FITCH AFFIRMS HALYK BANK OF KAZAKHSTAN AT 'BB', UPGRADES KAZKOMMERTSBANK TO 'BB-'

Fitch Ratings-Moscow/London-31 August 2017: Fitch Ratings has affirmed Halyk Bank of Kazakhstan's (HB) Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) at 'BB' and removed them from Rating Watch Negative (RWN). Fitch has also upgraded Kazkommertsbank's (KKB) Long-Term IDRs to 'BB-' from 'CCC' and removed them from Rating Watch Evolving (RWE). The Outlooks on both banks' Long-Term IDRs are Stable. A full list of rating actions is at the end of this commentary.

The rating actions follow HB's acquisition of 96.81% of KKB's ordinary shares and the latter's recapitalisation in July 2017. The acquisition was performed after the provision of financial support for KKB by the state authorities of Kazakhstan and HB, which primarily involved the following:

- The state-controlled problem loan fund (PLF) provided KZT2.4 trillion to KKB's largest problem borrower, BTA, which repaid almost the entire amount of BTA's outstanding loans from KKB.
- KKB utilised the proceeds from the BTA loan repayment mainly to repay its own KZT0.6 trillion stabilisation loan from the National Bank of Kazakhstan (NBK) and KZT0.2 trillion of repo funding.
- KKB also purchased KZT1 trillion of long-term tenge-denominated sovereign bonds with an average coupon rate of 9.25%.
- KKB created KZT0.6 trillion of additional reserves, mostly for impaired loans.
- HB contributed KZT0.2 trillion to KKB's common equity.
- KKB generated an additional KZT0.2 trillion (pre-tax) gain on restructuring of deposits from the PLF.
- KKB entered into a KZT1 trillion foreign-currency swap with the NBK to be able to close its open currency position.

KEY RATING DRIVERS
HB'S IDRS AND VIABILITY RATING (VR)
The affirmation of HB's 'BB' Long-Term IDRs, which are based on its 'bb' VR, and the removal of these ratings from RWN, reflect Fitch's view that the acquisition of KKB should have only a moderate negative impact on the bank, whose post-acquisition credit profile should still be commensurate with the ratings.

The 'bb' VR continues to be driven by HB's strong domestic franchise, solid, albeit somewhat weakened profitability and capitalisation, as well as its limited refinancing risks and robust liquidity. The rating also takes into account HB's elevated loan impairment levels and the risks of potential further provisioning needs with respect to KKB's loans and property investments.

Fitch estimates HB's consolidated NPLs (after adding KKB's on a gross basis) to have increased to 22% of loans after the acquisition from 10% at end-1H17, while other impaired loans (mainly, restructured/distressed and high-risk bullet repayment loans) would have risen to 18% from 11%. Impairment reserves should have increased to 31% of gross loans from 11% at end-1H17, covering 77% of NPLs and impaired loans, which is a significant risk-mitigating factor.

Capital is now less robust than before the acquisition due to weaker IFRS ratios and an increased unreserved amount of NPLs and other impaired loans. The consolidated Fitch core capital (FCC) ratio is expected to have dropped to 14% post-acquisition from 22% of risk-weighted assets

(RWAs) at end-1H17. Meanwhile, NPLs and other impaired loans, less specific reserves, increased to 0.3x and 0.6x FCC from 0.1x and 0.3x of FCC at end-1H17, respectively.

Regulatory capitalisation is relatively unaffected, as equity investments in KKB are not deducted from HB's regulatory capital. HB's core Tier I, Tier I and total capital ratios all stood at 22% of regulatory RWAs at end-July 2017, almost unchanged from end-June 2017.

HB's consolidated profitability ratios will likely fall somewhat initially, due to KKB's weak pre-impairment performance. Fitch expects HB's pre-impairment profit/ net loans and operating profit/ RWAs ratios to fall by about 2 ppts from an annualised 8.4% and 4.8%, respectively, in 1H17. Internal capital generation could also reduce to low double digits from 20% for 1H17. Positively, pre-impairment profit should still be sufficient to fully reserve NPLs and impaired loans over three years.

The consolidated bank's liquidity and funding profile has remained strong with highly liquid assets estimated at about 60% of total assets, partly thanks to KKB's purchase of repoable sovereign bonds.

KKB'S IDRS AND VR
The upgrade of KKB's Long-Term IDRs to 'BB-' from 'CCC' reflects Fitch's view of a moderate probability of support for the bank, if needed, from HB. The Stable Outlook on KKB's Long-Term IDRs reflects that on its parent. Fitch classifies KKB as a strategically important subsidiary for HB given the former's significant 40% share in the group's consolidated assets, as well as the parent bank's direct ownership, control and supervision over its new subsidiary.

The one-notch ratings differential between HB and KKB's ratings reflects uncertainty about KKB's performance prospects and hence HB's future commitment to the subsidiary, KKB's large size relative to HB (which could constrain HB's ability to support in certain circumstances) and the currently untested institutional support to the bank. The cross-default linkage of KKB with HB provides only a moderate incentive to support, in Fitch's view, given HB's limited own Eurobonds (2% of group post-acquisition assets), which would be subject to acceleration.

The upgrade of KKB's VR to 'b' from 'f' (failure) follows the improvement in KKB's balance sheet structure and its capitalisation. This was primarily a result of the repayment in cash of loans by the distressed asset management company BTA, which equalled 60% of KKB's pre-acquisition loans. HB's KZT185 billion equity injection in KKB, coupled with the KZT170 billion pre-tax gain on restructuring of the PLF deposits also helped to improve reserve coverage of impaired loans.

The 'b' VR continues to reflect KKB's weak asset quality in light of its still high NPLs at 38% of post-acquisition gross loans and 28% of other impaired loans and its low estimated post-recapitalisation FCC ratio of 8% of RWAs. High loan impairment reserve coverage, at about 57% of gross loans (or 87% of combined NPLs and impaired loans) mitigates risks to a significant degree, but the unreserved amount of NPLs and impaired loans at a sizeable 0.9x FCC and 1.6x FCC, respectively, remain considerable. KKB's property investments, which may also be a source of risk, comprised a further 1.1x FCC.

Fitch expects KKB's pre-impairment profit is now close to break-even, meaning that any reserve creation would lead to losses. However, potential future improvement in funding and operating costs, combined with a gradual build up interest-earning assets, could be moderately positive.

KKB's liquidity profile significantly improved as the ratio of liquid assets to total liabilities jumped to 70% from 11% at end-1H17. The repayment of expensive funding, combined with the potential ordinary benefits of parental support, could improve depositor confidence, funding stability and reduce funding costs.

SUPPORT RATINGS (SR) AND SUPPORT RATING FLOORS (SRF)
The affirmation of HB's SR at '4' and SRF at 'B' reflects Fitch's view of a moderate probability of sovereign support. This considers positively the bank's exceptional systemic importance and close government relations. However, the ratings remain constrained by Kazakhstan's mixed track record of support to systemically important banks.

The upward revision of KKB's SRF to 'B' from 'No Floor' reflects its alignment with HB's SRF, as in Fitch's view any sovereign support would likely be made available to both banks. The withdrawal of the SRF reflects the fact that institutional (shareholder) support has now, in Fitch's view, become the primary source of support for KKB. The upgrade of KKB's SR to '3' from '5' mirrors Fitch's upgrade of the bank's Long-Term IDRs and reflects the potential for support from HB.

DEBT RATINGS
The senior unsecured debt ratings of both banks are aligned with their respective Long-Term IDRs, reflecting Fitch's view of average recovery expectations in case of default.

The upgrade of KKB's perpetual debt rating to 'B' from 'C' reflects the fact that this is now notched off the bank's Long-Term IDR, as Fitch believes the parent bank would likely neutralise the non-performance risk on its subsidiary bank's perpetual debt, if required. The two-notch difference between KKB's Long-Term IDR and the perpetual debt rating reflects the likely high loss severity in case of default, as the notes are deeply subordinated instruments.

JSC HALYK FINANCE AND JSC HALYK BANK GEORGIA
The removal from RWN and affirmation of the support-driven Long-Term IDRs and SRs of HB's subsidiaries - JSC Halyk Finance (HF) and JSC Halyk Bank Georgia (HBG) - mirrors the rating action on their parent.

RATING SENSITIVITIES
An upgrade of HB's ratings is unlikely in the near term, as it would require successful integration of KKB, a reduction in residual asset quality risks and normalisation of the latter's performance. HB's ratings could be downgraded in case of further deterioration in asset quality leading to significant capital erosion.

An upgrade of KKB's IDR to the level of HB would be possible if the bank becomes more deeply integrated with HB leading to a higher propensity to support it. This may be the case if HB develops a clear strategy for the bank and aligns KKB's risk management more closely with its own, and if KKB demonstrates an ability to generate considerably stronger core profits. KKB's IDRs could be downgraded should the parent's ability or propensity to support KKB reduce.

KKB's VR could also be downgraded if, in Fitch's view, it needs significant additional impairment reserves, or if core profitability is persistently weak, either of which could result in an erosion of core capital.

An upgrade of KKB's VR would require its legacy problem loans to be substantially reduced without impairing the bank's capital position. Improved capitalisation and stronger core profitability could also be positive for the rating.

HF and HBG's ratings will likely remain linked to HB's Long-Term IDRs.

Debt ratings will likely move in tandem with the respective bank's Long-Term IDRs.

The rating actions are as follows:

Halyk Bank of Kazakhstan
Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs): affirmed at 'BB', removed from Rating Watch Negative (RWN); Outlook Stable
Short-Term Foreign- and Local-Currency IDRs: affirmed at 'B'
Viability Rating: affirmed at 'bb', removed from RWN
Support Rating: affirmed at '4'
Support Rating Floor: affirmed at 'B'
Senior unsecured debt: affirmed at 'BB', removed from RWN

Kazkommertsbank
Long Term Foreign- and Local-Currency IDRs: upgraded to 'BB-' from 'CCC'; removed from RWE; Outlook Stable
Short Term Foreign- and Local-Currency IDRs: upgraded to 'B' from 'C'; removed from RWE
Viability Rating: upgraded to 'b' from 'f'
Support Rating: upgraded to '3' from '5'; removed from RWP
Support Rating Floor: revised up to 'B' from 'NF'; removed from RWP; withdrawn
Senior unsecured debt long-term rating: upgraded to 'BB-' from 'CCC'; removed from RWE
Senior unsecured debt short-term rating: upgraded to 'B' from 'C'; removed from RWE
Perpetual debt rating: upgraded to 'B' from 'C'; removed from RWE; recovery rating withdrawn at 'RR6'

JSC Halyk Bank Georgia
Long-Term IDR: affirmed at 'BB-', removed from RWN, Outlook Stable
Short-Term IDR: affirmed at 'B'
Support Rating: affirmed at '3', removed from RWN

JSC Halyk Finance
Long-Term Foreign- and Local-Currency IDRs: affirmed at 'BB', removed from RWN, Outlook Stable
Short-Term Foreign- and Local-Currency IDRs: affirmed at 'B'
Support Rating: affirmed at '3', removed from RWN

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Applicable Criteria
Global Bank Rating Criteria (pub. 25 Nov 2016)
https://www.fitchratings.com/site/re/891051
Global Non-Bank Financial Institutions Rating Criteria (pub. 10 Mar 2017)
https://www.fitchratings.com/site/re/895236

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