world is not in imminent danger of running out of oil, but certain countries/regions are depleting much faster than others. This will cause a shift in the geographic dominance of production sources.**
- 2. In spite of high oil prices, Non-OPEC production has been stagnant with the notable exception of the FSU. This trend is likely to continue through this decade.**
- 3. Exploration results in the last 10 years (with a few exceptions like Angola, Sudan, Mauritania) have been much less significant than in previous decades. Without a significant reversal of this trend, Non-OPEC production is likely to peak just after 2010 and begin a long term decline.**

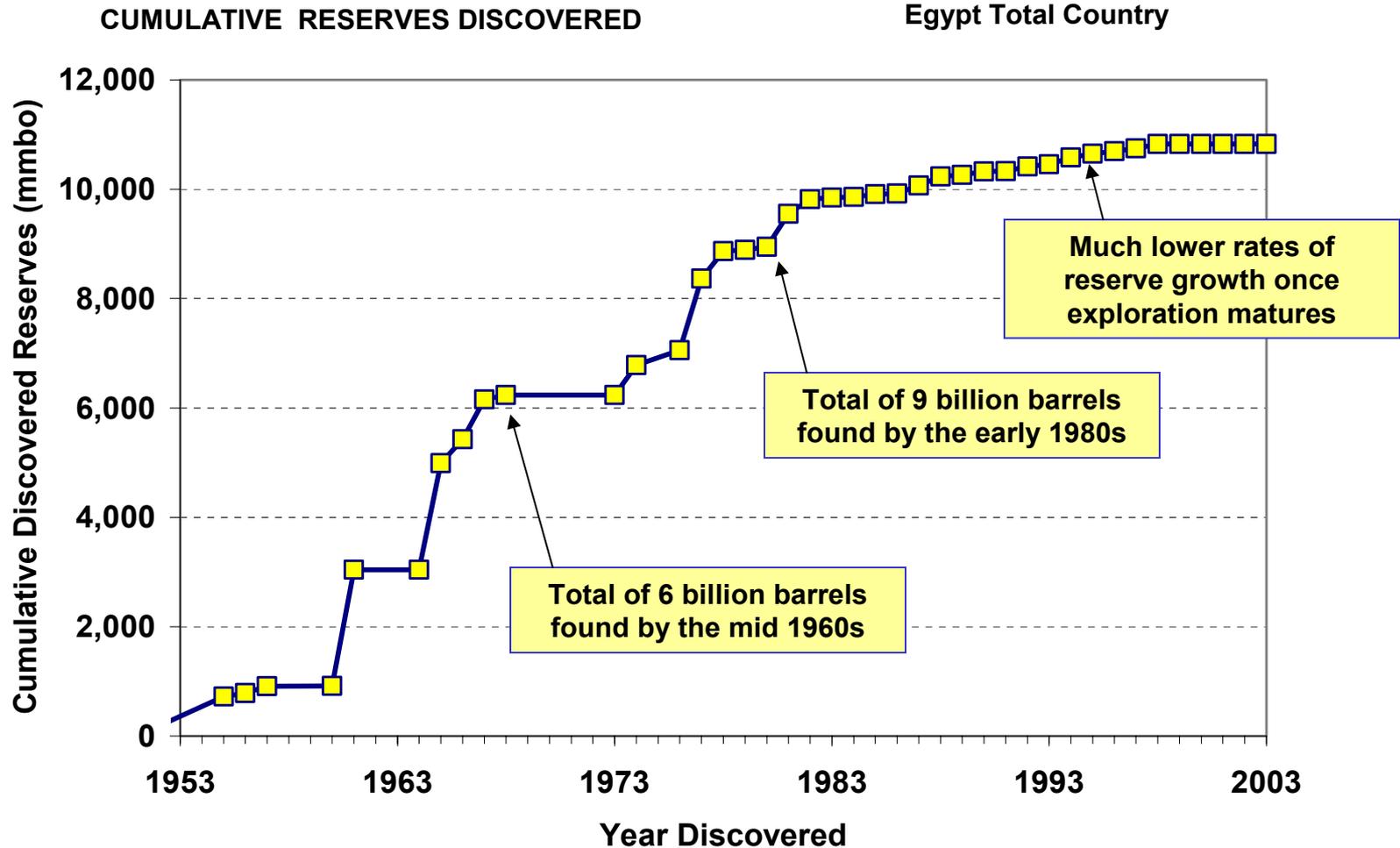
4. **Every year, in every region (including OPEC), the world produces more oil than it finds. It is only logical to conclude that inevitably this will lead to dwindling supplies.**
- **As demand continues to grow beyond 2010 and Non-OPEC production capacity plateaus or falls, OPEC will have an increasing burden to make up the difference resulting in an inevitable increase in dependency on OPEC sources.**
- **OPEC production capacity and reserves will suffer from the additional strain and some models suggest that even OPEC will struggle to fill the differential between Non-OPEC supply and global demand beyond 2015-2020.**

Total Onshore Wells



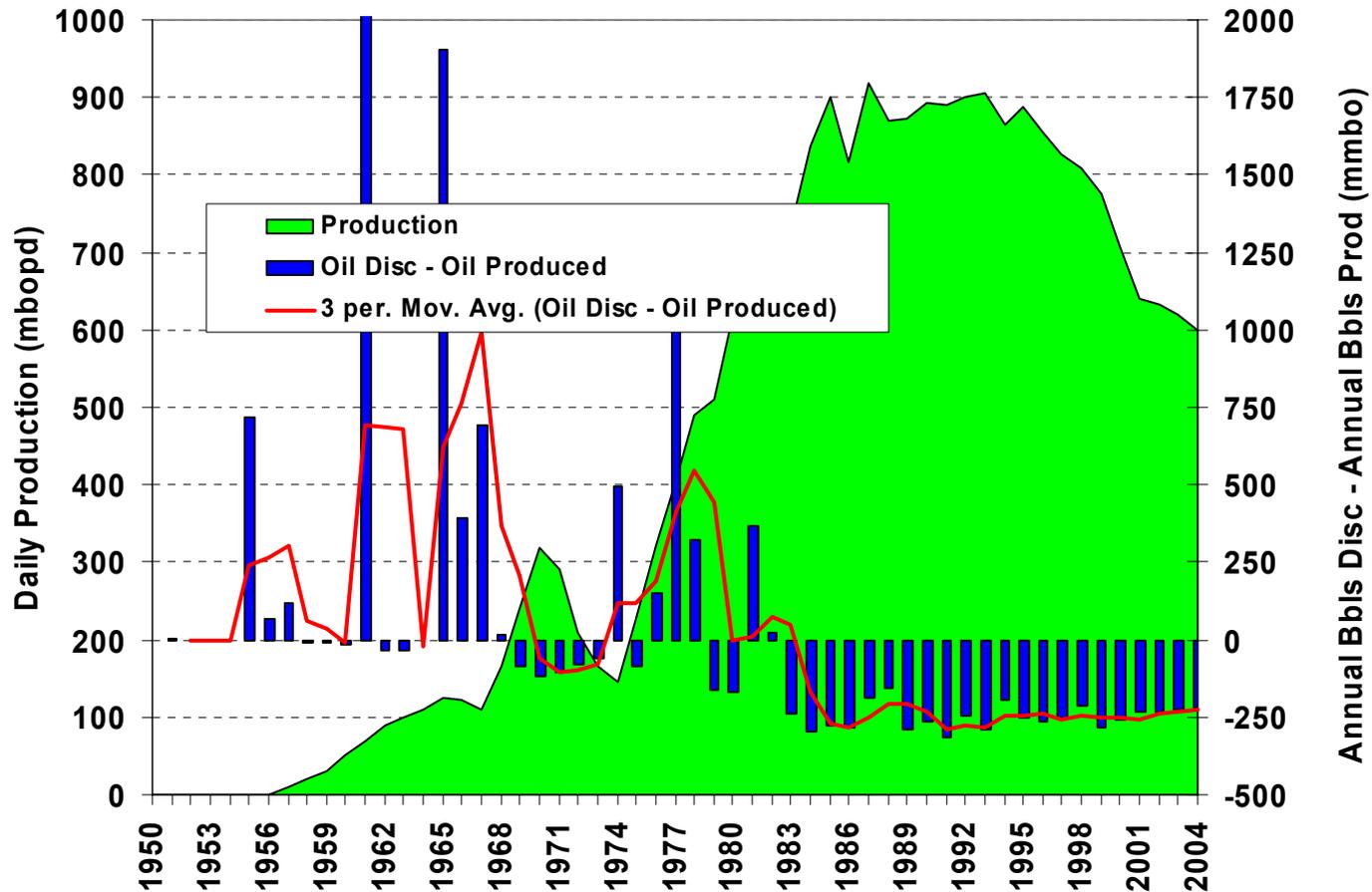
Exploration usually begins with a play concept which if successful (results in oil discoveries) leads to increasing numbers of wells over time – *generally speaking the percentage of exploration wells which are discoveries does not change much over time*

Egypt – A Typical Life Cycle for an Oil Producing Country



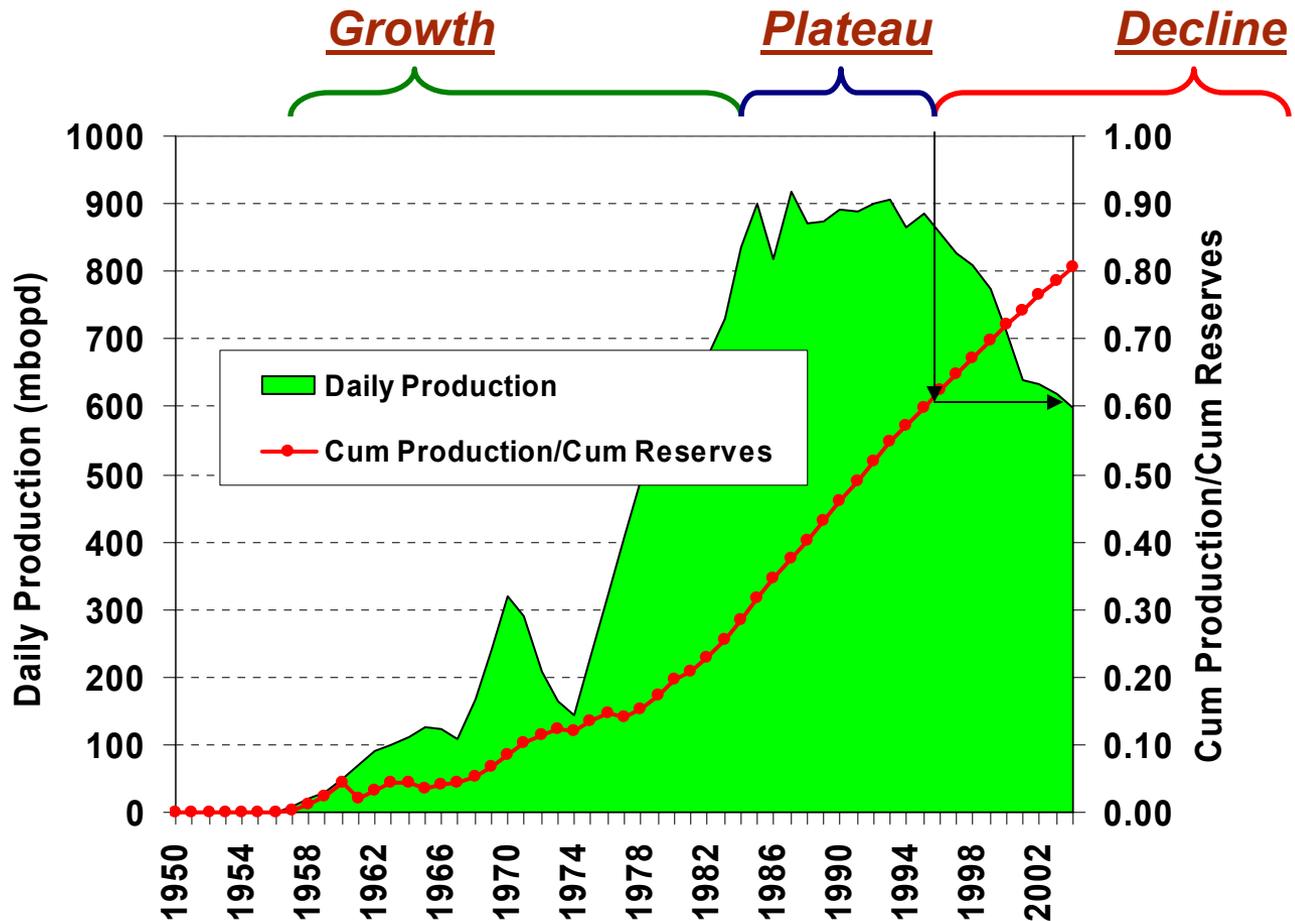
Typically large reserve growth occurs in the early years with large steps followed by smaller steps and much lower rates of reserve additions in the later years

Egypt – A Typical Life Cycle for an Oil Producing Country



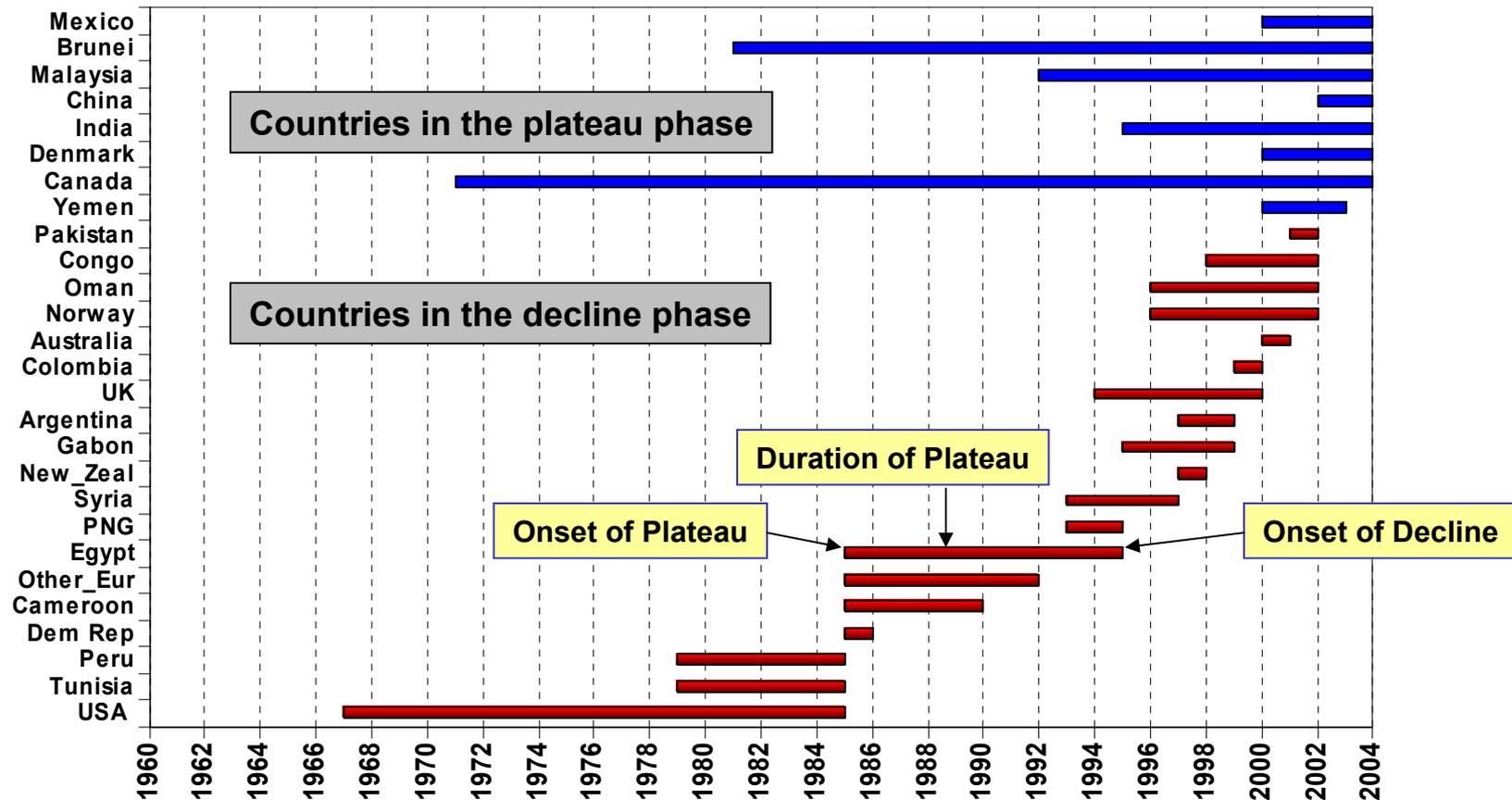
As reserve additions fall and production rates increase countries evolve from having net a positive annual reserve balance to a negative annual petroleum balance – *in the case of Egypt there have been 20 consecutive years where 250 mmbo more oil is produced than discovered every year*

Egypt – A Typical Life Cycle for an Oil Producing Country



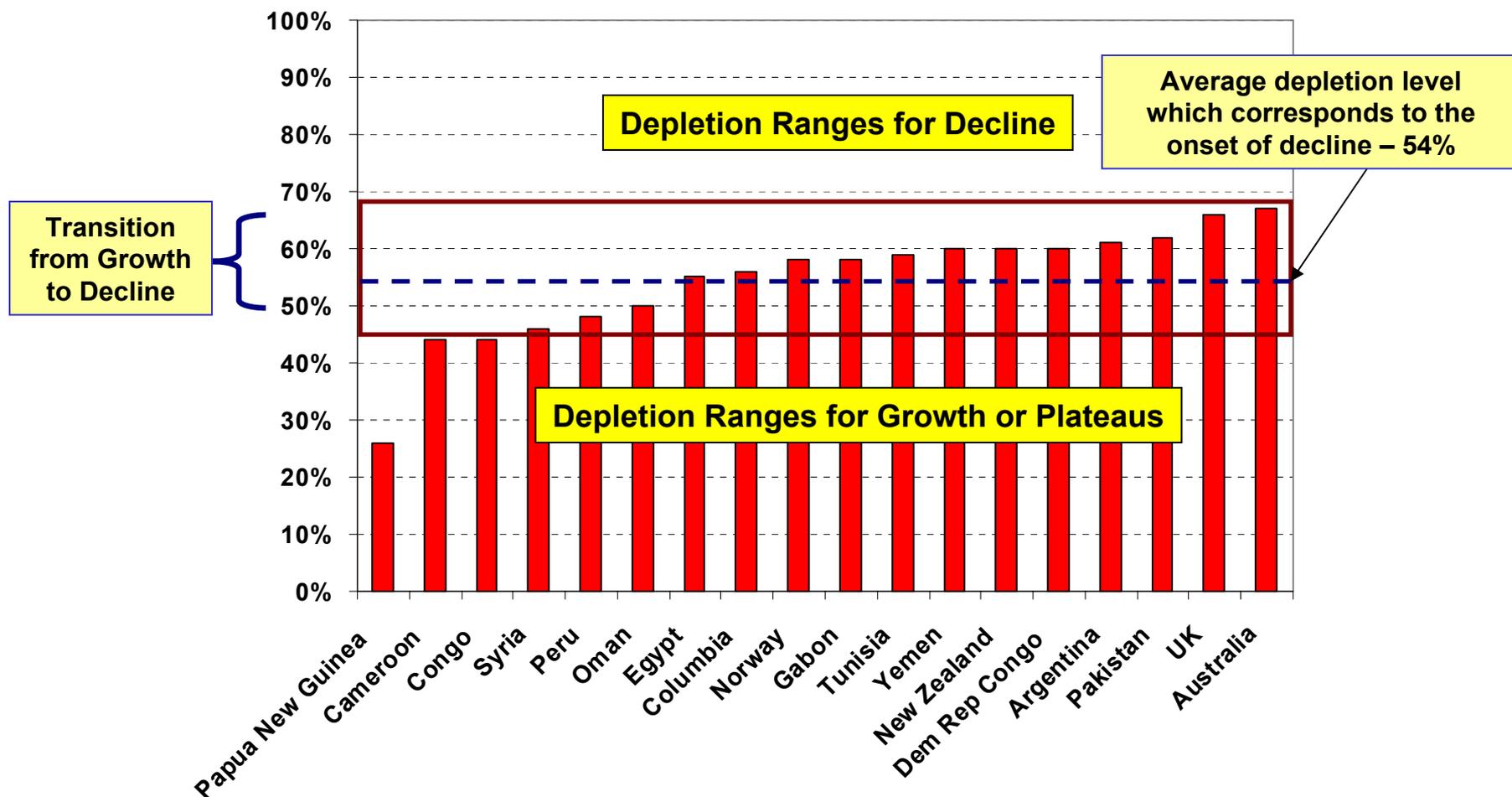
Once large discoveries are no longer made and production rates increase, depletion levels (percentage of oil discovered that has been produced) accelerate – *this depletion history has been mapped for every major oil and most minor producing countries*

Non-OPEC Countries that are Either in Decline or Currently in a Plateau



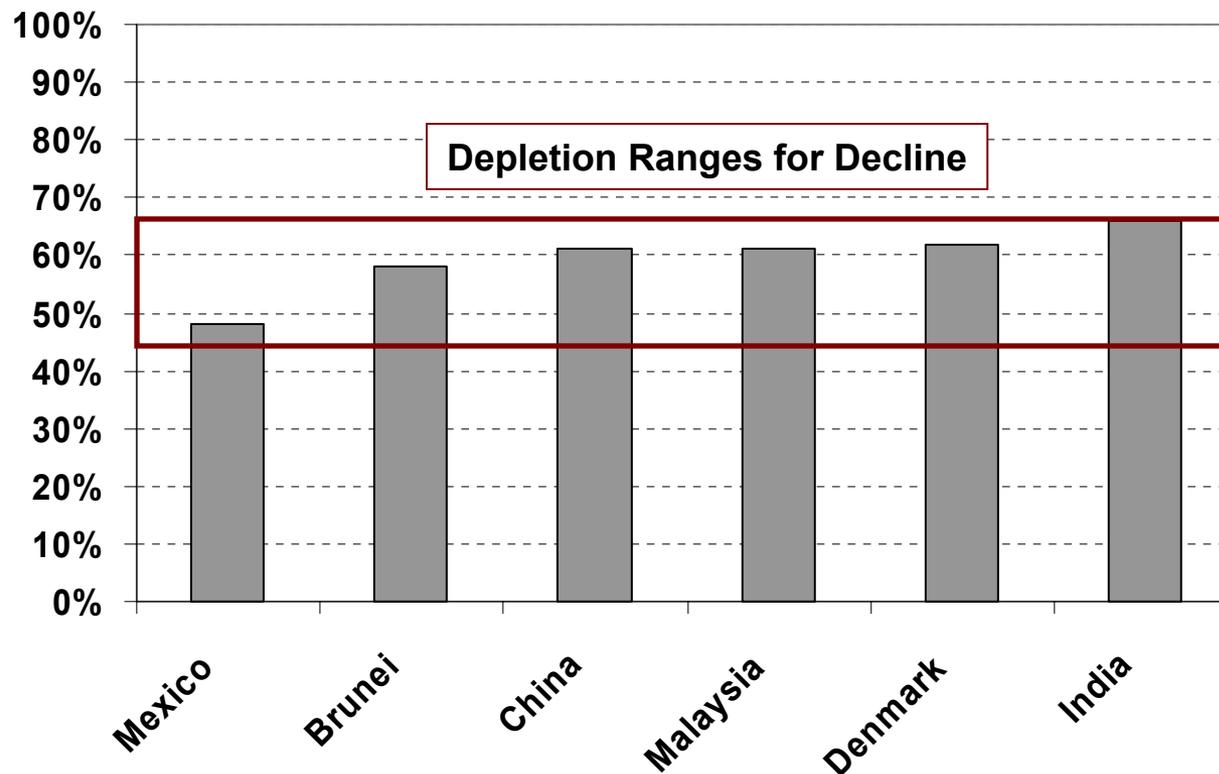
The above bars show the onset and duration of documented production peaks or plateaus – *tracking country life cycle shows an acceleration of the number of countries passing from peak to decline*

Non-OPEC Countries that are in Decline



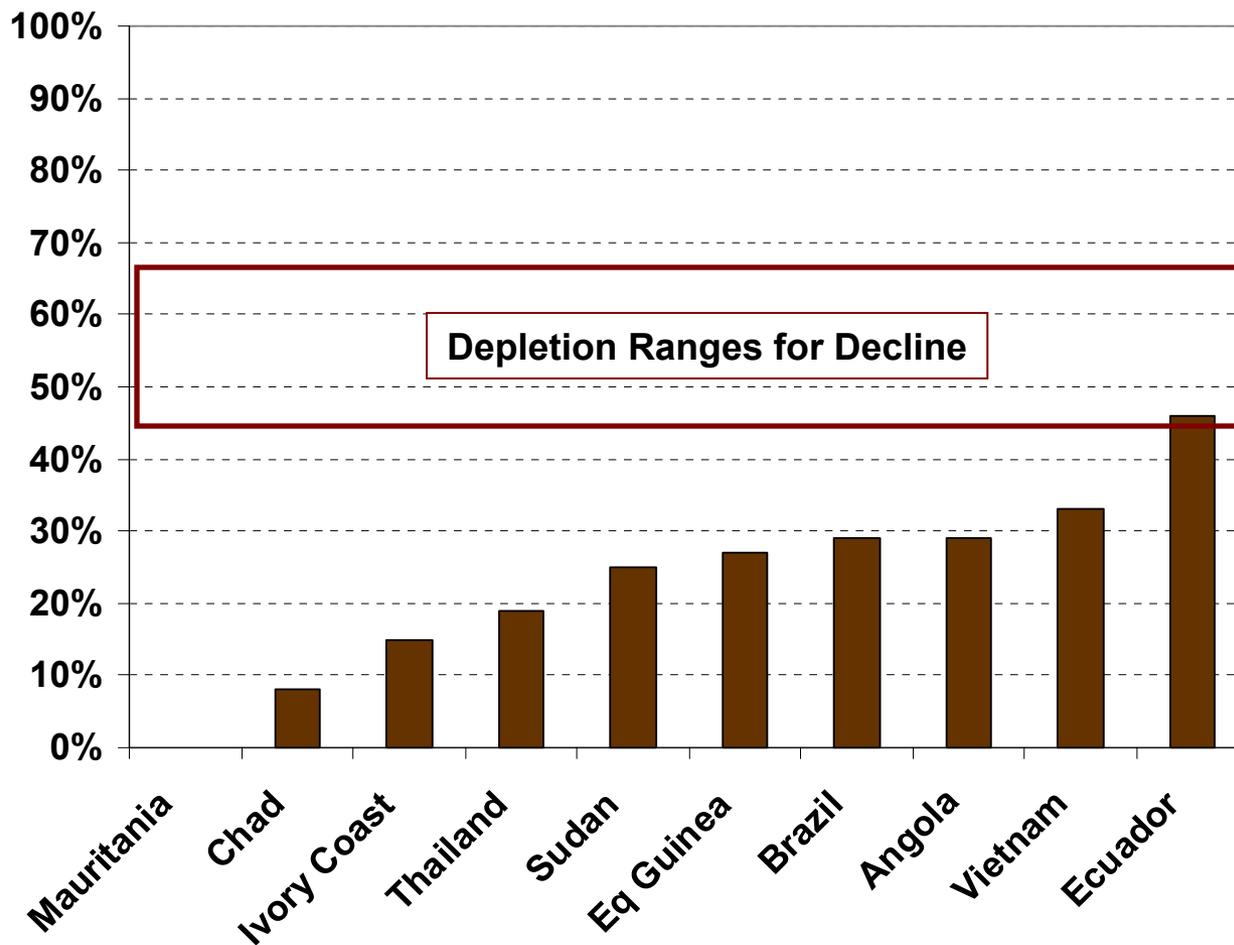
The above bars shows the depletion level at the transition from peak/plateau to decline – *tracking depletion level is a good way to anticipate the cessation of growth and the onset of decline*

Non-OPEC Countries that are in Plateau



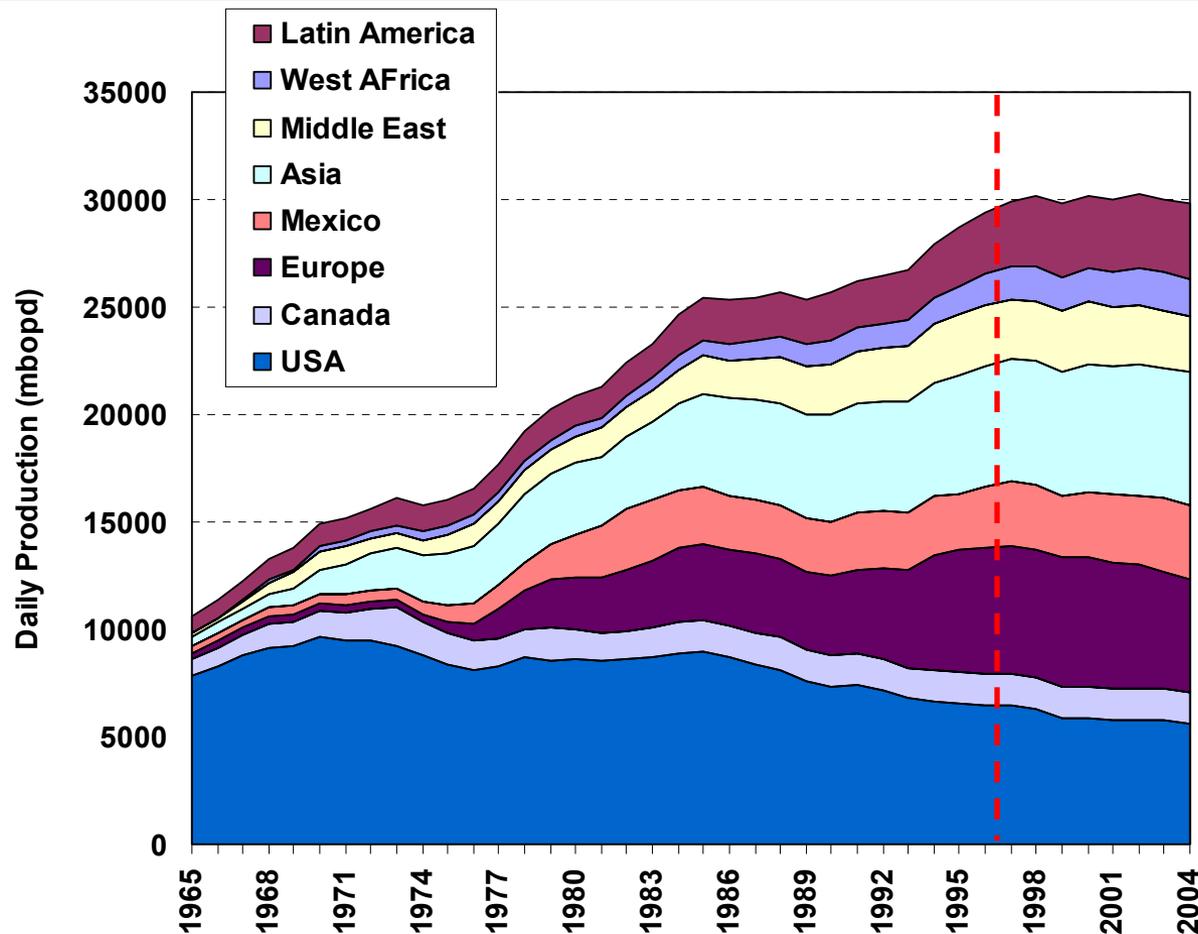
The above bars shows the depletion level of several producers which have reached a production plateau – *several significant producers are rapidly approaching critical (60 – 65%) depletion levels which typically signal the onset of production declines*

Non-OPEC, Non-FSU Countries with Production Growth Profiles



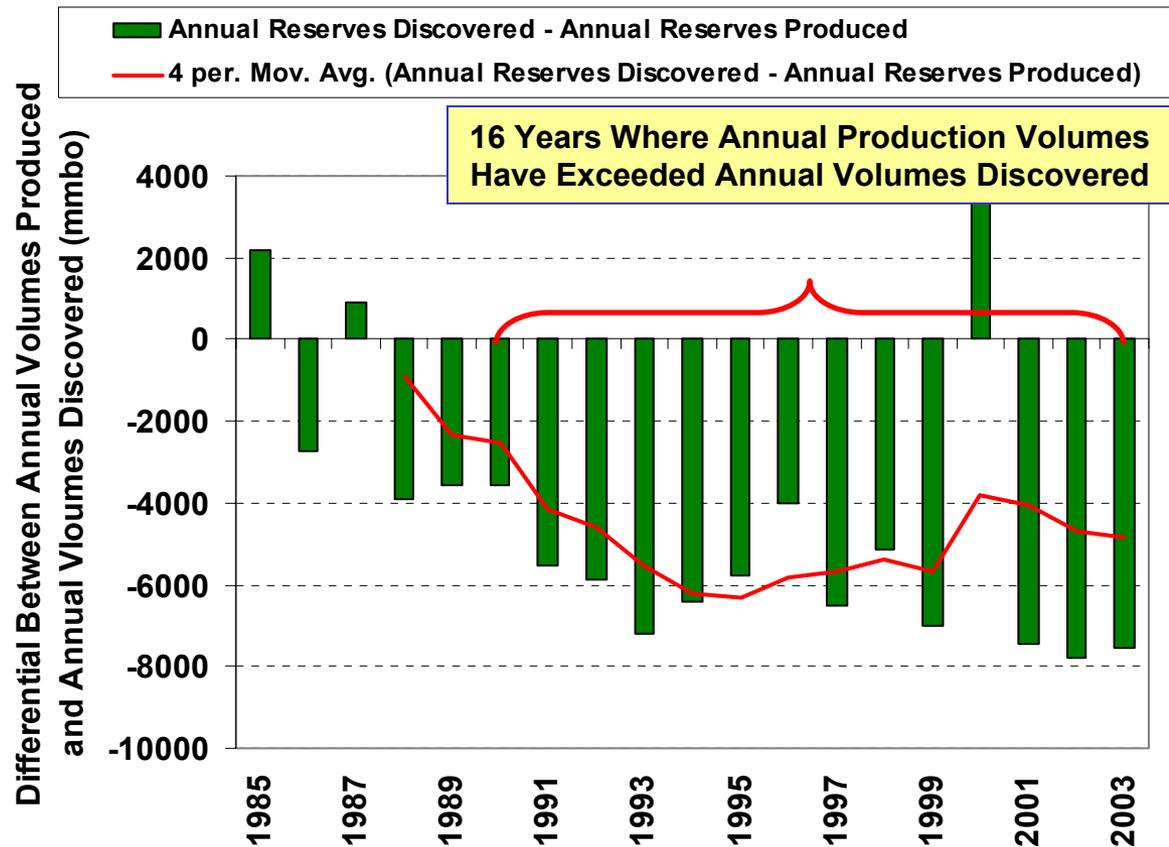
The above bars shows the depletion level of several producers which have new discoveries and are considered very likely to increase production – Azerbaijan, Kazakhstan and Russia are also expected to have growth profiles

Historical Crude Production (Excluding OPEC, FSU, Natural Gas Liquids and Canadian Oil Sands)



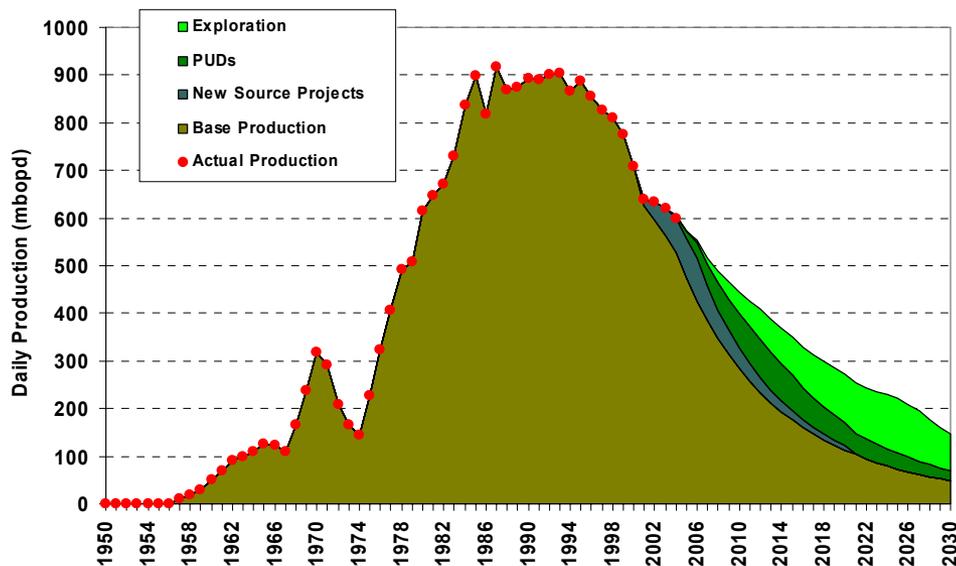
Several key producing regions have reached or exceeded the critical depletion point of 50-60% which typically marks the onset of production decline. It is worth noting that production gains from large new projects have not increased the aggregate production capacity of these regions for about 8 years.

Annual Crude Oil Production Balance (Excluding OPEC, NGL and Canadian Oil Sands)



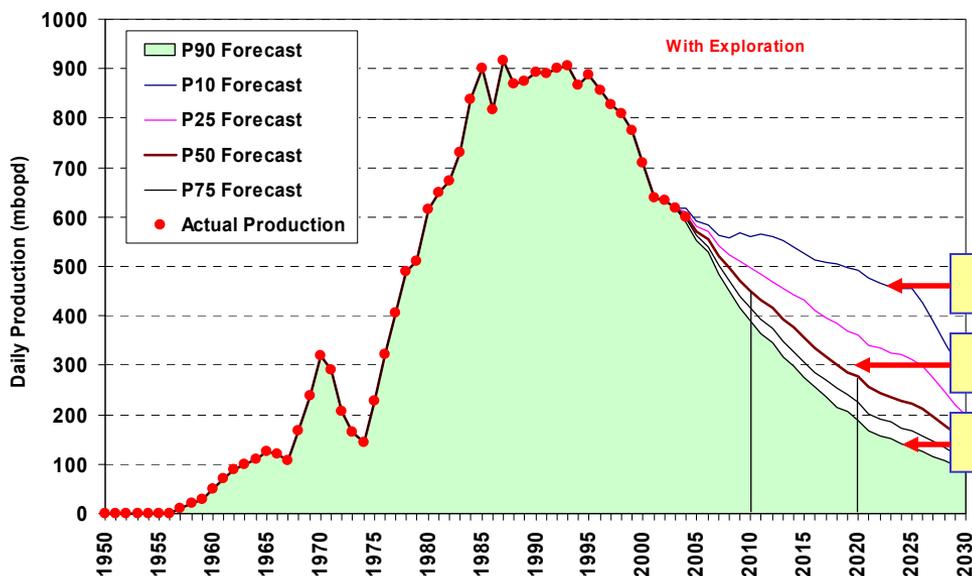
PFC Energy's data analysis indicates that Global Non-OPEC crude production is currently exceeding volumes discovered by as much as 8 billion barrels per year – *this continuing depletion of the reserve base will ultimately lead to the inability to continue growing production*

Egypt – Modeling Different Reserve Categories



Reserves for each country are separated and modeled independently. Each category is modeled probabilistically, using country typical, peak rates, decline rates, announced project schedules, historical drilling levels, recent field size distributions, and commercial thresholds.

Egypt is a good example where if we assume another 10 years of exploration results similar to the last 10 years, the incremental volumes are small relative to historical rates.



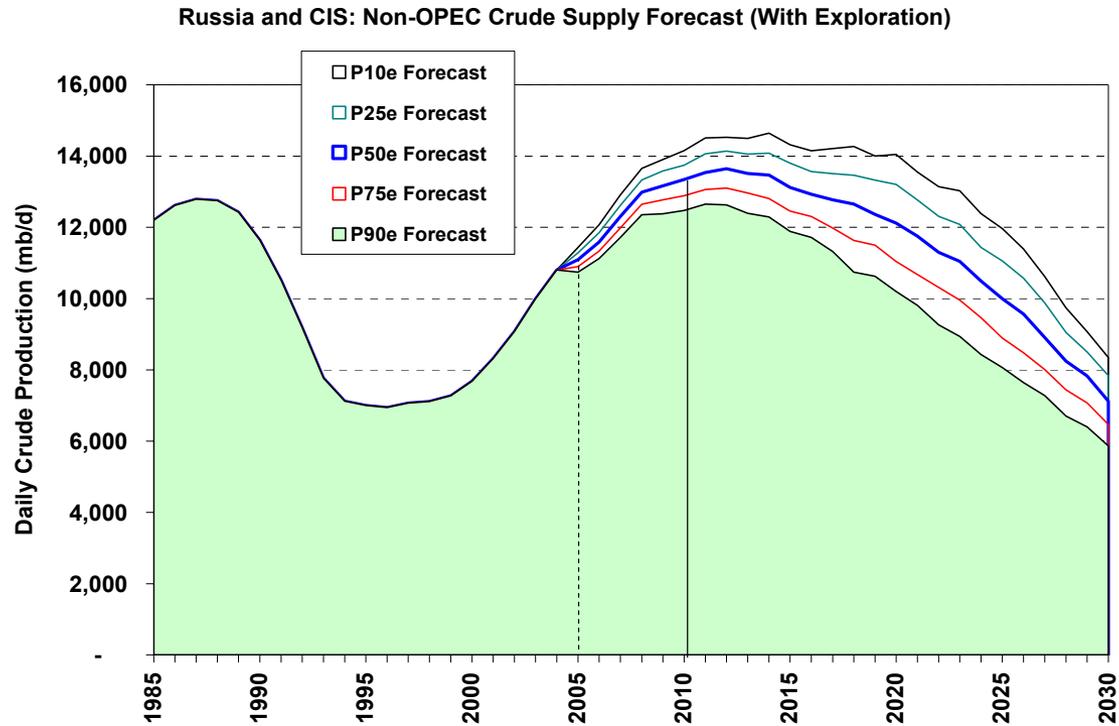
Modeled production uncertainty for each reserve category is combined to create production probability ranges for each country.

Low probability that production will exceed this level

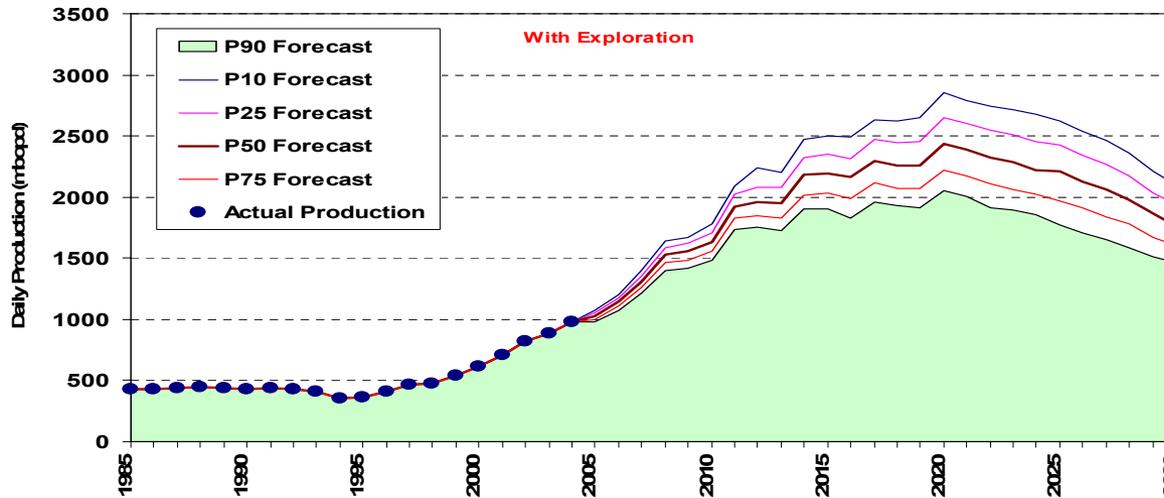
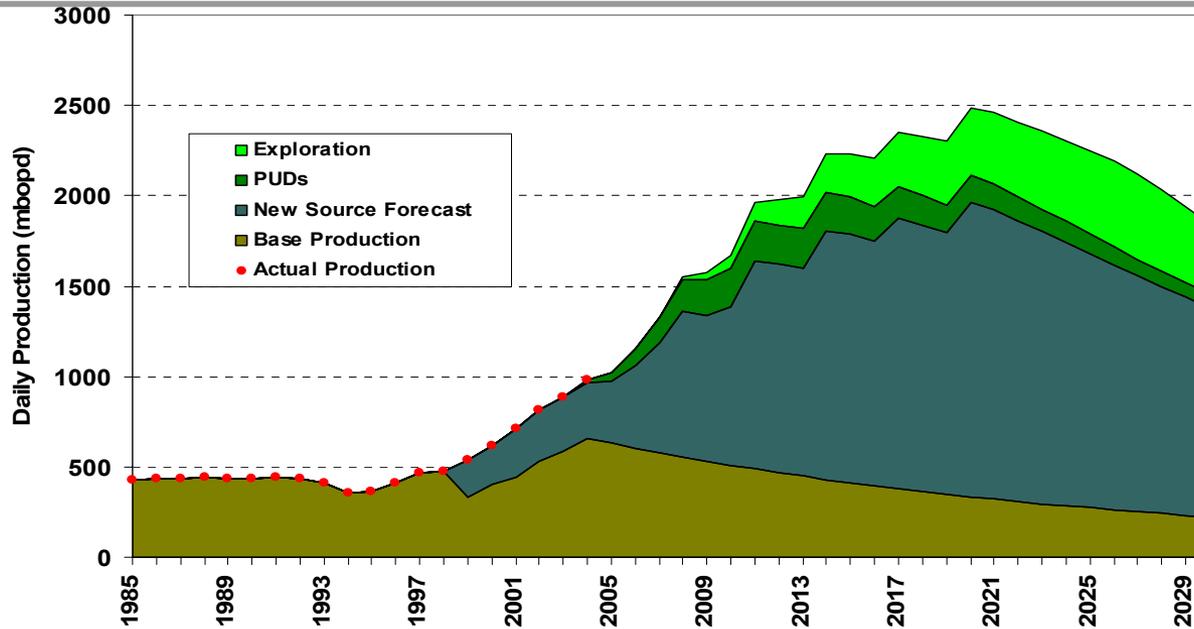
Most likely production path

High probability that production will exceed this level

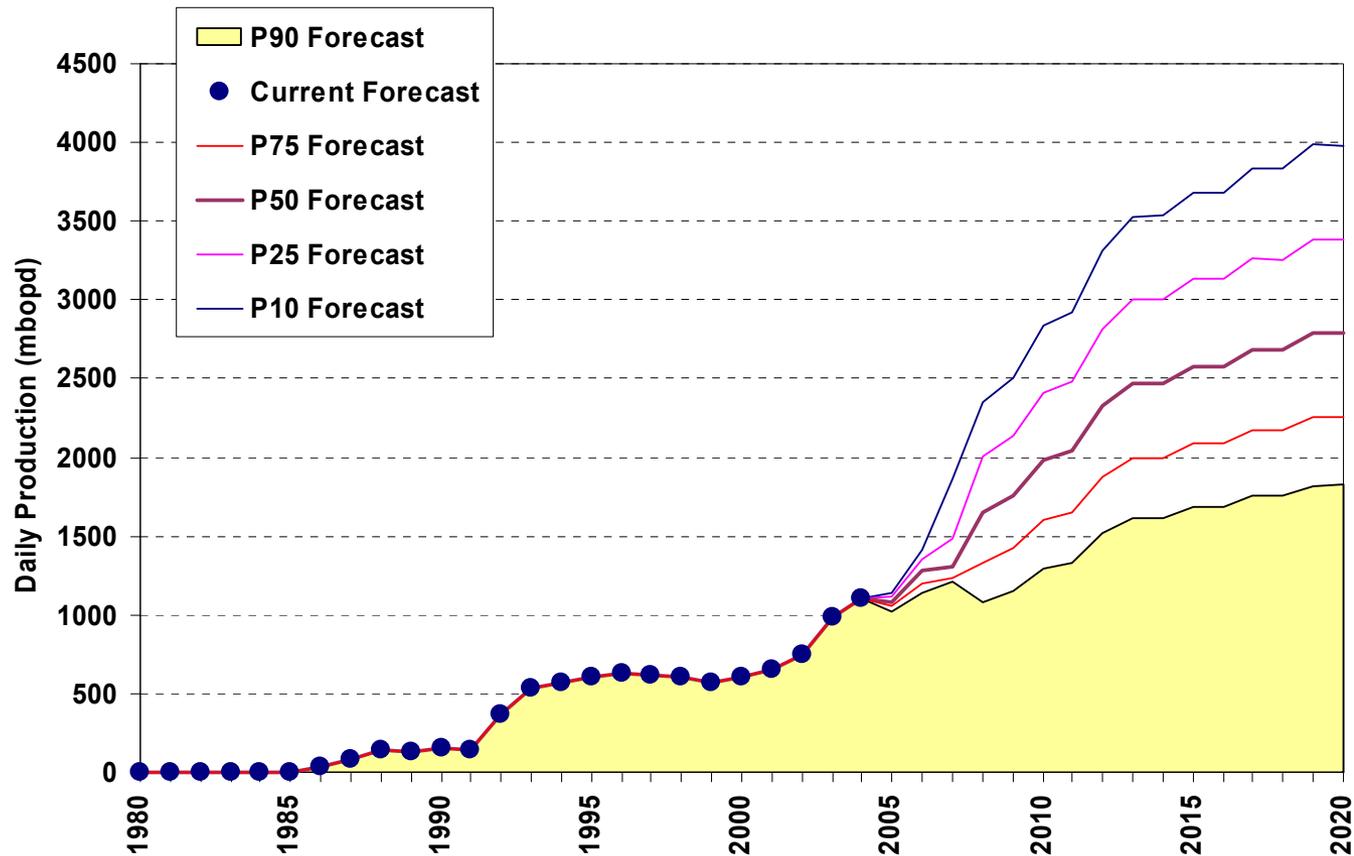
FSU Oil Production Forecast



Kazakhstan Oil Production Forecast

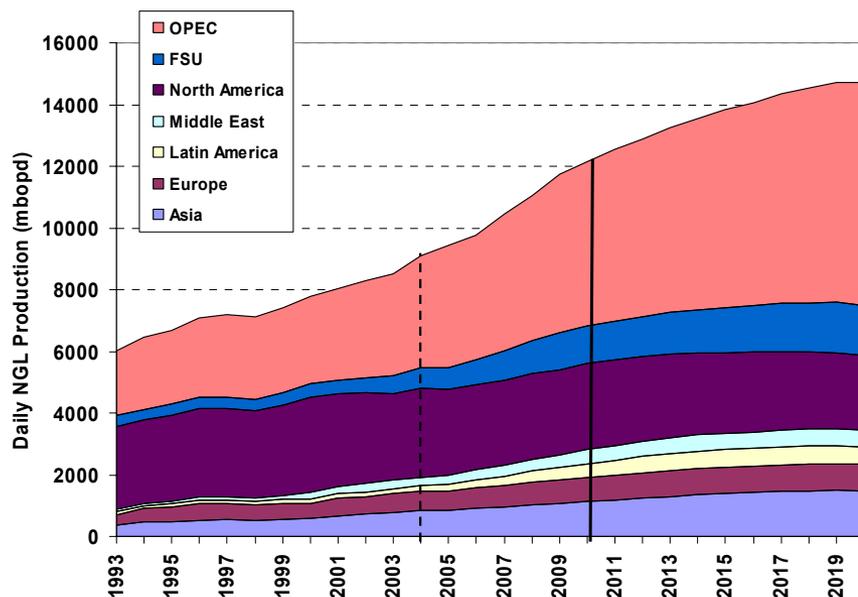


Production Forecast from Canadian Oil Sands

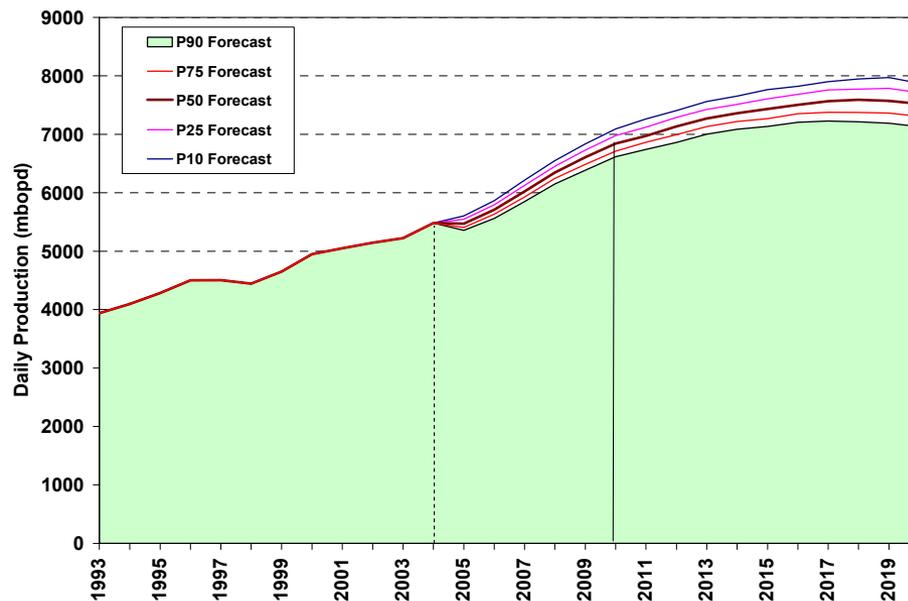


A review of various project proposals suggests that in an optimistic case Canadian Oil Sand production could quadruple by 2020 although the Canadian Government has stated the most likely case is a doubling of production by 2012 and continued growth beyond

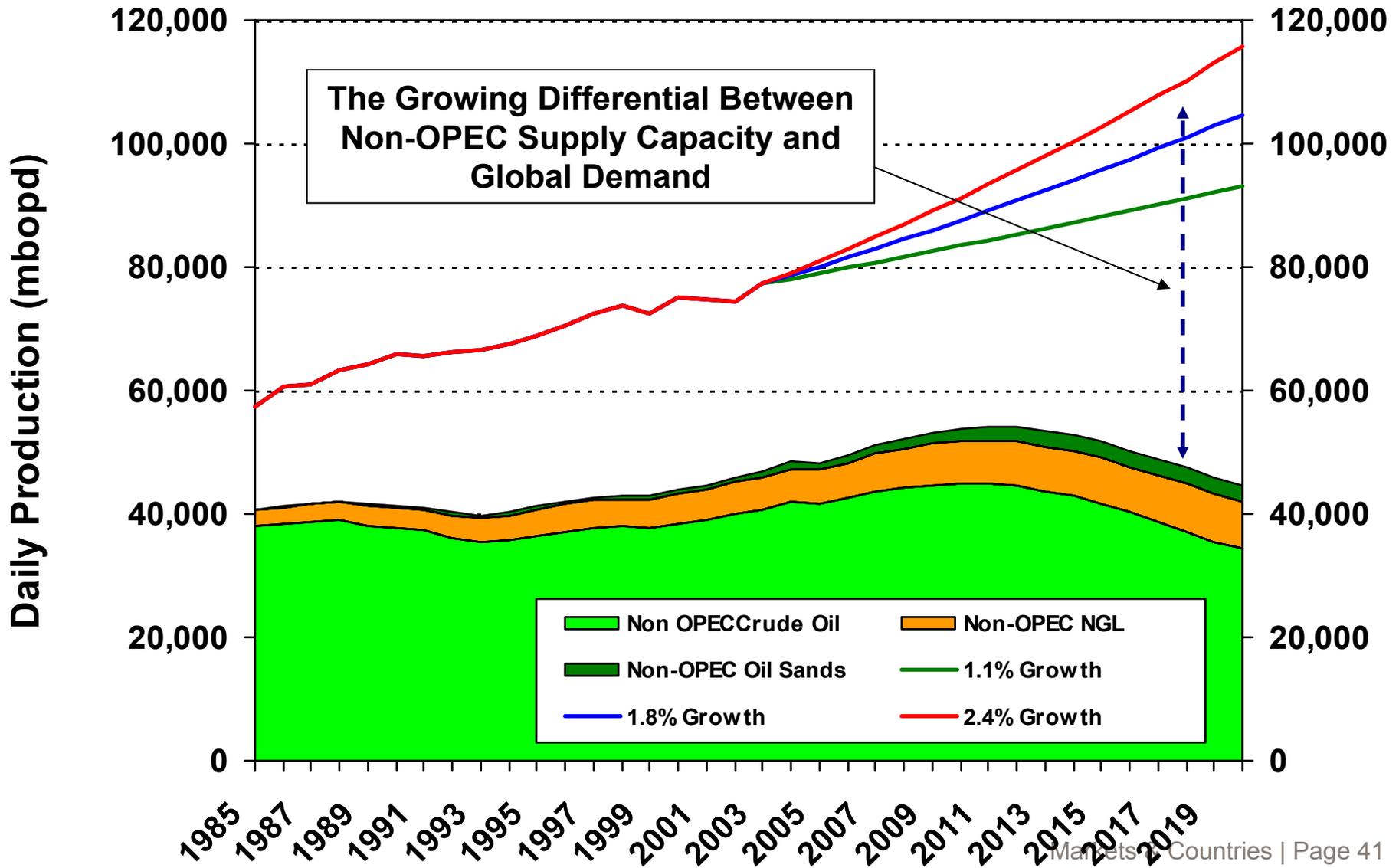
NGL Production Forecast



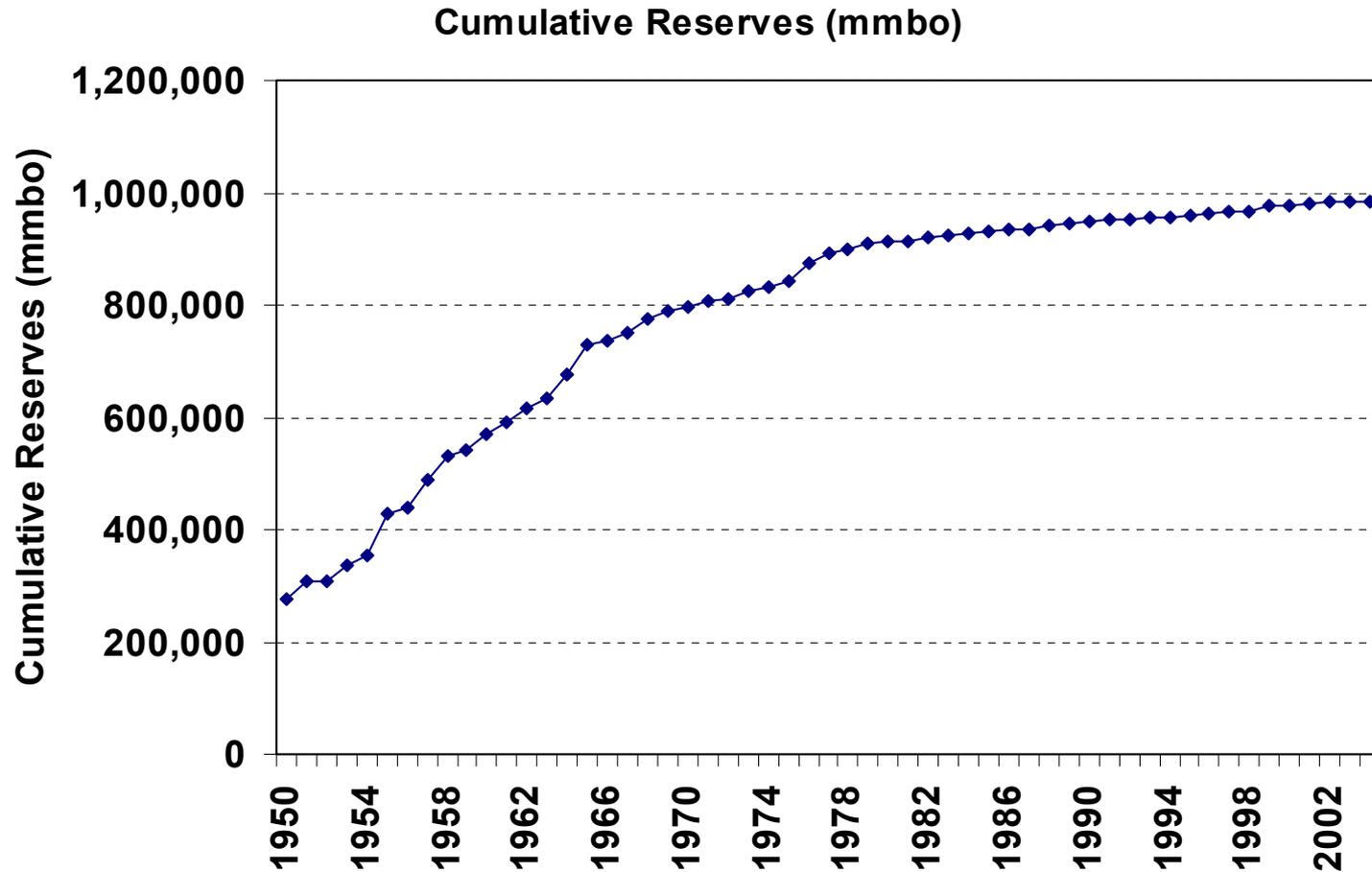
NGL Production will grow as large scale global gas projects are built to supply growing demands for natural gas. Much of the NGL growth is located within OPEC group countries like Qatar, UAE, Nigeria and others.



The Expected Growing Gap Between Global Demand and Global Non-OPEC Supply

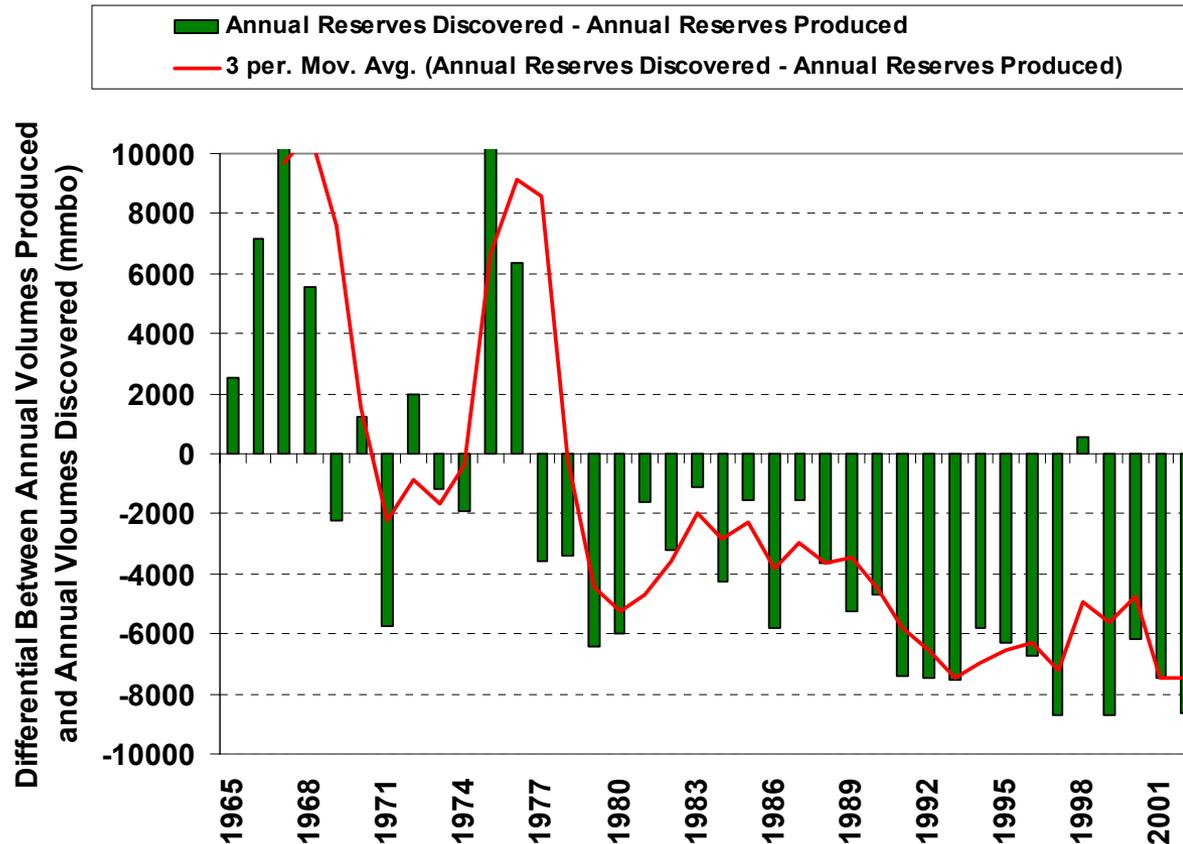


OPEC Creaming Curve



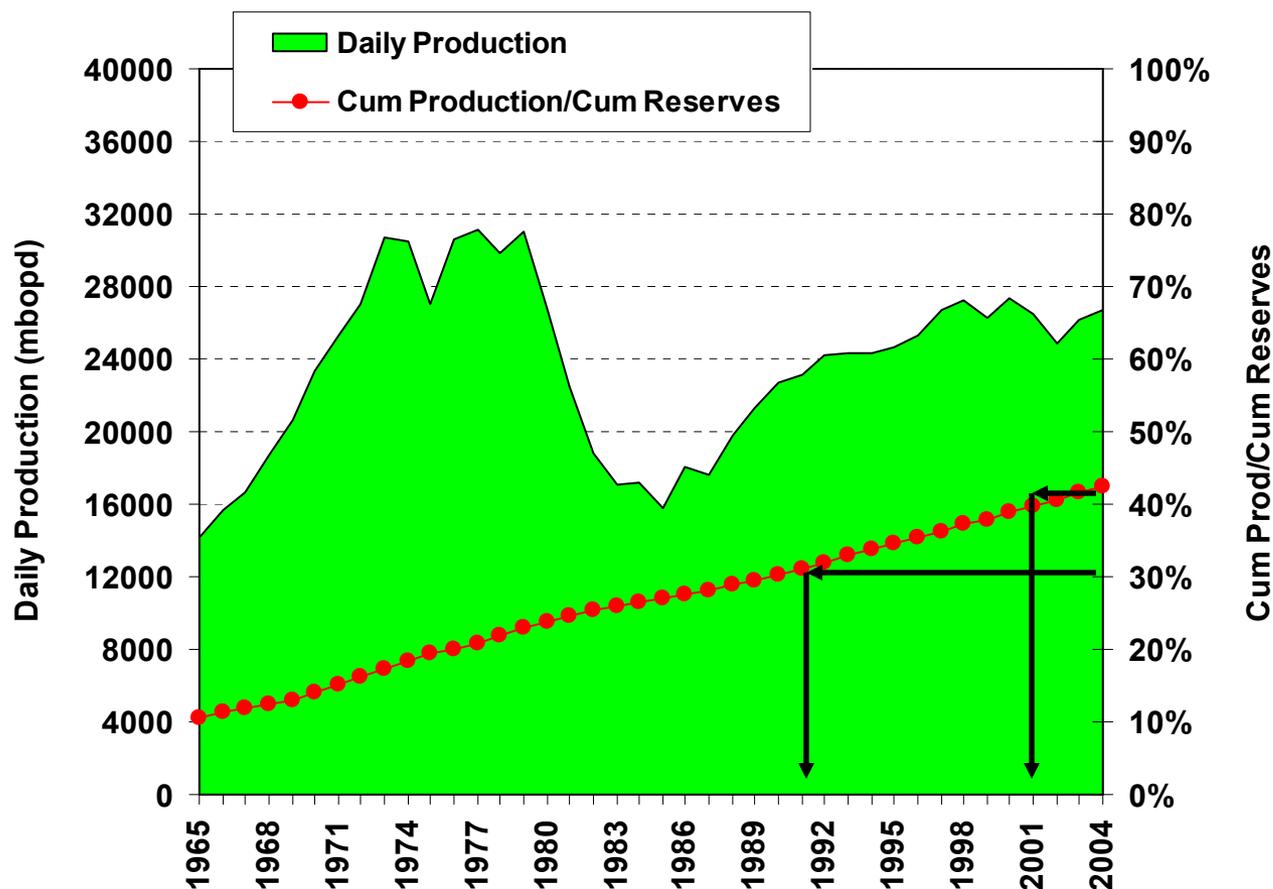
OPEC's creaming curve is no different from creaming curves for other basins, countries, or regions – *hundreds of new fields were discovered during the period 1975 to Present but like other areas they are considerably smaller than fields discovered in years prior*

OPEC Historical Annual Crude Production Balance (OPEC)



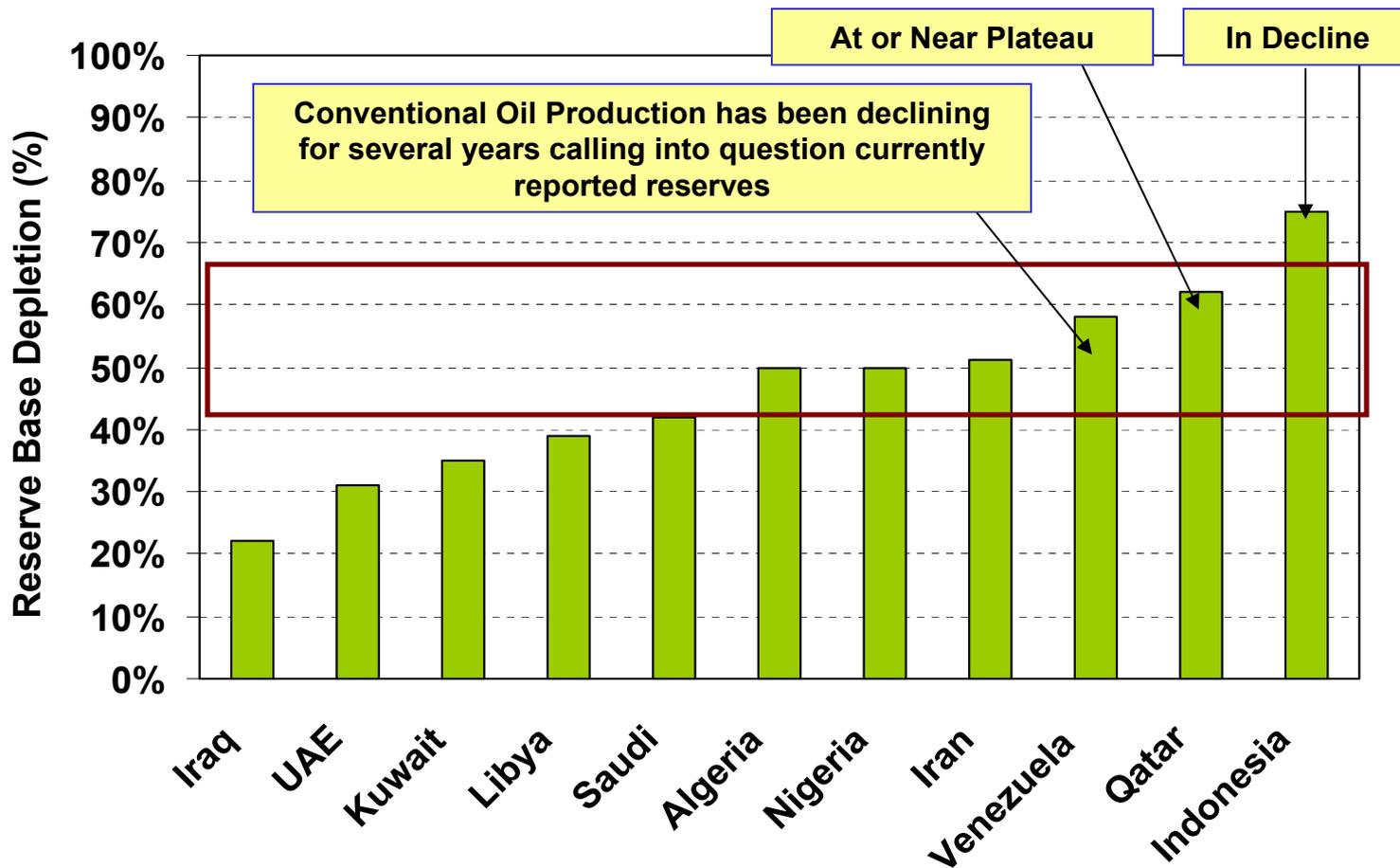
Like all other areas of the world, PFC Energy's data analysis indicates that Global OPEC crude production is currently exceeding volumes discovered. OPEC specifically is producing about 8 billion barrels per year more than it has been finding.

Historical Production and Depletion Levels (OPEC)



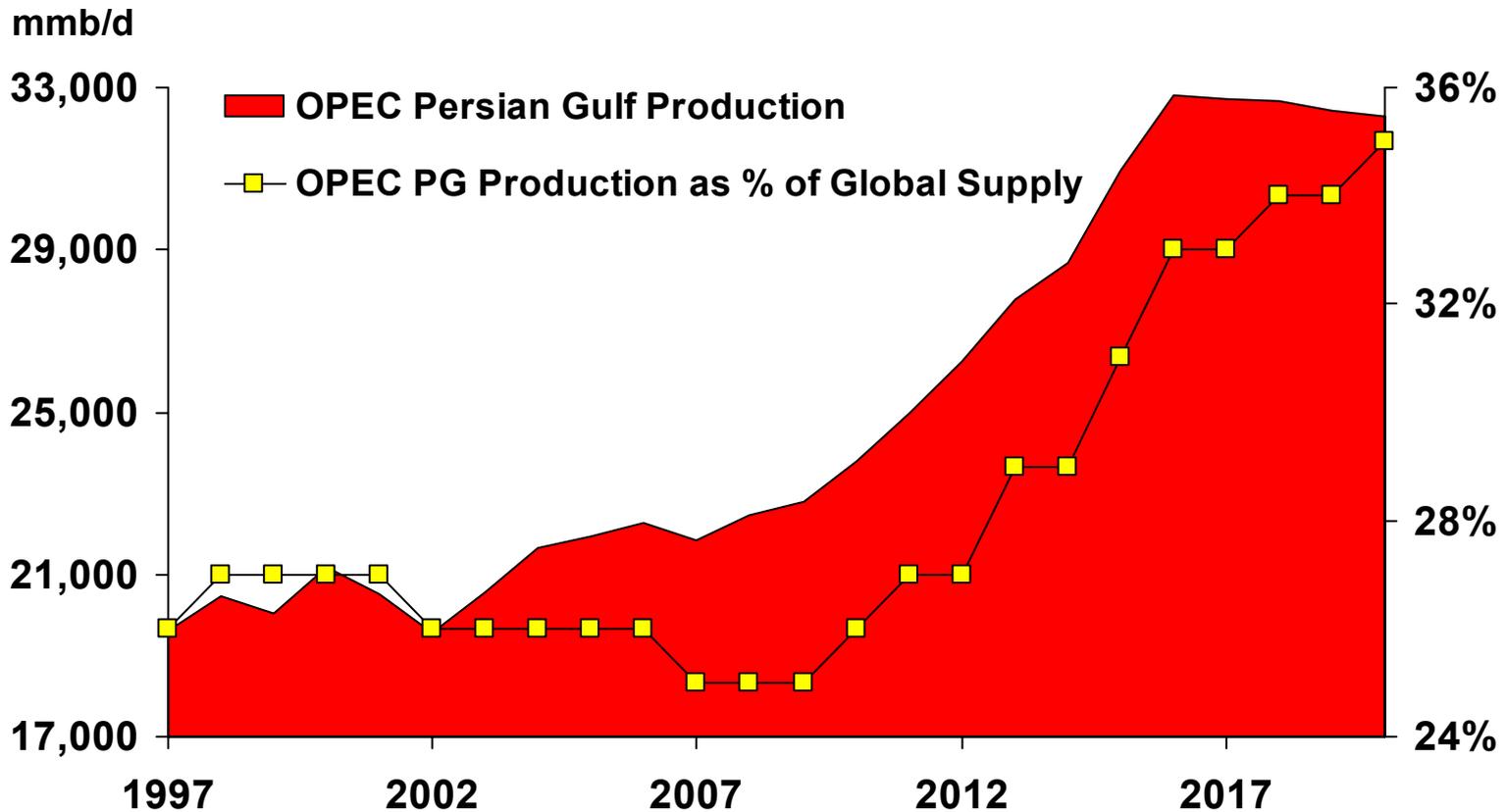
OPEC as a group is depleting at a rate of about 1% per year, even taking into account new discoveries – *during the 1990s reserves likely depleted by another 10 percentage points*

Historical Production and Depletion Levels (OPEC)



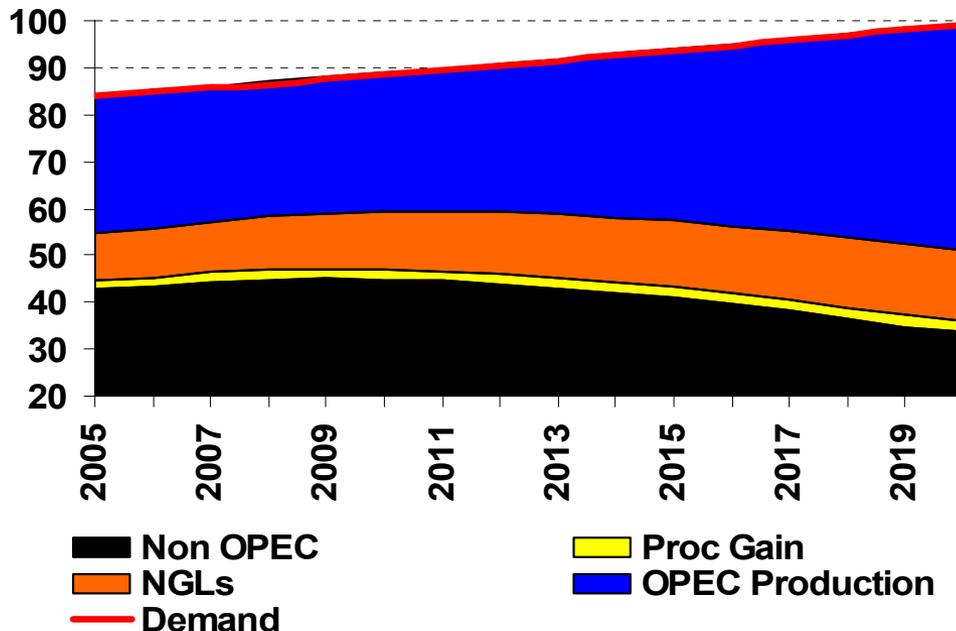
OPEC as a whole is depleting but some countries are depleting faster than others

The Persian Gulf Can Grow Production



When Is The Tipping Point in a Low (1.1%) Demand Growth Scenario?

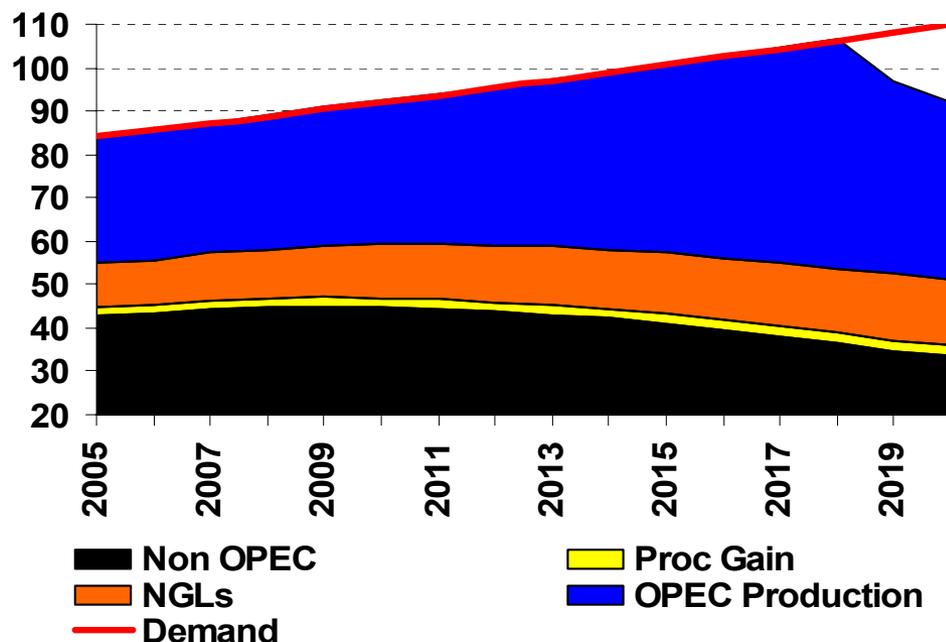
In a low demand growth scenario, as in all demand growth scenarios, OPEC will see a growing market share as non OPEC liquids production falls in the latter part of the next decade. Based on estimates of remaining OPEC reserves and persistent negative annual petroleum balances, there will come a time when OPEC production will not be able to fill the growing gap between demand and non-OPEC production capacity. ***In a low demand growth scenario, OPEC production will likely meet global demand through the end of the next decade but not beyond 2025.***



Global Supply and Demand; million b/d

When Is The Tipping Point in a Base Case (1.8%) Demand Growth Scenario?

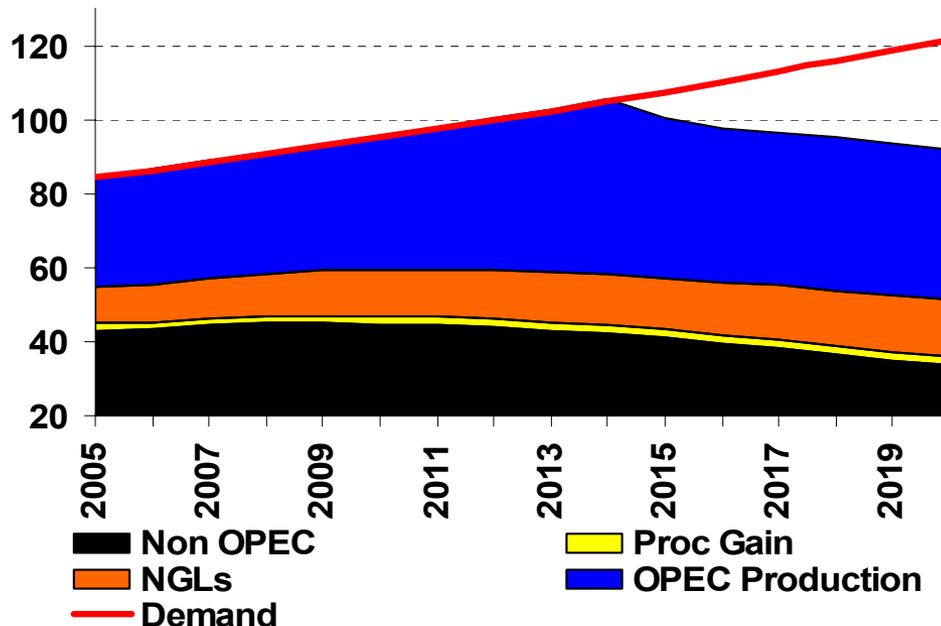
In a base case demand growth scenario, as in all demand growth scenarios, OPEC will see a growing market share as non OPEC liquids production falls in the latter part of the next decade. Based on estimates of remaining OPEC reserves and persistent negative annual petroleum balances, there will come a time when OPEC production will not be able to fill the growing gap between demand and non-OPEC production capacity. ***In a base case demand growth scenario, OPEC production will likely not be able to meet global demand in the latter part of the next decade.***



Global Supply and Demand; million b/d

When Is The Tipping Point in a High (2.4%) Demand Growth Scenario?

In a high demand growth scenario, as in all demand growth scenarios, OPEC will see a growing market share as non OPEC liquids production falls in the latter part of the next decade. Based on estimates of remaining OPEC reserves and persistent negative annual petroleum balances, there will come a time when OPEC production will not be able to fill the growing gap between demand and non-OPEC production capacity. ***In a high demand growth scenario, OPEC production will likely not be able to meet global demand as early as the middle part of the next decade.***

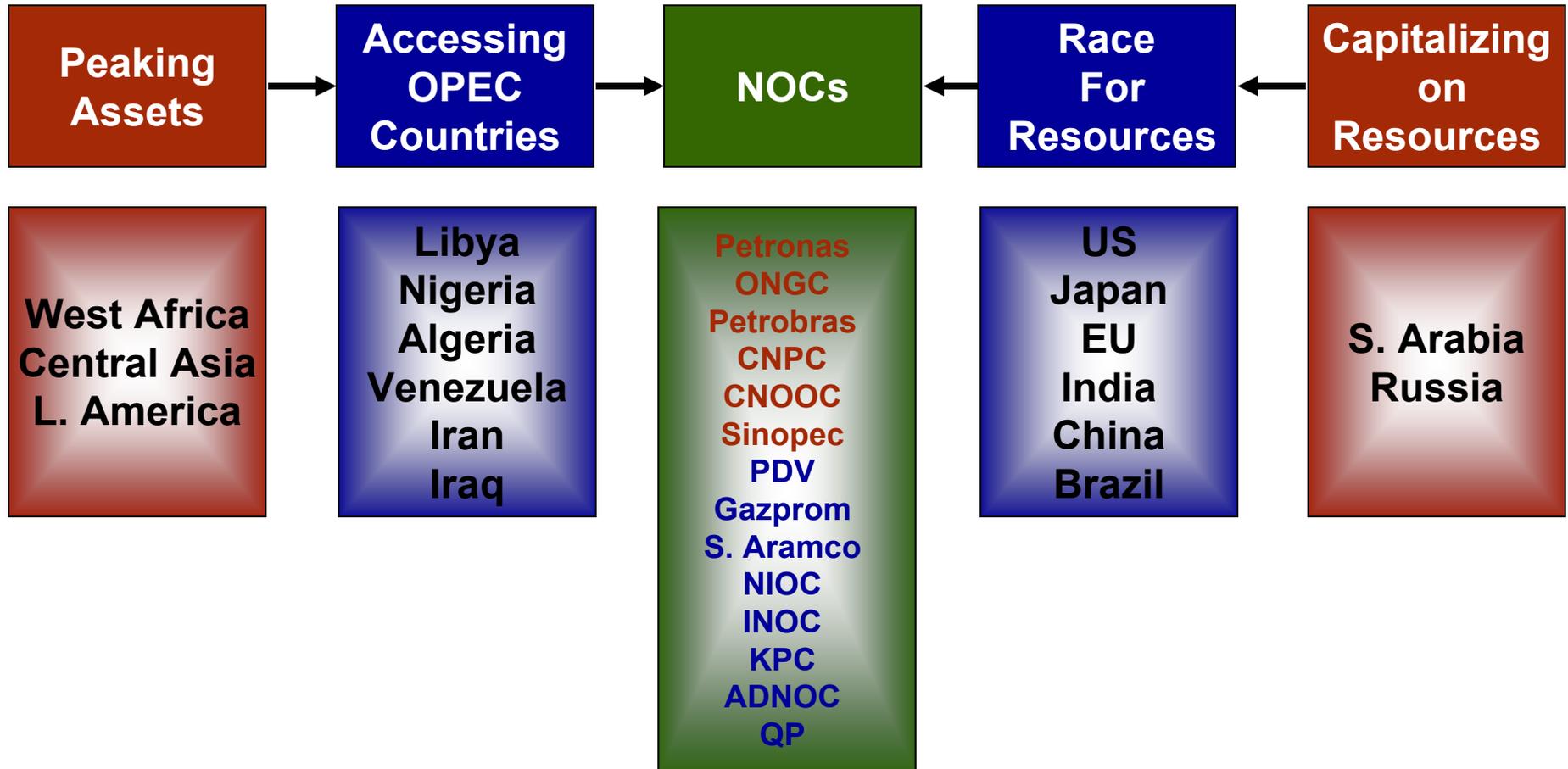


Global Supply and Demand; million b/d

The Quest for Energy Security

Producer Policies

Geopolitics



Red = Resource Seekers
Blue = Resource Holders

What Are The Major Producers Doing?

- **Saudi Arabia:**
 - **Prudent Fiscal Policies:**
 - Learning from the 1990s
 - Catching up on infrastructure investment
 - Promoting private sector investment in key sectors
 - Monetary policy subordinate to fiscal policy
 - Driven by inflation management and stable exchange rate
 - Improving bank supervision
 - Expanding capital markets
 - **For the first time investing in increasing oil production capacity:**
 - Going from 10.5 million b/d to 12.5 million will take 48 billion
 - Major debate in the country resolved: intertemporal and intersectoral allocation of funds – geopolitics wins
 - Gas investments left to external and internal private sector
- **Russia:**
 - **Curbing the activities of private oil firms:**
 - Capacity expansions sufficient
 - Cooperating with OPEC
 - **State promoting 8 strategic areas of investment:**
 - Oil and gas support wider policy – big question on whether this will succeed
- **Venezuela:**
 - **Social policies dominate:**
 - Major revolution in distribution of income
 - Oil and gas investment to come from private firms who have to accept lower returns

- **Understand and monitor oil markets:**
 - **Expect volatility in oil markets:**
 - Understand the impact of Kazakhstan production on oil markets
 - Understand the behavior of other oil producers
 - **Get a real understanding of the capabilities of your own oil and gas sector:**
 - What is the long term production profile of your sector? Don't take it for granted
 - What do you want from the oil and gas sector?
 - You can do a lot more than extract rents
- **Building a oil and gas sector to promote development:**
 - **Backward linkages:**
 - Gas as an engine of growth
 - Oil services and engineering
 - The Norwegian model
 - Oil/gas sector policies are any important signal for FDI promotion
 - **Build a national oil company with a long term vision:**
 - Devise a strategy to make it a viable private company
 - Use it to develop indigenous skills
 - Do not give ita all the assets – have some competition
 - It should not make policy – but give it a stable planning horizon
 - **Fiscal policy (and exchange/monetary policy) should take into account your oil/gas sector developments:**
 - Understand your long term revenue potential
 - Integrate longer term saving plans with oil/gas sector revenue and investment potential

PENSION & INSURANCE ATTACHMENTS



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Benchmarking for Kazakhstan Pension Funds

Paul E. Carlson CFA
September 2005

Introduction

The personalized pension program in Kazakhstan has developed rapidly since its inception in 1998. Total assets now stand at well over 570 billion KZT and are increasing by 10 billion KZT per month. However, this success is also creating the need for more sophisticated oversight of the funds' investment performance.

Clients, regulators and supervisors measuring the investment results of these funds must have strong standards for determining how well asset managers are handling the funds entrusted to them. The normal practice is to compare fund results to benchmarks - indices that measure returns available in the investment markets during the measurement period from the universe of acceptable investments. Examples of benchmarks are:

1. a well recognized price or total return index using the actual returns on market assets,
2. a tailored composite of assets or indices, or
3. an index calculated using the average returns of a peer group of similar funds.

Each of these types of benchmarks is widely used in the investment management industry.

The choice of the benchmark is usually a matter discussion between the fund client and the fund manager. In Kazakhstan, the Financial Supervision Agency (FSA) represents the pension participants in setting investment guidelines and parameters. Thus, the agency needs to work with the fund managers to design benchmarks that reflect the needs of the fund participants and that reflect the investment opportunities for the fund managers.

This paper will review performance measurement and benchmark methodology and usage and will present specific recommendations for adaptation by the Kazakhstan pension regulator and industry. The recommendations will be summarized at the end of the paper.

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Investment Performance

The key factor in the calculation of investment performance is the reliable and objective evaluation of portfolios adjusting for all changes in the balances of the fund including expenses. The evaluations should be done every day new assets are accepted into the fund or paid out to fund owners and on days used for performance measurement purposes. The changes in these evaluations with the inclusion of all investment gains and losses and expenses constitute the total investment return of the fund. The periodic changes are expressed as percentages and are linked to calculate investment returns over time.

In the Kazakhstan pension program the portfolio evaluations are performed daily by the fund management companies using either market prices provided by the Kazakhstan Stock Exchange or amortized values for bonds held in investment accounts. The valuation process is under the guidance of the Financial Service Agency (FSA). An analysis of the policies and procedures for fund valuation is beyond the scope of this paper.

Benchmark Selection

A benchmark that reflects the investment goals of a fund is an important tool for establishing the risk patterns of the fund. A carefully selected benchmark also aids in communicating the goals and objectives of the funds to clients, regulators and asset managers. Asset managers usually tailor their portfolios to represent the benchmark's asset distribution. Whether the fund benchmark is very aggressive (high risk, high return) or risk averse, the manager must manage the fund accordingly. To do otherwise will risk losing assets under management as the portfolio returns differ from the expectations of the clients. Worse, the clients may decide the manager is ignoring their investment objectives. **Benchmark selection has a major impact on the investment results of the fund.** No rational asset manager will allocate an important portion of client assets at variance with the benchmark assigned to the fund.

Therefore, the clients (or, in the case of the Kazakhstan pension funds, the regulator) must be careful to specify an appropriate benchmark. The selection of a cautious benchmark will lead to lower investment returns; an aggressive benchmark will lead to too much volatility or risk. If the benchmark does not contain any foreign assets, the portfolio managers cannot be expected to take important positions in such assets.

Other considerations for benchmark selection:

1. A valid benchmark must also be **investable**; that is, the fund managers must be able to match the asset allocation of the benchmark. For example, it would not be appropriate for a benchmark to have 50% of its composition in foreign equities if the funds were prohibited from having more than 20% of the portfolio invested in such assets. The benchmark must represent viable investment alternatives.
2. The calculation of the benchmark must be **unambiguous**. This point may seem obvious, but there are many cases where performance standards and client objectives are not clearly stated leading to poor communications

between fund managers and clients/regulators. The better approach is for the regulator, perhaps in consultation with the fund managers, to specify clearly a certain benchmark that is calculated in a disciplined and objective manner.

3. The benchmark should be **appropriate** to the risk and performance characteristics of the fund. The Kazakhstan pension funds appear to be invested for moderate risks and returns. An aggressive benchmark would clearly be inappropriate.
4. The benchmark must also be **specified in advance** so that both the fund manager and the client/regulator know what to expect. The asset management industry has known many cases where the benchmarks were changed after the fact to the benefit of either the asset manager or the client. Such changes are most likely to occur when the original benchmark was ambiguous or not investable. In other cases, the unannounced changes occur due to poor communications between the parties.
5. The benchmark should also reflect securities about which the fund managers should be able to have an **informed opinion**. This point is highly relevant for more diversified markets where there are a wide variety of investment styles. In the case of Kazakhstan, a foreign bond benchmark should probably focus on sovereign and top quality corporate issues since the local managers may not have the resources to adequately research lower quality issues.

The selection of benchmarks requires a choice between a published index or combination of indices and a peer group of funds with similar objectives. Each has a role for performance measurement as well as pitfalls. Indices are the most common and the preferred benchmarks, but peer group comparisons are often used when suitable index alternatives are not present. Basically, the selection should be based on fund goals and investment opportunities.

Examples of Index Benchmarks

Indices of unmanaged assets are the preferred benchmark when they meet the criteria above. They reflect all the assets available to the fund and to other funds with similar objectives. Furthermore, the advent of low cost index funds gave fund sponsors a realistic alternative to fund managers who could not earn the index return. Index publishers have now created indices to reflect investment performance specific to:

- growth and value shares called style indices,
- large, medium and small market capitalization shares,
- conservative and aggressive bonds and shares,
- different countries and regions for shares and bonds,
- hedged and GDP weighted strategies, and
- different economic and market sectors for shares and bonds.

In each case above, the index publisher chooses assets that meet the criteria and uses the returns on those assets to calculate the index. For example, the publisher would use the shares that meet “value” criteria (low price to earnings or price to book value)

and are among the 1000 largest of market capitalization to create a large capitalization value index.

The number of available indices is huge and new ones are created frequently to reflect emerging views of the capital markets. Morgan Stanley Capital International alone has numerous indices in the categories above for 23 developed and 27 emerging markets. Frank Russell has 24 indices reflecting various market capitalization and style breakdowns of the American equity market.

There are four leading publishers of capital market indices. Each of them calculates their indices on the basis of market weightings and total return. With the exception of Lehman, they publish their figures daily on websites.

Standard and Poors – www2.standardandpoors.com

- One of the oldest publishers of capital market indices
- Equity indices in USA, Europe and rest of world
- S&P 500 is most widely used equity index in USA

Morgan Stanley Capital International (MSCI) – www.msci.com

- 35 years of experience
- Publishes widely used equity and fixed income indices on a global, regional, country and style basis
- Also publishes the MSCI Global Capital Markets Index

Frank Russell & Company – www.russell.com

- US equity indices
- Focuses on market capitalization and style indices
 - High, medium and low cap
 - Growth and value

Lehman Brothers – www.lehman.com/fi/indices

- Numerous widely followed benchmarks in the global debt markets including:
 - Global Aggregate Index
 - U.S. Aggregate Index,
 - Euro-Aggregate Index,

The MSCI Global Capital Markets Index is designed to measure the performance of the core capital markets asset classes comprising global equities and fixed income. It is a market capitalization weighted composite of the MSCI All Country World Index for equities and the MSCI Global Total Bond Index.

Some investors combine these indices to create customized benchmarks. However, with the large number of indices available from these suppliers, most users are able to find a well constructed index to meet their needs.

Peer Group Benchmarks

Nevertheless, in some cases available capital market indices do not match the investment situations of funds. There may be an unusual set of constraints on the investment managers that are not captured by commercially published indices. For these managers, such indices are simply not investable or appropriate for the funds. A popular solution is the use of peer group universe of managed assets. In developed

markets, indices of venture capital, private equity and real estate are actually peer groups of managed assets. There is no trading market in these assets that can be used to create a market index.

The advantage of peer group benchmarks is that they reflect the actual returns earned by managers operating in the specified market taking full account of transactions and other operating costs. They reflect the decisions taken across the portfolios on available investment alternatives for clients.

Peer group benchmarks are also attractive where the investment goal is to beat the competition rather than an abstract calculated index. The Lipper group publishes mutual fund peer group performance statistics reflecting a wide variety of strategy parameters including style, market capitalization, sector, geography, and risk. The Frank Russell group, in addition to the market indices above, also calculates peer group benchmarks for pension, endowment and other private funds. Clients are shown how their funds have performed versus similar funds absolutely and by quintile.

The drawbacks to peer group universes are that:

1. They are not available on a real time basis; there is usually a time lag for comparison,
2. They can not be readily replicated which prevents the manager from taking a neutral position,
3. Often there is no oversight process for determining universe participants and whether the universe accurately represents the entire asset class although Lipper and Russell do a good job on including all participants, and
4. Without careful attention, survivor bias will develop over time as poor managers are deleted from the universe. In the case of the Lipper rankings, the publisher deletes the results of funds that failed, went out of business, or were merged into other more successful funds. Thus, the actual historical performance of the peer group is compromised.

The Kazakhstan pension program has adopted a peer group benchmark. Each fund's investment returns are measured against the weighted average returns of all the pension funds in the program. When a fund does considerably worse than the average, the fund manager must contribute enough money to the fund to bring the performance up to the average. While strong performance will lead to large inflow of funds, poor performance can lead to assets flowing out of the funds and a large capital contribution. The cost of negative relative performance is probably greater than the benefit of positive performance except for small funds (with small loss potential) managed by wealthy management companies willing to assume the risks.

Therefore, established asset managers have a strong disincentive to stray far from the consensus strategy. As a result investment decision making cannot be very creative or imaginative. On the other hand, the pension clients are not exposed to high risk strategies for their savings.

While these funds face considerable investment restrictions, they all face the same restrictions. Furthermore, there are no established market indices that accurately

reflect the domestic investment opportunities and restrictions of these pension funds. **Thus, it is reasonable and fair to use the peer group method for benchmarking domestic holdings given the limited opportunities available in spite of the above drawbacks to this type of performance measurement.**

Investment Risk

The Kazakhstan benchmarking system makes no allowance for the degrees of risk incorporated in the asset manager's investment strategies. While opportunities are limited, some funds could invest more in corporate shares and bonds, while another could concentrate in government bonds and national bank deposits. With only fourteen funds in the market, the industry is too small to create numerous risk indices. The FSA is experimenting with risk measures, but the agency is concentrating on default risk. Equities, which have no default risk since they have no defined obligations to share holders, are classified as no risk securities. We are certain that the agency will deal with equities more realistically as their risk measurement program develops. In the meantime, we applaud the agency for its initiative in this difficult area.

Portfolio risk is often defined as the volatility of returns. Safer investments have stable returns, high risk investment have returns that fluctuate widely due to changing market conditions and perceptions of the outlook for the issuer.

The table below summarizes the volatility of fund returns for the five largest pension funds and the market weighted total industry.

Standard deviation is a statistical measure of the volatility of a fund's returns. When a fund has a high standard deviation, its range of performance has been very wide, indicating that there has been greater volatility in the returns. For example, an investor can compare two funds with the same average annual return of 10%, but with different standard deviations. The first fund has a standard deviation of 2.0, which means that 67% of the time during the period measured its returns have been between 8% and 12%. On the other hand, assume that the second fund has a standard deviation of 10.0 for the same period. This higher deviation indicates that 67% of the time this fund experienced returns between 0% and 20%. With the second fund, an investor might expect greater volatility.

Standard Deviation of the Monthly Returns
December 2000 to July 2005

Fund	Market Value July 2005 (billion Tenge)	Mean Monthly Return	Standard Deviation of Returns	Coefficient of Variation ¹
SAPF	117	0.00734	0.00494	0.67297
HBKPF	145	0.00734	0.01288	1.75442
UlarUmit	102	0.00740	0.00630	0.85238
ABN AMRO	41	0.00737	0.00870	1.18073
BTA Kurmet-Kazak	41	0.00774	0.00523	0.67597
Total Pension Industry	569	0.00745	0.00630	0.84524

¹ Coefficient of variation is defined as the Standard Deviation divided by the Mean

At least on this measure there are considerable, but not statistically significant, differences in the volatility of the funds.

We recommend that the FSA continue to develop and monitor risk measurement systems that will help asset managers and fund participants understand the nature of the investment returns.

Alternative Solutions

An important issue for the Kazakhstan pension funds is that there are limited domestic assets available for investment and the funds are competing for those assets against a large inflow of oil proceeds and foreign investment. Real rates of return on those investable assets are low. Often, greater prospective and historical real rates of return are available in foreign markets. For example, the MSCI Global Capital Markets Index has earned an annualized 13.5% on a USD basis and 6.9% on a EUR basis since the beginning of 2003. Given the disparity between domestic and foreign returns, there ought to be incentives for the fund managers to invest outside the country.

While domestic opportunities are limited and poor, foreign opportunities are much more liquid and diverse and, on a long term basis, returns should be higher. Greater diversity also normally results in more stable returns. There are at least four ways of dealing with this disparity:

1. Each fund could decide how much to invest in foreign markets and the existing peer group benchmark would be used for the total fund. Those funds that made the right decisions about the level of foreign exposure would win and those that made the wrong decision would lose. This system mimics the existing program which unfortunately has effectively limited foreign investment.
2. Since relatively simple accounting methods allow funds to isolate the investment results of segments of the portfolio, many funds track the performance of fund segments against relevant benchmarks. If a fund had a portion of its assets invested in foreign markets, the performance of that segment could be compared to either a very broad index such as the MSCI Global Index or to a more relevant index such as an equity index if the manager invests its international segment only in international equities. The domestic segment of the fund would then be compared to a peer group index of the domestic segments of all the funds in a manner similar to current practice. The two segments could then be aggregated to calculate a combined performance index which could be compared against other funds with other levels of international exposure.
3. The FSA could determine that the industry performance standard would include a foreign index. For example, the agency could determine that the funds should have a target of 30% invested in foreign markets and that the performance standard for the foreign assets would be the aforementioned MSCI Global Capital Markets Index. The pension funds would then have

their investment results measured against an index composed of 70% the actual domestic peer group results and 30% the MSCI index.

4. Alternatively, the FSA could mandate a certain foreign percentage exposure with the money to be invested in a specified index fund or indexed exchange traded fund (ETF) that tracks a broad international index or combination of indices. Then, all funds would be compared using the existing peer group benchmark.²

In the first two cases, the asset manager would determine the appropriate international exposure for the fund while in the third and fourth cases the FSA would effectively determine the exposure.

The advantages of having the fund managers decide on the level of international exposure are:

- The fund managers have the responsibility and resources to determine how to invest fund assets.
- Each fund management company could structure the fund assets to attract a segment of the pension market, allowing sophisticated clients with varying risk tolerances to find an appropriate investment vehicle.
- A government agency such as the FSA may be uncomfortable in recommending or mandating foreign investment, in spite of the country's large foreign exchange inflow.

The advantages to having the FSA determine the foreign exposure are:

- Competitive forces have resulted in limited foreign exposure reducing opportunities for the funds and their clients.
- Few clients are sophisticated enough to make the decisions about risk tolerance. Those that are sufficiently sophisticated probably have other assets they can use to reflect that tolerance.

We believe that alternatives #2, 3 & 4 are all appropriate for the funds. The FSA and the industry should agree on one of them and implement it. The decision should not continue to be made on a default basis as represented by alternative #1.

Using the Benchmark

In this section we will discuss some considerations for the use of the benchmarks and performance measurement.

1. These funds should be invested for long term returns. Very few clients will be receiving money from the funds for the next ten to twenty years. Short term investing with its lower returns represents a disservice to the clientele. As a result, the FSA should look at the results over a longer rather than a short

² We have not found an index fund or ETF that directly captures the MSCI Global Capital Markets Index. We use this index simply as an example. The FSA and the asset managers should agree on an appropriate investment asset or group of assets if this option is selected.

term. **The recent change to performing a monthly review of the investment results for the past three years is a highly positive step and we recommend that the agency continue this practice.** As the history of reliable returns grows, perhaps a three and five year comparison should be used. Any lesser time period will result in an excessively short term focus by the fund managers.

2. While the fund clients deserve up to date information about fund performance, the use of daily, weekly and even monthly returns is counter to their best interests. Clients that chase short term performance will only loose out in the long run. The fund that has done the best for the past month or year is unlikely to repeat that performance. The conflict between the interests of transparency and the best long term investment results is a troubling one in every market, even with sophisticated investors since more information generally leads to more counterproductive trading by clients and fund managers. **We recommend that all fund comparisons should feature three and five year returns.** If shorter term comparisons are also included, the reports should include prominent warnings about the use of this data.
3. **All fund and benchmark returns should be translated into the same currency, preferably the KZT.** Otherwise, the results will not be comparable.
4. The current calculation for determining whether to apply sanctions against the fund managers is whether their return is within 10% of the peer group benchmark. The problem with this system is that 10% of a 20% average return is much more important than 10% of a 2% average return. **We recommend that the relative performance calculation be:**

$$\frac{1 + \text{fund return}}{1 + \text{benchmark return}}$$

The returns are expressed in decimal form.

Thus, if the three year fund return was 20% and the three year benchmark return was 18%, the relative performance index would be:

$$\frac{1.00 + .20}{1.00 + .18} \quad \text{or} \quad \frac{1.20}{1.18} = 1.017$$

5. One result of the performance measurement program is the imposition of sanctions for poor performance. Usually regulators allow the market to award good performance. The market will also punish bad performance. If the FSA wants to impose its own sanctions as is required by law, consideration should be given to graduated sanctions. A schedule of sanctions could be:

Relative performance index below	Sanction
0.95	FSA closely monitors investment activities Sanctions imposed if the index does not rise above 0.95 after three months.
0.90	The above If performance index does not rise to 0.95 after three months, the management company must make a contribution to the fund as is currently required. The FSA might also require that the asset management company post a bond for the proposed contribution until the performance problem is cured through an actual contribution or better investment returns.
0.85	Fund management contribution. Suspension of asset management license and assignment of fund management to one of the top three performing managers through an auction process with proceeds going to the existing fund.

Using performance statistics since December 2000 for all the funds, there were two readings where the three year index fell below 0.95. In each case, the shortfall was remedied in the following month.

We recommend that the FSA adopt a graduated schedule of sanctions for poor performance.

- Typically, attention is focused on poor performance. However, most major mutual and pension fund scandals develop from results that are too high rather than too low. These scandals occur when an unscrupulous manager figures out how to report false investment returns that are far above the norm. As a result of the phony high returns, the fund then attracts a large inflow of investors. When the bubble bursts, the investors' losses are enormous, thoroughly damaging confidence in the industry and regulator. While not all high performance is dangerous, **the regulator should carefully review the assets and pricing of any fund that has a relative performance index over 1.25.** Given the restricted investment options of the funds, even this threshold may be too high.

Investment Alternatives

Investing in foreign markets can be done through the direct purchase of individual foreign securities or through the purchase of passively managed index funds that replicate foreign markets. The direct purchase can be accomplished through the fund management companies or by retaining respected international investment managers.

While we believe the index funds are the better method for the Kazakhstan pension funds, there are advantages and drawbacks to each method.

The advantages offered by the index funds are:

1. They represent a low cost method for acquiring a diversified portfolio in capital markets.
2. In efficient markets well managed index funds typically perform better than 80% of the portfolios actively managed by professional asset managers.
3. There is no need for expensive and uncertain research on individual securities to determine which ones to buy and sell. The funds represent the market performance of all securities in the relevant markets.
4. Management fees on the funds are in the range of 0.1% - much less than the cost of investment research and management.
5. Since the funds are passively managed, there is very little portfolio trading which further reduces costs and enhances investment returns.
6. Funds can be chosen to replicate broadly diversified indices such as the MSCI Global Capital Markets Index, country indices, and equity and bond indices.
7. The funds quickly adjust for changes in index composition, most of which are minor.
8. The trading costs of buying and selling actively traded Exchange Traded Funds (ETF's) are lower than buying numerous individual securities.
9. All dividends and interest received are reinvested promptly and efficiently.
10. ETF's are denominated in specific currencies, most commonly the USD and EUR. Hedging the currency risk for KZT investors is, therefore, simplified in comparison with the purchase of shares of companies from a variety of countries with differing currencies.

The drawbacks to the index funds are:

1. The funds do not have credit ratings as required by law or regulation for Kazakhstan pension funds. This law or regulation should be changed. There are numerous quality ranking systems for investment funds, such as provided by Morningstar.
2. Through individual asset choices, a very clever and sophisticated asset manager may be able to earn sufficiently higher investment returns than the ETF's to cover the incremental costs.

As an alternative to using available index funds, the Kazakhstan pension funds are now getting large enough to hire investment managers to replicate specific indices for them at very low cost.

On balance, **we strongly recommend that managers of Kazakhstan pension funds adopt indexing for their foreign investment programs.** While the MSCI Global Capital Markets Index will cover the entire capital market, the funds may want to manage the debt/equity components directly by using a global equity index and a global bond index in different proportions than the debt/equity proportions in the overall index. The funds are somewhat unique in that they will not be making significant distributions for many years which should impact portfolio duration.

Recommendations

The recommendations we have discussed in this paper are summarized below:

Page #	Recommendation
6	The FSA should continue to use the peer group method for benchmarking domestic holdings given the limited opportunities available.
8	We recommend that the FSA continue to develop and monitor risk measurement systems that will help asset managers and fund participants understand the nature of the investment returns.
9	For the purpose of benchmarking foreign investment, alternatives #2, 3 & 4 on page 7 are all appropriate for the funds. The FSA and the industry should agree on one of them and implement it.
9	The recent change to performing a monthly review of the investment results for the past three years is a highly positive step and we recommend that the agency continue this practice.
9	We recommend that all published fund comparisons should feature three and five year returns when available.
9	All fund and benchmark returns should be translated into the same currency, preferably the KZT.
9	We recommend that the relative performance calculation be: $\frac{1 + \text{fund return}}{1 + \text{benchmark return}}$
10	We recommend that the FSA adopt a graduated schedule of sanctions for poor performance.
10	The regulator should carefully review the assets and pricing of any fund that has a relative performance index over 1.25.
11	We strongly recommend that managers of Kazakhstan pension funds adopt indexing for their foreign investment programs.

Brief Report on the Actuarial Training in August, 2005

In response to request of the Financial Supervisory Agency of Kazakhstan, Pragma Corporation, in co-operation with the USAID, offered two actuarial training courses in August, 2005, on Financial Reporting of Insurance Companies (Course 6B) and on Investment (Course 6A). This report provides a summary of these courses. There are two-fold purposes to the courses:

- To accelerate the actuarial training with the target of producing 30 fully qualified actuaries (who have completed all six actuarial examinations) by 2007.
- To train Kazakhstan actuaries to fully understand the international accounting principles and solvency rules

Course 6B - Financial Reporting of Insurance Company

Instructor s- Mike Sze / Morris Chambers

This was a very intensive course offered during the week of August 8 to 13, with a comprehensive examination on August 15. The course covered many important topics on financial reporting and solvency protection of insurance companies:

- Overview of financial accounting for insurance companies
- New International Accounting Standards on insurance, and International Financial Reporting Standards 4
- Standard of practice of the International Association of Actuaries
- New solvency rules of the International Association of Actuaries
- Solvency standards of the International Association of Insurance Supervisors
- Solvency standards of the European Union
- Principles of Risk Based Capital
- International Risk Based Capital Systems
- Insurance Regulatory Information System

35 students attended the course, including over 10 officers of the Financial Supervisory Agency of Kazakhstan who audited the course. 17 students took the comprehensive final examination. 8 students passed. This represents 47% of students taking the examination, which is higher than expected, considering the breadth and depth of the subject material covered. A survey of the students showed very positive feedback from the students. There was strong demand for a repeat offering of the course in early January, 2006. However, the students all felt that the course material should be covered in two weeks instead of one.

Proposed follow-up action

In response to request of students, we propose to repeat Course 6B for two weeks next year starting on January 9, 2006.

Course 6A Investments

This was an intensive two weeks course offered during the weeks of August 15 – 27. The course covered:

- Ethics
- Quantitative methods
- Accounting
- Corporate finance
- Portfolio management
- Equity investment
- Fixed income investment
- Derivatives
- Alternative investments

There were two lectures each morning, followed by a test and tutorial each afternoon. The lectures were given in English with translation by the tutors. 20 students took the course. 17 students took the final examination, with questions provided in both English and Russian. **Only four students passed.** This represents 24% of students taking the examination. The results showed that students with strong English skill have clear advantage over the non-English speaking students. While the results are slightly disappointing, it is comforting to know that two of the students passing this examination have completed all six examinations, bring the total number of fully qualified actuaries to 16.

Follow-up action

The instructors of the course all feel that there are more students who have chance to pass the examination if given a second chance. The handicap in this examination is that there are too many verbal questions, putting non-English speaking students at a handicap. Based on that we propose the following actions:

- To translate the 68 pages of the text on Ethics into Russian
- To offer another examination on 6A in November without teaching the course. This time, except for the Ethics section, the questions will be more numerical than verbal.
- Even though there will not be formal teaching of the course, there will be five evening tutorial classes reviewing the topics covered in the course.
- We expect that this will offer additional training for the actuaries, and will enhance our chance to reach our target of **30** fully qualified actuaries by 2007.

Conclusion

The training courses in August, 2005 have been successful. Kazakhstan actuaries are beginning to understand the implications of the new international accounting standards and solvency rules. We are approaching our target of **30** fully qualified actuaries by 2007. We cause will be further promoted with the recommended follow-up actions.

Small Entrepreneurship Development Fund

Sustainability Analysis

September 20, 2005

USAID Financial Services Protection Initiative / Pragma Corporation

By

Douglas E. Whiteley

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Small Entrepreneurship Development Fund (“SEDF”)

Sustainability Analysis

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Analysis of Model -- Results

Scope of Work

- Perform a sustainability analysis for the Fund and make recommendations as to how the Fund should operate under prudent norms given the mandated 1% cap on loan guarantees.
- Advise on the viability of Fund using insurance company guarantees to protect the Fund.
- Review investment instruments available to the Fund in determining its sustainability.
- Review the default history in other countries that have similar funds for estimating the default risk to the Small Enterprise Development Fund. (“SEDF”)

Background

The Republic of Kazakhstan has allocated funding from the RoK budget to finance a SME loan guarantee program to increase small business formation in Kazakhstan. The funding for the SEDF guarantee program will be made annually in the amount of *4.6 in 2005, 5 in 2006, 6 in 2007 for a total of KZT15.6 billion!*

- SEDF Capitalization at 15.6 billion KZT

Given the capitalization and the following legislative directives:

- Risk to capital ratio of 10 to 1
- Premium of 1.0% annually on the outstanding balance.

The questions that need to be answered are:

How long will the 15.6 billion KZT last under the terms and conditions of the proposed SEDF loan guarantee program that will be offered?

SEDF management has indicated that the terms of their proposed guarantee program coverage will include:

- Maximum LTV ratio of 75%.
- Maximum guarantee will be 80% of the loan balance.
- *Minimum loan amount expected to be USD125,000 while maximum could rise to USD860,000*

SEDF management has also indicated a desire to:

- Adjust the first year premium rates.
- Adjust the renewal premium rates.
- Offer guarantees coverage on several types of very high-risk SME loans.
- Limit the amount of very high-risk loan guarantees issued.

The sustainability model is designed with flexibility to meet both the legislative directives to test the outcomes of the various hypothesis proposed by SEDF management. The model will not propose a pricing scheme but rather indicate the viability of the program over a 20-year period.

International Experience

Research on default ratios done by the consultant or FSI staff would indicate default rates in the ranges of 1.3% and 40%. There is no information contained on their websites or reports to assist an observer in either the compilation process or data interpretation. These ratios can be very misleading because they are most likely based on the annual period in which they are reported.

*For example a portfolio of loans with a reported annual default ratio of 2.0% for each year over their 5 year loan term period and which also had a zero percent loan payoff rate would yield a **book year default rate** of 10.0%.*

Information that is made available through publicly reported means would indicate that the default ratio for the above example never exceeded 2.0%. To accurately determine the default ratio for an insurance guarantee product where the pricing is fixed on the loan closing date a book year default rate is required. The international experience when researched is not adequate in the context of developing a default model based on the lack of book year performance data that is available.

Research Results and Observations:

Asian countries average between 5% and 10% default rates, of interest Hong Kong SME loan program did report one of the lowest SME default rates at 1.3%.

The consultant did have the opportunity to discuss the USA Small business Administration loan program default data with an experienced guarantee default model analyst, who was familiar with and had worked with the SBA data. The expert indicated that the data when properly analyzed (book year basis) reveals a default ratio in excess of 10.0%, actually in the low teens.

The SME loan defaults occur predominantly in the early years of the loan regardless of the country in which they were originated. For example for 5-year loan most of the defaults (60 to 70%) will occur during the first 2 years of the loan term. The survival rate for SME's appears to be very low at around 70%. Only 2% to 40% of small enterprises are active after 5 years.

Government SME loan and guarantee programs have higher default rates than private guarantor programs; this may be due to the inherent moral hazard risk of government programs. Much of the government program experience we believe can be attributed to the fact that the private financing takes the best risks first with the remaining left for government guarantee programs which are the highest risk small enterprise companies.

Some examples of international small enterprise lending program reported default rates are: These default ratios are being reported for their respective current year period.

Country	Average Default Rate
USA Private SME loans	3%
USA SBA	11%
Australia Private SME loans	2%
Australia Government	8%
South Korea	3.8%
Japan	5%
Hong Kong	1.3%
England	40%
All Developed Economies	2%
All Developing Economies	15%

Characteristics of Successful Programs

Kazakhstan

There are commercial banks in Kazakhstan and donor organizations such as the European Bank for Reconstruction and Development (EBRD) that are actively lending to the SME's. These banks generally avoid start up enterprises or high-risk enterprises as the banks wish to review a company's performance via financial statements and P&L figures prior to providing them with financing.

The SEDF intends to fill the void that is not being met by the existing bank lending programs and demonstrate that it would be profitable for the banks to extend their current underwriting risk acceptance parameters to a larger segment of the SME loan applicants. The SEDF has experience in providing business support services to the SME's such as accounting, technology and tax guidance. They have also been involved in direct lending to several types of SME's over the past 7 years. The consultant was told that the availability of their default data was not readily available due to a conversion in their IT systems. SEDF management did indicate that as a Rule of Thumb that the SEDF reserves about 10% for defaults and experiences a 5% actual default loss rate. Several programs that apparently did experience extremely adverse performance are no longer being underwritten by the SEDF. One of the discontinued programs was loans to specific types of agriculture enterprises.

Characteristics of Successful Programs

- **Pricing alone** cannot sustain any type of loan guarantee program!
- Absence of appropriate controls by the guarantor in either the underwriting or

- Servicing functions will negate any method employed for pricing the guarantee.
- Allowing utilization of “the banks” underwriting criteria and “the banks” servicing criteria, as SEDF risk acceptance parameters will most likely lead to levels of defaults far in excess of those that could be predicted by any model.

Underwriting

It is strongly recommended that the SEDF adopt its own specific underwriting requirements and acceptance parameters for each type of small enterprise lending program that the SEDF will insure. It would be reasonable to work with the banks to develop underwriting requirements, particularly where they have had success. For those types of loans where Kazakhstan’s banks will not currently make loans the SEDF should take a cautious approach and limit the amount of guarantees and number of banks that participate until some experience can be obtained. We would advise against guaranteeing the high-risk loans during the initial years of the SEDF program.

Servicing

The SEDF needs to establish specific servicing requirements that banks are required to follow in the event of a delinquency and default in order to obtain a guarantee payment from SEDF.

Blanket Policy – Master Policy

The SEDF must develop a contract between the bank and SEDF that specifies the terms and conditions under which the bank can file a valid claim for loss with SEDF and the terms of the claim payment. The critical requirements are to provide clarity of each party’s roles and expectations. The contract must specify that fraud and misrepresentation are not insurable, and no guarantee payments will be made if either of these acts is discovered. Additionally, only Arms length transactions, no bank management personal or family relationships should exist between the bank that is making the loan and the borrower(s).

Access to Training and Support Resources

Regardless of the type of enterprise it appears that when an entrepreneur has access to training and support resources that are related to their business operations that these are more important than technology to their long-term success.

Hong Kong Program

The Hong Kong SME program is very heavily dependant upon technology in the application process and the monitoring process. Applicants are required to make application electronically and they are required to report performance results on a regular basis electronically. This level of automation requires that specific loan guarantee requirements be in place and adhered to. It also mandates that the servicing and follow up procedures are closely monitored and addressed whenever any deviations from the expected is identified.

EBRD – European Bank for Reconstruction and Development

The EBRD has operated a successful program in the Republic of Kazakhstan and has recently turned its management authority for the small business lending over to KazKommertsBank. The EBRD has developed an operational model that has application value for the SME fund. Specifically they hire and train personnel in the EBRD's underwriting and servicing policies, practices and procedures. The same EBRD staff person responsible for originating the loan is also responsible for servicing the loan, in other words a single individual is responsible for the success or failure of each enterprise that has been granted credit as long as the SME remains a customer.

Sustainability Model – Purpose and Use

The purpose for development of the SEDF Sustainability Model is to ascertain the financial viability of the proposed SEDF guarantee program to guaranty bank originated loans for small enterprises in the Republic of Kazakhstan for a limited period of time. The SEDF program intends to demonstrate the profitability of extending the existing bank lending requirements to SME borrowers.

The sustainability model takes into consideration:

- Specific legislative requirements of the Fund
- Similar experience in other developing countries
- Assumptions and variables controlled by the SEDF
- Currently unknown but an expected stable future economic environment

The model assumes that SEDF has in place:

- Underwriting and servicing guidelines that adhere to reasonable and prudent standards and that any exceptions are well documented and kept to less than 1.0% of the SEDF guarantee portfolio risk.
- Fraud and misrepresentation are not insurable by SEDF.
- All loan guarantee transactions are considered to be arms length.

The model is expected to be a tool that can be used by SEDF management to determine their degree of risk assumption and the business percentage of each degree of risk within their portfolio to optimize the growth potential for small enterprise lending in Kazakhstan given SEDF specified capitalization.

SEDF management indicated that they did not intend to operate the guarantee fund permanently. Therefore the model is structured for the funds termination after a 20-year period unless the fund assets have been utilized prior to that time. This condition requires that no new business will be accepted by the SEDF after the 16th year of its operation to allow for run off of guaranteed loans.

Description of the Model

Pragma/USAID has been asked to provide a “Sustainability Analysis Model” for the SEDF Guarantee Program. The SEDF Guarantee Fund has some definitive criteria for

development of the sustainability analysis but the actual design and methodology was not specified. The sustainability model has been designed to provide flexibility to allow SEDF management to change several data input items in order to “test” various risk class hypothesis

The sum of the defaults (losses and expenses) less income (premium and investment) over the entire book year period is an appropriate method for determining the long-term viability of a guaranty program with fixed guarantee premium rates.

Losses:

To perform this analysis it is critical to have credible knowledge of the incidence, timing and degree of loss for defaults. This information was not available to the consultant. The consultant utilized experience and judgment to select a book year default ratio for the respective risk classes. Additionally, the business volume distribution selected by the consultant was chosen for its prudent approach and ability to remain financially viable over 20 years of operation. The loss distribution is weighted toward the beginning of the loan term and is increasingly shifted toward earlier defaults as the level of risk increases.

Expenses:

Expenses have been set at 20 basis points and may be adjusted at SEDF’s management direction. The expenses are for the management of a guarantee fund business operation and not applicable for a direct lending program.

Premium Rates:

The first year and renewal premium rates have been set at 1.0%, in accordance with the legislative direction. The premium rates can be revised by SEDF’s management to ascertain the impact of higher or lower rates and to perform “what if scenarios”.

Investment Income:

The investment income rate of return used is 6.0%. Investment income is derived from the interest income on (1) SEDF’s retained capital and (2) the guarantee premiums written. The investment of the funds assets should be very safe and secure, which means that the return on the invested assets will be on the low side of those available in the market. SEDF’s management may revise the return on investment if in their view higher rates of return will be realized on their investments.

Model Assumptions are:

1. Maximum LTV Ratio is 75%
2. Maximum SEDF loan guarantee is 80%
3. Maximum loan amount is \$100,000.00 (USD)
4. Loan Term: 5-year *maximum* loan term
5. Interest Rates: Fixed interest rates only.
6. No recoveries will be made in the event of a default.
7. Capital: Republic of Kazakhstan funded at 4 billion KZT annually for 3 years.
8. Risk to Capital ratio is 10 to 1
9. No prepayment of the loans will occur.

10. Expense ratio is 20 basis points.
11. Investment rate of return is 6.0%
12. Premiums will be collected at the beginning of each year.
13. Guarantee Fees:
 - a. Legislative direction was for a maximum rate of 1.0% annually based on the unpaid principal balance of the loan.
 - b. SEDF management expressed interested in potentially charging a first year rate of up to 4.0%.
 - c. The model will allow the user to change the premium rates by risk class; however the projections made by the consultant will be based upon a 1.0% annual premium rate.
14. No new business will be written after the 16th year in order to terminate the SME guarantee program by the end of its 20th year of operation. The SEDF Guarantee program can be discontinued sooner than 20 years if the variables are changed and the fund fails to generate sufficient capital to pay future losses and provide capital for new business.

Model Variables are: To be used for “what if testing” by SEDF management are all located on the first worksheet – Assumptions.

1. Distribution of capital to risk classes -- volume of expected business written by risk class. See Assumptions Line 5 Cells: E5, G5, I5, K5, M5
2. Risk Class Default Ratios
 - a. Risk Class 2 at 10.0% is deemed to be an as expected book year default ratio for a well-designed SME loan program with average risk assumption parameters.
 - b. Risk Class 5 at 40% is deemed to be a high risk SME loan made to agriculture or start up types of businesses. Default ratios could easily exceed 40% for these types of loan absent prudent underwriting requirements.
See Assumptions Line 6 Cells: E6, G6, I6, K6, M6
3. First year premium rate for the risk class. See Assumptions Line 13 Cells: E13, G13, I13, K13, M13
4. Renewal premium rate for the risk class. See Assumptions Line 14 Cells: E14, G14, I14, K14, M14
5. Banks interest rate charged by the risk class. See Assumptions Line 15 Cells: E15, G15, I15, K15, M15
6. Expense Ratio. See Assumptions Line 19 Cells: C19
7. Return on Investment rate. See Assumptions Line 20 Cells: C20
8. Conversion rate of USD to KZT (tenge). See Assumptions Line 21 Cells: C21

All model calculations are in USD, except for the RiskClassSummary worksheet, which displays both USD and KZT (tenge).

Analysis of Model Results

The results contained in this report are based on input variables and modeling assumptions derived almost exclusively from the consultant's best judgment and experience. Given the lack of actual data available from various research sources and the SEDF itself this was deemed to be the approach to take in order to initiate discussion. The model is not a pricing tool but rather an assessment of the financial viability of the SEDF fund given a specific set of input variables and a neutral economic environment.

The most important Sustainability Model output results can be found on the RiskClassSummary worksheet column AS.

These results are reported in both USD and KZT.

1. How much financial market stimulus can be derived as a result of the SEDF guarantee funds existence?
2. How long can the SEDF survive?
3. What funds, if any, will remain at the end of a 20-year period?

The respective Risk Class results are indicated on each respective worksheet. Line 25 of the model Risk Class worksheets 1 through 5 indicates the assets remaining, from those allocated to the respective Risk Class, at the end of each year. If this number is positive then that Risk Class is still viable on its own, if the number is negative the Risk Class is no longer sustainable without capital support from one or more of the other better performing Risk Classes.

The RiskClassSummary worksheet (Line 25 and 51)] indicate the SEDF fund balance (assets remaining) at the end of each year. If this number is positive then the SEDF fund is still viable, if it becomes negative the SEDF fund will no longer be able to write any new business due to the lack of capital. RiskClassSummary takes into account the performance of each Risk Class and offsets the poor performers with the better performers to extend the life of the SEDF Fund to 16 years if possible.

Results:

The input utilized above would allow the SEDF fund to operate for the entire 20-year period.

Loans Guaranteed by the SEDF would be:

USD \$2,602,509,007

KZT 351,338,715,935

Market Capital and Financing for SME's would be:

USD \$3,470,012,009

KZT 468,451,621,247

SEDF Capital Balance would be:

USD \$19,184,146

KZT 2,589,859,692

MORTGAGE ATTACHMENTS

Training Assessment
JSC, Kazakhstan Mortgage Guaranty Fund

August 2005

Douglas E. Whiteley
USAID FSI – Pragma Corporation
Almaty, Kazakhstan

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Training Assessment for KMGF

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2.0 Situation Analysis

3.0 Conclusions

4.0 Recommendations

Attachments:

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Mortgage Information Web Sites

Exhibit B

Summary of Interview Results

Exhibit C

Analysis of Mortgage Insurance Disciplines

1.0 Introduction

The Kazakhstan Mortgage Guaranty Fund (KMGF) began issuing mortgage insurance guaranty's in the beginning of 2005.

At the end of July 2005 KMGF had 18 of the 20 Banks and 4 of the 4 Finance Companies had signed Blanket Policies with KMGF, in essence agreeing to the terms of being their customers. There are only 2-second tier banks that are currently in the mortgage lending market who have not agreed to become customers, Blanket Policy Holders, of the KMGF as of this date.

The insured loan volume as of the beginning of July reached approximately 280 insurance policies issued for approximately 1.5 billion tenge in insured loans. The insured loan volume in numbers of guarantees issued was split between KMGF's standard programs and the State Housing Program sponsored by the Republic of Kazakhstan. The majority of the business activity has occurred since March 2005 through the end of June or within the last 4 months.

With the foregoing situation in mind it is not surprising that the KMGF management and staff have begun to experience the normal operational situations and questions of any new enterprise in a growth mode. "The less we know about a business the easier we think it is to run that business." KMGF has now had some operational experience and is going through normal growth pains as one would expect and most important is that they are learning what they do not know and that is critical to evolving to the next step!

The consultant's opinions that follow were developed through prior knowledge of the Funds beginnings regarding legislative initiatives, corporate structure, organizational requirements, over 30 years of Mortgage insurance operational experience as well as personal interviews with the Funds management, department managers and individual interviews with several of KMGF's operational staff.

2.0 Situation Analysis

KMGF – Corporate Expertise

The Funds management and the Funds staff are all in the process of learning the mortgage insurance business. Since there is no prior mortgage experience to draw upon in the Republic of Kazakhstan the most likely business areas to find staff with related experience would be from the banking and insurance sectors. The Fund was provided with very basic knowledge of mortgage insurance, risk management practices, underwriting, loss mitigation, pricing, and IT systems and data base design were supported at a basic level prior to KMGF commencing its business activities. The Fund was given guidance (enough to create an awareness) with respect to developing processes, procedures, management reporting, risk analysis', quality control programs, loss mitigation strategies and operational structure The Fund was provided with no significant guidance regarding sales and marketing, consumer education, bank credit officer training or data base maintenance and integrated systems design.

KMGF Staff Experience

The majority of the Funds personnel are very new employees. The average tenure of the nine personnel interviewed for this report was 3 months. Many members of KMGF's staff have very limited or no experience in mortgage lending or insurance. This is a

double-edged sword! On one side it provides the Fund with an opportunity to “train them right” but on the other side it also means that the Fund’s training will have to be very good and emphasize the basics first. The second tier of training will need to provide development programs as the knowledge levels of the staff increases. The Fund currently employs over 20 persons with all located in Almaty except for 1 person in Astana.

KMGF Staff Education

The Funds employees as a group are very well educated and intelligent. They seem to have a positive attitude and they express great degree of interest in improving their level of knowledge of the mortgage insurance business and the mortgage lending market. It appears that all members of the current staff, regardless of their areas of responsibility have had basic training in the background of the Fund, legal and regulatory initiatives, policy and insurance forms purpose and use and some hands on underwriting training.

KMGF Management

The Funds management has done a good job of implementing the management concepts and activities recommended by the consultants. The Fund is in the process of experiencing the normal “operational issues” that are encountered in the course of doing business in a real market environment. Many of the current situations KMGF is facing will be resolved by the Fund’s management making decisions based on the limited amount of information available to them >> which means >> making some mistakes in the natural course of operating their MI business. The experience KMGF gains will allow the Fund to learn from the mistakes. The most critical issue is for KMGF’s management to avoid putting the Fund’s capital in a terminal position by accepting a risk that if it turns out poorly could bankrupt the FUND. This requires a level of risk analysis that may need some additional seasoning and market exposure. The lack of knowledge has resulted in an underwriting decision process that may be too slow and cumbersome for the longer term. It appears to have been established in an effort to acquire business knowledge by the Funds managers.

3.0 Conclusions - Findings

Several of the mortgage insurance disciplines will require additional support from experts in some of the respective disciplines to achieve the best results. In all instances the experts should leave the Fund with adequate information and materials to allow KMGF to use them internally for the future for training of their new employees. It appears that training of new hires will be an on going endeavor due to the high turnover in the Almaty employment market.

Improved access to information that is readily available on the Internet should be addressed because of the extensive resources available in English. Most of the oldest mortgage insurance participants world wide are of English speaking decent, therefore the largest amount of information available to serve the on going nature of training and to enable KMGF to be more self supporting in the long run is available in English. The best way to stay informed of international practices being developed in Europe or worldwide over the long term is to develop personal contacts at the International Mortgage Insurers and to facilitate access to available information from the Internet.

The IT and systems area needs to be developed in a manner that embraces corporate wide integration of information but in a manner that does not restrict the respective functional areas from being efficient. Functional areas will need some independence in developing their own processes and procedures. However there should never be any deviation from corporate standardized data definitions regardless of the functional area. Consolidating the IT staff into a single functional area could be useful in prioritizing KMGF's systems projects and coordinating the consistency in data definitions and data integrity between all functional areas of KMGF.

4.0 Recommendations

FUND Management – Chairman and Deputy

1. Hire a translator experienced in English and preferably with experience in mortgage lending or banking. This position will enable the Funds management and staff to take advantage of the mortgage insurance, mortgage lending, statistical data and educational materials available from “English based” web sites. The majority of mortgage insurance information that is available is provided by US and Canadian mortgage insurers, including the their respective federal governments or English speaking service providers. This position could be used a resource by the functional areas of KMGF to locate specific types of training materials and information that the Funds manager are seeking.
2. Communication to Staff – the Funds underwriting staff interacts with the banks loan officers on a daily basis. It is important to keep underwriting personnel as well as any other customer contact staff up to date and well informed regarding any new or proposed legislation and current developments in the mortgage lending market. This will enable them to be viewed as an expert and a valuable resource to the Funds customers.
3. Establish IT as a separate department that serves the needs of all areas of KMGF in a prioritized and coordinated effort. The location of independent IT staff through out the functional areas will eventually lead to development of systems that meet only that functional areas requirements along with the development of “department definitions” for data and reporting formats. This is not happening today but it will evolve over time.
4. Create functional job descriptions for employees that will communicate to others what their responsibilities are from their position title. The position descriptions can be one of several tools used to develop a career growth path for the staff with in a specified discipline.

Training Programs of the KMGF

Training programs should be developed for several operational disciplines.

1. Formal Training Program for New Hires.

The new hire-training program should provide a new employee with basic knowledge of what each area of KMGF is responsible for doing and where a new employee should go to seek any additional clarification.

Areas that should have introductory training programs for new hires are:

Risk management – Underwriting, Quality Control, Loss Mitigation, Blanket Policy Holder Requirements and Monitoring. Management Reports, their purpose and function.

Legal

IT Systems Training

Customer Service

Pricing Concepts

Marketing and sales

Hands on training

Corporate Goals and Objectives

The new hire should be provided with a binder / workbook that contains all the relevant training materials for their future reference.

2. Continuing Education and Training – Improvement of Skills

Longer-term employees need continuing education training programs to provide them with a sense of career development and a personal growth component. There appears to be a very strong self-improvement incentive amongst the KMGF staff. These courses should be made available after the employee has had a reasonable amount of experience and / or time on the job. There are some very good self-study courses available from the Mortgage Bankers Association, but they are in English. A variety of training resources are available to gain an insight into other countries practices and procedures particularly from the secondary market entities in the USA and Canada. Much of this information, particularly the mortgage insurance basics, is available for free by requesting it from either the private or government insurance companies and government-sponsored entities in the country where they operate and are licensed.

3. The Fund would be well served to obtain guidance from outside experts and / or topical Internet Web Sites when developing Training Programs for disciplines in the following areas of Risk Management.

Risk Management Committee – organization and Policy Role function

MI Business Reporting –

Management Reporting

Regulatory Reporting

Customer Performance

Portfolio Analysis

Product and Program Profitability Analysis

Analysis of Loan Characteristics relative to Pricing and

Underwriting Policy Exception Report

Risk Management Operational Areas:

Underwriting

Loss Mitigation / Claim Payments

Risk Analysis of customer proposed programs

Quality Control Programs

4. IT (Information Technology) –

Data base design and development of an integrated interactive transaction based operating systems. The IT systems for the respective areas must

have data consistency and data integrity. This requires standard data definitions and standard report heading definitions. Much of this work has been done under the ANSI standards for mortgage lending, which is available at no cost. Licensing and certification training for the hardware and software should be made available from the vendors (such as Cisco, Oracle, Sun Micro Systems for the IT staff. Some of the certification courses are fee-based training but they are worth the expense to KMGF.

5. Marketing –

KMGF should provide marketing and sales materials to the banks and bank loan officers for their use when explaining the KMGF mortgage insurance benefits to their mortgage loan customers. Periodic invitations to bank loan officers to get together and hear an expert speak on a specific subject or to introduce and discuss the implications of a new mortgage lending law can be directed at the banks front line staff. The goal should be to build relationships and establish KMGF as the place to find out “what is happening” in the lending market in Kazakhstan.

6. Efficiency –

The current underwriting process needs to be reviewed and an expedited process should be established to speed up turnaround time. Response time, based on my years of doing independent customer surveys, is the number one criteria utilized by US mortgage lenders in determining which mortgage insurer or government program they will use. KMGF current IT system also needs to be addressed to allow underwriters the ability to make changes and corrections (but these need to be transaction based with parties and dates identified) to existing mortgage insurance records to improve customer service and turnaround time.

7. Financial –

Investment Strategies – The current structure of the FUND, absent any change to the requirement that 100% of the premium received is allocated to the Loss Reserve, will necessitate an investment program that generates sufficient income for the Funds payment of all their expenses as well as allowing some cushion for cash flow shortages during down periods.

Reserves – The Fund will need to develop a case basis reserve and loss reserve methodology eventually. Since there are no losses or delinquent loans at this time it is not critical. It will in time become a critical component of the Funds profitability, cash flow management strategy and improve justification to regulatory agencies for premium rate adjustments. Proper reserve requirements will validate the Funds capital adequacy requirements. Additionally, if the current legislative requirements that provide for 100% of KMGF’s premium income to be placed in the Loss Reserve are changed to a Contingency Reserve concept then this issue should become a very important regulatory concern.

Attachment A

Information Access Resources

Private Mortgage Insurance Companies in USA, Canada or Australia / NZ
Web Sites of Private MI's and MICA.

These sites have marketing, pricing, underwriting, loss management and links to other relevant mortgage related sites.

- Mortgage Guaranty Insurance Corporation (MGIC) - Wisconsin
- Genworth Mortgage Insurance (GE) – North Carolina
- United Guaranty Residential Insurance Corporation (AIG) – North Carolina
- PMI Group (PMI) - California
- Radian Mortgage Insurance - Pennsylvania
- Republic Mortgage Insurance Company – North Carolina
- Triad Guaranty Insurance – North Carolina
- CMAC – Canada Mortgage Assurance Company

Web Sites of Government mortgage insurance. These sites have information about all the products and programs of these agencies as well as forms to request free information, in the USA. The HUD Reading Room site has reports and statistical data on the FHA performance as well as an annual analysis of the MMIF's on going sustainability.

- Housing and Urban Development (HUD)
- Federal Housing Administration (FHA)
- Veterans Administration (VA)

Web sites of Government Sponsored Entities (GSE's)

- Freddie Mac (FHLMC)
- Fannie Mae (FNMA)
- Ginnie Mae (GNMA)

ANSI Standards – ANSI standards have been developed for the US mortgage lending market and are available. There is no reason to reinvent the definitions for Kazakhstan since the current ANSI standards provide definitions for many aspects of mortgage lending that have been and that are still to be developed in Kazakhstan.

MBA – Mortgage Bankers Association has several publications and training programs related to mortgage lending. They provide beginner as well as advanced continuing education courses.

Fair Isaacs & Company – FICO Score. This company is responsible for the credit scoring system employed by the three major credit bureaus operating in the USA. They have training courses to explain the development basis and use of their scorecards.

Attachment B Interview Summary Results

Interview Results

- A. Work Experience at KMGF
 - a. Length of Employment at KMGF
 - i. *Less than 3 months on average*
 - ii. *All 9 interviewed were less than 6 months – very new staff*
 - b. Job Function at KMGF
 - i. *Guaranty / Underwriting* - 4
 - ii. *Legal* - 2
 - iii. *Analytical Statistical* - 2
 - iv. *Treasury* - 1
 - v. *IT – staff is allocated to departments* - 3
 - c. Responsibilities at KMGF
 - i. *Virtually everyone says they are an economist?*
 - ii. *One person said IT*
 - iii. *Legislative Issues*
 - iv. *Model Act for Kazakhstan*
 - v. *100% versus Contingency Reserve*

- B. Previous Work Experience
 - a. Industry of Employment
 - i. *Government* - 4
 - ii. *Banking* - 1
 - iii. *Law Firm* - 1
 - iv. *Oil Company* - 1
 - v. *Student – in school* - 2
 - b. Term of Previous Employment
 - i. *Most were less than 1 year*
 - ii. *2 government over 5 years*
 - c. Related Work Experience
 - i. *Banking*
 - ii. *IT*

- C. Knowledge – Training Needs
 - a. Abilities or Skills of Interest
 - i. *Accounting* - 2
 - ii. *Risk Management* - 2
 - iii. *Math* - 1
 - iv. *Marketing and Sales* - 2
 - v. *Management Training* - 1
 - vi. *Customer Service* - 1

- b. Types of Preferred training
 - i. *Study Trips or Job Swaps*
 - ii. *On the Job – Hands on Training*
 - iii. *Self Study*
 - iv. *Class Room*
 - v. *Seminars from Experts in a Discipline*
 - vi. *Continuing Education – Saturday and Sunday Classes*
- c. Business Training Needed to Improve Performance
 - i. *Taxation*
 - ii. *US Regulatory Practices*
 - iii. *Underwriting – comprehensive*
 - iv. *Mortgage lending*
 - v. *Pricing*
 - vi. *Surrender Values*
 - vii. *Mortgage Insurance*
 - viii. *International Practices*
 - ix. *Investments*
 - x. *Management Communication of new or proposed laws*
 - xi. *Management reports*
 - xii. *Data base flexibility and access to make changes*

D. Education

- a. University Degree
 - i. *At least 1 degree and some with 2 degrees*
- b. Academic Discipline
 - i. *Legal* - 5
 - ii. *Appraisal* - 1
 - iii. *Economics* - 2
 - iv. *Computer Science* - 1

E. Training Provided by KMGF

- i. *Laws*
- ii. *Legislative Acts*
- iii. *Blanket Policy and Policy Forms*
- iv. *Underwriting Guidelines*
- v. *Underwriting – hands on*
- vi. *IT – underwriting systems*

Attachment C Disciplines

Several disciplines are required to effectively operate a mortgage insurance business which can be categorized by those disciplines that are (1) specific to the mortgage insurance business operations and (2) non-mortgage insurance specific (these disciplines are employed in many other types of businesses and are not specific to mortgage insurance).

(1) Mortgage Insurance Disciplines

The current level of expertise at KMGF can best be expressed as they are learning to walk but they are not ready to run yet! The Fund is in its start up phase and will need to gain additional experience either through “on the job training” or with the help of outside expert’s or both to get to the next level.

One of the difficulties in developing training programs for unaffiliated start up Mortgage insurers is that the mortgage insurance industry is too small to support formal university education or training programs. Mortgage insurance training tends to be “company specific” and of a proprietary nature. Additionally, most of the internal training programs of the USA mortgage insurers are too advanced for the current situation in Kazakhstan. There are many banking, mortgage lending, processing and servicing types of training, materials, seminars and courses available which do have relevance to the mortgage insurance business. A few universities in the USA offer insurance risk management courses but they are not mortgage insurance specific. Mortgage insurance training is not publicly available, it can be obtained by contracting with a mortgage insurance entity, I am aware that the Canadian mortgage insurance company does offer training internationally.

Disciplines

Risk Management related functions encompass the majority of the *specific* mortgage insurance disciplines along with sales / marketing and regulatory reporting. Primary attention will be on the areas of risk management.

Risk Management

The Underwriting and Loss Mitigation functions have components that serve both an internal and an external customer. The Pricing and Reporting functions serve primarily internal customers.

- Underwriting – external and internal role
- Loss Mitigation – external and internal role
- Pricing – internal support role
- Management Information and Reporting – internal support role

All of these functions are inter-related and cannot operate independent of each other. To be effectively co-ordinate a Risk Management Committee should provide overview and direction to the department managers as well as ensure that the corporate standards are being maintained. Management Information and Reporting can be developed and provided by each department but it may be beneficial to have any reports that combine data from several areas compiled by an independent analysis department.

To effectively manage these functions KMGF should create a Risk Management Committee with a defined role that is focused on policy establishment and performance reporting. The Risk Management Committee should not be involved in the daily operational aspects of the business.

For example:

Risk Management Committee Role and Responsibilities

- Establish Corporate Policy for customers, underwriting and loss mitigation including providing the limits for department manager latitude.
- Approve Exceptions for Products and Programs requested by Customers (this is not at a loan level)
- Review policy, product or program performance and revise as necessary
- Review customer performance and recommend corrective action as necessary
- Establish Pricing
- Determine the corporate reporting requirements
- Establish corporate resource priorities

Underwriting / Guaranty Department and Loss Mitigation Department

These two departments serve a role that bridges the gap between the customer and KMGF policy. They need to represent KMGF management's interests to customers in a clear, concise and timely manner. They will also need to communicate customer requests that are non- loan level based to the Risk management Committee for their consideration.

These departments are responsible for the development and communication of KMGF's policy and are responsible for developing, communicating and implementing their respective procedures and processes.

Each Department should also be responsible for providing the data acquired in the normal process of performing their responsibilities and information to the other functional areas of KMGF.

Each department should be responsible for monitoring and reporting on the performance - success or failure of their direct activities.

The Deficient Areas of Development for the Underwriting / Guaranty Department Functions at KMGF currently appear to be:

Quality Control Program

- On site reviews of the processes, procedures and underwriting of the Blanket Policy Holders insured loans and practices.
- Production Reporting

- Analyzing Customer Program Requests for risk acceptance

The Deficient areas for the Loss Mitigation Department functions are everything. Since there have been no losses to date; there is and has been no sense of urgency to develop:

- Policy, procedures, processes
- Loss and Reserves Reporting
- Fraud and Misrepresentation

Pricing

This area will need information and time to move beyond the current models and assumptions. It will be critical that the amount, type and accuracy of the data being collected and maintained by KMGF currently are adequate to meet future needs. The data must include sufficient information to develop book year performance analysis and delineate the transactions by time and amount at a loan level data.

The Deficient Areas of Development for Pricing Department functions appear to be:

Defining the data collection and retention requirements for the respective departments.

Cost analysis related to customer proposals or product enhancements.

Management Information and Reporting

The Deficient Areas of Management Information and Reporting appear to lie in the organizational structure of KMGF. KMGF management will need to determine if the respective functional area departments can support these reporting functions or if a separate department would best serve their long-term needs?

- Establish data definitions and accuracy requirements – requires a corporate level decision resolution process or responsible person.
- IT –Systems and data base design
 - A comprehensive database should be developed to address the long term data needs of KMGF as well as provide adequate information for transaction reporting.
- Fraud or Misrepresentation Monitoring – this is a function that can be supported by the Loss Mitigation area (or in their absence the Underwriting / Guaranty area).
- Monitoring the performance of the Blanket Policy Holders insured loan portfolio – Institutional Credit Risk
- Performance Reporting – Products, Programs, Policy
- Risk Concentrations – Lender, geographic, project, contiguous project, builder, borrower levels of risk acceptance need to be tracked.
- Regulatory Reporting
- Loss Reserve Methodology

The consultant's recommendation would be to assign responsibility for all KMGF's reporting to a single department, which would be accountable to the Risk Management Committee. The Pricing component could also be incorporated into this department. Any type of daily operational reports required for the operational aspects of underwriting and loss mitigation could be provided by this function as well.

The advantage of this structure would be to consolidate all corporate information requirements to avoid any duplication of effort. It also ensures that consistent data definitions and report headings will be maintained. It will also provide the IT staff with a single point of reference to resolve any conflicts arising from the different approaches taken by the functional areas of KMGF.

The disadvantage is that the consolidation of information and reporting in a single area may not be able to meet the urgent needs of the front line departments such as Underwriting / Guaranty, Loss Mitigation or Sales and Marketing.

Sales and Marketing – the focus of these efforts should be on consumer and customer education. Marketing examples and materials that could be adapted for KMGF's use are readily available from MI Internet web sites.

Regulatory Reporting – this is in a development stage and will need to be addressed subject to the changes being sought in the current mortgage insurance regulation and following the definitive requirements of regulators.

Disciplines Assessment Overview:

Core Knowledge (managers and staff) – Adequate for the current point in the Funds life cycle development. There is an immediate need by the staff and department managers to increase their current level of expertise in addressing proposals and new programs. Lack of practical experience and exposure to previously never addressed topics appear to be a critical challenge.

Skills (of staff) – Education, willingness to learn, a good customer focus and communication skills appear to be excellent, along with some very strong analytical abilities. The varied backgrounds from seasoned government employees to recent university graduates with economic, legal and technical oriented backgrounds provides a diverse base but virtually no practical experience in mortgage lending or insurance, with a few exceptions. Lack of any sales and marketing experience would indicate a need to provide support in this area.

Reinsurance

Reinsurance of KMGF's mortgage insurance risks is not possible (in my opinion) under the current legislative requirement that 100% of premium be allocated to the Loss Reserve. The mortgage insurance market in Kazakhstan is too new and still unproven as well as being too small to be of interest to any significant International Reinsurer.

Reinsurance is an area that can best be addressed by engaging an active negotiation between KMGF and a professional reinsurance broker, such as Marsh McLennan. The terms of international reinsurance agreements are determined by the entities organizational structure, capital adequacy, experience, their market area, growth potential, political environment and track record. The reinsurers (generally a consortium) may or may not have an appetite for the mortgage insurance risk that is being presented by KMGF. It is recommended that KMGF management contact a reinsurance broker to make inquiries on their behalf in order to develop this opportunity for the future of KMGF. It has been my experience that it takes several years to negotiate an agreement.

(2) Non-Mortgage Insurance Specific Disciplines

The types of non-mortgage insurance specific disciplines that will not be addressed here include:

- Investment portfolio strategy and advice.
- Software or hardware Training for IT systems
- Taxation
- Accounting Practices – e.g. A/P, A/R, pay roll

These items are important to the successful operation of the KMGF but are not within the consultant's area of expertise. A professional person or entity with no mortgage insurance experience should be able to provide the relevant advice or counsel required in these areas.