Kazakh Banks Face High Risks in 2016 from Thinning Capital Cushions as the Economy Stagnates

By Standard & Poor's

Standard & Poor's Ratings Services believes the Kazakh economy will stagnate or contract modestly in 2016, due to low oil prices, weaker exports, and shrinking consumption. This backdrop, together with a volatile currency, complicates operating conditions for the country's banking sector.

Overview

- We expect Kazakh banks will face deteriorating asset quality amid contracting GDP growth and tenge depreciation, with nonperforming loans increasing.
- Banks' rising credit costs and narrowing margins, and their shareholders' limited willingness and ability to provide them with new capital will prompt declines in the sector's capitalization, in our view.
- We view banks' pronounced asset and liability mismatches in foreign currencies and tight tenge liquidity as additional risk factors to the banking system's stability.
- Although only seven of 19 Kazakh banks we rate carry negative outlooks, we anticipate that negative rating actions will outnumber positive ones in 2016, due to weakening capitalization and liquidity, and the absence of positive outlooks currently.

We believe that Kazakh banks' business prospects will be constrained over 2016, resulting in a stable loan portfolio (net of devaluation effect). We expect asset quality in the Kazakh banking sector will deteriorate, with nonperforming loans (NPLs; loans overdue by more than 90 days) increasing to 11%-13% by year-end 2016 from 8.3% currently, calculated per the National Bank of Kazakhstan's (NBK's) approach. We foresee credit costs (new loan loss provisions to total loans) increasing to 3.0%-3.5% of gross loans in 2016 from 2.1% in 2015 to cover elevated loan losses. This, together with low earnings on the back of depressed economic conditions, is likely to restrict banks' internal capital generation and increase the need for new capital injections from shareholders. However, we see shareholders' willingness and ability to provide new capital as limited. For these reasons, we expect negative rating actions on certain Kazakh banks this year.

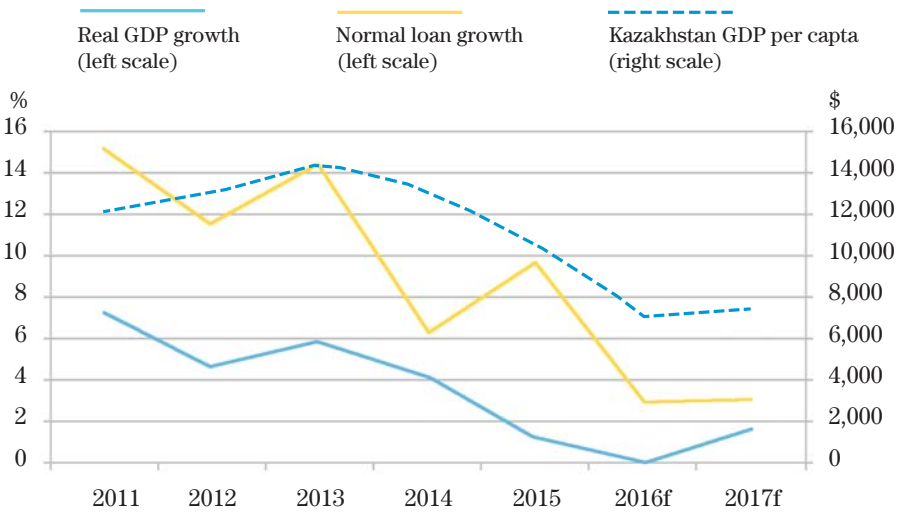
We anticipate continued systemwide pressure on the funding and liquidity of Kazakh banks in 2016. The high level of deposit dollarization and uncertainty about banks' ability to replace foreign currency swaps with the NBK at expiration remain additional risks to the banking system's stability.

DOWNGRADES ARE ON THE HORIZON

Given the elevated risks in the Kazakh banking sector, we expect to see volatility in the ratings on Kazakh banks in 2016. Rating actions this year will likely depend on developments with regard to banks' risk positions, capitalization, and liquidity. We anticipate that negative rating actions will outnumber positive ones, given that seven of the 19 commercial banks we rate in Kazakhstan have a negative outlook, while the rest have a stable outlook.

The stable outlooks on Kazakh banks should be viewed in the context of downgrades over the past 12 months and the average low rating level of Kazakh banks compared with global peers. Our average long-term rating for Kazakh banks is 'B', which in some instances includes uplift for potential support from the government or a parent company. The average rating on Kazakh banks is also significantly below our 'BBB-' sovereign rating on Kazakhstan. We continue to classify Kazakhstan's banking sector in group '8' under our Banking

Chart 1.
Kazakhstan's GDP growth, GDP Per Capita, an the banking system's loan growth



f-Standard & Poor's forecast
Sources: National Bank of Kazakhstan, Standard % Poor's estimates

Industry Country Risk Assessment (BICRA; with '1' being the lowest-risk banking system and '10' the highest). Our BICRA and, in turn, our ratings on banks in Kazakhstan already factor in the banking sector's structural limitations, such as extremely high credit risk in the economy, weak banking regulation and supervision, and low governance and transparency.

Our negative outlooks on Kazakh banks reflect the particular sensitivity of these banks to the negative industry risk trend related to systemwide funding pressure and the banks' decreasing capital buffers. In particular, negative rating actions could stem from our reassessments of the capital and earnings position of those banks whose capitalization, as measured by our forecast risk-adjusted capital (RAC) ratio, will be materially impaired by recent tenge depreciation, among other economic factors. We also view significant deposit outflows or diminished liquidity negatively.

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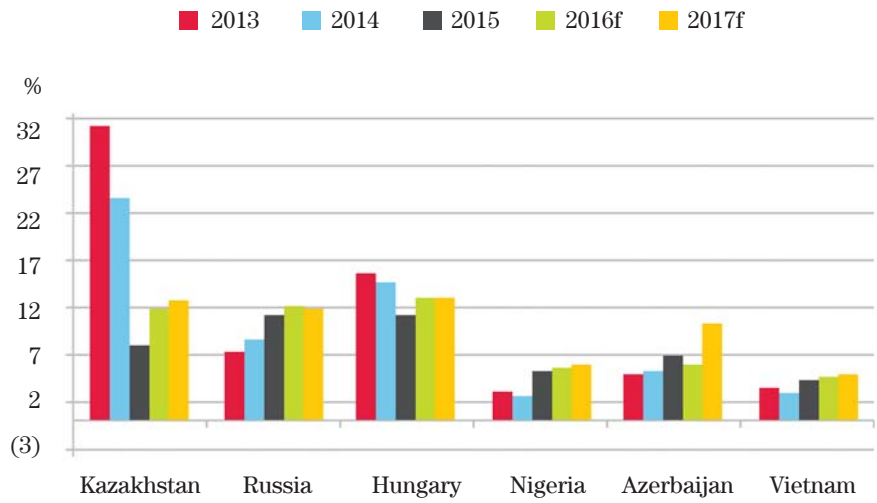
THE WEAK ECONOMY IS CURTAILING LOAN GROWTH

In 2016, Kazakh banks have found themselves in the unchartered territory of conducting business in a stagnating or even modestly contracting economy with a floating exchange rate, following 15 years of real GDP growth averaging 7% annually. We expect moderate economic recovery in 2017-2018, as oil prices, consumption, and investment gradually pick up. Recent tenge depreciation, coupled with rising inflation, has ultimately reduced the population's real disposable income and consumer demand. We expect GDP per capita measured in U.S. dollars to halve to about $7,000 by year-end 2016 from the peak of $14,400 at year-end 2013 (see chart 1). We anticipate that the economic slowdown and postponement of investment and expansion by companies, on the one hand, as well as low capital availability and lack of tenge funding, on the other, will constrain new business generation for Kazakh banks in 2016.

Chart 2.
Nonperforming loans for Kazakh banking system and peers



Nonperforming loans defined as loans more then 90 days overdue. F-Standard & Poor's forecast.
Source: National banks, Standard & Poor's estimates

For the Kazakh banking system overall, we forecast annual nominal loan growth of about 3% in 2016-2017. This is below the 10% nominal growth (net of the tenge devaluation) that we forecast for the Russian banking sector and the 25% for neighboring Uzbekistan, where growth is supported by the government's recapitalization programs. Nominal growth in Kazakhstan will ultimately depend on the scale of devaluation and inflation. Nevertheless, we expect some small and midsize banks will continue growing above system averages from lower bases, yet at reduced rates compared with the previous few years.

Due to the sizable reduction in disposable income, we expect that newly generated retail loans will substitute maturing ones, resulting in the Kazakh banking system's retail portfolio remaining at about 25% of the gross loan portfolio and stable in absolute terms.

In the corporate segment, we expect banks will prioritize lending under government-support programs of the DAMU Entrepreneurship Development Fund, the Development Bank of Kazakhstan JSC, and JSC National Management Holding KazAgro, backed by government funding in tenge.

We consider this segment to be of lower risk than traditional corporate lending because debt burden for borrowers is substantially lower due to low government-subsidized lending rates. We believe loan growth is also somewhat supported by government-funded infrastructure projects, such as the construction of roads and railroads. Demand for corporate loans, as in previous years, should come from small to midsize corporates, predominantly in the weaker and more volatile sectors of trade, infrastructure construction, agriculture, and consumer goods. This is because large cash-rich corporates, notably in the commodities sector, are able to secure financing on the international capital markets and have limited need for local bank financing.

A TURN IN THE CREDIT CYCLE IS SET TO CAUSE ASSET-QUALITY DETERIORATION

We believe that the credit cycle in Kazakhstan is turning, following a period of growing loan portfolios and decrease of legacy NPLs. We think it is inevitable that stagnating or even contracting GDP and sharp tenge depreciation will lead to some deterioration in borrowers' creditworthiness. We observe that state-owned or related companies are starting to delay their payments to contractors. In addition, Kazakhstan has a weak payment culture and low income. Traditionally high sector and individual borrower concentration in a global comparison add to high credit risk in the banking sector, in our view.

We expect that problem loans, according to Standard & Poor's definition, which include loans overdue more than 90 days and restructured loans with altered original terms, could account for about 25%-30% of total bank loans in 2016. This estimate is comparable to our estimate for the Russian banking system and is significantly higher than NPLs, calculated according to NBK's approach. We expect the latter will increase to about 11.0%-13.0% by year-end 2016 from 8.3% on March 1, 2016. These levels will be comparable to those reported according to national statistics for Russia and Hungary, but about double those of Azerbaijan, Vietnam, and Nigeria. All these banking systems face levels of risk similar to Kazakhstan (see chart 2). We understand that the Kazakh regulator has extended the regulatory target date for achieving a maximum of 10% NPLs (according to the NBK approach) to Jan. 1, 2018, from the originally planned date of Jan. 1, 2016.

The most pronounced asset-quality deterioration and thus creation of additional provisions is likely to come from banks that exhibited double-digit growth rates over the past few years and whose credit portfolios start to season amid tougher operating conditions. Banks, which have a share of foreign currency-denominated loans in their portfolios at the system average level of 35%-40% or higher, particularly to unhedged borrowers, will also be affected. We observe that the share of foreign currency-denominated loans among rated banks varies widely from 15% to 65%.

We already factor the abovementioned risks in our assessment of risk position for the vast majority of rated Kazakh banks as moderate. Although some rapidly growing banks report currently low levels of NPLs, we consider these levels to be unsustainable in the next few years. In our view, rapid loan growth, unaccompanied by appropriate underwriting and risk management systems, is likely to lead to accumulation of latent risks.

Under our base-case scenario, credit losses in the Kazakh banking system are likely to increase in 2016 to about 3.0%-3.5%, following a reduction to 2.1% in 2015 (see chart 3). This will be higher than historical credit losses in 2010-2015, because of delayed recognition of problem loans in Kazakhstan historically. We anticipate credit losses in Kazakhstan will be somewhat below our forecast for the Russian and Azerbaijan banking systems but above those of other peers.

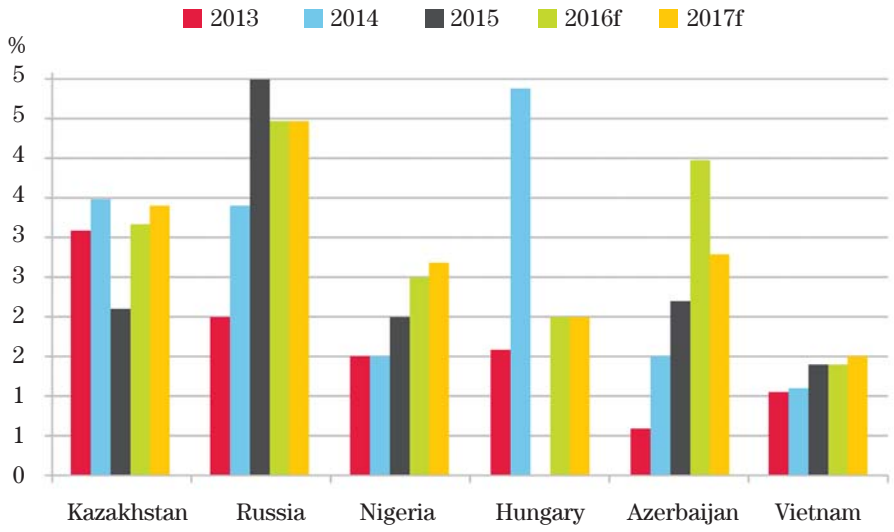
LIMITED SHAREHOLDER SUPPORT AND ANEMIC EARNINGS UNDERMINE CAPITAL

In our view, Kazakh banks' weak earnings potential is likely to diminish further, affected on two fronts. We expect that the net interest margin may narrow further, reflecting stiff competition for good-quality borrowers, rising interest rates on tenge deposits, and the high cost of foreign currency swaps. Rising credit costs due to weaker asset quality will weigh on the bottom line, particularly for the rapidly growing banks whose credit portfolios will season amid loan growth slowdown. As a result, we forecast the sector's return on average assets (ROAA) will decrease to 0.7%-0.9% in 2016-2017 from 1.17% in 2015 (see chart 4). This will be in the middle of the range relative to peers.

Because of their weak internal capital generation and limited other sources of capital, coupled with capital depletion due to the tenge depreciation, banks will call for shareholder support to absorb a potential rise in impaired assets and credit costs. However, we understand that the majority of Kazakh banks' shareholders have limited willingness or ability to inject sufficient capital in 2016 to fully offset these negative effects.

We understand that according to NBK's official statistics, the domestic K1-1 and K-2 capitalization ratios, standing at12.3% and 15.6%, respectively, for the banking system on Feb. 1, 2016, were well above the minimum requirements of 5.0% and

Chart 3. Credit losses for Kazakh Banks and Peers



F-Standard & Poor's forecast.
Source: National banks, Standard & Poor's estimates

7.5%, respectively. These figures are 6.0% and 8.5%, respectively, including countercyclical buffers, and 6.5% and 9.0% for systemically important banks. Such a strong level of regulatory ratios leads us to believe that we are unlikely to see a government capitalization program over the next 12 months similar to the ones we observed in Russia in 2015 (amounting to 1% of GDP) or in Kazakhstan in 2009 (amounting to 6% of GDP). At the same time, we consider that the regulator is cautious in not introducing significant additional pressure on banks' capital by tightening respective regulations, given the already difficult operating environment for the banking sector.

Our view on capitalization of the Kazakh banking sector is different from the official regulatory statistics, due to varying approaches in calculating risk-weighted assets and capital. We view capitalization of the Kazakh banking sector as moderate at best, as shown by Standard & Poor's average RAC ratio of about 7% as of year-end 2014. We expect the average RAC ratio for Kazakh banks will deteriorate to about 6.0%-6.5% for year-end 2015 and remain at this level in 2016 due to the impact of tenge depreciation, weak profitability, and limited new capital provided.

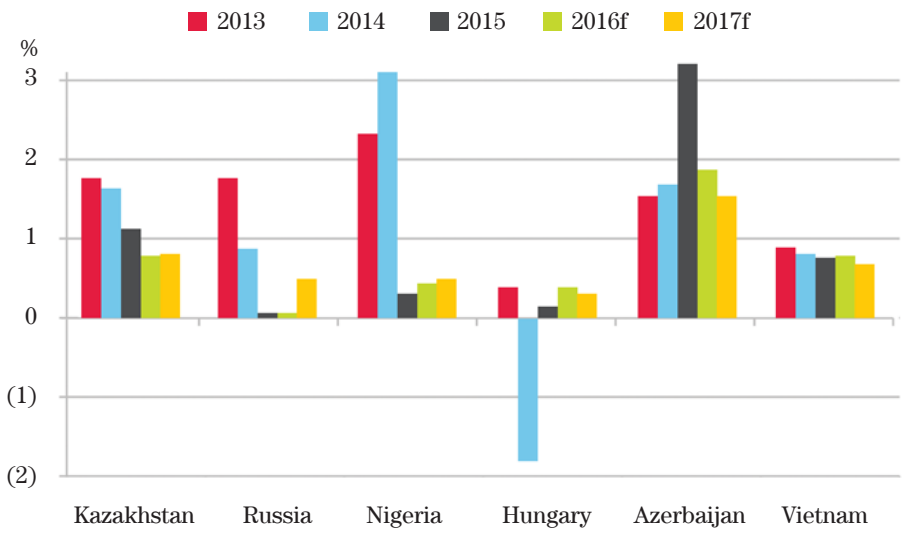
TIGHT TENGE LIQUIDITY THREATENS THE BANKING SYSTEM'S STABILITY

While we view the easing of tenge liquidity since February 2016 and the increased clarity on potential liquidity support from the NBK to the banking system as positive for Kazakh banks, we believe they will continue to experience pressure on funding and liquidity in 2016. The very high level of dollarization of deposits of 70% reached on Feb. 1, 2016, is unlikely to decrease substantially in 2016. We observe that the government's moral suasion for state-owned enterprises to convert U.S. dollar deposits into local currency and an increase of the rates on deposits in tenge has had little impact on the level of deposit dollarization in the sector in 2015.

Deposits remain the backbone of funding for Kazakh banks. We expect to see lower savings rates among corporates, state companies, and retail depositors because of economic contraction and sharply reduced purchasing power as measured in U.S. dollar. In addition, retail deposits will continue to be volatile, due to depositors' weakened confidence in the Kazakh economy and the tenge. Smaller banks will be particularly vulnerable to withdrawals and possibly panic-driven deposit outflows.

Kazakh banks' instruments to manage their widened foreign currency asset and liability mismatches are limited to interbank foreign currency swaps and repurchase agreements (repos). We understand that rates on overnight swaps and repos have reduced to about 15% currently from their peak triple-digit rates in late December 2015. However, we do not exclude volatility or a significant rise in swap rates in the future, depending on tenge exchange rates and liquidity availability.

Chart 4. Return on avarage assets for Kazakh Banks and Peers



F-Standard & Poor's forecast.
Source: National banks

The role of the NBK in providing liquidity to the market remains crucial. We understand that the NBK does not intend to extend foreign currency interest rate swaps, which were provided to banks for about $7 billion from the fourth quarter of 2014, on favorable terms for one to three years. In our view, key risk to the system's stability is related to new instruments that replace expiring swaps with the NBK and how the terms of these instruments will affect banks' cost of funding. We anticipate that Unified Pension Fund will remain the main investor in domestic bonds of Kazakh banks, thus providing additional tenge liquidity.

THE COMPETITIVE LANDSCAPE WILL LIKELY REMAIN UNCHANGED

We do not expect to see material consolidation in the Kazakh banking sector in 2016. This is in contrast to Russia and Ukraine, where the number of licensed banks has rapidly diminished due to bank failures, in particular small pocket banks serving financial-industrial groups. It also reflects that the NBK has modified its planned changes to banks' minimum capital requirements. It previously intended to have banks increase capital to an absolute amount of Kazakhstani tenge (KZT) 100 billion by 2019, but has now decided to link the requirement to the size of the banks' retail deposits.

Given that Kazakh banks have drastically reduced NPLs (to the current 8.3% from the 31% peak at year-end 2013), we do not expect any licenses to be revoked owing to capital depletion as a result of asset-quality deterioration. This is in contrast to the Central Bank of Russia, which aims to clear the banking system of weak banks. We also do not anticipate the entrance of new foreign players to the Kazakh banking sector, in view of the sharply reduced growth and earnings prospects in Kazakhstan and pressure on foreign banks' capitalization in their home markets.

The industry continues to remain concentrated at the top, with the top five banks controlling 59% of the system's assets as of March 1, 2016, and the top 10 banks controlling 82%. Smaller banks consequently have limited influence on the sector's performance and risk profile.