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KAZAKHSTAN TAKES MEASURES TO STRENGTHEN FINANCIAL STABILITY

In line with Baker & McKenzie's practice of keeping clients informed of important legal developments that might influence your business, we would like to draw your attention to the following recent changes in Kazakhstani legislation.

1. New Legislation on Financial Stability

1.1 Overview

On 23 October 2008, Kazakhstan promulgated a law, the Financial Stabilization Law,¹ aimed at strengthening the stability and resilience of the country's financial system in the face of the global financial crisis. The law seeks to enhance mechanisms allowing the state to timely reveal and respond to risks in the financial system, to reduce the likelihood of banks facing difficulties, to reduce the impact if any bank difficulties occur, and to strengthen the powers of the country's financial authority (the FMSA).²

The Financial Stabilization Law is basically a set of amendments to various other laws, including the Criminal Code and ten banking, pension, insurance, securities market, corporate and other laws.³ Some of the most important changes are outlined below.

¹ Law *On Making Amendments to Certain Legal Acts of the Republic of Kazakhstan Relating to Stability of Financial System* dated 23 October 2008.

² The Agency of the Republic of Kazakhstan on Regulation of Financial Markets and Financial Organizations.

³ The Financial Stabilization Law makes amendments to the following laws:

- (i) *Criminal Code of Kazakhstan* dated 16 July 1997 (the "**Criminal Code**");
- (ii) *Law On Banks and Banking Activity in the Republic of Kazakhstan* dated 31 August 1995 (the "**Banking Law**");
- (iii) *Law On Pension Provision in the Republic of Kazakhstan* dated 20 June 1997 (the "**Pension Law**");
- (iv) *Law On Insurance Activity* dated 18 December 2000 (the "**Insurance Law**");
- (v) *Law On Joint-Stock Companies* dated 13 May 2003;
- (vi) *Law On the Securities Market* dated 2 July 2003;
- (vii) *Law On State Regulation and Supervision of Financial Market and Financial Organizations* dated 4 July 2003;
- (viii) *Law On Credit Bureau and Formation of Credit Stories in the Republic of Kazakhstan* dated 6 July 2004;
- (ix) *Law On Investment Funds* dated 7 July 2004;
- (x) *Law On Mandatory Guaranteeing of Deposits in the Second-Tier Banks of the Republic of Kazakhstan* dated 7 July 2006; and
- (xi) *Law On Accounting and Financial Statements* dated 28 February 2007.

1.2 Mandatory Share Issuance

The Government (directly or through the national management holding company JSC National Welfare Fund Samruk-Kazyna) now has the right to have a bank issue shares to the Government without consent of the bank and its shareholders. The Government can exercise this right if the bank: (i) violates the applicable capital adequacy ratio or liquidity ratio (even once), or (ii) violates any other prudential requirements two or more times during any consecutive 12-month period.

The Government decides how many shares to acquire, although such number must not be less than 10% of the shares. The purchase price for the shares is determined by the Government on the basis of the market price for such shares as of the date when the Government took its decision to purchase the shares. However, the Government has the right to engage a valuator to determine the purchase price, rather than to purchase the shares at the existing market price.

The new shares will be issued to the Government without the need for approval by any of the bank's management bodies, such as the board of directors or shareholders. The bank's shareholders will not have a preemptive right to purchase the shares issued to the Government.

After the Government purchases the shares, it will be entitled to appoint up to 30% of the bank's management board and/or board of directors. This may result in a situation where a majority shareholder (holding, say, 90% of the bank's shares) prior to the issuance to the Government will have less than 50% representation on the bank's board of directors following the issuance to the Government. This is because of the legislative requirement that not less than 30% of a board members each Kazakhstani joint stock company must be independent, i.e., not affiliated with the company or its shareholders.

The Financial Stabilization Law does not provide how the Government shall appoint its members to the management board / board of directors. Presumably, such members are appointed without voting by the shareholders. In addition, it appears that the Government would also have the right to vote its shares in election of the other board members. Because Kazakhstan uses cumulative voting in the election of directors of a joint stock company, this could result in additional board member(s) being chosen by the Government.

The mandatory share issuance is likely to result in violation by the bank of its covenants under major loan agreements and other agreements with third parties. Although the Financial Stabilization Law is silent on this point, a bank which is forced to violate such agreements by a mandatory share issuance to the Government arguably may have the right to claim damages from the Government under the Civil Code.

The Government will be required to sell the shares after the bank's financial position improves so that it complies with the prudential requirements and other applicable requirements. The Government must sell the shares within one year after it purchased them. However, if the bank's financial position does not improve, this term can be extended indefinitely until the financial position improves. The FMSA will determine whether the bank's financial position improved on the basis of certain tests, which include certain subjective tests. It may not be entirely clear when such tests are satisfied.

The shares will be sold either through a stock exchange or to a particular purchaser. It is unclear whether the purchaser would have any of the special rights that the Government held as the shareholder, although the presumption is that the purchaser would be treated as any other

shareholder. Because there are no restrictions as to whom the Government may sell its shares, and is not obligated to offer its shares to the bank's other existing shareholders, the ownership of the bank following the Government's sale of its shares may be substantially different than before the mandatory issuance to the Government.

As of the date of this legal alert, the Government has not yet exercised its mandatory share issuance right. It has however, offered to purchase newly issued shares in four major Kazakhstani banks, not on the basis of this new right, but on the basis of a mutually agreed capital injection (see section 2.1 *Capital Injections* below).

This Government's right to a mandatory share issuance is in addition to the already existing right of the FMSA to buy shares from any existing shareholder of a bank (whether or not a major shareholder) without consent of such shareholder.⁴ The FMSA can exercise such right in case the bank's regulatory capital is negative. The purchase price for the shares is determined on the basis of the bank's total asset value minus the bank's liabilities as of the date when the FMSA takes a decision on purchasing the shares. After the FMSA buys the shares, it must immediately sell them at the same price to an investor who would undertake to procure the necessary strengthening of the bank's financial position.

1.3 Preventive Measures

The FMSA is responsible for monitoring the financial soundness of Kazakhstani banks. In addition to existing powers of the FMSA, the Financial Stabilization Law provides for certain preventive measures. Specifically, if the FMSA learns that a bank's financial position has deteriorated (which may be indicated by deterioration of liquidity coefficient or own capital ratio, etc.), the FMSA may require the bank to propose a plan for improving its financial position and to submit such plan to the FMSA.

If the FMSA is not satisfied with the bank's plan of improving its financial position, it will have the right to compel the bank to implement certain measures at the FMSA's discretion, including the following: (i) changing the bank's organizational structure; (ii) restricting the bank from accepting deposits; (iii) dismissing the bank's officers or other employees; (iv) suspending certain bank's operations if they pose high level of risk for the bank; (v) suspending the accrual and payment of dividends; (vi) increasing the amount of the bank's provisions; (vii) increasing the bank's regulatory capital, including by way of an increase in the bank's shareholders equity; (viii) restructuring the bank's assets; and (ix) decreasing the bank's expenses, including by way of closing down its branches and decreasing its shareholding in the bank's subsidiaries.

It should be noted that the criteria for the FMSA to determine whether the bank's financial position has deteriorated is vague and open-ended. As a result, the FMSA will have significant discretion in deciding whether to apply the above measures against a bank.

1.4 Possible Actions against Shareholders in Kazakhstani Banks

The Financial Stabilization Law clarifies and further advances the FMSA's right under the Banking Law to take certain measures against shareholders of a Kazakhstani bank. Such measures can be taken if a shareholder engages in actions that could harm the bank, or if a shareholder's financial position becomes "unstable" so that it could cause harm to the bank, or if

⁴ This existing right of the FMSA arises under the Banking Law.

the shareholder does not comply with orders of the FMSA, as well as in some other cases. While the FMSA will determine whether a particular shareholder's financial position is "stable," the amendments made by the new law do not provide any guidance or objective criteria in doing so. Thus, the FMSA will have significant discretion in deciding whether or not apply the actions against the shareholder.

Such measures can be imposed only on so-called "large shareholders," i.e., holders of 10% or more of the bank's shares, or on so-called "banking holdings," i.e., holders of 25% or more of the bank's shares.

In particular, the FMSA may order a large shareholder to decrease its direct or indirect shareholding in the bank to below 10%, or order a "bank holding" to decrease its direct or indirect shareholding in the bank to below 25%. It may also order a "bank holding" to dispose its shares in, or control over, subsidiaries of that "bank holding."

If the shareholder does not comply with the FMSA's order, the FMSA will have the right to take shares of such shareholder in trust management for up to three months. The FMSA will not need any court order for doing this. During the term of the trust management, the shareholder will not have the right to vote on its shares in the bank, to dispose of those shares or otherwise to do anything in relation to them. If the reasons for taking the shares in the trust management are not cured, the FMSA may sell the shares through a stock exchange and transfer the sale proceeds to the shareholder.

The Financial Stabilization Law introduces similar provisions to the Pension Law and Insurance Law authorizing the FMSA to impose actions against shareholders in pension funds and insurance companies, as well as to require them to increase the shareholder equity in certain cases.

1.5 Credit Ratings in Order to Accept Deposits

The amendments to the Banking Law made by the Financial Stabilization Law include prohibitions on banks from accepting deposits unless such banks have a major shareholder or a parent bank having a certain required minimum rating (to be established by the FMSA). This provision will come in effect on 1 January 2010.

This new requirement will present major issue for most Kazakhstani banks. To our knowledge, most Kazakhstani banks, including the three largest local banks, do not have a major shareholder with a credit rating.

1.6 Potential Criminal Liability

The amendments to Criminal Code made by the Financial Stabilization Law impose criminal liability on large shareholders of a bank, insurance company, or an open pension fund for willful actions (or refraining from acting) which caused insolvency or mandatory liquidation of that a bank, insurance company, or an open pension fund. The maximum penalty for this violation is imprisonment for up to three years plus fines in various amounts or confiscation of all the property of the person convicted.

Under Kazakhstani law, criminal liability applies only to individuals. So, if the shareholder is a legal entity, criminal liability under the amendments will be imposed on its chief executive officer.

This new provision is in addition to the already existing provision imposing criminal liability on management of a company (but not on the shareholders) for willful bankruptcy.

2. Other Measures

In addition to the Financial Stabilization Law, Kazakhstan is implementing certain other measures seeking to combat the financial crisis, as described below.

2.1 Capital Injections

In late October 2008, the Government announced that it was prepared to make a capital injection of up to US \$5 billion into certain major Kazakhstani banks. To date, four banks and their major shareholders have publicly confirmed their participation in the capital injection: BTA Bank, Halyk Bank, Kazkommertsbank and Alliance Bank. The closing of these injections is anticipated in March-April 2009. Separately, the government also proposed capital injections to ATFBank and Bank CenterCredit, but those banks rejected the proposal.

The proposed injections would be by way of purchasing of up to 25% of newly issued ordinary and preferred shares in those banks (by the state-owned fund JSC National Welfare Fund Samruk-Kazyna). In addition, the Government noted that it may provide financing by means of subordinated debt. According to publicly available information, the Government is contributing US \$1 billion to each of Halyk Bank and Kazkommertsbank by way of subscription to new shares and subordinated debt. The exact figures of the contributions to the other two remaining banks are expected to be confirmed in February.

The Government has stated that it does not intend to remain a shareholder in these banks for the long-term. Instead, the Government intends to sell the shares when the situation at the international financial markets improves. The Government has noted that it would not use its rights as the shareholder to interfere into the banks' business decision-making process. The banks' shareholders will have a 4-year option to buy back the purchased shares from the Government.

2.2 Distressed Assets Fund

In November 2008, the Government took a decision to create the so-called Distressed Assets Fund.⁵ The government stated that it intends to inject approximately US \$1 billion as a capital contribution, while it hopes to attract up to US \$5 billion from the international capital markets. The Fund has been established but to our knowledge has not yet started its operations.

The Distressed Assets Fund will be buying, primarily, loans secured by mortgage of real estate from Kazakhstani banks. The loans will be bought at a discount, which is expected to be in the range of 10%.

It is not yet clear how the Fund would raise funds. Some of the discussed alternatives indicate that it may issue mortgage backed notes either itself or through a securitisation SPV.

⁵ See Governmental Resolution *On Certain Issues Relating to the Creation of Joint Stock Company "Fund of Stressed Assets"* dated 1 November 2008.

2.3 Mortgage Financing and Real Estate Sector Support

In November 2008 the Government announced that it will arrange financing in the amount of up to US \$5 billion to stabilize the country's real estate market (to be financed partially by local pension funds, e.g., through their purchase of bonds issued by JSC National Welfare Fund Samruk-Kazyna). Some of this US \$5 billion will be advanced to certain Kazakhstani banks by way of loans for up to 15 years at low interest rates. The banks, in turn, will advance the borrowed funds to individual borrowers at a fixed interest rate equal to the National Bank's refinancing rate (currently 10.5%) for up to 15 years.

Certain categories of existing individual borrowers (social workers, etc.) will be entitled to receive mortgage loans with a fixed interest rate of 10.5% (which is significantly below the average market rate). All individual borrowers who already borrowed mortgage loans during the last three years will be entitled to a reduction of the interest rate to 12.5%. The reduced rate would be available to borrowers who have apartments not exceeding 120 square meters and which is their sole place of living.

Starting from early 2008, the Government has undertaken various measures to support the country's many unfinished residential property projects, in order to unwind the complex combination of the construction sector's weak financial condition, the substantial exposure of local banks to this sector and the complaints of citizens who lost their contributions (and sometimes apartments) in the affected projects. The measures originally included direct monetary intervention into the affected projects and/or the transfer of unfinished construction to newly created state-owned companies. Recently, the Government has suggested buying out the completed apartments at a firm price so that the construction companies have the funds to complete on-going projects or, if the original pool of investors-physical persons is formed, to co-finance such projects with less strict requirements for the price of construction. It remains to be seen how effectively the funds under the US \$5 billion program will be allocated to resolve unfinished residential property problem.

2.4 Further Measures

Other anti-crisis measures include state interventions to support critical infrastructure projects (to be done primarily through the Development Bank of Kazakhstan), small and medium enterprises (to be done through the state-owned investment fund JSC "Entrepreneurship Development Fund Damu," commercial banks and regional Akimats) and agriculture (to be done through KazAgroFinance and regional Akimats).



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Baker & McKenzie clients may obtain copies of the Financial Stabilization Law, in Russian and English, by contacting Zhanel Auezova at the above number or at: zhanel.auezova@bakernet.com

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