

INVESTMENT ACTIVITY OF COMMERCIAL BANKS IN KAZAKHSTAN: TRENDS, PROBLEMS, AND PROSPECTS

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International intergovernmental organizations and developed countries recognize the Kazakhstan economy as the most dynamically developing in the post-Soviet expanse. Kazakhstan is the first CIS state to be endowed with the status of a market-economy country by the U.S. and European Union.

Development of the Kazakhstan economy in recent years has been promoted by the stabilization on the world financial markets and the favorable price situation on the commodity markets, which stimulated and then led to the rapid growth of the global economy. The upswing in the world economy increased the demand for primary products and had a favorable effect on the economy of developing countries. Beginning in 2000, the country's economic development has been moving forward in leaps and bounds. The average annual rate of Kazakhstan's GDP increment for 2000-2006 was more than 10%, and the GDP in nominal terms and in the dollar equivalent increased approximately three-fold during this period.¹

The high prices for Kazakhstani export goods, primarily for energy resources and metals, was the main factor in economic growth. The annual rise in the price of oil, followed by that of other primary products, was particularly conducive to boosting the domestic economy. At the same time, the export volumes also rose, which in general ensured a significant annual increase in profit for exporters and the inflow of freely convertible currency revenue into the country. The development of the export branches pulled the rest of the economy along with them. Growth of the domestic economy is

¹ See: Statistical Bulletin of the National Bank 2006, No. 12, available at [www.nationalbank.kz], 1 February, 2007.

promoted by the strong tax policy, stable budget balance, rational exchange policy, and increase in real personal incomes.

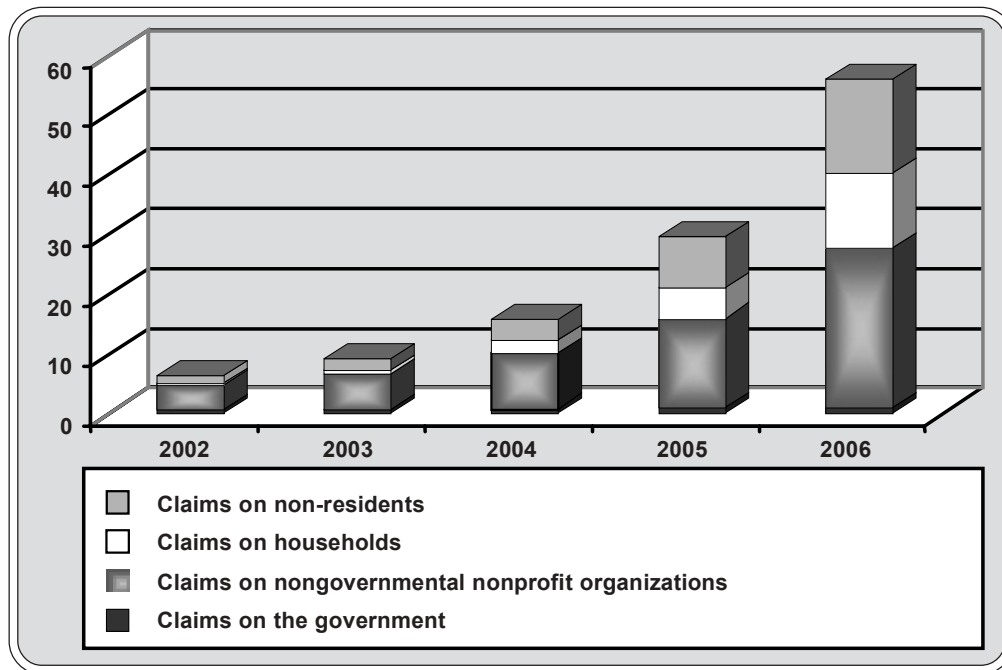
Strengthening of the stabilization trends designated in 2000 was reflected in the increase in the main macroeconomic indices: the GDP, output of industrial and agricultural production, retail goods turnover, freight shipment, fixed capital investments, and foreign trade turnover. The country's financial position also stabilized. The fact that during these years, the republican budget had either a net surplus, or a small deficit is sufficient proof of this. A rather moderate level of inflation and a relatively steady national currency exchange rate to the dollar were maintained, while the National Bank's gold and currency reserves and Kazakhstan's international reserves rose.

Positive macroeconomic conditions and the measures taken to reform the banking system helped to raise the trust in domestic banks both inside the country and among foreign investors. As a result, in recent years, the growth rate of the banking sector indices has been several times higher than the dynamics of economic growth. This made it possible to significantly raise the functional potential of the country's banking system. According to the results of 2006, the Kazakhstan GDP volume amounted to 77 billion dollars. The total assets of commercial banks with respect to the GDP rose to 91.1% and the ratio of estimated equity capital to the GDP reached 12%.

In the past five years, the volume of investments of Kazakhstan's commercial banks increased annually on an average of 60%, whereby the greatest increase of 99%, despite the growing basis of comparison, was noted precisely in 2006. The main recipients of banking investments were nongovernmental nonprofit organizations—43%, non-residents—26%, and households—20%. In absolute terms, the banking investment volumes were distributed in the following ratio: 26.8-15.7-12.4 billion dollars, respectively (Fig. 1).

Figure 1

Performance of Bank's Claims on Economic Entities (billion dollars)



The performance of claims on non-residents for 2002 to 2006 was characterized by a tenfold increase in banking investment volumes. The greatest growth was noted in 2005, when non-resident liabilities more than doubled. Nevertheless, it should also be noted that since the beginning of 2006, this growth has been on the downward trend.

Bank lending (46%) and the purchasing of non-resident companies' debt securities (29%) are the main ways Kazakhstani banks carry out investment on the foreign markets. In terms of regions, most loans are concentrated in the Russian Federation (40%), which is causing the high level of country risk for banks. Russia's dominant position with respect to non-resident lending is due to the close trade and economic interrelations between the two states. In turn, the level of country risk is minimized by Russia's higher sovereignty rating. What is more, the percentage of such loans in the total volume of the loan portfolio amounts to approximately 4%, which indicates that Kazakhstan's banking system is in the position to counteract any possible crisis phenomena in Russia.²

S&P Agency analysts also agree that there are additional risks related to the expansion of Kazakhstani banks on the foreign markets. The fact that these foreign markets are distinguished by a higher level of risks, economic, political and structural, than Kazakhstan is putting the analysts on their guard. They believe that the shrinking interest margin on the domestic market, primarily for loans to corporate clients, is prompting banks to seek customers on foreign markets. In addition, this allows Kazakhstani banks to put their business advantages (accumulated experience, attractive products) into play on more dynamically developing markets closer to Europe and, finally, to achieve the economies of scale. But despite the cultural ties with these markets, Kazakhstani banks do not have enough understanding of the local realities and working conditions, and, what is more, they do not have the political ties, which are absolutely necessary in these countries where business is often built on personal contacts.³

Despite the absolute growth, the claims on nongovernmental nonprofit organizations gradually decreased between 2002 and 2006 in the overall structure of banking claims on economic entities. For example, whereas at the beginning of the period under review, their share amounted to 68%, by the end of 2006, it fell to 25 percentage points. Claims on economic entities were largely represented by the loans issued—98%. Investment by purchasing securities amounted to less than 0.1% of the total amount of claims on nongovernmental nonprofit organizations.

The low level of investment using stock market instruments was due to the low issuing activity of entities in the non-financial sector. Despite the high growth indices in the volume of stock market trading noted in recent years, the nongovernmental securities sector is still extremely weak. Trading volume in this sector in 2005 amounted to 2.8 billion dollars, or 3.4% of the total trading volume. The financial sector held the leading position in the branch structure of the Stock Exchange Official List of bonds in 2005. The share of this sector amounted to more than 90% of the market debt value, while the oil and gas complex accounted for only 3.3%, and the other sectors for 5%. The branch structure of the official listing of shares in 2005 did not undergo any serious changes. Here, as before, the financial sector and oil and gas companies are the leaders. Their share in stock market capitalization amounted to 43% and 24.8%, respectively. The position of other branches of the economy on the Stock Exchange Official List has undergone little change and remains insignificant.⁴

Improvement of the population's welfare, which is characterized by an increase in average salaries, prompted an increase in the demand for credit resources on the part of households. Streamlining

² See: Report on Kazakhstan's Financial Stability, December 2006, available at [www.nationalbank.kz], 1 February, 2007.

³ See: Analysis of Risks in the Banking Sector of the Republic of Kazakhstan, available at [www.creditrussia.ru], 1 June, 2006.

⁴ See: KASE Report for 2005, available at [www.kase.kz], 1 February, 2007.

personal services and introducing new banking products for physical entities rapidly boosted the development of this type of credit activity. For example, in 2006 alone, the population took out twice as many loans and their share in the loan portfolio of commercial banks continues to increase. For the entire period between 2002 and 2006, banks' claims on households increased more than 30-fold in the dollar equivalent.

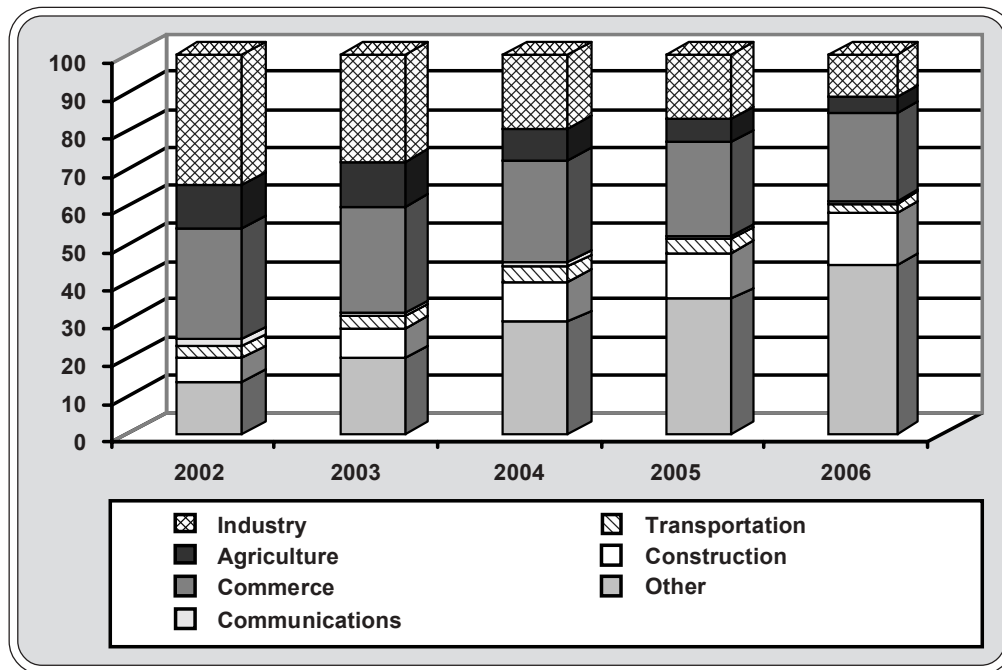
The high share of loans in the investment portfolio of second-tier banks calls for a more detailed analysis of the loan portfolio as a form of investment activity of commercial banks during earlier periods.

Positive changes have occurred in the loan portfolio composition with respect to time-limits. Against the background of the total increase in lending in the real sector of the economy, an accelerated increase in long-term loans is noted, the share of which increased to 73% and amounted to 37.6 billion dollars in 2006. On the whole, between 2002 and 2006, the amount of debt on long-term loans increased more than 1.5-fold annually. The share of short-term loans decreased compared with 2002 to 15.7 percentage points and amounted to 10.2 billion dollars at the end of 2006. More long-term loans are being taken out because commercial banks are extending the time-limits of funding.

An analysis of the loan portfolio of second-tier banks in terms of types of currency shows that the trend toward a decrease in the number of foreign currency loans designated since 2001 is continuing. As a result, the share of loans issued in the national currency (tenge) increased to 52% by the end of 2006. The decrease in the percentage of foreign currency loans was due to the steady strengthening of the tenge. Nevertheless, it should be noted that long-term foreign currency loans (34.1%) occupy the largest percent in the loan portfolio composition in terms of time-limits and types of currency, although the percentage of long-term loans in the national currency is gradually

Figure 2

Composition of the Loan Portfolio of Banks by Sector (%)



increasing (29%). The current loan portfolio composition is most likely related to the resource base of commercial banks, which in recent years has been steadily growing due to the long-term loans of foreign investors.

In terms of branches of the economy, the banking statistics show that in absolute terms bank lending has been on the steady rise in recent years. An analysis of the relative indices between 2002 and 2006 shows a decrease in the percentage of credit resources used to finance production enterprises, apart from construction companies, as well as a decrease in the percentage of lending in the communications, transportation, and trade spheres. Other industries account for almost half of the loan portfolio of banks (Fig. 2).

In the past five years alone, the percentage of lending in industry has fallen from 34% to 11%, including to 6.7% in the processing industry, and to 3.6% in the mining industry. Of the total volume of loans issued to finance the needs of the processing industry, which amounts to 2.5 billion dollars, a little more than 40% comprises loans to enterprises engaged in the production of foodstuffs, 12% to enterprises of the metallurgical industry, and 8% to enterprises manufacturing non-metal mineral products. The drop in loan to the production sector is largely explained not so much by the unwillingness of domestic banks to finance the enterprises of this industry, as by the desire of the latter, when necessary (the profitability of mining enterprises in Kazakhstan amounts on average to 70-90%), to use the resources provided by parent companies or acquired on the international capital markets.

By the end of 2006, lending to agricultural producers amounted to 4.4% of the total volume of loans issued, but this figure is 7 percentage points lower than the 2002 level.

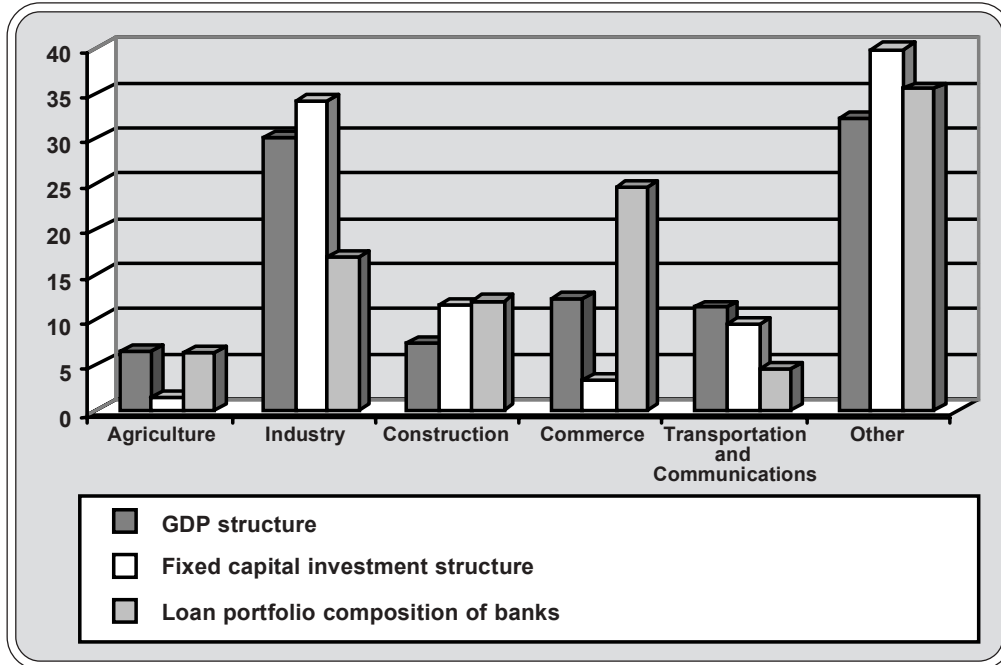
The increase in loans to the construction industry promoted the drop in lending in the production sphere. Beginning in 2001, the annual increase in bank financing of construction companies surpassed the growth rates in the total volume of the loan portfolio. As a result, the percentage of construction steadily rose and reached 13.9% by the end of 2006. Such high dynamics are explained by the development of housing construction in Kazakhstan, the steady increase in real estate prices, and the ongoing construction in the country's new capital.

Despite a certain downward trend, lending in spheres of activity ensuring a rapid cost recovery and return on investment, such as trade and marketing and financial commercial activity, continues to be preferable. According to the results of 2006, the share of this lending in the total volume of economic loans amounted to 23.3%.

In this way, despite the increase in the role of bank financing, the emphasis is being placed more on satisfying the needs of enterprises in the non-production sphere than on making investments in industry. In Kazakhstan, significant disproportions are noted in the logical chain of economic links in the loan portfolio composition of commercial banks, the amount of fixed capital investment, and the amount of GDP produced, which are manifested in the domination of non-production branches (commerce, real estate operations). At the same time, the investment activity of banks and other groups of investors is gradually being curtailed in industrial production, which is traditionally the main driving force of development of the Kazakhstani economy. It should be noted that this is happening during implementation of a strategy of industrial-innovative development in the country, which envisages "diversification and modernization of the economy and the creation of conditions for producing competitive commodities and increasing export." In so doing, commercial banks, which have the largest volume of financial resources, are seen as the largest institutional investors in this strategy. Figure 3 presents the loan portfolio composition of banks in terms of branch characteristics, the structure of fixed capital investment, in keeping with the types of economic activity, and the GDP of the country, in terms of branches of the economy, that have developed in Kazakhstan, according to the results of 2005.

Figure 3

Loan Portfolio Composition, Structure of Investments and the GDP in 2005 (%)



Keeping in mind the composition of bank loans in terms of lending targets, the following picture takes shape. At first glance, it can be said that lending to corporate business (Fig. 4) accounts for approximately 50% of all the loans issued by commercial banks to the economy.

Most bank loans are used by borrowers for supplementing their circulating capital. But a downward trend was noted between 2002 and 2006. At the end of the period under review, loans for this purpose amounted to 12.6 billion dollars or 33.4% of the total amount of loans, compared with 66.3% at the end of 2002.

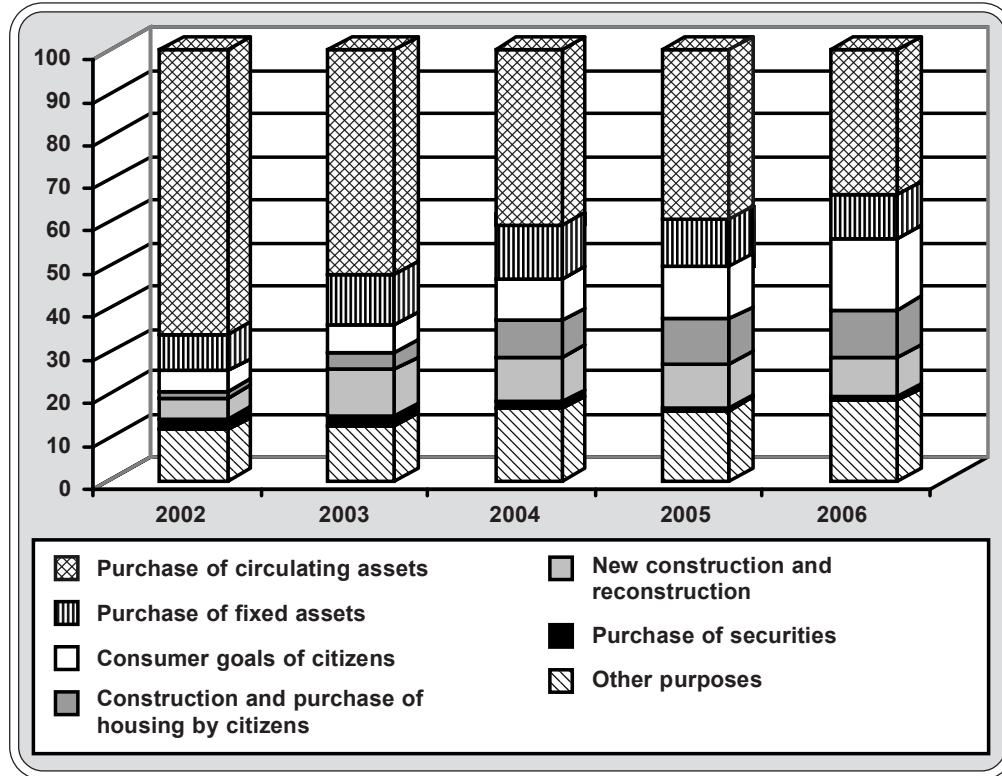
The structural changes in the loan debt of borrowers due to the purchase of fixed assets are characterized by a certain amount of growth in 2002 and 2004, but beginning in 2005, their volume began to decrease, and by the end of 2006 dropped to 10.3%. In absolute terms, the amount of loan debt of borrowers for the purpose of renewing and enlarging fixed assets increased almost 10-fold in five years and amounted to 3.9 billion dollars.

New construction and reconstruction are the next target of banking loans and present one of the types of capital-forming investments for economic entities. The development of the construction industry promoted an increase in the volume of loans issued for these purposes. However, beginning in 2003, a steady trend was noted toward a decrease in the percentage of loans for facilities under construction from 10.9% to 9.2% at the end of 2006.

The structural changes that occurred in the portfolio of commercial banks with respect to lending to the population should be noted. Consumer loan balances, which in world practice are assessed as the most risky, increased over the past five years from 0.1 to 6.2 billion dollars. Under conditions when access to credit resources is easier and express loan volumes without collateral are on the rise, this makes banks more susceptible to credit risks.

Figure 4

Loan Portfolio Composition of Banks in Terms of Lending Targets (%)



The increase in loans issued to the population is also related to the increase in lending for construction and the purchase of housing. The volume of mortgage loans issued to citizens doubled on average every year between 2002 and 2006. At the end of 2006, the percentage of loans issued for the construction and purchase of housing by citizens increased to 11.2%. In absolute terms, the lending volume reached 4.2 billion dollars, compared to 0.1 billion dollars in 2002.

When lending dynamically increases, the loan portfolio quality is affected and becomes more vulnerable to risks. At present, banks have reduced some of their claims on potential borrowers in order to more efficiently float the attracted funds. According to the regulating bodies, the main risk factors for banks related to lending to the population are general economic upheavals capable of leading to a decrease in the population's payment solvency, a drop in retail prices, and fluctuations in the currency exchange rates. As for the corporate sector, the risks here are primarily related to the high percentage of loans issued to branches of the economy where enterprises, in the event of a drop in the level of business activity, are more mobile, which could lead to an increase in bankruptcy and deterioration in the loan portfolio quality.⁵ What is more, banking risks are also augmented by several unsolved problems with respect to the lack of transparency of the property structure of Kazakhstan business. These particularly relate to the risk of banks providing less information than necessary on the amount of lending by the sides involved.

⁵ See: Report on Kazakhstan's Financial Stability, December 2006.

In world practice, the main analytical index reflecting the amount of economic risk is the hypothetical level of gross problem assets (GPS) in the financial system within the framework a realistic (but not catastrophic) scenario of economic recession. Problem assets include overdue loans, restructured assets (with a change in primary loan conditions), realized real estate mortgage, and other assets levied for the return of loan debts, as well as problem assets transferred to the management of special legal entities. The amount of GPS also reflects the level of outlays and problem assets that arose in this banking system previously. Taking into account the loan risks indicated above, S&P believes that in the event of an economic recession in Kazakhstan, the GSP level could amount to 35-50%.⁶

In Kazakhstan's banking practice, the level of banking risks is usually determined according to the size of the index characterizing the level of bad debts in the total volume of the loan portfolio of second-tier banks. This index was reduced to 1.6% at the end of 2006, which, according to the regulatory bodies, shows "the absence of alarming signals of the emergence of a systemic crisis at this stage of development."⁷ However, this assessment of the level of loan risks in the banking sector seems rather optimistic to us. This is primarily due to the structural changes in the loan portfolio quality. For example, whereas in 2002, the percentage of standard loans amounted to 71.6%, at the end of 2006, it had dropped to 52.6%. Correspondingly, the share of bad debts increased from 26.4% to 45.8%. It is particularly disquieting that such negative dynamics are being seen at a time of high growth in the volume of loans issued and a favorable macroeconomic situation.

The loan portfolio quality is only likely to deteriorate in the future. Credit risk remains the weakest point in the Kazakhstan banking system and one of the main factors making the prospects for its development indefinite. The situation could worsen in the very near future due to the fact that in April of this year the demands were toughened on the amount of foreign borrowing, which is to be limited to the amount of the banks' equity capital. According to the country's Central Bank, the banking sector's foreign liabilities at the end of 2006 amounted to 29.7 billion dollars, with an estimated equity capital of 9.3 billion dollars. The slowdown in the growth of the resource base of commercial banks is also having an influence on the decrease in volume of loans being issued, which in the end will reflect on the loan portfolio quality.

Problems in the future could also be aggravated if there is an abrupt slowdown in the growth dynamics of the economy. As a result of the reduction in revenue, the ability of borrowers to repay the loans they take out will also decrease. Taking into account the high dependence of the Kazakhstan economy on the fluctuations in the foreign situation, this possibility can simply not be excluded.

The changes in the branch structure and loan portfolio quality are making it necessary to review the investment policy of commercial banks and further improve the system of risk management. In the near future, the main task will be not building up the volumes of banking investments in the economy in absolute terms, but reorienting them from commerce and real estate to the manufacturing industry, transportation, and agriculture.

This is necessary in order to reduce the volumes of consumer lending, as well as lending in branches that ensure rapid cost recovery as a factor of launching inflation processes in the country, which happened last year. What is more, today, when banks are actively using the long money of foreign creditors to form their resource base, they are indeed capable of acting as investors, if not of long-term, at least of medium-term investment projects. And finally, it is not worth forgetting the industrial-innovative development strategy mentioned above, which is to be implemented before 2015, and the role allotted to the banking sector.

Nor should we believe that the volumes and vectors of banking investments in particular branches of the national economy are determined exclusively by the banks' own policy. The transformation

⁶ See: Analysis of Risks in the Banking Sector of the Republic of Kazakhstan.

⁷ See: Report on Kazakhstan's Financial Stability, December 2006.

mechanism (bank capital \Rightarrow investment in the economy) depends not only on the side supplying the investment capital, but also on the side requesting it. Unfortunately, today most enterprises of the real sector are simply not ready to accept large-scale investments on the conditions that are customary for all market economies today (the lender-investor demands financial transparency of the borrower and efficient assimilation of the corresponding funds). So the current situation is unlikely to change without the state's active participation in regulating the investment activity of commercial banks.

In so doing, it should be noted that state regulation is being urged not to cancel the principles and mechanisms of market management, or replace them with directive management, but to promote the creation of favorable conditions for stepping up the activity of all the participants in the investment process. So the state's task at the current stage of development of the macrosystem is to unite the advantages of state and market regulation. Market self-regulation of the investment process should be supplemented with different forms of government participation in those situations where the market cannot ensure optimal distribution of investment resources and, consequently, experiences failure. And vice versa, government measures in the investment sphere should be enhanced by using more flexible and mixed forms of investment.

Both sides—the market and the state—are important in investment activity, and so their optimal combination is important: the role of the state cannot become absolute in the investment process, but nor can the role of market instruments be underestimated. What is more, the state's potential should not be exaggerated, without recognizing the role of self-regulation and the stimulation of investment activity. A rational synthesis of state regulation and market mechanisms will make it possible to solve the main investment tasks.

The special features of state regulation of the investment activity of commercial banks consists primarily of assisting them to form a supply of investment capital, stimulate demand for it, and create a banking system capable of ensuring the redistribution of this capital, while preserving stability of the banking sector itself. The latter condition is only possible if alternative sources are developed for satisfying the investment demand, since the investment potential necessary for ensuring the growth of the Kazakhstan economy cannot be accumulated advantageously, and particularly exclusively, in commercial banks. In practice, this would mean the accumulation of systemic risks and an increase in the cost of borrowing. Financial mediation should be diversified by developing a stock market in order to raise the efficiency of the banking system in redistributing capital.

In our opinion, state policy aimed at regulating the demand for investment capital should be the focus today in developing the investment processes in the country as a whole and the activity of banks as investors in the national economy in particular. Conditions must be created for stimulating the investment activity of economic agents in priority branches of the economy, raising their investment attractiveness, and stimulating the activity of banks in these branches. The state controls the powerful levers of indirect influence on the volumes and vectors of investment flows, the rational use of which will help, first, to raise the role of banks' participation in the modernization and restructuring of the national economy, and second, lower banking risks when investing in the real sector of the economy.