

Mortgage Lending in Kazakhstan

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Kazakhstan is located at the Caspian Sea and neighbored by Russia in the north and China in the east.¹ Around 15m people enjoy a great deal of space. With 2.7m square kilometres in size, the country is five times bigger than France (with a population of about 56m people). Recently, the country has gained considerable attraction from foreign investors because of its large oil and gas reserves.

The high demand for oil from the Caspian Sea is also the main driver of economic growth in the country. According to the table below, GDP rose from 2.7 % in 1999 to 9.2 % in 2003. For 2004, a similar growth rate is expected.

GDP per capita has also risen but still lags behind neighbouring countries like Russia where it amounted to USD 3,041 (in 2003). Rising macroeconomic stability is reflected by steadily declining inflation rates. From 1999 to 2003, they have decreased from 17.8 to 6.4%. In 2004, only a slight increase to 7.0% is expected.

The labour market has benefited from the economic upswing. The unemployment rate has also fallen, now amounting to 8.7% in 2003. The positive economic development has led to rising wages, too. With an average salary of USD 194 (per 2003), Kazakhstan records the highest average wage in central Asia. However, it lags behind the central and eastern European countries where average wages amount to USD 472.² The highest salaries are paid in

Table 1 – Basic economic indicators of the Kazakhstani economy (1999-2003)

	1999	2000	2001	2002	2003
GDP growth in % to previous year	2.7	9.6	13.5	9.8	9.2
GDP per capita in USD	1,133	1,234	1,492	1,657	1,990
Inflation rate in %	17.8	9.8	8.4	5.9	6.4
Unemployment rate in %	13.5	12.2	10.2	9.3	8.7
Average salary in USD	91	117	142	157	194

Source: IMF, F.A.Z.-Institute.

The unemployment rate is calculated as a percent of the economically active population.

the financial sector and in mining where employees earn on average USD 377.28 and USD 304.71 respectively. Due to the favourable oil-price and implemented tax reductions, a further increase in average wages and employment is expected.

THE BANKING SECTOR IN KAZAKHSTAN

Since 2002, the Kazakhstani banking sector has grown rapidly, led by strong economic growth. Coupled with that, financial depth and intermediation have steadily increased. Factors responsible for financial deepening are faster and more transparent judicial procedures, more sophisticated legislation on banks as well as stronger supervision. The National Bank of Kazakhstan (NBK) envisages to achieve EU-standards in the banking sector by 2007.³ Growing confidence in the banking system has been facilitated by a deposit insurance system

introduced in 1999 (compulsory in 2004) and the Bank Secrecy Law of 2000.

The level of financial intermediation is still low in broader comparisons. In this context, administrative measures to control interest rates (for instance, the ceiling on deposit rates introduced by the Deposit Insurance Fund and tax incentives) only distort financial intermediation.

However, intermediation will be supported by shrinking spreads. From 1999 to 2003, they have declined from 13.77 to 7.32 percentage points. Especially better availability of creditor information have been beneficial to lower spreads. Despite shrinking spreads, banks have managed to remain profitable. This achievement has been due to a reduction in personnel expenses and in the number of branches⁴, a better enforcement of debts and slow entering into non-banking activities, like insurance, securities and real estate business.

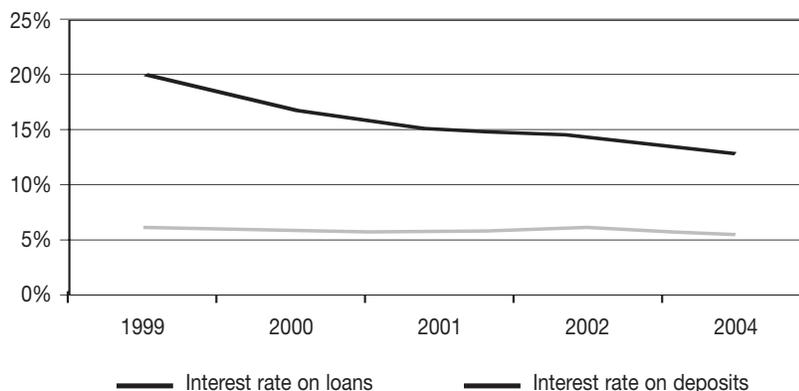
¹ Other bordering countries in the south are Turkmenistan, Uzbekistan and Kyrgyzstan.

² However, there are large differences among the countries: in Bulgaria, the average wage is USD 187.05. In Russia, it amounts to USD 255. In Poland and the Czech Republic, they have risen to about USD 683.7. With USD 1,394.5 on average, the Slovenians earn the highest salaries (data as per 2003).

³ See N. Zhushupova, "Geld für die Kleinen", Ost-West Contact 11/2003 and F. Herrmann/J. Wildenhain, "Reformen im Bankenwesen", Ost-West Contact 11/2003. For example, legislation on banks stipulates that banks have to apply IAS accounting standards. In their credit business, loans to one borrower may not exceed 25% of the bank's capital. Participation exceeding 10 % of the share capital are subject to approval of NBK.

⁴ Between 1999 to 2003 the number of branches was reduced from 426 to 355.

Chart 1 – Development of interest rates in the Kazakhstani economy (1999-2003)



Source: IMF, National Bank of Kazakhstan, authors' calculations

In addition, rising competition has helped lower interest rate spreads. In this context, competition is fierce among the banks within their group, but not necessarily between groups.⁵ Moreover, banks are competitive in and around big cities, but the smaller towns are catered for only by a few banks. In 2002, the banks recorded a combined profit of USD 132.2m.

On the whole, the banking sector is fairly concentrated. The three largest banks

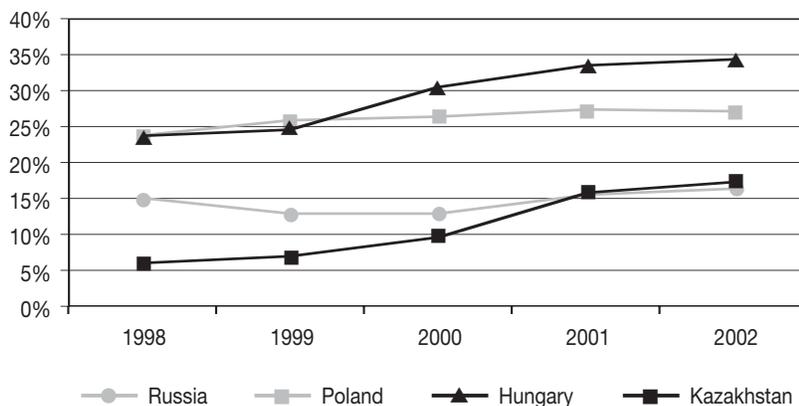
(Kazkommertsbank, Bank TuranAlem and Halyk Savings Bank) have a combined market share of about 60%. In 2003, they hold together 61% of the assets and 66% of the loans. Moreover, 69% of personal deposits are held by them. As per December 2003, 36 banks operated in the country, thereof 16 banks with foreign ownership.

Since 1998, bank lending to the private sector has increased. This development has

been due to better credit assessments, underpinned by strong real growth. The bulk of loans has gone to the industry and the trade sector. However, the share of lending to households is small but rising rapidly, with mortgage lending rising four times in 2003.

The graph below shows the development of private sector credit in relation to GDP (from 1998 to 2002). Four countries have been put into comparison: Russia, Poland, Hungary

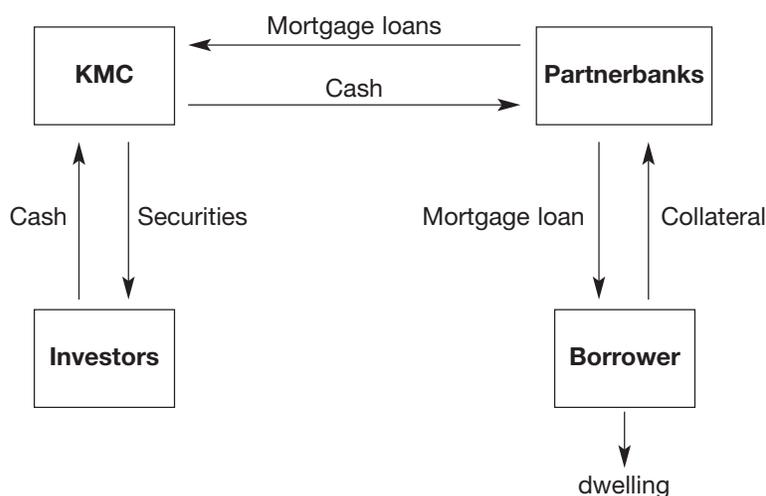
Chart 2 – Credit to Private sector in relation to GDP (1998-2002)



Source: International Financial Statistics, IMF, authors' own calculations

⁵ The three largest banks compete with each other, but view only some of the medium-sized and smaller banks as competitors.

Chart 3 – Model of the KMC facility



Source: KMC, Roy

and Kazakhstan. Kazakhstan shows a weaker performance than other central and eastern European economies. In comparison to Hungary and Poland, these figures also represent a lower grade of financial intermediation in Kazakhstan.⁶ With a private sector credit to GDP ratio of 18%, Kazakhstan is slightly above Russia (17%). Loans are mainly refinanced by deposits which constitutes almost 70% of banks' total liabilities. Around 55.5% of credit and 47% of deposits are denominated in foreign currency (mainly USD). The increasing share of households in total deposits reflects enhanced confidence in the banks.

THE MORTGAGE LENDING MARKET

Growing macroeconomic stability, declining interest rates and rising real incomes have favoured construction and mortgage lending. From 2002 to 2003, new construction rose by 16.9%. The

government supports housing with its national housing development programme of Kazakhstan for 2005–2007. This programme is aimed at providing affordable housing to the Kazakhstani citizens. It focuses on the creation of a full balanced housing market and the increase of mortgage loans and housing construction savings in order to finance new construction and renovation or modernisation of the existing housing stock.⁷

Since the state has withdrawn from providing funds for housing, there is a clear need to develop private housing finance. The previously state-owned dwellings have been privatised. As a result, 97% of the housing stock is in private ownership.

The entry of banks into the mortgage market has been supported by better regulations on property enforcement and an increase in the overall effectiveness of the judicial system. In addition, a Regulation on

Credit Register was adopted by NBK in 1998 in order to disseminate creditor information to banks.⁸ A law on credit bureaus has been submitted for the government's approval, which will also help reduce credit risk for the banks.

As a result, mortgage lending has steadily grown and is now accelerating at high pace. From July 2003 to January 2004, the total volume of mortgage loans soared by 208% (from KZT 14.1 billion to KZT 29.5 billion (about USD 197m)).⁹ However, experts fear that this rise in mortgage lending may also provoke a real estate bubble. The real estate markets in the large populations centres are already beginning to show signs of over-heating.¹⁰

The mortgage lending market is segmented: it can be broadly divided into the group of medium-sized banks participating in the new lending programme of the Kazakhstan Mortgage Company (KMC) that securitises

⁶ Besides broad money to GDP, private sector credit to GDP are used as indicators of financial depth and intermediation.

⁷ Fostering housing construction is one of the priorities of the 2030 Strategy of the Kazakhstani government. This strategy aims to maintain a stable rise in new construction and to improve housing affordability through a better supply of housing loans and cheaper interest rates on loans. Please see Kazinform at www.kazinform.kz.

⁸ Under this scheme, commercial banks are required to report to the regulatory authority if a single entity or an individual borrows in excess of KZT 3m (or KZT 1m). In addition, a new automated subsystem is being developed whereby banks can access current and periodic creditor data.

⁹ The KZT/USD exchange rate is 149.58 (as per 2003).

¹⁰ IMF, "Investment Opportunities for Pension Funds", Financial Sector Assessment Program Update, Republic of Kazakhstan, August 2004.

mortgage loans of these banks, and the largest banks having their own mortgage lending programme.¹¹ KMC mainly operates around the big cities. With a wider network and higher operational costs, the largest banks engage in mortgage lending in less urban regions, but are free to choose their interest margins. The newly licensed state-owned Zhilstroj Bank is a third player in the mortgage market, but solely caters to low-income groups.

DEVELOPMENT OF CAPITAL MARKETS

In order to stimulate long-term funding for mortgage lending, obtained from capital markets, NBK established the “Kazakhstan Mortgage Company (KMC)” on 29 December 2000. The objective of KMC is to refinance banks’ mortgage loans portfolios: KMC purchases mortgage loans from the participating banks and then issues securities to investors backed by the acquired mortgage debt. KMC benefits from an implied government backing through its complete NBK ownership.

The government considers KMC a part of its wider strategy to develop the housing finance market in Kazakhstan. Its activities are aimed at providing long-term mortgage loans at reasonable costs thereby

organising the market and fostering competition among banks.

KMC started its operations in 2001. The company has developed into an important market player in housing finance. It has a market share of 28 %. As per May 2004, it records an authorised capital of KZT 2.5 billion (about USD 17.9m). Assets amount to KZT 14.8 billion (about USD 105.7m).

Chart 3 shows how KMC operates.

KMC operates as a sales-of-asset liquidity facility. KMC signs an agreement with commercial banks or non-banking organisations (later called partner banks) which intend to securitise their mortgage loans. The banks grant mortgage loans to their customers who in turn provide the lending bank with a pledge on the dwelling. Then, partner banks sell their mortgage loans to KMC which in turn acquires a right on the mortgage housing loans. In case the housing loans do not comply with KMC requirements and standards, banks are obliged to either retract the loans and provide the corresponding value of the loan or to provide KMC with further enhancements. Thus, credit risk remains with the partner banks. In this way, KMC organises the market, further enhancing stability in mortgage lending. KMC bundles the loans and issues

securities in the capital markets which are bought by investors (typically pension funds or insurance companies). For every bond issue, there is one separate cover pool. The cover pools are registered in the Kazakhstani state register. Entries in the register can be modified if necessary. By law, the cover pools are bankruptcy removed. KMC uses the funds received from the investors in order to pay the banks the corresponding value of their mortgage loans.

The administration of the loans remains with the partner banks. However, they are obliged to transfer the redemption payments to KMC so that KMC is capable of meeting its obligations against the bondholders.

STANDARDS AND LOAN REQUIREMENTS OF KMC

In principle, KMC provides loans only to Kazakhstani citizens. In the loan agreement with the partner bank, the borrower commits himself to use the borrowed amount for housing purposes and to provide the partner bank with a collateral.¹² Before a loan agreement will be signed, the partner bank requires an appraisal of the market value of the pledged property. It will be provided by an independent appraiser.

Table 3 – Lending programme of KMC

Currency of loan	KTZ
Loan amount	Up to KZT 23m
Terms of loans	3 to 20 years
Required LTV ratio	70–85%
Debt ratios	
– redemptions payments/income	35–45%
– total redemptions payments/income	40–50%
Required insurance	Property and life insurance
Prepayment	Penalty of 2% of redemption payment; minimum amount KZT 184,000

Source: KMC

¹¹ For example, Kazkommertsbank entered retail banking only in 2000. In 2002, the bank started to develop its own lending programme for housing purposes.

¹² Besides the collateral, the borrower may also present third party guarantees for prompt payment of the loan and accrued interest.

As a further precondition, the partner bank requires a property and a life insurance.

The typical mortgage loan is granted in KTZ and indexed to inflation. Loans are annuity loans with monthly redemption payments. With the inauguration of the Kazakhstan Mortgage Guarantee Fund (KMGF), LTV ratios are likely to rise from 70 to 85%. The down payment may be even lowered to 10 % if the borrower has concluded a mortgage default insurance with KMGF. Prepayments are subject to a penalty which amounts to 2% of the redemption payment. The minimum amount for prepayments is KTZ 184,000. In addition, the customer has to wait for six months before prepayment is executed.

As soon as the partner banks sell their mortgage loans to KMC, they will also transfer the rights on the mortgage to KMC. The transfer of the collateral will be noted in the land registry. A Trustee nominated by NBK scrutinises and controls the value of the pledged mortgages. In a report, he will inform KMC about the value of the collateralised debt. KMC bundles the loans with the same maturity and terms and sells them as securities to investors like insurance companies or pension funds. Typically, KMC issues floating rate notes.

The maturity of the bond is up to 15 years. Redemption payments from the borrowers will be directly passed to the bondholders through KMC.

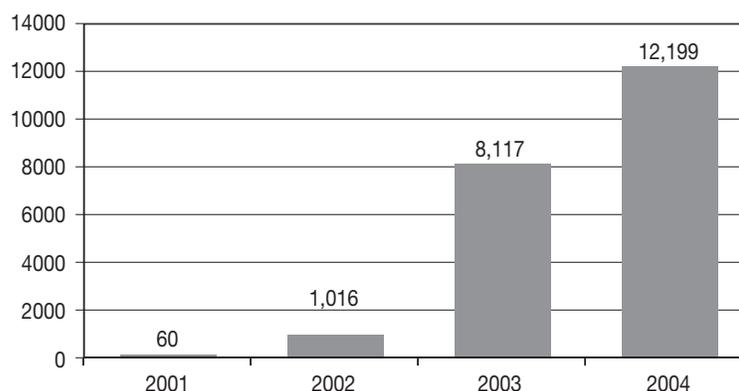
KMC is subject to the following risks which require full attention:

- Credit risk: credit risk to KMC is low because it purchases loans with full recourse to the banks. However, credit risk to partner banks is of more concern for KMC. Before concluding an agreement with a bank, therefore, it thoroughly analyses the creditworthiness of the bank. In addition, KMC does regular reviews on the financial stability of the partner banks.
- Interest rate risk is managed by the issuance of floating rate notes which are linked to inflation. In addition, KMC has introduced minimum interest rates for loans and bonds.
- Exchange rate risk: since bonds and loans are denominated in KTZ, exchange rate risk does not exist.
- Prepayment risk: it is lowered through advanced rated mortgages. Prepayment can be executed only with a time lag. In

addition, KMC bonds also bear floating rates.

- Liquidity risk: since the partner banks sell their mortgages, they are no longer concerned about liquidity risk. However, it is of concern to investors. KMC addresses this risk to a significant degree through offering bond issues with differing maturities. In this context, a major advantage of KMC compared to the individual partner bank is that its bond issuances will be greater in volume, thereby giving it greater flexibility in structuring them.
- Market risk: it may arise in case KMC will be unable to sell its securities in the market. KMC ensures the quality of the bonds in several ways: thorough selection of partner banks and careful assessment of the value of the underlying collateral. In addition, KMC provides further enhancement to bondholders through a guarantee of good financial performance of obligations. The NBK ownership of KMC also helps to increase confidence in its securities and to sell the bonds in the market.

Chart 4 – Growth of KMC mortgage portfolio in KTZ million (2001 – May 2004)



Source: KMC

ACHIEVEMENTS OF KMC'S ACTIVITIES

Since its inauguration in 2001, KMC has made a considerable contribution to the mortgage market development in Kazakhstan. As shown in Chart 4, KMC's mortgage portfolio has experienced a constant growth. As per October 2004, the total volume of outstanding mortgage loans has reached KZT 24 billion. In 2001, KMC co-operated with four partner banks. This number has risen to 14 banks, thus increasing mortgage loan supply at reasonable costs to the population.

Interest rates on mortgage loans have decreased from 28% in 2001 to 13.6% in 2004. Some partner banks offer mortgage loans at a rate of 12.6%. In 2001, loan terms amounted to a maximum of three years. Today, borrowers can be granted loans with terms up to 20 years. As per August 2004, the total volume of mortgage loans outstanding is worth KZT 95 billion. The market share of KMC is about 28%.

KMC bonds have also gained a nation-wide acceptance among institutional investors.

As per October 2004, the total volume of issued bonds amounts to KZT 21 billion. With a share of 56%, pension funds are the most important bondholders, followed by banks with 38%.¹³ KMC bondholders enjoy certain privileges: income on the bond is exempted from taxation. Banks have to hold only 20% of their risk-weighted capital against KMC bonds. However, there are special limits for insurance and pension funds. The share of KMC bonds may not be higher than 10% and 15% of their assets.

PROSPECTS FOR THE FUTURE

Inside the Commonwealth of Independent States,¹⁴ Kazakhstan has been the first country which has supported long-term funding of mortgage loans through the issuance of mortgage-backed securities. KMC, as the institution responsible for the organisation of these transactions, has clearly contributed to set up a stable and viable mortgage lending market in Kazakhstan. By lowering interest rates and increasing loan terms, access to affordable housing loans has risen. As a result of KMC's activities, competition among banks

has advanced. With ongoing macroeconomic stabilisation, a further reduction in interest rates and an increase in loan terms (up to 25–30 years) is likely.

In order to further stimulate the market, KMC envisages the introduction of fixed rate instruments and the improvement of bond issuing procedures. Competition will be enhanced by the government's plan to transfer KMC into private ownership.

The successful inauguration of KMC may work as an example for other countries which have similar plans to develop their national capital markets. Therefore, KMC's structure, policy and activities may be worthwhile studying.

For further information on the mortgage market in Kazakhstan see *Housing Finance International*, September 2003 which featured the article 'Establishing Mortgage Guarantee Insurance in Transition and Emerging Markets: A Case Study of Kazakhstan' by Sally Merrill and Douglas Whiteley.

¹³ Structure of KMC bondholders as per October 2004. The remaining 6 % represent other groups (figures are provided by KMC).

¹⁴ The Commonwealth of Independent States (CIS) comprises the following countries: Armenia, Azerbaijan, Belarus, Kazakhstan, Kyrgyzstan, Republic of Moldova, Russian Federation, Tajikistan, Turkmenistan, Ukraine and Uzbekistan.