

## CHAPTER 12. DEVELOPMENT OF MORTGAGE SYSTEM IN KAZAKHSTAN

by  
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### Introduction

The development of Kazakhstan housing attitudes began in 1991 after the acceptance of legislations on privatization and property. Later, acts were accepted for a pledge of investment activity, the new Civil code, the decrees of the President of the Republic of Kazakhstan validated laws on the mortgage of real estate and the state registration of the rights to real estate and its transactions. These fell under the laws of the Republic of Kazakhstan on housing attitudes.

With the aim of creating mechanisms for housing construction financing, solving of housing problems for wide layers of citizens, reduction of prices on housing and stimulation of construction of housing, the governmental order of Republic Kazakhstan #1290 "From 21 August, 2000 has approved the concept of long-term financing of housing construction and development of mortgage crediting in Republic of Kazakhstan." The concept stipulates an opportunity for attracting independent resources from creditors by issuing and distributing mortgage securities under condition of their covering, i.e. the two-level system of the mortgage loans, providing creditors with financial resources due to the means involved in the secondary market through specialized operators.

With a view to the practical realization of the long-term financing concept of housing construction and development of system of mortgage loans the decision to create a similar structure – the "Kazakhstan Mortgage Company " was accepted by National Bank of Republic Kazakhstan.

Basic examples of the organizations with this concept of functioning were considered during the creation of the Kazakhstan Mortgage Company, such as the American agency "Fannie Mae", German savings and loan associations and Malaysia corporation "Cagamas Berhad ".

### 1. Economy of the Republic of Kazakhstan

Kazakhstan, a part of Central Asia, is located almost in the centre of the Eurasian continent, and borders on Russia, Turkmenistan, Uzbekistan, Kyrgyzstan, China. The area of Kazakhstan 2,717,300 sq. km, with a population of over 15 million.

Kazakhstan possesses large stocks of oil and gas, nonferrous metals and other minerals. The current priorities for investment direction are: a fuel and energy complex; a building complex; a financial infrastructure; transport and telecommunications and a social infrastructure.

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Billion tenge

Year	1997	1998	1999	2000	2001	2002	2003	2004
GDP	1672	1733	2016	2600	3251	3776	4450	5542.5
Investments	119	189	277	519	776	1193	1259	1530.6
Export	6899	5871	5989	9288	8928	10066	13233	17989
Import	7176	6672	5648	6848	7607	7646	9145	11550
Budgetary deficiency of % of GDP	-3.7	-3.7	-3.7	-0.1	-0.4	0.03	0.7	N/A
Price index	11.2	1.9	17.8	9.8	6.4	6.6	6.8	6.9
The exchange rate (tenge / dollar)								130

Economic development of Kazakhstan is characterized by development of the basic macroeconomic indicators; the economy shows stable and regular increase of GDP in comparison to earlier. Average increase for the period 2003-2004 has reached 9.4%. For the year of 2004 GDP reached the sum of 5,542.5 billion tenge.

Also, a positive parameter is the growth of volume of investments into economy RK. Dynamics of investment growth shows that for the period of 1997-2002, the average indices equaled 59.20% showing a growth of 10.6% for the period 2003–2004.

For the period 2002-2004, inflation was under control and varied at a level of 6.4-6.8%. The forecast of National Bank RK for 2005 is 6%, a rather stable rate of inflation. This promotes an expectation of foreign investments stability and comprehensible rates of mortgage loans. The fixed capital investments performed positively and the growth of income of citizens, due to opening new workplaces, improved the base of mortgage loans. In activity KMC considers various methods of elimination of consequences of inflation, among them the hedging of inflationary and percentage risks, the application of alternative financial tools and the search for new sources of investments.

## 2. The Purpose of the Company

The purpose of the activity of JSC «Kazakhstan Mortgage Company» (KMC) is the refinancing of banks to purchase the rights of the requirements under mortgage loans.

The development of the mortgage loans market is primarily directed at the stimulation of accessible mortgage loans through the reduction of interest rates and comprehensible conditions of loans aimed at the lowest and middle class citizens of the country. KMC is non-banking financial organization, and its primary activity is directed at financing banks and other credit organizations which give out mortgage loans to citizens for the purchase, construction and repair of housing (which plays an important role in financing sphere development of housing construction) and stimulation of accessible mortgage loans for citizens in the Republic of Kazakhstan. KMC is the state tool for creating accessible mortgage loans. It has been assigned the responsibility for the expansion and introduction of the state program of mortgage loans as well as developing a share of securities markets by release of mortgage bonds.

## 3. Structure of Mortgage Loans KMC

JSC «Kazakhstan Mortgage Company» was created by the National Bank of the Republic Kazakhstan in 29 December 2000. Since 2001, the Company has successfully taken root in the process of mortgage loans and has led a leading position in this area of financial services.

The mechanism of KMC's mortgage loans is as follows: the company signs agreements on joint activity with commercial banks and the financial organizations which provide mortgage loans. According to agreements the Company redeems from banks - partners the right of the requirement under mortgage loans. Thus KMC completely compensates the sum of the credit to bank-partners. The borrower makes monthly repayments with interest, but payments to KMC come through the bank - partner as it is they who carry out confidential management of the requirement rights under the loan, for which it receives a part of the compensation paid by the borrower.

Under the mortgage loans the credit risk is also assigned to the bank. In the case of a default on the part of the borrower, the bank redeems rights of the requirement under the credit from KMC back.

KMC lowered interest rates amongst commercial organizations, by promoting the development of competition between the banks which are providing mortgage loans. For example, by the beginning of 2001, loans were no more than 3 years, and interest rates in national currency were 28% annually. When the Company began operating, the annual interest rates had decreased to 18-19% and loans began to be given for the period of 10 years. Now maximum loan maturity has been increased to up to 20 years, and rates have decreased to 13.6 % annually (at some banks - partners down to 12.6%).

Since it was established three years ago, KMC has essentially increased availability of mortgage loans to the citizens, and therefore, the demand for them.

#### **4. Results of Activity KMC for 3 Years**

As a result of the general stabilization of economy growth in the country, the expansion of an internal investment base and also the release of mortgage bonds, depreciation of involved investments for development of mortgage loans has been achieved. In turn, it has allowed for a considerable lowering of rates of compensation under mortgage loans and an increase in the availability of loans to citizens under the program of the Kazakhstan Mortgage Company.

For the three year period 2001 to 2004, KMC financed, in all regions of Kazakhstan, mortgage loans amounting to the sum 31 billion tenge. Therefore more than 16 thousand families have received mortgage loans, interest rates on mortgage loans have decreased from 28% to 13.6%, and period of loan repayment has increased from 3 to 20 years. Due to the support of the Kazakhstan Fund of Warranting of Mortgage Loans, the initial advanced payment has decreased from 30% to 10%.

In December 2004 the total sum of mortgage loans amounted to 151,297 billion tenge, of which KMC's share was 17% from the total sum.

The introduction of a control system on actives and passives, focused on the best foreign models, has allowed to provide profitable part in KMC assets, and in the sum on results of 3.5 years the accumulated to 631 million tenge of net profit.

KMC works with all commercial banks. The number of bank-partners has increased up to 15 (13 banks and 2 non banking organizations).

KMC, for the first time in the CIS countries, has carried out the release of mortgage bonds, and by December 2004 their volume has reached 25.6 billion tenge. The given program on accommodation of mortgage loans is one of the most unique and advanced in the CIS, and the demand of investors for KMC bonds, as a rule, considerably exceeds their offer.

It is obvious that for three years of activity KMC availability of mortgage bonds to citizens has essentially increased.

### ***Requirements to Mortgage loans and banks-partners***

Company purchase from banks the right of the requirement under the mortgage housing credits, adequate to the following characteristics and requirements:

- loans should be long-term, i.e. given for a term greater than three years;
- loans should be given to citizens RK, thus the borrower is obliged to get the property or take a loan to repair real estate (except for the ground areas), including other owner (e.g. to the guarantor)
- the minimal sum of the mortgage loan from 300 thousand tenge and can be established by the decision of the Company for each region separately;
- the sum of the basic debt and repayments on it are paid monthly as annuity payments;
- the real estate transmitted to a pledge, should be insured (insurance of risk of loss (destruction), damage of property), thus the insurance sum can't be less than sum of the rest of the basic obligation under the contract of the bank loan;
- the borrower (the physical person) should insure the life and work capacity on all validity of the contract of the bank loan;
- cost estimation of mortgaging property should be made by an independent appraiser possessing the corresponding license for the right of realization of estimated activity, according to the legislation of Republic Kazakhstan;
- the mortgage of the real estate should be registered at the "Real estate registration center"

The compensation paid by the Company to the bank-partner under the "contract of asset management of the rights of the requirement under mortgage loans", includes service charges of mortgage loans and the obligation of the return repayment under the given loans. The rate of commission is stipulated by the parties in the contract of asset management and in the contract of cession and established in percentage items from the rest of the basic debt under the mortgage housing loan.

The company has the right to establish limits on the purchase of mortgage loans for banks-partners. Thus purchase of mortgage loans can be carried out under the initiative of each of the parties.

### ***Conditions for mortgage loans reception***

The potential borrower interested in reception of the mortgage loan under the program of the Company chooses for itself one of banks-partners of the Company, from whom they receive the full information on mortgage loans and pass a preliminary qualification. Preliminary qualification of the borrower includes granting full information on conditions of crediting. During interview with the potential borrower, necessary explanations and consultations regarding terms of granting and repayment of the mortgage loan, the rights and duties of the parties (the creditor and the borrower) are carried out. The purpose of preliminary qualification is to inform the potential borrower of opportunities of obtaining the mortgage loan and about the concrete conditions of granting of the loan.

Having passed the preliminary qualification, the potential borrower has the following opportunities:

- reception of a mortgage housing loan without an initial payment, in case of granting by the borrower of the additional real estate
- receptions of a loan of up to 85% in the case of insurance of the civil legal responsibility;
- receptions of a loan in size up to 90%, in the case of signing guarantee contract with the "Mortgage Guarantee Fund of Kazakhstan";
- in the case of insufficiency of the income of the borrower attraction co-applicant (which quantity has no limit) or the guarantor individual or legal entity

Passing the preliminary qualification to the bank-partner, the sum of the mortgage loan is defined and enables the borrower to choose the real estate suiting his requirements on the market and to plan monthly charges in view of repayment of the future loan.

Interest under credits is formed taking into account an index of inflation and the credit of a spread bank fixed for the whole period. Interest rates under the credit are floating and reconsidered twice a year on April 1 and on October 1, depending on the change seen in the annual index of inflation (for last 12 months).

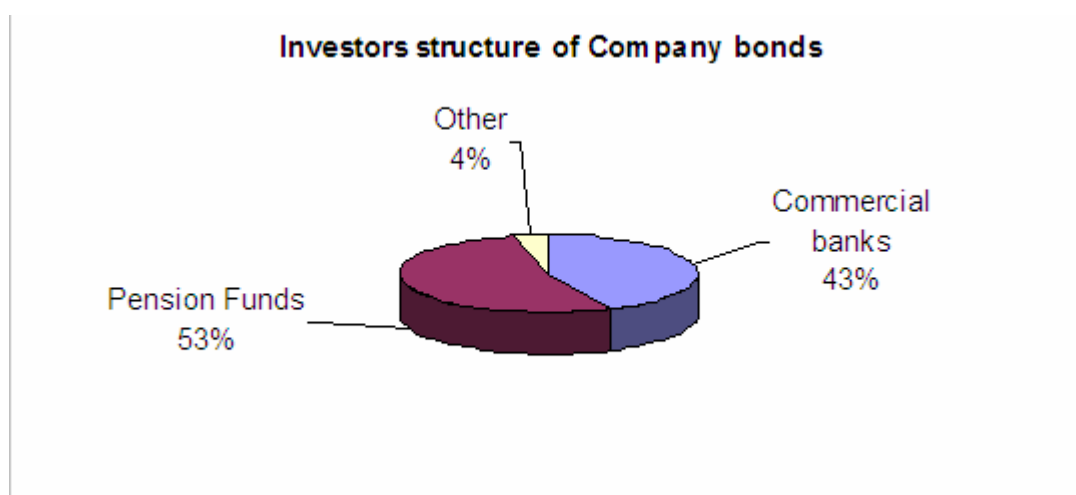
The company, on the basis of studying the international experience, develops the mechanism of protection against uncontrollable increase in interest rates, using of the top limit of the rate of compensation (cap). The top limit of interest rate - the maximal value of the rate which can be established to the borrower, without dependence from the economic situation. According to a technique authorized by the National Bank of the Republic of Kazakhstan, within a calendar year interest rates cannot be increased by more than 4.5 per cent, and this is only in the case of a significant growth of the index of inflation.

## **5. The Secondary Mortgage Market**

Results which have been achieved in Kazakhstan in the system of mortgage loans within last three years would have been impossible without the development of the mortgage bond market - a source of financing the system of mortgage crediting.

Since 2002, in the Kazakhstan funding market, investors essentially use a new financial tool - mortgage bonds. Activity carried out by the Kazakhstan Mortgage Company has served in the given direction both in the development of the system of mortgage loans of the republic, and a variety of financial tools of the securities market.

Analysis made by Kazakhstan Mortgage Company in December 2004, according to the statistical data of Agency of Republic of Kazakhstan, on regulation and supervision of financial markets and financial organizations (AFR) testifies that pension funds are the basic holders of mortgage bonds - more than 50% of KMC bonds.



One of the basic objects of an investment of pension money is corporate bonds of the Kazakhstan emitters. Though the market of non-state bonds constantly grows, it is necessary to note insufficiency in the share market of qualitative financial tools. Investments in the KMC agency mortgage bonds being a part of the market of non-state bonds of the republic possess the greatest appeal to investors as they have additional preference such as:

- bonds weighed on a 20% risk degree (other corporate bonds of domestic emitters - 100%);
- bonds included in structure high liquid assets
- bonds can purchased by participants of the pension market without dependence from own capital of the emitter;
- income of operations with bonds is released from the taxation, by analogy to the state securities.
- pledge of the bond is withdrawn from liquidating weight of the emitter and goes for calculation by investors

The potential for investment by pension funds in KMC bonds in view of established prudential specifications, is practically unlimited; now the volume of the money enclosed by pension funds in KMC bond goes from 0.14% up to 9.42% from a total sum of pure pension assets, with a maximum possible level of investment of up to 20%. Thus, only 2 out of 14 pension funds do not place pension actives in KMC bonds.

Name	0.14% – 2.50%	2.50% - 5.00%	5.00% - 7.50%	7.50% - 9.42%
Q-ty Pension Funds	3	3	3	4

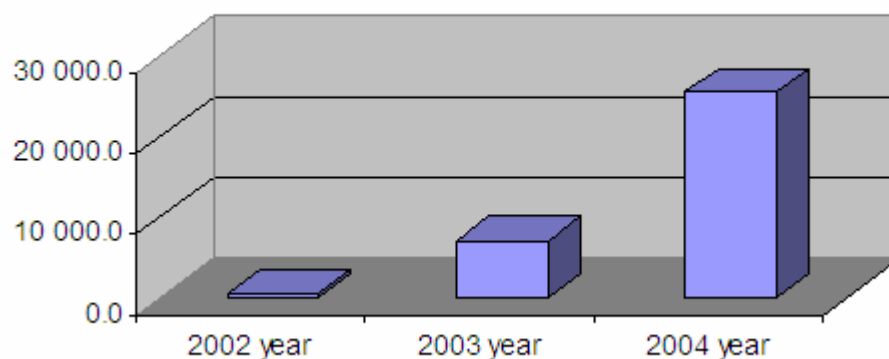
What involves investors in mortgage bonds? Successful symbiosis of reliability, liquidity and profitableness. Presence of mortgage bonds in a portfolio of any investor allows effectively diversify risks at a sufficient level of profitability.

KMC mortgage bonds are the highly reliable and liquid financial tools that are provided with a pledge of a personal estate - the rights of the requirement under mortgage credits, which in case of bankruptcy of the emitter are excluded from competitive weight. Bonds are included in listing "A" on the

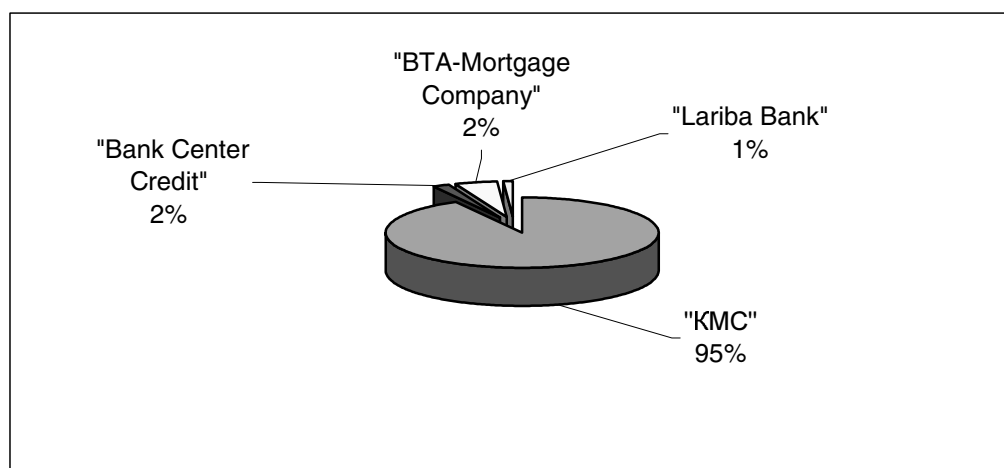
Kazakhstan stock exchange and have the status of agency securities which assumes clearing of surtaxes for holders of these bonds.

To date, KMC has released mortgage bonds totaling the sum of 25.6 billion tenge. In 2004, the additional registration of 5 issues has been placed.

**Dynamics of placing of bonds of the Company**



The first emitter of mortgage bonds "LARIBA BANK" has appeared in 2001 in the market, in 2003 "BTA-MORTGAGE COMPANY" issued mortgage bonds (total amount of issue from 2001-2003 1,656 million tenge), and in 2004 "Bank CenterCredit " with volume 500 million tenge. Thus, 95% of the mortgage bond market will consist of KMC bonds and it is possible to ascertain from this fact that there are no competitors in the market for KMC.



The rate of the coupon under bonds is floating and pays off on the basis of an index of inflation in annual expression. The rate is reconsidered twice a year according to change of an index of inflation. Thus it is necessary to note, that AFR has been proclaimed introduction of the responsibility of pension funds for negative profitableness on pension assets (in a percentage parity to the sum of own capital). Thus, the structure of the rate of coupon compensation under KMC bonds will allow supporting profitableness of pension assets at a sufficient level.

KMC Bonds have the top and bottom limits of rates of compensation (cap and floor), i.e. the maximal revision of the rate in the second fixed period can make 4.5 %. It means, that if there will be a sharp

splash in inflation the next half-year interest will pay off on the top rod of the established corridor. And, on the contrary, in case of strong falling a rate of inflation, KMC interest will be paid within 6 months, proceeding from the bottom rod of a corridor. As soon as the stressful period will end, KMC will return to the former scheme of calculation of the investment income.

It is necessary to note, that KMC also for the first time has issued corporate bonds with term of the reference of 10 years that has allowed transforming KMC bonds in some kind of "benchmark" for other corporate bonds.

KMC constantly worked on creation of such structure of bonds which optimum would answer both to investors' interests and specificity of KMC activity. And, from one issue to another there was improvement of structure.

Under KMC forecasts, development of the market of mortgage bonds will proceed in the future. Thus, roughly, KMC in the near future can stabilize releases at a level about 2.0 billion tenge a month, and in the long term up to the end of 2005 - up to 5 billion tenge a month. The significant potential of internal investments of republic consists in the further realization of pension reform which gives a positive pulse to development of the funding market.

In March, 2004 the head of the state in the annual message to people of Kazakhstan has proclaimed necessity of development of a new policy of housing construction. In particular, the purpose to put into operation up to the end 2007 12 million square meters of housing has been determined, that is to increase annual input of housing on the average twice to a level of 2004. Accordingly, prospects of development of the market of mortgage securities in Kazakhstan look optimistically.

For financing mortgage loans within the framework of the State Program of development of housing construction in RK in 2005-2007 KMC plans to release bonds in volume 146.1 billion tenge, from which 34.9 billion - in 2005, and 111.2 billion tenge - per 2006-2007.

## **6. Mortgage Insurance System**

In order to increase citizens prosperity by creating access to mortgage system, "Mortgage Guarantee Fund of Kazakhstan JSC" (further Fund) was funded under the initiative of National Bank of Republic Kazakhstan which appeared as unique founder. The primary goal of establishment and functioning of Mortgage Guarantee Fund of Kazakhstan JSC the National Bank of Republic Kazakhstan sees in:

- creation of favorable conditions for increase in term of the mortgage credit;
- decrease in a level of their interest rates, increases in the sizes of credits and decrease in size of an initial payment at mortgage loans;
- formation of system of guarantee of mortgage credits and a corresponding segment of the insurance market.

The fund is the self-financed organization which basic income should become payments under contracts of guarantee of mortgage credits.

It is necessary to note, that requirements of Fund on guarantee mortgage credits have been developed on the basis of requirements of the Kazakhstan mortgage company, in the same time work and under own programs of banks is planned. Mortgage guarantee considerably reduces the credit risk of banks connected to a default of the borrower, and in many cases, it can exclude this risk completely. Because



Mortgage Guarantee Fund of Kazakhstan JSC divides this credit risk, banks can offer the expanded portfolio of mortgage credit products focused on more broad audience of borrowers.

According to the State program of development of housing construction for 2005-2007, these three years will see more than 12 million sq. meters habitation constructed. Housing construction has been called to become one of the priority directions of the development strategy of Kazakhstan until 2030, and is one of the most important problems of national character. Maintenance of a steady rate of growth in housing construction, accessible across the board to citizens is impossible without a reduction in cost, an increase in housing credit and a decrease in initial payments and rates of loans. The given purpose can be achieved, through the development of the system of mortgage loans and the guarantee of mortgage loans.

## **7. Government Support**

The state program of development of housing construction during 2005 – 2007 plays a very important role in solving complex problems in this domain, providing the availability of housing to citizens and certainly plays one of the most important roles in the developing mortgage system.

The state housing development program, Kazakhstan Mortgage Company (KMC), is entrusted to develop the Special Program of mortgage crediting of accessible housing. KMC tries to generate more comprehensible conditions of mortgage housing credit for wide citizens from diverse socio-economic groups.

Mortgage loans under KMC Program will be provided to the citizens upon purchase of accessible housing whose cost will not exceed the sum equivalent to 350 US dollars per m<sup>2</sup> which follow the conditions of, and according to, the basic requirements of KMC to mortgage housing loans. Mortgage credit under the State housing program will be made in all areas with the accessible housing planning to be built in all regions of Republic.

The state housing development program provides, first of all, stimulation of solvent demand due to reduction of interest rates, decrease in an initial payment and increase loan terms. The realization of accessible housing under the State program is governed by local agencies authorized by the Government.

## **8. Risks of Mortgage Loan in Kazakhstan**

The company closely watches risks which can damage the interests of investors and the Company, monitors and analyses the current condition of the market for this purpose. There are various kinds of risks which can negatively affect on KMC and for this purpose, as methods of estimation, the following tools are used:

***The credit risk*** - credit risk is actual for the Company in case of bankruptcy of the bank - partner is ordered to prevent that risk the company established special financial condition to bank - partners.

***The risk of prescheduled repayment*** - is applied the moratorium on prescheduled repayment and collection of a commission for prescheduled repayment.

***The risk of liquidity of assets*** - for restriction of the given kind of risks by the Company is created a liquid stock which consists of the state securities intended for sale with the purpose of full and duly repayment of obligations. It is necessary to note that if the size of a liquid stock exceeds the maximal sum of lump sum payment under obligations to investors on all released bonds.

**The percentage risk** - Regulation of the given risk is carried out by use floating interest rates under loan and bonds. Thus as a basic index inflation is used.

**The inflationary risk** – if a substantial increase in the rate of inflation takes place, an increase in the quoted rate that can result in reduction in demand of borrowers for mortgage housing loans, and also growth of number of defaults.

**Risk of devaluation** - In connection with that assets of the Company, the rights of the requirement under mortgage loans are received by the Company in tenge, and passives, emitted in bonds, are nominated in tenge, the risk of devaluation is absent. The given risk can arise at decision-making to involve to the international market and attract investments in a foreign currency.

**The risk of liquidity of a security paper in the fund market** - the given risk arises in case of the impossibility of selling bonds in the financial market. Restriction of the given risk is a guarantee of good financial performances of obligations to bonds holders (a pledge of a personal estate - the rights of the requirement under credit obligations of borrowers), reliability of the Company (performance prudential the specifications established by Authorized body), the appeal of the given bond following from its status « an agency valuable paper » (it is distributed all releases of mortgage bonds of the Company, except for the first release) and so forth.

**Risk of the competitive environment** - the Mortgage loans offered by the Company, have a number of advantages compare to other commercial banks offer and the financial organizations that make their more attractive to potential borrowers, namely:

- Rather low rates of compensation;
- Nominated in tenge, without fixing their currency equivalent;
- Long term (20 years);
- Repayment of annuity payments.

All this allows that the substantial existing demand for mortgage loans will become covered due to the activity of the Company.

Alongside the KMC program, commercial banks offer their own mortgage loan products in tenge, and other currency (mainly in USD).

## **9. Products of Crediting of Housing Loans**

Now, as their primary activity, KMC plans to carry out three degrees of operational work on mortgage loans.

### **1) The Market program on purchase and repair of housing**

- loan period from 3 to 20 years
- currency of loan - tenge
- the sum of the loan from 300 thousand tenge and higher

- the rate of compensation - floating, on occasion fixed (revision 2 times a year)
- the size of an initial payment of 15% of the cost of the house, under conditions of insurance of the general liability, it is possible to grant the sum at a rate of 10% and more, in the case of a guarantee of the credit with joint-stock company « Kazakhstan Fund of Warranting of Mortgage Loans».

**2) *The special program on purchase of accessible housing***

- the interest rate - 10%;
- an initial payment - not less than 10% of the cost of the house;
- loan period - 20 years;

It is the state housing development program which provides first of all a stimulation of solvent demand due to reduction of interest rates on the basis of: fixed rates, the reduction of the size of the initial payment and the increase of the loan period.

**3) *KMC plans to cover the share market*** by selling mortgage bonds up to 221.9 billion tenge from 2005-2007. This will create an additional stimulus for development of the market share, and investment in the Republic of Kazakhstan.

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