S&P Global Ratings

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Banking Industry Country Risk Assessment: Kazakhstan

November 28, 2019

Banking Industry Country Risk Assessment Group				9
9	Economic Risk		9	Industry Risk
Economic resilience	High Risk		Institutional framework	Extremely High Risk
Economic imbalances	Very High Risk		Competitive dynamics	Very High Risk
Credit risk in the economy	Extremely High Risk		System wide funding	High Risk

Government Support:

Supportive

Major Factors

Strengths:	Weaknesses:
- Kazakhstan's strong fiscal and external net asset positions enable the government to support the banking sector. - Funding is predominantly by customer deposits with limited reliance on external debt.	- Extremely high credit risk due to prevailing aggressive lending and underwriting standards. - Weak regulation and supervision, prone to regulatory forbearance. - Distortion of the competitive landscape from the government and government-related entities (GREs). - The economy has been in a prolonged correction phase since the 2008 crisis and credit costs will likely increase in 2019-2020. - High funding and lending dollarization exposes banks to potential increases in credit risks and costs to match assets and liabilities in foreign currency.

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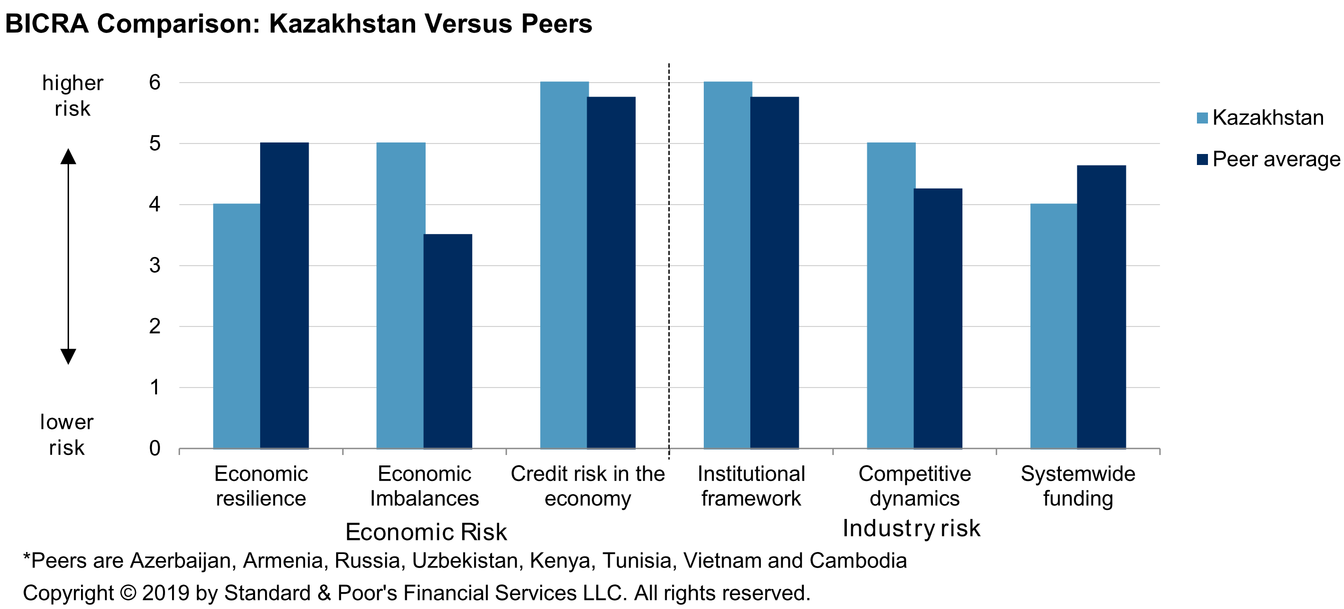
Rationale

S&P Global Ratings classifies the banking sector of Kazakhstan (BBB-/Stable/A-3) in group '9' under its Banking Industry Country Risk Assessment (BICRA). Other countries in group '9' are Argentina, Turkey, Kenya, Tunisia, Vietnam, Papua New Guinea, Azerbaijan, Bangladesh, Cambodia, Egypt, Mongolia, Sri Lanka, and Greece. We also compare Kazakhstan with Russia and Armenia in group '8' (see chart).

Chart 1



Under our bank criteria, we use our BICRA economic risk and industry risk scores to determine a bank's anchor, the starting point in assigning an issuer credit rating. Our anchor for a commercial bank operating only in Kazakhstan is 'b+'. A BICRA analysis for a country covers rated and unrated financial institutions that take deposits, extend credit, or both. BICRA scores range from '1' to '10', the lowest-risk banking systems scored in group '1' and the highest-risk systems in group '10'. Our economic risk score on Kazakhstan's banking sector is '9' and industry risk score is '9'.

In our view, economic risks have increased in Kazakhstan. We believe Kazakh banks will continue to display higher credit losses for longer than we previously expected. The economy's commodity dependence exposes it to terms-of-trade volatility. For 2019-2021, we expect economic growth to average 3.5%-3.7%, supported by rising oil production and exports. Extremely high credit risk remains a key weakness for Kazakh banks, in our view. We estimate that Stage 3 loans in the system comprised 20%-25% of total loans at year-end 2018, and were not adequately provisioned. We anticipate provisions for credit losses in the system will increase to about 5% of total loans in 2019 and remain elevated at 3%-4% in 2020.

Banking industry risks are also high. We believe Kazakhstan's banking regulators could be subject to political interference and are also prone to regulatory forbearance policies. Generating sufficient risk-adjusted returns over a cycle will remain difficult for most banks, owing to narrowed margins and elevated credit and funding costs. We believe that the government, GREs, and well-connected bank owners have influence on the competitive landscape. We do not expect material market consolidation over the next two years following a few M&As and seven defaults in the previous three years. We expect stable customer deposits and sufficient Kazakh tenge liquidity across the system in 2019-2020, which should favor larger, more creditworthy banks.

Economic And Industry Risk Trends

The economic risk trend for the Kazakh banking system is stable. This reflects that we do not expect any positive developments in asset quality in the banking sector in the next two years given that legislation is not conducive to large-scale write-offs. Also, recoveries of legacy nonperforming loans (NPLs) are lengthy and small due to the inefficient judicial system, widespread fraud, and pervasive related-party lending.

We also view the trend for industry risk in Kazakhstan as stable. We do not envisage substantial improvements to the regulatory framework while political influence prevails. We think that further material market consolidation is unlikely following a few M&As and license revocations in the past three years. We expect the banking system to be predominantly funded by retail and corporate depositors, with deposit dollarization at broadly stable levels and no growth in net banking sector external debt.

9 Economic Risk

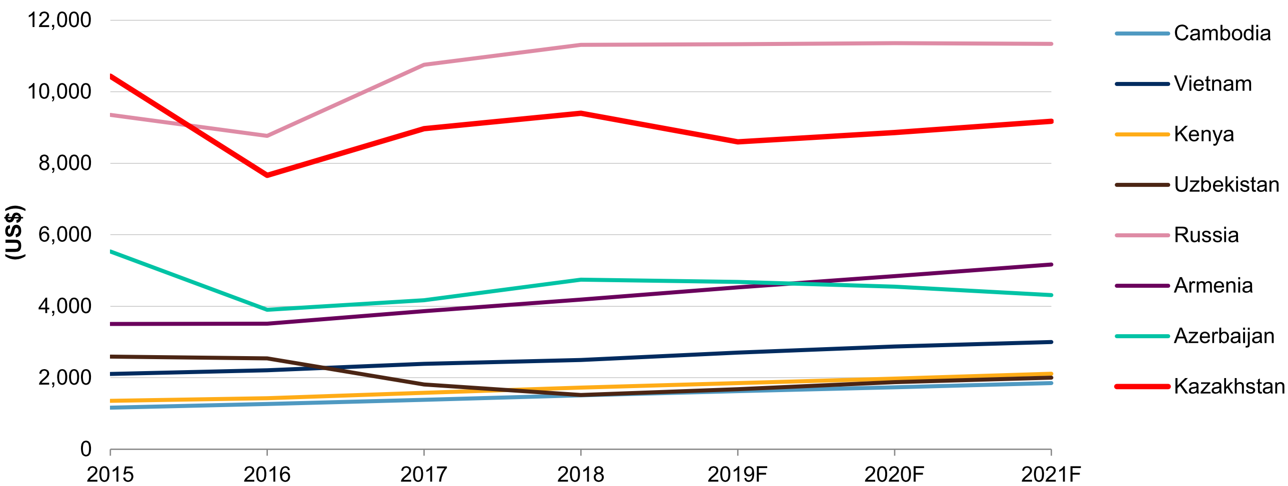
The key factors that determine our economic risk assessment for Kazakh banks are expected steady economic growth, the prolonged negative effects of the correction phase on the banking sector, and prevailing extremely high credit risk in the economy.

Economic resilience: High risk owning to high dependence on commodities, and despite a smooth transfer of power

Economic structure and stability. We expect economic growth will be 3.5%-3.7% in 2019-2021, which is in the middle of the peer group, supported by increases in oil production and exports (chart 3). Kazakhstan's economy depends heavily on commodity production, owing to its relatively small size and the country's considerable natural resources. The oil and gas sector accounts for over half of exports and about 15% of GDP, exposing the economy to external shocks. We forecast Kazakhstan's GDP per capita to be US$8,600-US$9,200 in 2019-2021, still short of the high of US$14,000 at year-end 2013. Although GDP per capita remains the second highest (after Russia) among its peers, it is only moderate in a global comparison (chart 2).

Chart 2

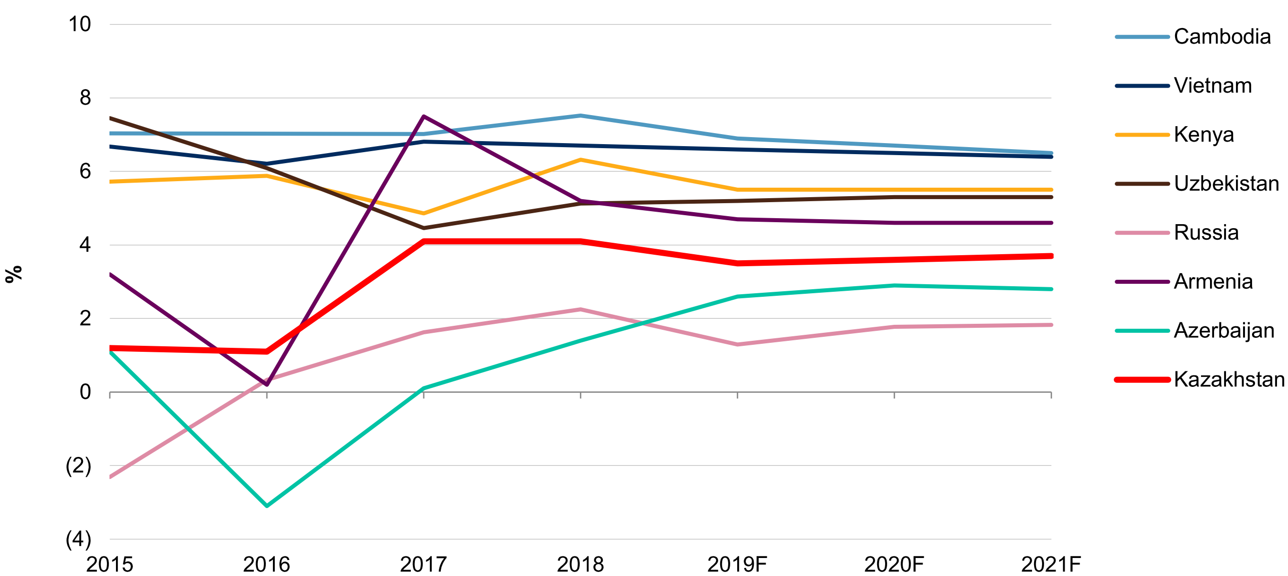
GDP Per Capita



Source: S&P Global Ratings.

Chart 3

Real GDP Growth



F--Forecast. Source: S&P Global Ratings.

Macroeconomic policy flexibility. Kazakhstan's government maintains a strong balance sheet, built on past budgetary surpluses accumulated in the National Fund of the Republic of Kazakhstan (NFRK), primarily during the latest period of high commodity prices ending in late 2014. Kazakhstan's liquid external assets exceed external debt in our projections to 2022. We forecast that the consolidated general government balance will be in deficit in 2019 (about 1%) and 2020 (about 0.2%) before returning to small surpluses over the rest of our forecast horizon.

Political risk. Kazakhstan's first transfer of power could lead to improvements in institutional effectiveness and stability of policy making. After more than 30 years under President Nazarbayev, in June 2019 Kazakhstan elected a new president, former Speaker of the Senate Kassym-Jomart Tokayev. He belongs to the ruling political party Nur Otan, which Nazarbayev heads. In our view, despite the transfer of power, First President Nazarbayev will likely retain significant influence over decision making in Kazakhstan.

Table 1

BICRA Kazakhstan--Economic Resilience

	Year ended Dec. 31						
	2015	2016	2017	2018	2019F	2020F	2021F
Nominal GDP (bil. $)	184.4	137.3	162.9	172.9	160.3	167.3	175.5
Per capita GDP ($)	10,434.8	7,661.4	8,971.0	9,401.2	8,601.0	8,860.9	9,174.0
Real GDP growth (%)	1.2	1.1	4.1	4.1	3.5	3.6	3.7
Inflation (CPI) rate (%)	6.6	14.6	7.4	6.0	5.7	5.5	5.3
Monetary policy steering rate (%)	5.5	5.5	10.3	9.0	N/A	N/A	N/A
Net general government debt as % of GDP	(38.6)	(25.7)	(3.4)	(16.6)	(17.7)	(18.3)	(19.7)

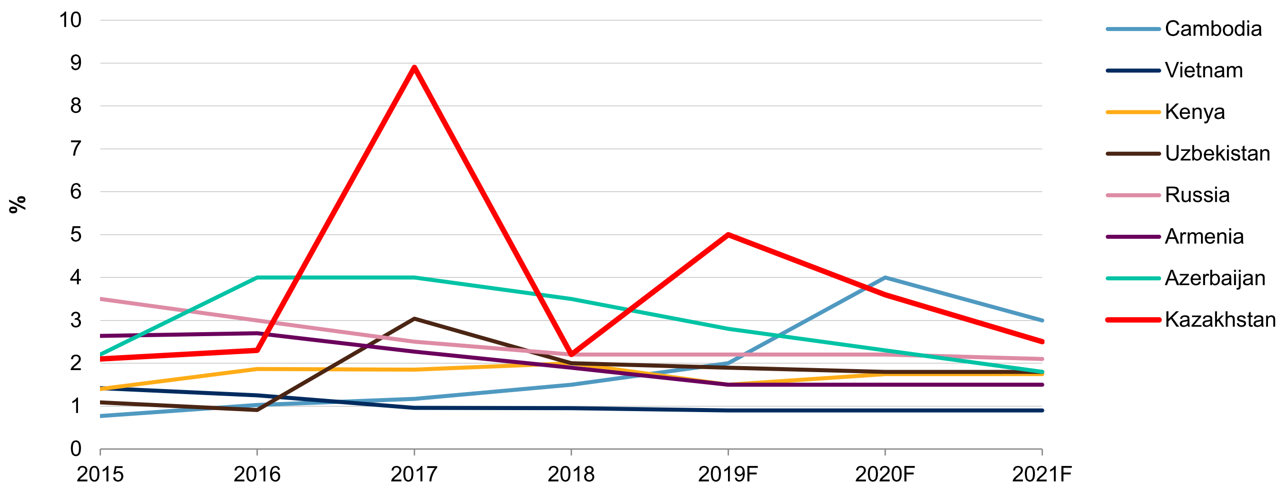
N/A--Not applicable.

Economic imbalances: The economy is in a prolonged correction phase with high NPLs and an expected increase in credit losses

Correction phase. We believe the Kazakh economy has been in a prolonged correction phase since the credit and real estate bubble burst in 2008-2009. Kazakh banks will continue to display higher credit losses for longer than we previously thought and higher than most of peers (chart 4). We anticipate provisions for credit losses in the system will increase to about 5% of total loans in 2019, and remain elevated at 3%-4% in 2020. Provisions should return to a more normal 2.0% in 2021, similar to the 2.2% seen in 2018. In the first nine months of 2019, provisions for credit losses were 4.8% of total loans mainly as a result of a significant increase in provisions at First Heartland Jusan Bank (formerly Tsesnabank).

Chart 4

Cost Of Risk



F--Forecast. Source: S&P Global Ratings.

We forecast that the majority of Kazakh banks will demonstrate growth in loans and deposits in 2019-2021, but only slightly above real GDP growth. We think that loan growth will be restricted by banks' shareholders ability and willingness to inject fresh capital amid modest earnings generation and capital being needed for new provisions to address still-weak asset quality. We expect loan growth in 2019-2020 to be driven by unsecured and secured retail loans.

We forecast broadly stable property prices adjusted for inflation in 2019-2020. We do not see high risks in residential mortgages due to their low volumes. Currently mortgages in Kazakhstan account for only 4% of GDP compared with more than 6% in Russia.

Table 2

BICRA Kazakhstan -- Economic Imbalances

	Year ended Dec. 31						
	2015	2016	2017	2018	2019F	2020F	2021F
Annual change in claims of resident depository institutions in the resident nongovernment sector in % points of GDP	5.7	(5.8)	(8.2)	(2.7)	(0.7)	(1.3)	(1.2)
Annual change in key index for national residential house prices (real) (%)	15.5	(33.6)	(15.6)	(4.7)	(4.4)	(3.6)	(4.1)
Annual change in inflation-adjusted equity prices (%)	(15.4)	43.5	51.9	0.6	N.M.	N.M.	N.M.
Current account balance/GDP	(3.3)	(5.9)	(3.1)	(0.0)	(1.4)	(1.1)	(0.8)
Net external debt / GDP (%)	(50.1)	(45.8)	(22.6)	(38.9)	(38.8)	(37.6)	(36.7)

F--Forecast. N.M.--Not meaningful.

Credit risk in the economy: Extremely high risk persists, reflecting prevailing aggressive underwriting standards, high problem loans, and a weak payment culture and rule of law

Private-sector debt capacity and leverage. Kazakhstan has low corporate and household bank debt in a global comparison. We expect domestic credit to the private sector to reduce to about 23% of GDP by year-end 2021 (lower than peer average) from 26% at year-end 2018, and considerably lower than 59% at year-end 2007. We estimate the ratio of household debt to GDP (net) to slightly increase to about 11% by year-end 2021 from 9.5% at year-end 2018 (of which mortgage loans will be about 4%-5% of GDP) supported by renewed demand for consumer loans and mortgages, but much lower than before the tenge depreciation of 2015-2016.

Nevertheless, there are few households with adequate payment capacity because of the significant income disparity between a few very rich and the rest of the population. The corporate sector shows the same overwhelming credit gap between large government-owned corporations and other large companies in energy and commodities, which dominate the economy, and the less creditworthy small and midsize enterprises. We forecast the ratio of net corporate debt (issued by banks) to GDP to somewhat reduce to about 12% by year-end 2021 following a downward trend over the past six years from 29% at year-end 2012. This is due to moving problem loans off balance sheet, creating significant provisions, and our expectation of some reduction in related-party lending due to license revocations from a few pocket banks.

Lending and underwriting standards. In our view, lending practices and underwriting standards in Kazakhstan have remained aggressive following the 2008 crisis. Although reducing, the share of foreign-currency-denominated loans in banks' portfolios stayed around 25% as of mid-2019, and we expect concentration on the real estate sector to remain at about 12%-13% over the next two years. We also note prevailing high concentrations in lending to single borrowers: The top-20 loans make up 2x-3x rated banks' capital.

We estimate that average Stage 3 loans comprised about 20%-25% of total loans in the Kazakh banking system as of year-end 2018, based on reported IFRS accounts, and they were only half covered by provisions. In our view, problem loans are still high because, over the past 10 years, Kazakh banks have been slow to reduce those generated before the crisis. Furthermore, the regulator was not proactive in strengthening regulation and banks continued aggressive lending practices after the crisis.

Ultimately, seven banks, including Tsesnabank, which used to be the second-largest--and which expanded aggressively in 2014-2016 through related-party lending--have defaulted over the past four years due to this pervasive activity.

Payment culture and rule of law. We view payment culture and rule of law in Kazakhstan as very weak. In our opinion, Kazakhstan has an inefficient and arbitrary judicial system, an underdeveloped legal framework, and pervasive corruption in the private and public sectors. Kazakhstan's relatively immature banking market appears to have a weak and still-evolving payment culture. This partly explains the magnitude of the rise in problem loans after the 2007-2008 financial crisis compared with countries experiencing a similar crash in their property markets. Realizing the proceeds of collateral on delinquent loans can take more than a year, and further progress is necessary to safeguard creditors' rights, in our view.

Table 3

BICRA Kazakhstan--Credit Risk In Economy

	Year ended Dec. 31						
	2015	2016	2017	2018	2019F	2020F	2021F
Claims of resident depository institutions in the resident nongovernment sector as a % of GDP	42.9	37.1	29.0	26.3	25.6	24.3	23.0
Household debt as % of GDP	11.0	9.6	9.3	9.5	10.2	10.7	11.1
Corporate debt as % of GDP	28.2	24.6	16.7	14.3	12.3	10.9	10.4
Real estate construction and development loans as a % of total loans	11.8	11.5	11.0	12.0	13.0	13.0	13.0
Foreign currency lending as a % of total domestic loans	42.7	40.0	24.6	26.2	26.9	26.8	26.6
Domestic nonperforming assets as a % of systemwide domestic loans (year-end)	8.0	6.7	9.3	7.4	10.2	10.7	11.2
Domestic loan loss reserves as a % of domestic loans	10.6	10.6	15.3	12.9	19.6	22.9	24.5

9 Industry Risk

The key factors that determine our industry risk assessment for Kazakh banks are its weak regulation and supervision, aggressive risk appetite, and favorable loan-to-deposit ratio.

Institutional framework: Weak regulation and supervision, governance, and transparency

Banking regulation and supervision. We assess banking regulation and supervision in Kazakhstan as weak. In our opinion, Kazakhstan's banking regulators lack independence and can be subject to political interference from the government, GREs, and politically connected bank owners. Kazakh banks do not properly disclose their real asset quality, in our view. This is reflected in the wide discrepancy between interest income accrued and received in cash at some banks, as well as between Stage 3 loans in IFRS accounts (an average of 20%-25% in the sector at year-end 2018) and published loans over 90 days overdue (only 9.1% at Oct. 30, 2019). We believe that regulators tolerate under-provisioning at some banks, which falls short of international regulatory best practice.

Regulatory track record. The magnitude of banking system stress in Kazakhstan in 2008-2009 and afterward was very high, highlighting large shortfalls in banking supervision before the crisis. Kazakhstan's regulatory track record is weak because, in our view, its regulatory policies and practices were not proactive with respect to the 2008-2009 crisis and accumulation of risk after the crisis. Over the past 10 years, regulators have not yet fully cleaned up the banking system from the very high level of problem loans generated before the crisis. Regulators have done little to strengthen regulation to prevent ongoing aggressive lending practices after the crisis.

Governance and transparency. We consider governance and transparency in Kazakhstan's banking industry to be weak, although we note some improvement since the crisis. All Kazakh banks are required to prepare monthly financial accounts under IFRS. In our view, some banks do not properly disclose the true level of their problem loans.

Competitive dynamics: Stable banking system despite M&As and defaults

Risk appetite. We consider Kazakhstan's banks to have an aggressive risk appetite. Some banks grew very aggressively over 2010-2017 and provided extensive related-party loans. This resulted in seven banks defaulting over the past three years and the provision of substantial government support (KZT4 trillion [$10.5 billion] or about 7% of GDP) to larger banks. We have observed continued interest from Kazakh banks in financing real estate and construction due to a lack of opportunities in other sectors. Currently unsecured consumer loans are the fastest-growing segment with expected average annual growth rates of about 20% in 2018-2020 and increased penetration into low-income segments.

Overall, the Kazakh banking system is struggling to generate a risk-adjusted return on core banking products that is adequate to meet banks' cost of capital. The banking industry's risk-adjusted performance is weak, largely due to weak profitability at the majority of banks, partly compensated by a few strong performers. This reflects the aim of bank owners for their banks to finance their business projects at favorable terms rather than maximize return on investment.

Industry stability. We believe that the Kazakh banking system will remain stable over the next two years following recent events such as:

- Halyk Bank's acquisition of Kazkommertsbank (KKB) in July 2017, creating a clear market leader with over 30% market share in key segments;
- ForteBank's acquisition of Bank Kassa Nova (belonging to the same shareholder) in June 2019;
- License revocations from five weak banks over the past three years; and
- Pending regulatory approval merger of three small banks (Tengri Bank, AsiaCredit Bank, and Capital Bank).

We do not anticipate further meaningful market consolidation in the next two years unless it is government-driven. We see a higher likelihood of a banking sector clean up via license revocation than consolidation through M&A. This is because, in our view, larger players have limited appetite for M&A, while small foreign players are satisfied with their niche franchises.

The industry continues to be concentrated at the top. The top 10 banks controlled about 85% of the system's assets as of mid-2019, indicating that 18 other smaller banks have limited influence on the sector's performance and risk profile.

Market distortions. We think that the stability of individual banks is highly dependent on decisions taken by the government, which can be unpredictable and lack consistency for external observers. Although the share of state ownership in the Kazakh banking sector is currently below 5%, banks are highly confidence sensitive, typically have franchises that depend in part on the perceived reputation of their owners, and some rely meaningfully on public sector financing in the form of GRE deposits. We think that allocation of GREs' deposits, which account for about a quarter of total deposits in the system, is confidence-sensitive, volatile, and highly dependent on one-off government decisions.

Table 4

BICRA Kazakhstan--Competitive Dynamics

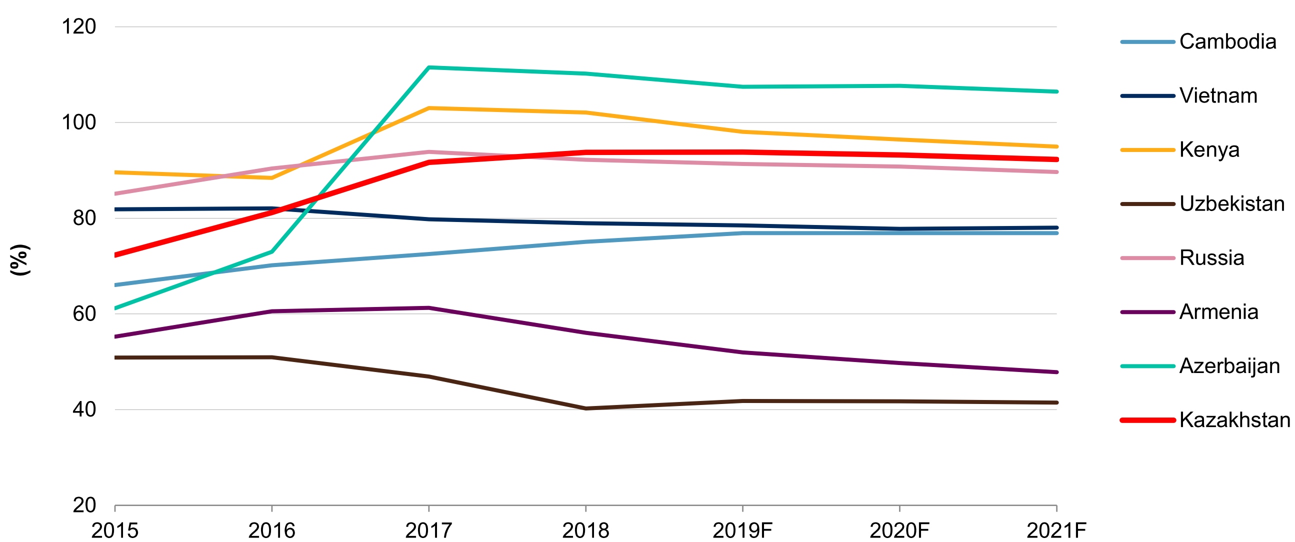
	Year ended Dec. 31						
	2015	2016	2017	2018	2019F	2020F	2021F
Return on equity (ROE) of domestic banks	9.4	15.2	(0.6)	21.4	14.0	13.0	12.0
Systemwide return on average assets (%)	1.2	1.6	(0.1)	2.6	1.8	1.7	1.6
Market share of largest three banks (%)	46.4	46.3	44.0	49.0	50.0	50.0	50.0
Market share of government-owned and not-for-profit banks (%)	2.0	2.4	3.2	5.0	5.0	5.0	5.0
Annual growth rate of domestic assets of resident financial institutions (%)	30.4	7.5	(5.2)	4.2	0.2	0.8	4.0

Systemwide funding: Flight to quality at the system level

Core customer deposits. Core customer deposits (defined as 100% of household deposits and 50% of corporate deposits) increased over the past five years to 93% of systemwide loans as of mid-2019, compared to about 51% in 2011-2013 due to deleveraging by a few large banks. We expect this ratio to be about 85%-95% in the next two years, which compares favorably to peers, due to moderate loan and deposit growth (chart 5). Banks are heavily reliant on corporate deposits (48% of total deposits as of mid-2019) for funding, which creates concentration risks in banks' funding bases. We also consider that retail deposits could be volatile and generally expensive, especially for banks that are not in the top tier.

Chart 5

Systemwide Domestic Core Customer Deposits By Formula As % Of Systemwide Domestic Loans



F--Forecast. Source: S&P Global Ratings.

We expect GRE and retail deposits to be concentrated at larger, more-creditworthy banks and for smaller banks to struggle to attract depositors. We do not foresee deposit dollarization reducing below 40% of total deposits in the next two years from 43% at mid-2019, in view of the historically high dollarization of Kazakhstan's economy. We expect the system overall to have ample liquidity both in tenge and foreign currency over the next two years, supported by government funding provided under a variety of government support programs.

External funding. We expect the banking system's net external debt to be close to zero in 2019-2021. Gross banking system external debt should remain stable at around $6 billion due to scheduled repayments and the limited number of new trade finance transactions.

Domestic debt-capital markets. We view Kazakhstan's domestic debt capital markets as narrow and shallow, with private-sector debt issued in domestic capital markets representing less than 15% of GDP at mid-year 2018.

Government role. The Kazakh government's adequate support of its banking system has been demonstrated by its provision of liquidity during periods of market turmoil, as well as ongoing liquidity support to systemically important banks and some smaller banks on a selective basis.

Table 5

BICRA Kazakhstan--Systemwide Funding

	Year ended Dec. 31						
	2015	2016	2017	2018	2019F	2020F	2021F
Systemwide domestic core customer deposits by formula as a % of systemwide domestic loans	72.3	81.2	91.6	93.8	93.8	93.2	92.3
Net banking sector external debt as a % of systemwide domestic loans	6.4	0.7	(1.3)	(0.3)	0.0	0.0	0.0
Systemwide domestic loans as a % of systemwide domestic assets	65.4	60.7	56.1	54.5	54.3	54.9	55.4
Total consolidated assets of FIs as a % of GDP	58.2	54.4	45.6	42.3	40.2	37.4	34.9

F--Forecast.

Peer BICRA Scores

BICRA Component scores for Kazakhstan are broadly in line with other banking systems in BICRA group '9' and '8' (see table 6).

Table 6

BICRA Scores Comparison

	Kazakhstan	Azerbaijan	Armenia	Russia	Uzbekistan	Kenya	Tunisia	Vietnam	Cambodia
Government Support Assessment	Supportive	Uncertain	Uncertain	Supportive	Supportive	Uncertain	Uncertain	Highly supportive	Uncertain
Anchor	b+	b+	bb-	bb-	bb-	b+	b+	b+	b+
BICRA Group	9	9	8	8	8	9	9	9	9
Economic Risk	9	9	8	8	7	8	8	9	9
Economic Risk trend	Stable	Stable	Stable	Stable	Stable	Stable	Negative	Stable	Stable
Industry Risk	9	9	8	7	9	9	9	8	9
Industry Risk trend	Stable	Stable	Stable	Stable	Stable	Stable	Stable	Stable	Stable

Government Support

We classify the Kazakh government as supportive toward the domestic banking system. This classification recognizes the government's current capacity and track record of providing support to banks with high and moderate systemic importance, including during the 2008-2009 crisis, through the following:

- Capital injections into the largest banks;
- Tenge liquidity support through foreign currency swaps with the central bank in 2014-2016;

- Support to KKB through the Problem Loans Fund in 2014-2017;
- KZT1 trillion of liquidity and problem loans support to Tsesnabank in 2018-2019;
- Provision of KZT653 billion of subordinated loans at below market rates to five midsize banks in 2017; and
- Provision of long-term funding under government support programs to banks.

We believe Kazakhstan's government has the capacity and willingness to support domestic banks with high and moderate systemic importance. The government's liquid assets accounted for about 40% of GDP at year-end 2018. We think that the approach of the Kazakh government to providing support is gradually changing. We consider that the number of banks to which the government is likely to provide timely extraordinary support has decreased.

Since early 2018 the government has taken a firm stance that it will support only high and moderate systemically important banks for the stability of the banking system while smaller banks with a market share of less than 1% need to rely on shareholders' support. As a result, we saw defaults of six smaller banks in 2016-2018 whose shareholders were not able or willing to support them with capital and liquidity.

Table 7

Top Five Kazakh Banks By Assets As Of Sept. 1, 2019

	(Tril. KZT)
Halyk Savings Bank Of Kazakhstan	8.5
SJSB Savings Bank Of Russian Federation	2.1
Kaspi Bank JSC	2.0
ForteBank JSC	1.8
Bank CenterCredit JSC	1.5

KZT--Kazakhstani tenge.

Related Criteria And Research

- Banking Industry Country Risk Assessment Update: October 2019, Oct. 29, 2019
- Analytical Linkages Between Sovereign And Bank Ratings, Dec. 6, 2011
- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Sovereign Rating Methodology, Dec. 18, 2017

This report does not constitute a rating action.

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