Shelter Sector Reform Project
Newly Independent States of the Former Soviet Union

An ICMA Report

Prepared for the Office of Housing and Urban Programs
Agency for International Development

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STATUS REPORT
ON THE IMPLEMENTATION
OF HOUSING FINANCE SECTOR REFORM
IN KAZAKHSTAN

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ABSTRACT

On September 6, 1993, President Nazarbaev issued Presidential Decree No. 1344, *"On a New Housing Policy,"* which, along with subsequent regulations of the Cabinet of Ministers, set out a detailed program for reform of the housing and housing finance sectors in the Republic of Kazakhstan (ROK). Central to the implementation of the new housing policy was the creation of the Ministry of Construction and Housing ("Minstroi") to administer all ROK public sector housing programs and a specialized housing credit institution, Zhilstroibank ("Zhilstroi"), which would serve both as the administrator of government housing finance subsidy programs and the institution charged with the development of a market-based housing finance system in Kazakhstan.

Since November, 1993 the U.S. Agency for International Development ("USAID"), through ICMA, has provided technical assistance to Minstroi and Zhilstroi to assist them in designing and implementing market-based housing and housing finance programs and to provide training for the management and staff of these and other Kazakhstani institutions. The consultant's visit to Kazakhstan from April 11 through April 21, 1995, was a continuation of this technical assistance and training effort. There were two purposes for the consultant's visit. The first was to meet with senior officials from Minstroi and Zhilstroi to determine what progress had been made in housing finance sector reform and, more specifically, what new housing finance programs had been introduced or were under consideration. The second phase of the assignment was to teach a one-week course in the Principles of Real Estate Finance and Investment as the initial seminar in ICMA's Advanced Professional Training in Real Estate Finance and Investment Program. This report addresses the technical assistance components of the consultant's visit and evaluates the accomplishments and failures of the implementation of housing finance sector reform. A separate report discusses the housing finance training elements of the consultant's work.

EXECUTIVE SUMMARY

On September 6, 1993, President Nazarbaev issued Presidential Decree No. 1344, *"On a New Housing Policy."* The Presidential Decree set out a detailed program to restructure the housing and housing finance sectors in the Republic of Kazakhstan ("ROK"). The objectives of the New Housing Policy were to create a more market-based housing construction, distribution and financing system, to implement a scheduled phase-out of housing subsidies for the general population and to target a reduced subsidy program towards low income and other "socially protected" classes, to introduce a system of mortgage finance for home construction, purchase and upgrading and to foster competition and greater efficiency in the housing construction sector. Although some of the policies and programs mandated by the New Housing Policy and subsequent implementing regulations have been realized, a number had not been achieved by the end of April, 1995.

USAID has provided housing finance technical assistance through ICMA for the last two years. The extent of this technical assistance has been somewhat limited due to policy issues raised by the structure and function of the housing finance system envisioned by the New Housing Policy. Of particular concern was the creation of a state-owned housing and savings bank - Zhilstroibank - in which all housing finance functions were to be concentrated. The mission of the Zhilstroibank was to administer government ("GOK") housing finance subsidies, provide 30 year mortgage loans at a 5 percent interest rate to designated segments of the population and mobilize savings for housing. The GOK and USAID negotiated an agreement that USAID would provide technical assistance to Zhilstroibank if the GOK agreed to have the bank function primarily as an apex institution which would support and facilitate the establishment of a competitive, market-based housing finance system involving a broad base of commercial banks.

The purpose of this report is to evaluate:

(1) the status of implementation of the New Housing Policy and other housing finance sector reform initiatives as of April, 1995;

(2) impediments to the development of the housing finance sector; and,

(3) the need for further reform in the sector.

The experience of the last eighteen months since the Presidential Decree "On a New Housing Policy" was issued has demonstrated that although progress has been made in introducing a market-based housing finance system in Kazakhstan, much remains to be accomplished. Development of an effective and efficient long term financing market is not feasible when the prospects for inflation, interest rates and real incomes are as uncertain as they are in Kazakhstan. The GOK may have to rethink its approach to housing finance sector reform to deal with the difficult fiscal, economic and market conditions in Kazakhstan today.

STATUS REPORT ON THE IMPLEMENTATION OF HOUSING FINANCE SECTOR REFORM IN KAZAKHSTAN

I. BACKGROUND

A. THE NEW HOUSING POLICY

On September 6, 1993, President Nazarbaev issued Presidential Decree No. 1344, *"On a New Housing Policy."* The Presidential Decree set out a detailed program to restructure the housing and housing finance sectors in the Republic of Kazakhstan ("ROK"). The objectives of the New Housing Policy were to create a more market-based housing construction, distribution and financing system, to implement a scheduled phase-out of housing subsidies for the general population and to target a reduced subsidy program towards low income and other "socially protected" classes, to introduce a system of mortgage finance for home construction, purchase and upgrading and to foster competition and greater efficiency in the housing construction sector. A summary of the key provisions of the New Housing Policy dealing with housing finance is included as Annex A to this report.

Subsequent regulations of the Cabinet of Ministers of the ROK (10.06.93) set an ambitious timetable for implementation of the New Housing Policy. The goal was to adopt the required policies and regulations and establish the new institutions mandated in the policy during the first half of 1994. Although the institutions had been established, and some of the policies and programs mandated by the New Housing Policy had been realized, some of the reform initiatives set out in the New Housing Policy had not been implemented by the end of April, 1995.

B. THE CREATION OF MINSTROI AND ZHILSTROIBANK

Central to the implementation of the new housing policy was the establishment of the Ministry of Construction and Housing ("Minstroi") to administer all government ("GOK") subsidized housing finance programs and a specialized housing credit institution, Zhilstroibank ("Zhilstroi"), which would serve both as the administrator of government housing finance subsidies and the institution charged with the development of a market-based housing finance system in Kazakhstan. These institutions have been established, but have not been able to perform their intended functions due to a number of economic, political and institutional factors.

C. HOUSING FINANCE POLICY ISSUES OF THE NEW HOUSING POLICY

The New Housing Policy raised several serious financial sector policy reform issues. The housing finance system for Kazakhstan conceived by the New Housing Policy was founded on the concept of Zhilstroi as a government owned and funded full-service universal bank providing a broad range of housing related financial services directly to the public, including construction and mortgage loans and "construction savings" accounts. The creation of a new state-owned bank with a virtual monopoly in the housing finance sector was inconsistent with the GOK's overall program of financial sector reform. Although the Housing Policy states the GOK's intention to divest Zhilstroi's banking operations by 1997 and limit the institution's functions to those of a facilitator of housing finance, the prospects for such divestiture did not appear likely in the projected economic environment in Kazakhstan.

II. USAID TECHNICAL ASSISTANCE FOR HOUSING FINANCE

A. TECHNICAL ASSISTANCE PROGRAM

An ongoing program of USAID technical assistance for housing finance has been provided through ICMA over the last two years. This program has focused on institutional development in the housing finance sector. The principal elements of the technical assistance program have been:

a. Evaluation of and recommendations for the structure, institutions and operations of a competitive housing finance system in Kazakhstan;

b. Recommendations for housing finance policies, regulations and programs to support sector reform;

c. Development of mortgage and construction loan policies, procedures, documents and credit instruments suitable to the current economic environment in Kazakhstan;

d. Design of programs and products to mobilize savings and investment funds for housing; and,

e. Support for the entry of commercial banks into the housing finance market.

B. LIMITATIONS ON TECHNICAL ASSISTANCE FOR ZHILSTROI

USAID determined that it would be inconsistent with financial sector reform policies to support the development of Zhilstroi as a government monopoly housing and savings bank. USAID's position was that the best way to develop a housing finance system would be to encourage banks to enter the market through well supervised and managed financing programs. USAID's concerns about Zhilstroi and the GOK's entire housing finance sector strategy were enunciated in a letter from Mission Director Craig Buck to the Vice President of Kazakhstan in April, 1994. Because of its concerns, USAID proposed that technical assistance be provided to Zhilstroi only if the GOK committed to four policy conditions:

1. The Zhilstroi Will Function as a Housing Credit Facility Which Will Support the Development of a Competitive Housing Finance System in Kazakhstan.
2. GOK Housing Subsidy Programs Administered by Zhilstroi Will be Kept Separate from Banking Operations.
3. The Mortgage and Construction Credits Offered by Zhilstroi Will Provide for Cost Recovery and a Return on the Bank's Investment.
4. Zhilstroi Will Adopt Sound Credit Underwriting, Servicing and Risk Management Policies, Procedures and Practices.

The GOK determined that they could not agree to all of the four conditions precedent to the provision of a comprehensive program of USAID technical assistance to Zhilstroi. The GOK and USAID agreed to a more limited technical assistance program for Zhilstroi which was set out in a July 1, 1994 letter from Mission Director Buck to the Vice President. USAID agreed to provide specific training and technical assistance to Zhilstroi on the condition that the bank limit its retail banking activities to a single office in Almaty. Outside Almaty, mortgage lending and savings mobilization programs would be offered through banks with which Zhilstroi would conclude agency, onlending, joint venture or similar arrangements. Financing for housing construction, completion, improvement or maintenance to commercial developers, companies and other organizations could be offered through all bank branches. Zhilstroi also was expected to comply with the other three conditions of the comprehensive technical assistance proposal: (1) to separate its subsidy administration function from bank operations, (2) to use loan structures which provide for cost recovery, and (3) to employ sound credit underwriting and servicing policies and procedures.

Since the execution of the July 1, 1994 agreement, technical assistance has been limited to short term technical assistance for specific projects which meet USAID criteria, including the design and implementation of: (1) financing programs for commercial developers engaged in competitive bidding and completion of unfinished housing; (2) sound credit underwriting and servicing policies and procedures; (3) agency and onlending agreements with other banks; (4) lending and funds mobilization programs suitable to the economic and financial environment in Kazakhstan; and (5) technology for managing real estate finance operations.

C. IMPACT OF USAID TECHNICAL ASSISTANCE

This evaluation of the status of housing finance sector reform in Kazakhstan indicates that USAID housing finance technical assistance has had a material impact on housing finance policies and programs at both the GOK and Zhilstroi levels. GOK resolutions and decrees and Zhilstroi's internal loan policies and procedures have incorporated many of the market concepts endorsed by USAID and have laid the foundation for the implementation of sound mortgage finance programs when market and economic conditions in Kazakhstan become more favorable for credit financing.

III. SUMMARY AND CONCLUSIONS

The experience of the eighteen months since the Presidential Decree "*On a New Housing Policy*" was issued has demonstrated that although progress is being made to introduce a market-based housing finance system in Kazakhstan, much remains to be accomplished. Development of an effective and efficient long term financing market is not feasible when the prospects for inflation, interest rates and real incomes are as uncertain as they are in Kazakhstan. The GOK may have to rethink its approach to housing finance sector reform to deal with the difficult fiscal, economic and market conditions in Kazakhstan today.

The GOK is undertaking initiatives to stabilize the Kazakhstani economy. At the same time, government officials should address the other requirements for a well functioning housing finance system.

1. A mortgage law and other laws and regulations necessary for the maturation of a market-based housing finance system should be enacted as soon as possible so that financial institutions can begin to consider entering the housing finance market. In the interim, the GOK should consider establishing a mortgage insurance program to reduce the credit risk of mortgage lending.
2. The GOK should design a subsidy system which targets limited GOK resources to those most in need and which leverages budget resources through public-private partnerships, financial and regulatory incentives, credit guarantees and other techniques.
3. The goals and objectives of Zhilstroibank should be re-evaluated and clearly defined and the institution's programs designed to achieve the defined goals and objectives.
4. The GOK and NBK should identify and remove any legal, regulatory, tax and procedural impediments to entry into the housing finance market by Kazakhstani banks.
5. The development of housing finance should be coordinated with other financial sector reform efforts.
6. Lease-purchase financing should be analyzed fully and if this structure appears feasible to both sellers and buyers, the financing structure should be introduced in a demonstration project. USAID housing finance consultants in Russia have been working on a lease-purchase structure and several Russian banks have already introduced lease-purchase programs. The Russian experience can provide useful guidance for the implementation of a similar financing program in Kazakhstan.
7. Funds mobilization programs should be evaluated to determine their appropriateness for Kazakhstan. These programs could include public-private partnerships, tax and other financial incentives and debt and equity capital market financing for housing construction and purchase.

IV. IMPLEMENTATION OF HOUSING FINANCE SECTOR REFORM

Several housing finance sector reform initiatives had been implemented and were operational as of the end of April, 1995, but much remained to be done to create a functioning market system for housing finance in Kazakhstan.

A. ADOPTION OF MARKET-BASED HOUSING FINANCE POLICIES

Regulations have been issued by the Cabinet of Ministers, the National Bank of Kazakhstan ("NBK"), the Minstroi and the Ministry of Finance ("MOF") which have incorporated many of the recommendations which have been made by ICMA and other USAID advisors. These policies and regulations include provisions which require:

- reduction of GOK housing finance subsidies and targeting of subsidies to those most in need;
- risk sharing in GOK housing finance programs between the GOK, the lender and the borrower;
- appraisals of real property to be financed performed by trained appraisers according to standard appraisal procedures and loan underwriting criteria based on the ability to pay;
- lending to individuals and companies based on the borrower's creditworthiness and ability to pay; and,
- mortgage loan financing structures which are adjusted for inflation to provide a positive real return to the lender.

Whether these regulations are being implemented fully is an unanswered question, but as the banking and bank regulatory systems develop in Kazakhstan, more prudent credit underwriting standards, loan pricing based on a positive real return and risk management will be adopted by all well managed banks.

B. RATIONALIZATION OF GOK SUBSIDIZED HOUSING FINANCE PROGRAMS

1. Housing Finance Subsidies

The New Housing Policy included the majority of Kazakhstani households in the definitions of privileged classes of the population entitled to receive housing finance subsidies (See Annex A). The GOK recognized that the budgetary resources required to provide subsidies of this magnitude were beyond the ability of the GOK to support. The Housing Policy also mandated an up-front (down payment) subsidy, an unrealistically low interest rate of 5% and a long maturity of 30 years for GOK assisted mortgages. Mandating the interest rate and maturity for GOK assisted mortgages is contrary to the goal of developing a market-based housing finance system. Financial institutions must be permitted to price housing loans based on market conditions and their cost of funds and operations. If the GOK determines that it is sound public policy to provide an interest rate subsidy to increase housing affordability until economic and financial conditions in the country improve and interest rates decline, the subsidy structure should be designed to maximize the benefit of the scarce resources available.

The New Housing Policy did acknowledge that 5% mortgages should be indexed to provide a positive real return to the lender and a method of indexation adjusting the tenge mortgage payment to the dollar exchange rate was adopted by the Ministry of Finance. However, almost complete reliance on indexation to provide a return on a financial institution's investment in its mortgage portfolio creates excessive risk for the lender and makes assisted housing finance very unattractive. These loans would not be prudent investments for private sector financial institutions. If the banking system is unwilling to provide assisted housing credit under the terms and conditions set out in the Housing Policy, Zhilstroi will be the only institution offering subsidized loans.

2. Outlook for ROK Budget Funding for Fiscal Year 1995-1996

The consultant met with Minstroi Deputy Minister Zhitpispai Duisembekov and his staff to discuss Minstroi's objectives and plans for 1995 and 1996 relating to housing finance and housing finance subsidies. Mr. Duisembekov's department is in charge of Minstroi's housing finance programs. Mr. Duisembekov discussed the ROK budget constraints on the provision of housing finance subsidies. Funds have been appropriated for housing finance in the ROK FY 1995-1996 budget approved in March, 1995. The budget appropriated 3.58 billion tenge (US$ 60 million at an exchange rate of Tg 60:US$ 1) for Zhilstroi, of which 2.2 billion tenge (US$ 37 million) would be allocated to increase the institution's charter fund (i.e. paid in capital).

As of the end of April, 1995, Minstroi was awaiting a specific budget resolution committing funding to implement the New Housing Policy for the current fiscal year. At that time, a draft resolution regarding Zhilstroi's legal organization as a state bank or as a commercial bank and funding for Zhilstroi was being negotiated by Minstroi, Zhilstroi and the Vice President and First Deputy Prime Minister. Minstroi and Zhilstroi were charged with the responsibility of preparing a draft proposal for submission to the GOK. Minstroi officials were not very optimistic that Zhilstroi actually will receive the funding included in the FY 1995-96 budget because of potential GOK revenue shortfalls.

3. Minstroi Housing Finance Programs

From its creation in November, 1993, through April, 1995, Minstroi had focused its attention and efforts on resolving the housing problems of low income families and other disadvantaged groups through the provision of GOK housing subsidies. Today Minstroi recognizes that resolution of the housing problem depends on the development of a viable housing finance system and that in 1995 and 1996, the GOK's efforts should concentrate more on facilitating the completion of unfinished housing projects and on mobilization of non-GOK funds for housing, including household savings, domestic investment capital and international donor agency loans and grants. Tax incentives to stimulate housing savings and investment are under consideration as part of the tax reform program and new capital market instruments are being authorized. Minstroi is interested in information about public-private partnerships and other funds mobilization initiatives which might be appropriate for Kazakhstan.

4. Completion of Unfinished Housing Projects

Minstroi officials realize that fiscal realities require them to implement a plan to rationalize and target housing finance subsidies. Because of the uncertainty about the availability of state budget funding, Minstroi will be concentrating its efforts in 1995 on developing ways to fund completion of the many unfinished housing units throughout the country. This unfinished construction is a significant unutilized asset in which the GOK has invested billions of tenge. The problems facing Minstroi are to identify the housing projects which are physically and financially feasible to complete, to develop procedures for conveying the unfinished housing projects for completion and sale and to design appropriate incentives to commercial developers capable of completing the projects and to banks to finance the completion and purchase of these housing units.

5. Mortgage Insurance

Another Minstroi priority for 1995-1996 is to evaluate the appropriateness and feasibility of establishing a GOK-sponsored mortgage insurance system as an incentive to banks to provide housing finance. Mr. Duisembekov provided the consultant with a short issues statement (See Annex B) setting out his staff's initial thinking about how to approach the question of mortgage insurance. Minstroi recognizes that mortgage insurance will be effective only if the GOK enacts a mortgage law and laws governing credit guarantees. They also endorse a policy that any mortgage insurance program which may be adopted should involve risk sharing among the borrower, the lender and the insurer rather than a 100% government guarantee. The consultant regards Minstroi's position on these two critical issues as very positive and indicative of Minstroi's receptivity to the adoption of sound market policies.

The recent collapse of the private loan insurance market also was discussed. Banks in Kazakhstan required commercial borrowers to provide credit insurance policies from insurance companies as a condition to granting a credit. However, when the borrowers defaulted, the insurance companies could not pay the claims filed by the banks. The NBK responded by terminating all credit insurance programs for insurance companies and effectively suspending the insurance licenses of most insurance companies pending the enactment of a new insurance law. Given the current crisis in the insurance industry in Kazakhstan and the uncertainty about the future prospects of the domestic insurance industry, it does not appear feasible for mortgage insurance to be offered by private insurance companies, even with GOK participation. If mortgage insurance is offered at all, it will have to be through the GOK or a newly created government agency.

The consultant provided Minstroi with a short paper on mortgage insurance (See Annex B) discussing the FHA system in the U.S. and the problems and prospects of establishing a mortgage insurance system in an emerging market economy. Mr.

Duisembekov requested that ICMA provide additional technical assistance to assist him in making recommendations to the GOK regarding a mortgage insurance system for Kazakhstan. Specifically, he has requested information about the terms, conditions and pricing of FHA and other government sponsored mortgage insurance programs and, if possible, consultation by FHA officials.

C. SUPPORT FOR A COMPETITIVE HOUSING FINANCE SYSTEM

There are indications that several banks could enter the housing finance market within the next year. Most large banks already extend housing credit to their officers and employees and have a growing housing loan portfolio. Kazakhstani banks also have real estate owned ("REO") as a result of defaults on commercial loans where real estate was pledged as collateral. The banks must provide financing to divest these assets. Other institutions are considering real estate as a viable line of banking business. The participation of senior officers of Kazcommercebank and Turan Bank in ICMA's real estate finance and investment training program is evidence of the potential interest of banks in developing real estate finance capabilities.

Bank real estate finance operations probably will be part of vertically integrated real estate services subsidiaries or "strategic alliances" similar to those found in Germany and other EU countries. These subsidiaries will own and develop housing projects, frequently in joint ventures with commercial developers, market the houses through a captive real estate brokerage firm, sell property insurance through an affiliated insurance company and finance the purchase of the houses through the bank or a mortgage bank controlled by the bank. Banks considering adopting this business strategy may be interested in completing unfinished housing projects on a direct investment or joint venture basis if the government contributes the project to the bank at no cost or on a deferred payment basis.

The consultant met with the Vice Chairman and other senior officials of Turan Bank to discuss the bank's interest in developing their real estate finance capabilities. The officers interviewed indicated that housing finance is part of the bank's strategic plan, but its current weak financial condition, combined with the unfavorable economic and financial conditions in Kazakhstan, prevented the bank from developing a housing finance program today. The bank was interested in working with ICMA to create an in-house training program for regional office bank managers.

D. ESTABLISHMENT OF ZHILSTROI AS A SPECIALIZED HOUSING CREDIT FACILITY

The New Housing Policy mandated the establishment of a housing construction bank owned by the Council of Ministers and funded primarily through GOK budget appropriations. The mission of the bank was to administer GOK housing finance subsidies, provide 30 year mortgage loans at a 5 percent interest rate to designated segments of the population and mobilize savings for housing. The bank, called the Zhilstroibank, was established in early February, 1994. As of April, 1995, Zhilstroi had an organization structure in place at its

Almaty headquarters and six oblast branch offices and had introduced both lending and savings mobilization programs.

Under the terms of the July 1, 1994, agreement between USAID and the GOK, Zhilstroi has limited the housing credit and savings mobilization activities offered through its oblast branches and offers its full range of services only at its Almaty headquarters. Zhilstroi concluded an agency agreement with Narodny Bank, which has an extensive retail banking network throughout Kazakhstan. However, Zhilstroi has not been successful in implementing the agency agreement with Narodny Bank due as much to reluctance by Narodny Bank to cooperate with Zhilstroi as to a failure on Zhilstroi's part. In addition, the Chairman of Narodny with whom Zhilstroi negotiated the agency agreement is no longer with Narodny and apparently there has been some turmoil within the management of the bank.

The principal reason why Zhilstroi has been prevented from fulfilling its mandate and complying with the terms of the GOK's agreement with USAID to operate as an apex institution has been the failure of the GOK to provide the funding promised to adequately capitalize the bank and provide it with a funding source for its housing loans. The 1994 GOK budget originally committed over 800 million tenge (US$ 13.3) to Zhilstroi to capitalize the bank, fund its mortgage credit operations and finance subsidized mortgage credits to people who had been waiting on the housing lists for ten years or more. Due to the fiscal difficulties which the GOK experienced during the year, the bank did not receive anywhere near the level of funding budgeted. As of April, 1995, Zhilstroi had received only the initial capitalization of 30 million tenge (US $500,000), from the state budget, but as of April, 1995, Zhilstroi had received only 80 million tenge (US $1.33 million) in funding for privileged mortgage credits for eight oblasts and 8 million tenge (US $133,333) to acquire a portfolio of "old" housing loans from Narodny Bank. Other than the funds designated for the purchase of the Narodny Bank housing loan portfolio, all of the credit resources provided to Zhilstroi to date have been allocated for subsidized mortgage credit to people on the housing queue for ten years or more. Zhilstroi has been left to its own devices to raise funds to finance market-based housing credits. Without an adequate and stable source of funds to finance its lending programs, Zhilstroibank cannot be an effective catalyst for the development of housing finance system in the Kazakhstani financial sector.

E. HOUSING CREDIT POLICIES AND PROCEDURES AND PROGRAMS

Other than Zhilstroi, few banks have adopted housing finance policies and procedures. Zhilstroi has adopted and the NBK and the MOF have approved policies and procedures for both the bank's subsidized and market housing finance programs. These policies and procedures require valuation of the property to be financed in accordance with established appraisal procedures and loan documentation and loan underwriting based on the market principles promoted by USAID-sponsored training and technical assistance. ICMA consultants reviewed the drafts of these policies and procedures and provided comments and suggestions for amendment, many of which were incorporated into the final regulations and policies.

F. HOUSING CREDIT PROGRAMS

Zhilstroi's housing credit programs include a German-style contract savings program and an inflation-adjusted mortgage indexed to the US$/tenge exchange rate. As of late April, 1995, there had been minimal lending activity in these programs. Zhilstroi also was in the process of developing a financing program for the completion and sale of unfinished apartment units and a home equity credit program.

1. Construction and Other Housing-Related Commercial Loans

Zhilstroi has extended approximately 100 million tenge (US $1.67 million) in commercial housing-related credits. Of the total, 70 million tenge were funded through the NBK's directed credit program. The recipients of directed credits were designated by Minstroi and the MOF and included commercial developers, local administrations and a bank located in Akmola which onlent the proceeds to a developer for completion of unfinished apartment projects. Approximately 25 million tenge in credits were granted on a market basis with funds borrowed from the NBK at the regular NBK auction. The remaining loans were funded through Narodny Bank and with Zhilstroi's own resources.

The primary purpose of Zhilstroi's commercial housing credits was to fund the completion of unfinished apartments, although some loans were for working capital to building materials manufacturers and suppliers. ICMA does not know to what extent these credits were underwritten properly. Directed credits may have received little scrutiny because they were guaranteed by the MOF. Zhilstroi management maintains that the credits granted on a market basis were underwritten in accordance with the bank's credit policies and procedures. However, ICMA has not had the opportunity to review and evaluate the credit files for these loans. In addition to the customary concerns about credit quality, there was a substantial concentration of credit to one borrower to complete unfinished apartments in Akmola.

The performance of the construction credits granted by Zhilstroi has been mixed, but may have been as good as could have been expected under the circumstances. Zhilstroi management provided the consultant with information on the current repayment status of five of the borrowers. Management reported that as of April, 1995, the Orgcapstroi, Pavlodar and Zhamboul credits, totaling 30 million tenge, had been repaid in full and that the Akhmolaazatstroyinvest and Plastic loans were in default. No information was given on the remaining five credits, but indications were given that these credits were also seriously delinquent, if not officially in default. The problems cited were cost overruns due to inflation in building materials costs and the necessity to pay for off-site infrastructure because local administrations had not put in the required improvements. The unanticipated increase in construction costs prevented commercial developers from completing the projects with the funds available. The proceeds of some loans made to some local administrations appeared to have been used for emergencies and natural disasters rather than for their intended purposes.

The Akmola loans, with an aggregate outstanding balance of approximately 25 million tenge, were in default as of the end of April, 1995. One of the reasons for the problems in Akmola was that Zhilstroi did not have a regional office located in that city, proving the principle that financial institutions should not extend credit outside their market areas. As of late April, Zhilstroi was negotiating work-outs with the borrower in default and had accepted one 90% complete 23 unit apartment building appraised at 16 million tenge in partial satisfaction of the debt. Zhilstroi was evaluating other parcels of real estate owned by the defaulted borrower to identify those which it would be willing to accept in payment for the remaining 25 million tenge plus accrued interest due.

A 6 million tenge loan to the Plastic building materials manufacturing company also was in default as of the end of April, 1995. The loan was guaranteed by the Kurylys state stock holding company, but collection of the amount due on this credit appeared doubtful.

2. Privileged Mortgage Credits

As of late April, 1995, Zhilstroi also had extended privileged mortgage credits funded with GOK budget appropriations and had received additional funding of 20 million tenge for this subsidized housing finance program. There is some question whether these mortgages were subjected to even minimal underwriting. One credit officer expressed concern that the bank was not underwriting these credits, but was granting loans based solely on the borrower having been designated as a beneficiary by the local administration. The mortgage credits granted have been at the mandated 5% interest rate. It is not certain whether the outstanding balances on these credits are being indexed to adjust for inflation.

3. Proposed Housing Credit Program to Finance the Completion and Sale of Unfinished Housing Projects

Zhilstroi has been developing a program to finance the completion and sale of unfinished housing projects (See Annex C for Zhilstroibank's draft regulations), beginning with the REO project acquired in partial satisfaction of one of its Akmola construction loans. As of the end of April, 1995, the details of this financing program had not been finalized. The basic concept is that a local administration or Minstroi would convey title to an unfinished housing project to Zhilstroi which the bank had determined would be feasible to complete and sell at market prices. The local administration or Minstroi would receive no payment for the property or would defer payment until all units were sold. Purchasers of the units to be completed would be qualified by the local administration and Zhilstroi and would be required to deposit funds with Zhilstroi equal to each buyer's pro rata share of the cost to complete construction. The buyers also would be required to organize a homeowners' association to enforce the deposit and repayment requirements of the program and to manage the property when it has been completed. Zhilstroi had not yet determined whether the bank or the homeowners' association would retain the general contractor to complete construction.

Upon completion of construction, Zhilstroi would enter into a lease-purchase agreement with each buyer or execute a master lease-purchase agreement with the homeowners' association with each buyer co-signing or guaranteeing the master lease-purchase agreement individually. Zhilstroi anticipates that the term of the lease will be ten years with a portion of each lease payment applied to the purchase price of the housing unit. If an outstanding balance remains at the end of the term of the lease, the bank would consider granting a short term mortgage until the full purchase price has been paid in full. Zhilstroi has not determined how the lease-purchase financing will be priced to provide a real rate of return to the bank.

This concept appears to have merit and could be developed as a model for financing apartment completions throughout Kazakhstan and Kyrgyzstan. Zhilstroi's program for financing unfinished apartments appears to be consistent with ICMA's efforts to identify and secure financing for a financially feasible apartment completion project. Technical assistance to design a financially sound construction and lease-purchase financing package could result in a significant volume of apartment completions and lending for housing.

4. Lease-Purchase as a Viable Transition Housing Finance Structure

Uncertainty about conveyancing of title to real property and the failure of the government to enact an effective mortgage law have led Kazakhstani bankers to consider lease-purchase arrangements as a housing finance option. Russian bankers have already implemented lease-purchase programs. The laws governing eviction of tenants are more clearly enforceable than the repossession authority granted under the Law of Pledge. Evicting tenants also is less politically sensitive than evicting home owners. Until a mortgage law has been in force for several years, the lease-purchase financing structure may be the lowest risk option for housing lenders. The key question on which the feasibility of lease-purchase financing will turn is whether the tenant-buyers will be able to afford a lease payment which will make the investment financially attractive to the bank.

A lease-purchase is a combination real estate rental, sales and finance technique. It is a property lease for a fixed time period at the end of which the tenant-buyer purchases the property. A lease-purchase obligates the tenant to purchase the property at the end of the lease. The lease-purchase may be structured so that the property is paid in full at the expiration of the lease term or, more commonly, with a balloon payment at the expiration of the lease term. If the landlord-seller is a financial institution or is affiliated with a financial institution, there may be a commitment to finance the buy-out. The terms of the lease-purchase agreement may give the tenant-buyer the option to purchase the property by paying off the outstanding balance on the purchase price at any time during the lease term or at specific time intervals.

Tenant-buyers find lease-purchase arrangements attractive because they are able to obtain housing with no down payment or a lower down payment than an outright purchase. In Kazakhstan, buyers would have pay the full purchase price in cash or have at least a 20% down payment if they were able to obtain a mortgage from Zhilstroi or another lender on the terms specified in the Housing Policy. Many prospective home buyers do not have sufficient cash to pay the full purchase price or meet down payment requirements. The lease-purchase solves this problem by giving the tenant-buyer a rent credit towards the down payment. It is similar to a contract savings scheme, with the advantage that the tenant-buyer can occupy the property during the contract period. Typically the rent credit is 10 to 100 percent of the monthly rent, depending on how motivated the seller is to sell.

In the case of unfinished apartments, the seller may require that the tenant-buyers pay all or a large portion of the cost to complete the units up-front. In this way the seller-landlord will not incur any financing costs to complete the construction. Unless the cost to complete is low, requiring tenant-buyers to pay the full cost of completion may limit the affordability and marketability of housing projects using a lease-purchase financing structure. The lower the up-front costs, the more marketable the units will be.

Another advantage to the tenant-buyer is that the price of the house is set in the lease-purchase contract. The tenant-buyer has protection against inflation in home prices which may outpace his/her ability to accumulate savings. The purchase price of the house should be computed as the present value of the future lease payments and the pay-off amount at a current market interest rate.

Sellers like lease-purchase because the financing structure provides cash flow from tenants who have a vested interest in treating the property well and who are likely to become owners. Sellers also may be able to obtain a higher price for the housing units with a lease-purchase than with a cash sale. Another seller advantage is earning above market rent. Typically a lease-purchase landlord will charge 10 to 20 percent above the market rent. For example, the market rent for an apartment may be $600 per month and the rent with a lease-purchase may be $700 a month, with a $300 per month rent credit toward the down payment. The seller receives above market cash flows and the tenant-buyers consider this to be a bargain because they are paying only $400 a month in rent on a $600 per month apartment. Another potential advantage of lease-purchase financing is that there may be tax benefits to the landlord-seller which are not available on an outright sale. At a minimum, the landlord-seller may be able to defer capital gains or profits taxes on the profit earned on the sale of the units.

5. Other Lending Programs

Banks in Kazakhstan are just beginning to offer consumer credit. Alem Bank has introduced a Visa card and ATMs and other banks are looking at consumer finance as a large, profitable and low risk business. Credit card and home equity lending may be promising lines of business for Kazakhstani banks. Zhilstroi submitted a written request to the consultant for ICMA to provide information on both credit card and home equity financing. Since most home owners in Kazakhstan have no debt on their homes, home equity lending programs could generate significant loan volume. Unlike home equity lenders in the U.S., in most cases Kazakhstani banks would have a first mortgage on the property pledged as collateral. Home equity lending also would enable entrepreneurs to finance new business ventures at a lower cost than commercial loan rates, if they can find financing at all.

G. FUNDS MOBILIZATION

A lack of even intermediate maturity funding is one of the major impediments to progress in creating a housing finance system in Kazakhstan. Funding housing finance is and will continue to be one of the greatest challenges to the GOK, the NBK and housing finance institutions. Banks cannot lend on a longer term basis if their sole funding source is short term, interest rate sensitive deposits. The solution to the funds mobilization problem may require both public and private sector participation.

The situation may improve as the financial markets in Kazakhstan develop and new debt instruments are introduced. The GOK has begun issuing treasury bills and legislation and regulations authorizing the private issuance of debt securities have been enacted. As economic and financial market conditions stabilize, it may be anticipated that an active market for debt securities will develop.

1. Zhilstroi Funds Mobilization Programs

The failure of the GOK to fund Zhilstroi at budgeted levels has placed great pressure on the institution to develop its own funds mobilization mechanisms. Zhilstroi cannot fulfill its mandate if it lacks a stable source of funds for housing finance. In addition, Zhilstroi cannot be expected to function as an apex financial institution as required under the GOK agreement with USAID if it does not have funds to onlend to participating banks.

Zhilstroi has implemented several savings mobilization programs approved by the NBK and MOF, including a contract savings scheme, a housing lottery and housing bonds, and is in the process of developing several others. The Zhilstroi housing bonds were the first private debt securities registered in Kazakhstan and could contribute to the development of a capital market for debt financing of housing construction.

At least in the early stages of implementation, none of the programs has proven effective in raising a meaningful amount of funds. There are numerous reasons for the disappointing public response to Zhilstroi's savings and other funds mobilization programs:

- The public lacks trust in the integrity of the banking system as a whole and is reluctant to place money in financial institutions. There is little that Zhilstroi can do to restore the public trust. The GOK guarantee of its deposits does not reassure the public since the GOK did not honor its commitments to depositors at Narodny Bank.
- Zhilstroi does not have the distribution system necessary for gathering retail deposits and has not been able to negotiate acceptable arrangements with other banks to act as its agent in deposit solicitation.
- The public has not been receptive to the German-style contract savings program, due in part to the long term commitment which must be made. This may not be a product well suited to the culture and life-styles of Kazakhstan.
- The first housing lottery was not well managed and promoted because of inadequate advertising and promotion and the failure of the lottery management firm retained by Zhilstroi. Offering specific apartments in Almaty as the large

prizes for the lottery also may have limited the appeal of the housing lottery to some extent.

- The housing bonds, which entitle a purchaser to buy one square meter of an apartment in a designated building or project, sold well initially, but the escalation of construction costs has priced the bonds beyond the means of many buyers for the units being offered. The escalation in housing construction costs has forced Zhilstroi to increase the cost of one bond from 10,000 tenge to 14,000, the current cost of one square meter of an apartment in the housing project being financed. Per square meter housing construction costs may be as high as 25,000 tenge by the end of 1995.

2. Prospects for the Future

The funds mobilization outlook, however, is not entirely bleak. There are some encouraging indications that deposit and other savings and investment vehicles may gain greater acceptance as Kazakhstan moves towards greater economic and financial stability.

Deposits: Zhilstroi has had draft regulations approved (See Annex C) to offer bills of exchange which can be used by depositors as a medium of exchange to pay debts and bills. Zhilstroi also intends to offer foreign exchange denominated deposit accounts if the NBK approves the institution for foreign currency transactions.

Lottery: As of the end of April, 1995, Zhilstroi was in the midst of the second housing lottery. In the first two months of the second lottery Zhilstroi had raised more than the 5 million tenge (US$ 83,333) sold during the entire first lottery program. Zhilstroi had made arrangements for more distribution outlets for lottery tickets and an expanded media advertising campaign. Zhilstroi is planning a new lottery bond program similar to those offered by Japanese shinkin banks which will offer cash prizes rather than an apartment (See Annex C for draft terms and conditions). The NBK and MOF have approved the Zhilstroi lottery bond program. Lottery bonds with cash prizes may attract a broader segment of the population.

Contract Savings Plan: Three enterprises had entered into contracts with Zhilstroi to contribute to their employees' contract savings plans. Negotiating arrangements with enterprises to contribute to contract savings as part of their employee benefits package may be the best method of implementing a contract savings program. Zhilstroi continues to work closely with a German bausparkasse for technical assistance in developing a viable contract savings scheme. Zhilstroi also is working on flexible contract savings programs to meet the specific needs of different market segments.

Housing Bonds: Zhilstroi had sold 2 million tenge (US $33,333) in housing bonds as of the end of April, 1995. The most promising market for housing bonds may be enterprises which have a commitment to provide housing for their employees, but cannot afford to build or complete the required housing units. Several enterprises have purchased housing bonds for officers and employees instead of providing them with a housing unit. There may be substantial potential for development of this market, particularly for enterprises in the process of privatization.

V. IMPEDIMENTS TO HOUSING FINANCE SECTOR REFORM

Despite these accomplishments, as of April, 1995, several of the most fundamental steps in the process of reforming the housing finance sector had not been implemented. The most important impediments to the achievement of an effective strategy for the housing finance sector have been:

- the failure to establish and maintain the economic and financial stability essential to mobilize domestic and foreign financial resources for the housing sector and to provide financially feasible housing finance;

- the failure to enact the laws to establish the clearly defined and enforceable system of property rights necessary for a mortgage finance system; and

- the failure to develop an effective institutional framework for the housing finance sector.

A. ECONOMIC AND FINANCIAL INSTABILITY

Economic conditions in Kazakhstan in 1994 and early 1995 made mortgage financing difficult, if not impossible. Inflation exploded in Kazakhstan after the conversion of the Kazakhstani currency from the rouble to the tenge in November, 1993. As of April, 1995, inflation had pushed housing prices up to more than $233 per square meter and, although interest rates fell sharply in the fourth quarter of 1994 and the first quarter of 1995, they remained at 120% and higher. Most investments are not financially feasible at nominal interest rates of over 120%. The GOK and NBK have made substantial progress in bringing down inflation and interest rates, but it may be some time before an active market for housing loans will develop.

Real wages have not increased as quickly as the price level and people have seen their standard of living deteriorate dramatically. The average wage-earner has difficulty meeting the day-to-day necessities of life, much less saving and investing. Unemployment is increasing as inefficient state enterprises sink into bankruptcy or are downsized after privatization. Households whose real incomes have not kept pace with inflation simply cannot afford the payments required and fledgling commercial real estate developers cannot absorb the financing costs at the current high levels of interest rates.

High inflation and the devaluation of the tenge from its initial exchange rate of 4 tenge to over 60 tenge to the dollar undermined whatever confidence the population may have had in the government and its institutions. People do not trust the banking system and are unwilling to invest their money in financial investments such as bank deposits. Inflation virtually wiped out the savings people did have, primarily in the Narodny Bank. There have been cases when banks have turned depositors away because they could not honor their requests to withdraw funds. This is certainly not an atmosphere conducive to the development of new financial markets and instruments.

B. LACK OF LEGAL FOUNDATIONS OF HOUSING FINANCE

The GOK has failed to enact an effective mortgage law, although it has had a draft under consideration for over a year, and there are still questions about title conveyancing which must be resolved. Without clearly defined and enforceable property rights and the right to take possession of mortgaged property and realize on the collateral, no financial institution will lend solely on the security of real estate. No workable housing finance system will develop in Kazakhstan until the laws establishing a secured creditor's rights in the mortgaged property are enacted and enforced. Several financial institutions have expressed an interest in entering the housing finance market if they are assured that a mortgage will be enforceable or that the GOK will provide some protection from loss on default. Until the GOK acts, housing finance probably will be limited to credit to employees of state enterprises and wealthy clients. Affordable housing finance will not be accessible to most Kazakhstani citizens.

C. NO INSTITUTIONAL FRAMEWORK FOR A HOUSING FINANCE SYSTEM

The institutional structure for an effective housing finance system includes sound financial institutions able to attract savings and investment resources to fund housing and construction loans. Such an institutional structure does not exist in Kazakhstan because:

- the public lacks confidence in the financial and managerial integrity of Kazakhstani financial institutions;
- consumer finance of any type is just being introduced in Kazakhstan; and
- there are no sources of long or even intermediate term funding.

The failure to create the institutional framework for a housing finance system is due in large part to the lack of a clear and coherent vision on the part of the GOK and the NBK of how development of the housing finance sector should be coordinated with broader economic and financial sector reforms. Housing finance issues have not been integrated into the programs to reform the financial sector.

D. LACK OF EXPERIENCE AND EXPERTISE

Zhilstroi and other Kazakhstani banks have no experience with market-based real estate lending and require training and technical assistance to develop the necessary expertise and skills. In addition, banking personnel lack needed skills in accounting, financial management and internal control. Training in bank management, real estate finance and investment and risk management is being offered through foreign-sponsored technical assistance programs, but it will be some time before local bankers develop the financial and managerial expertise to effectively manage a sound housing finance function.

ANNEX A

SUMMARY OF THE PRESIDENTIAL DECREE ESTABLISHING "A NEW HOUSING POLICY"

A. INTRODUCTION

On September 6, 1993, President Nazarbaev issued a Presidential Decree setting out "A New Housing Policy." This policy was intended to transform the state monopoly of the housing sector into a market-based system through a series of institutional reforms. Subsequent detailed steps for implementation of the Decree were issued in September and October, 1993. The following summarizes the policy initiatives undertaken in the Decree and the implementing regulations.

B. PROVISIONS OF THE NEW HOUSING POLICY RELATED TO HOUSING FINANCE

1. Objectives of the New Housing Policy

The objectives of the housing finance provisions of the New Housing Policy were:

a. To gradually decrease the state's monopolistic role in the housing sector, including the construction, ownership and financing of housing

b. Strengthen the financial system;

c. Stimulate savings and investment;

d. Enable moderate income families to construct or buy dwellings with their own resources and only moderate subsidies;

e. Further the objectives of creating the necessary elements of a market economy: a housing market, a labor market and the effective transfer of capital and other resources;

f. Transform the housing delivery system from the direct distribution of housing constructed from budget allocations to requiring individuals to build or purchase housing from their own resources;

2. Principles of Implementation

The New Housing Policy established the principles on which reform of the housing finance sector were to be based. These were:

a. To create the conditions to insure the constitutional right of citizens to housing, including the provision by the state of dwelling units to specified categories of the population based on need:

- *change the attitude of the population through education and information from regarding housing as a social right guaranteed by the state to a*

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benefit to be earned through their individual efforts, based on their own capabilities;

- *amend laws and regulations relating to housing finance, including enactment of laws relating to mortgages and condominium ownership;*
- *create conditions which will attract private resources and companies and foreign capital.*

b. To initiate a phased transition from a heavily subsidized state system to an unsubsidized system of mortgage finance based on the financial capability of each home buyer. Free housing would be provided only to low-income, elderly, disabled and other specifically designated segments of the population and direct government grant subsidies would account for only 20% of the cost of a house for other targeted groups;

- *provide long term (30 year) mortgage credit at a 5% interest rate and to adopt a system of indexation to adjust for inflation;*
- *reform the system of financing housing and communal services;*
- *gradually reduce state subsidies to a level sufficient to finance housing for socially protected segments of the population.*

c. To establish the State Construction and Housing Bank (Zhilstroibank) as a bank founded by the Council of Ministers and registered under the banking law of the Republic of Kazakhstan. Zhilstroi was intended to:

- *fund housing construction loans, fund long term mortgages, and mobilize funds for housing;*
- *be the source of financing for virtually all new housing construction and home purchase except for state owned housing distributed directly to people already in housing queues and other designated groups;*
- *encourage the development of a housing finance system based on market principles;*
- *be funded primarily through GOK budget appropriations which, for 1994, were budgeted at 800 million tenge;*

d. To enact laws authorizing the issuance of housing bonds, housing lotteries and other means of mobilizing savings for housing.

C. OBJECTIVES OF THE NEW HOUSING POLICY

1. To gradually decrease the state's monopolistic role in the housing sector, including the construction, ownership and financing of housing;

2. Develop housing as a stimulus to the economy, and a source of employment through a republic-wide program of stimulation of housing construction;

3. Strengthen the financial system;

4. Simulate savings and investment;

5. Reduce unemployment by increasing public works;

6. Enable moderate income families to construct or buy dwellings themselves;

7. Further the objectives of creating the necessary elements of a market economy: a housing market, a labor market and the effective transfer of capital and other resources;

8. Transform housing delivery system from the direct distribution of housing constructed from budget allocations to requiring individuals to build or purchase housing from their own resources;

9. To replace the existing decentralized control over the construction industry and the development of land through cities and oblasts with an oversight authority at the ROK level.

D. DEFINITIONS

1. "Housing Sphere" means all matters directly or indirectly related to shelter, more specifically:
   - habitable areas of settlements, including infrastructure;
   - the existing housing stock and all dwelling units under construction;
   - housing and communal services;
   - the housing industry, including building materials and equipment for the construction and repair of dwellings;
   - information and documentation on design and cost estimates.

2. "Commercial Developer" means a legal entity licensed by an authorized government body to manage housing construction and perform services such as the sale, purchase and exchange of dwelling units.

3. "Mortgage Lending" means the financing of the construction and purchase of dwelling units on the security of real property or on dwellings to be constructed.

4. "Real Property" means land and buildings and amenities firmly connected to the land, the displacement of which cannot be effected without inflicting disproportionate damage to the land.

5. "Social Norms of Dwelling Space" means the measure of total living space granted per family member, together with additional family space and individual sanitation standard space, within a dwelling necessary for safe and sound habitation for a family, including single-person households.

E. PRINCIPLES OF IMPLEMENTATION

1. To create the conditions to insure the constitutional right of citizens to housing, including the provision by the state of dwelling units to specified categories of the population based on need

   - *change the attitude of the population through education and information from regarding housing as a social right guaranteed by the state to a benefit to be earned through their individual efforts, based on their own capabilities*
   - *amend laws and regulations relating to the housing sector*
   - *provide a simplified procedure for land allotment and registration*
   - *to establish effective organizations and systems to carry out the state housing policy*
   - *create conditions which will attract private resources and companies and foreign capital*

2. To initiate a phased transition of the housing sector from the current state monopoly system to a non-subsidized system except for subsidies targeted to low-income, elderly, disabled and other specifically designated segments of the population.

   - *de-nationalize housing construction, maintenance, repair and utility services*
   - *reform the system of financing housing and communal services*
   - *gradual reduction of state subsidies to a level sufficient to finance housing for socially protected segments of the population*

3. To grant preferential treatment for legal entities engaged in housing construction as an incentive to participation in the housing sector

4. To modernize the construction and building materials industries to improve the efficiency and quality of housing construction and reduce construction costs. Financial and economic incentives will be provided to encourage the use of modern technologies and cost effective building techniques to reduce the cost of housing.

5. To maintain and improve the existing housing stock

6. To assure that persons currently in housing queues receive state-provided apartments

F. INSTITUTIONAL ARRANGEMENTS

1. Ministry of Housing (Minstroi)

The Ministry of Housing (Minstroi) was established officially on November 16, 1993 to provide control at the Republic level over housing construction and land development. Minstroi was the successor to the State Committee for Architecture and Construction and retains all of the functions of the prior entity. Minstroi would have regional branches to administer the ministry's functions at the local level. In addition the Minstroi would hold 35 percent of the seats on all Boards of Construction and shall have the right to vote on behalf of state shares.

The authority, powers and responsibilities of the Minstroi are:

- *to develop and approve regulations concerning the design and construction of housing and infrastructure and to enforce such regulations through inspection;*
- *together with the Ministry of Justice, to promulgate such statutes and regulations as are needed to enable the housing sector to function effectively;*
- *together with the National Bank of Kazakhstan (NBK) and the State Housing Construction Bank (Zhilstroibank), to adopt standards of prudent loan underwriting and servicing for construction and mortgage lending;*
- *to adopt rules, regulations and standards of professional competence and managerial and financial integrity for the licensing of commercial developers, real estate appraisers, surveyors, and building materials companies;*
- *to adopt and enforce policies and procedures for construction activities, including state inspection regulations and the conduct of inspection of construction projects to assure compliance with state regulations pertaining to the design and quality of building and construction;*
- *together with the NBK and the Ministry of Finance (MOF), adopt rules and regulations governing the provision of housing finance;*
- *to review construction designs and enforce competitive bidding;*
- *to apply administrative sanctions against organizations which violate the rules, regulations and standards adopted.*

- *to establish and be the principal shareholder in State Companies of Commercial Developers, the State Company on Appraisal of Realty (SCAR)*

2. State Housing Construction Bank (Zhilstroibank)

a. Establishment and Organization: The State Housing Construction Bank (Zhilstroibank) was established and registered as a state bank in February, 1991, under the banking law of the ROK. The founders of the Zhilstroibank were the Council of Ministers and the majority of the Board of Directors are GOK officials. Zhilstroibank operates from its headquarters office in Almaty and a system of oblast branch offices. The Presidential Decree states that "until the establishment of its own network, the Housing Construction Bank will execute long-term mortgage credit for individual housing construction and organize the system of savings and loan accounts through the Kazakhstan Savings Bank (since January, 1994 the "People's Bank of the Republic of Kazakhstan" or Narodny Bank), on a contractual basis. Branches of Narodny Bank will execute housing construction loans using the resources of the Zhilstroibank, and resources accumulated in savings and loan accounts."

b. Purpose of Zhilstroibank: Zhilstroibank was created to perform three basic functions: funding housing construction loans, funding long term mortgages, and establishing a system of funds mobilization for housing. The bank was intended to be the source of financing for virtually all new housing construction and home purchase except for state owned housing distributed directly to people already in housing queues and other designated groups. The mission of the bank was to administer GOK housing finance subsidies, provide 30 year mortgage loans at a 5 percent interest rate to designated segments of the population and mobilize savings for housing. The Housing Policy explicitly limited Zhilstroi's banking transactions to those related to housing finance: "The Housing Construction Bank...will at the first stage perform the functions of 3 financial institutions: the Mortgage Bank, the Savings and Loan Bank and the Housing Bank." The Housing Policy provided for divestiture of the Mortgage Bank and the Savings and Loan Bank after the housing finance system in Kazakhstan became well established. The remaining institution would function as a credit conduit, securing funding from domestic and international sources, to be onlent for housing purposes. The intent of the Housing Policy appears to have been for Zhilstroibank to focus its activities fairly narrowly on mobilizing funds for housing and administering the GOK's privileged housing loans.

c. Funding Sources: All existing financing schemes for housing at the oblast and municipal level were consolidated into Zhilstroibank. The initial capitalization of the bank was funded from the state budget. Additional funding for Zhilstroibank was to have come from the state budget and other GOK funds. Annually, the Zhilstroibank was to have received the following transfers:

1. 10 percent of the Assets of the Economic Transformation Fund, with 40 percent of this amount allocated to modernizing the building industry, 40 percent to finance long term credits and 20 percent for financing infrastructure;

2. the tenge equivalent of at least Rbl 2 billion from the State Budget to replenish the capital accounts of the bank and an additional unspecified appropriation for housing construction, half of which will be allocated to the construction of social or government housing;

3. 20 percent of the proceeds from the privatization of state property allocated to long term financing;

4. 15 percent of the resources of the Employment Fund to be allocated to public works and the construction and maintenance of existing enterprise-related housing and housing infrastructure; and

5. 20 percent of the NBK's Credit Resources Regulation Fund.

The funding sources for Zhilstroibank may have been amended in a 1995 decree. The principal new funding source may be royalties from gold mining operations.

d. Mortgage Lending Operations: The supplement to the Presidential Decree set out specific terms and conditions for mortgage lending by the Zhilstroibank. The bank was required to lend at a 5 percent nominal interest rate for up to 30 years for the groups defined in the Housing Policy. The defined groups included a large percentage of the total population of the ROK. Higher income borrowers also received a concessionary interest rate equal to the NBK subsidy rate for centralized credit resources.

Mandating a 5 percent nominal interest rate would have guaranteed the financial insolvency of the Zhilstroibank in a very short period of time if the bank had any meaningful volume of lending. The Housing Policy proposed that housing credits be indexed for inflation to preserve the purchasing power of the bank's financial resources.

G. CONCESSIONARY FINANCING ARRANGEMENTS FOR TARGETED GROUPS

1. People on the Housing Queue

People who have been in a housing queue for 10 years or more would be entitled to receive a one-time grant equal to 20 percent of the purchase price of a house and a 5 percent, 30 year mortgage loan for the balance of the cost to build or purchase a house.

2. Families with Partially Completed Houses

If the state appraiser determined that the value of the completed portion of the house was less than or equal to 20 percent of the total construction cost, the family would be entitled to receive a government grant equal to 25 percent of the total cost of the house, deposited into the family's housing/savings account, plus an additional 25 percent subsidy from the enterprise by which the owner was employed. The balance would be financed with a 5 percent mortgage for up to 30 years. If the value of the completed portion of the house were more than 20 percent, but less than 50 percent of the total cost of the house, the amount of the mortgage loan for which the family would be eligible would be decreased by a commensurate amount. If the value of the completed portion of the house were equal to 50 percent or more of the total cost of the house, the balance would be prorated between the state subsidy and the subsidy from the enterprise.

3. Enterprise Workers

Any enterprise worker who had accumulated funds for a down payment of 20 percent of the cost of a house would be entitled to receive a grant from the enterprise equal to 25 percent of the house cost, a grant from the state made to the worker's housing/savings account equal to 25 percent of the cost and a mortgage loan equal to 30 percent of the cost. If the worker had accumulated a down payment greater than 20 percent, pro rata reductions would be made in the grants and the mortgage. If a worker had been in the housing queue for 5 years or more, the enterprise could grant a subsidy equal to or greater than half of the down payment. If an enterprise worker did not have an uncompleted dwelling unit or had not accumulated a 20 percent down payment, he/she could negotiate with his/her employer for an additional grant to be placed into his/her housing/savings account.

4. Government Employees

Government employees would be entitled to housing grants and mortgages on the same basis as non-government workers. In addition, government workers who had accumulated a down payment of 20 percent or more would be entitled to a state grant of 30 percent of the cost of the house, deposited to the employee's housing/savings account, and a mortgage loan for the balance. If a government worker were not entitled to a state grant and mortgage, he/she would be authorized to transfer up to 30 percent of his/her salary into a housing/savings account.

5. Military

Servicemen would be entitled to state housing grants based on their years of service according to the following schedule:

10 to 15 years	30 % of house cost
15 to 20 years	50 % of house cost
20 years or more	100% of house cost

Servicemen also would be entitled to a mortgage loan at 5 percent for the balance of the cost of the dwelling.

6. Families Not Included in Any Protected Class

Families which were not low income families and were not included in any of the protected classes would be entitled to receive long term mortgages at the subsidy interest rate established by the NBK for centralized credit resources. This is a rate higher than the 5 percent interest rate available to other classes, but is still lower than rates available in the open market for other forms of bank credit.

ANNEX B

MORTGAGE INSURANCE

I. MINSTROI STATEMENT OF ISSUES RELATING TO MORTGAGE INSURANCE

1. To reduce the credit risk of mortgage loans in the emerging market economy in Kazakhstan, where the financial sector is not well developed and in the absence of effective foreclosure, we consider it necessary to establish initially an institution of mortgage insurance.

2. The advantages of FHA mortgage loans make it possible to apply such a system in the Republic.

3. Insurance premiums set by the FHA at 2.25% of the original loan and 0.5% of the outstanding balance annually may also be set by the mortgage insurance companies in the Republic.

4. At the initial stage, the Government should develop public mortgage insurance and, concurrently, determine on what conditions private insurance firms may function.

5. In accordance with the New Housing Policy, insurance coverage may be tied to certain conditions for obtaining loans, taking into account compensation paid to the population and enterprises, and may cover 65% to 80% of the outstanding balance on a mortgage or even less provided that Minstroi take certain actions to complete unfinished construction.

6. Lenient treatment of a delinquent borrower, similar to the grace periods which FHA is authorized to grant, may be applicable in this country.

7. At this stage, it is necessary to develop all documents required for the operation of mortgage insurance institutions and form a working group including representatives of governmental organizations and other insurance companies for detailed analysis of the issues related to the creation of mortgage insurance companies.

If necessary, to arrange tours of members of the working group to other countries to study their experience in implementing mortgage insurance programs.

After training, the members of the working group must submit their proposals about what legislative framework is necessary for establishing the institutions of mortgage insurance and what funds are required for initial capital.

Head of the Department of Minstroi B. S. Mukhametzhanov

II. PROSPECTS AND PROBLEMS OF MORTGAGE INSURANCE PROGRAMS

Mortgage insurance is an effective means of encouraging financial institutions to provide housing finance because it reduces the credit risk of mortgage lending. Mortgage insurance can be provided through the government or private mortgage insurance companies. In emerging market economies, where the financial sector is not well developed and, in the absence of effective foreclosure, the risk of mortgage lending is high, the only feasible option is government mortgage insurance. A government mortgage insurance agency would make no loans. Approved lenders would submit mortgages which meet the insurer's standards for approval for insurance. The mortgage insurer would agree to pay the lender if the borrower fails to make the agreed-upon payments of principal and interest and would receive an insurance premium paid by the borrower.

A. THE ROLE OF GOVERNMENT MORTGAGE INSURANCE IN THE U.S. HOUSING FINANCE SYSTEM

In the United States, the Federal Housing Administration (FHA) is the government agency which insures home mortgages. The FHA is a department within the Department of Housing and Urban Development (i.e. the Ministry of Construction and Housing). Another government agency, the Veteran's Administration (VA) guarantees home mortgages made to veterans. FHA mortgage insurance was created in 1934 to address the real estate crisis caused by the Great Depression. The stated objectives of FHA mortgage insurance were to "facilitate home ownership, stimulate the construction and financing of housing, upgrade the quality of housing and improve mortgage lending practices." The FHA was effective in achieving these objectives and, in later years, in facilitating the financing of residential properties involving risks too great for the private sector to assume. The creation of FHA laid the foundation for the use of long term fully amortized loans with low down payment requirements, improved property standards and appraisal procedures and a standardized mortgage qualification process.

Until the advent of private mortgage insurance in the 1960s, FHA insured loans were the predominant type of home mortgage in the United States. The reasons for the widespread adoption of FHA programs are apparent:

1. *Lower down payment requirements;*
1. *Longer maturities;*
1. *Assurance of minimum property standards and an appraisal performed under uniform procedures;*
1. *No penalty for prepayment;*
1. *Mortgage assumability;*

1. *Lower mortgage interest rates;*

1. *Greater flexibility in granting forbearance or delaying foreclosure.*

The importance of FHA in the U.S. housing finance system has declined over the last 35 years. In 1994 FHA insured mortgages accounted for only 13 percent of the estimated $770 billion in home mortgages originated during the year. The remaining 87% of home mortgages in the United States either have no mortgage insurance or are insured by private mortgage insurance companies, if the amount of the loan is 80% or more of the value of the property being financed.

B. FEATURES OF FHA INSURED MORTGAGES

In the past, FHA insured loans had an advantage over non-federally insured loans because they required less of an initial investment - down payment- by the home buyer. The basic FHA home mortgage insurance program allows a home buyer to borrow up to 97% of the first $25,000 of the lesser of the sales price or value of the house plus 95% of the balance up to the maximum mortgage amount permitted under the FHA mortgage insurance program. The maximum mortgage limits for single family homes are calculated at 95% of the median house price in the local market area, as determined by FHA. Today, privately insured mortgages can be for loan-to-value ratios as high as 95% and some mortgage insurers have begun to offer 97% insured loan programs. An advantage of FHA insured mortgages is that FHA loans can be assumed by any qualified purchaser when the original home buyer sells the home. Privately insured loans may be assumed only if the lender approves the assumption.

Until the late 1980s, the FHA set a maximum interest rate ceiling for FHA insured loans. When market interest rates rose above this mandated ceiling, lenders would charge up-front "points" to the borrower to increase the effective yield on the mortgage. In other words, the lender would discount the amount of the loan so that the effective interest rate on an FHA loan would be equivalent to market interest rates on non-federally insured loans. This practice increased the amount of funds a home buyer was required to invest to purchase a home and, as a result, many prospective home purchasers could not qualify for FHA loans. In response to this problem, FHA now permits the market to determine the interest rates on FHA mortgages.

The FHA administers over 40 different mortgage insurance programs. The most widely used programs are the Basic Mortgage Insurance Program (Section 203(b)), the Condominium Mortgage Insurance Program (Section 203(c)) and the Rehabilitation Program (Section 203(k)). The basic home mortgage and condominium mortgage programs insure mortgages on new and existing one-to-four family dwellings. The mortgages can be for a 30 year or a 15 year term and can be at a fixed (FRM) or variable interest rate (ARM). The FHA ARM program requires that the mortgage interest rate be indexed to changes in the average yield on one-year United States Treasury Securities. The interest rate can be adjusted annually, but cannot be changed by more than 1% each year and a total of 5% over the life of the loan. Negative amortization is not allowed, but interest can be deferred.

C. INSURANCE COVERAGE, PREMIUMS AND CLAIMS PROCEDURES

FHA insurance covers 100 percent of the outstanding balance on a mortgage for the full life of the loan, while private mortgage insurance insures only 20% to 25% of a mortgage. FHA insurance premiums are 2.25% of the original loan balance when the loan is granted, plus .5 % of the outstanding balance each year the loan is outstanding. The FHA premium is the same for middle income home buyers and high risk borrowers. The premium for private mortgage insurance also is not risk-adjusted, but all borrowers must meet the higher credit standards imposed by the private mortgage insurance companies. Although the premium structures for private mortgage insurance vary based on the insurer and the type of loans, a typical insurance premium on a 90%-95% loan-to-value loan would be .67 % of the outstanding balance of the mortgage with the first 3 months' premiums paid in advance when the loan is granted.

Studies of the rate and pattern of mortgage defaults over the 60 years since the FHA was created indicate 100% insurance coverage may be excessive and exposes the insurance fund to undue risk. Shifting all of the risk of loss on default to the government has reduced the incentive for FHA mortgage lenders to diligently collect on insured loans. The FHA can deny a lender access to the FHA program if it does not adhere to FHA underwriting standards, policies and procedures and can prosecute institutions and their officers where mortgage fraud is discovered, but these are remedies to recover losses, not limit the risk exposure of the insurance fund.

The FHA treats a delinquent borrower more leniently than private lenders or mortgage insurers. If a borrower of an FHA insured loan is delinquent for three months, the lender must inform both the borrower and the FHA of the default. The borrower also is told of the possibility of forbearance which will allow a delay in initiating foreclosure procedures and a possible restructuring of the mortgage. If the delinquency is due to circumstances beyond the borrower's control, such as loss of employment, disability or the death of the principal wage earner, and there is a reasonable prospect that the mortgage will be repaid, FHA may accept assignment of the mortgage. If the mortgage is assigned, FHA will pay the outstanding balance on the loan to the lender or investor and will service the loan itself. The borrower will be given a grace period to make up the delinquency and the mortgage may be restructured so that the borrower can afford the payments. If FHA does not take an assignment of the insured mortgage, the lender must acquire title to the property from the borrower by a voluntary conveyance or must institute foreclosure proceedings. The lender can sell the property itself or transfer the property to FHA and request reimbursement of the principal, delinquent interest and other costs of the foreclosure. FHA pays the claim from its reserves and then must sell the house to recover its costs.

D. THE FUTURE OF FHA

The U.S. government and Congress have questioned the need to continue the FHA as a government agency. The fundamental question is whether the government should be involved in insuring home mortgages when experience has proven that the private sector is ready, willing and able to provide mortgage insurance at an affordable cost. Opponents to government mortgage insurance argue that there is no longer a need for the FHA, that it's role has diminished steadily over the last 35 years, that the private sector can deliver mortgage insurance more efficiently and at lower cost to the borrower and that it involves a needless government expense. Like many other government social programs created during the Depression of the 1930s, the FHA is viewed by many as a financial dinosaur.

The defenders of the FHA 100% insurance program argue that private mortgage insurers have gone out of business, that the private sector cannot always be relied upon to meet the demand for insured home mortgages and that the private sector will not insure mortgages to high risk segments of the mortgage market. They claim that private mortgage insurers will not match FHA's low cash down payment requirements, more flexible underwriting standards and willingness to continue to serve economically depressed markets. There is agreement between the opponents and proponents of the FHA, however, that there is a need to reform and reengineer the agency.

The FHA insures an estimated 300,000 loans each year which would not have met private mortgage insurance standards. These loans include mortgages on inner city or older properties, loans to minority and new immigrant families and loans to first-time homebuyers. Opponents and proponents of the FHA agree that these borrowers probably would not have had access to financing without FHA insurance. One proposal for reform of FHA is to convert FHA to a government-owned corporation similar to Fannie Mae when it was spun off from the Department of Housing and Urban Development. The new corporation would concentrate on the segments of the market not served by private mortgage insurers. However, having a concentration in high risk loans can be expected to increase losses, resulting in the need to assess higher insurance premiums.

E. POTENTIAL FOR MORTGAGE INSURANCE PROGRAMS IN EMERGING MARKET ECONOMIES

A government mortgage insurance program would be effective in supporting the development of a housing finance market in an emerging market economy by reducing the credit risk of home lending. The creation of a system of mortgage insurance could play a key role in those countries in which foreclosure laws are weak or nonexistent. The rationale for creating an FHA type of institution as a stimulus to home finance in emerging economies is the same as the reason why FHA was created during the depths of the 1930s Depression in the United States: banks are unwilling to assume the risk of having a portfolio of long term mortgage loans. Mortgage insurance also would facilitate standardization of mortgage design, documentation and underwriting and would establish a high standard of quality for loan servicing.

Most emerging economies are not at a stage where credit risk can be assessed with any degree of reliability. However, as reforms are implemented, the economic transformation process proceeds and the residential real estate market develops, the ability of mortgage lenders to adequately evaluate the risk of potential loss will improve. The fundamental issue is whether mortgage insurance systems should be established today to stimulate mortgage lending in the current environment or should be delayed until the legal system and the economy have reached the stage of development where mortgage insurance can be offered as an actuarially sound line of insurance. A second consideration would be the extent of loss coverage which would be provided in a government insurance program.

It may be advisable not to develop a mortgage insurance program in an emerging market economy until the context of credit risks becomes clearer and key steps have been taken to limit mortgage credit risk. Until this has been accomplished, a mortgage insurance program will merely transfer all or a major portion of the risk from housing finance institutions to the government. Since all the benefit of risky lending will accrue to the lenders, but all of the potential losses will fall on the mortgage insurance fund, there will be little incentive for mortgage lenders to expend appropriate resources to diligently underwrite, service and enforce mortgages. In addition, borrowers of insured mortgages, particularly if the insurance covers 100 percent of the loss, may perceive their loans as government credits which they do not have to repay. Since the government is not likely to evict them from their homes if they default on an insured mortgage, there is little incentive for borrowers to make personal sacrifices to keep mortgage payments current.

Allowing government to assume all the risk of mortgage default is a costly subsidy which would be expanded by the perverse incentives inherent in any government mortgage insurance system. An alternative approach which does not create such perverse incentives is for the government to strengthen the mortgage lender's access to mortgage collateral before the government establishes a mortgage insurance program. Once foreclosure and eviction become a practical reality, lenders will be able to rely on the government insurance against loss on foreclosure to protect against major losses due to severe economic conditions, such as massive unemployment in a region.

Of course, adoption of such a plan can be expected to delay the development of the mortgage market. Those banks which express an interest in offering mortgage financing to their customers are reluctant to enter the business until the foreclosure issue is addressed or until they are satisfied that the government will afford them some protection from loss. Consequently, housing policy officials in several emerging market economies are considering establishing mortgage insurance systems. Initially, it was thought that the government could provide an unfunded guaranty of mortgage credits. However, reforms in bank accounting, regulation and supervision have imposed stricter standards for government guarantees. Banks can no longer maintain a loan on their books at full value unless the guarantee is legitimate and funding has been provided to pay off claims made against government guarantees.

The first step in designing a sound mortgage insurance plan is to develop projections of mortgage default and loss rates. The anticipated default and loss rates are critical to determining the amount of budget resources required to fund an actuarially sound insurance program and the insurance premiums which should be charged to borrowers. Projecting default and loss rates is difficult because there are no historical data upon which to base claims estimations. Mortgage default rates in the U.S. could serve as the base default rate on which to build a forecast. The mortgage default rate in the U.S. is about 4% of mortgages outstanding, but can run over 10% in areas suffering from economic problems. Unofficial data from housing finance institutions in some developing and emerging economies indicate that default rates may average 20% or more. Funding an insurance program which insures against 100% of losses on default at default rates of over 20% would require budget funding well beyond the means of most countries.

An analysis of the structure of a mortgage insurance program must include an evaluation of the extent of coverage offered. A maximum loan-to-value ratio should be established which requires the home buyer to invest an amount of his own money sufficient to give him/her an incentive to keep the mortgage current. Initially, it may be advisable to establish a maximum loan amount of no more than 70% or 75% of the lesser of the selling price or appraised value of the home being financed. If the selling price is greater than the appraised value, the home buyer will be required to pay the difference. Mortgage insurance should not cover the entire mortgage. Coverage of 100% of losses not only will be too costly, but may remove much of the incentive for sound loan underwriting and servicing. Consideration should be given to having mortgage insurance provide a lower level of coverage, perhaps 25% to 50%, to ensure that there are sufficient incentives for the lender to exercise prudent management. A mortgage insurance program which insures 50% of the outstanding balance on a mortgage distributes the risk equitably among all the parties to the transaction. If the original loan-to-value ratio were 70%, the home owner would bear 30% of the risk and the lender and mortgage insurer, 35% each. The home owner would absorb the first losses if the value of the property were less than the outstanding amount of the mortgage when the mortgage goes into default.

Typically, when an insured mortgage in which the insurance covers only a portion of the amount of the loss is declared in default, the mortgage insurer has two options. It can simply pay the claim or it can pay off the mortgage balance, take title to the property and sell the property to recover as much as possible. For example, if the outstanding balance on a 50% insured mortgage at the time of default is 100,000, the mortgage insurer could pay 50,000 to the lender or pay the lender the full 100,000 and sell the home. If the home can be sold for 90,000, the cost to the mortgage insurer would be 10,000, plus the costs of foreclosure.

F. FUNDING A MORTGAGE INSURANCE PROGRAM

The government will have to invest initial capital for a mortgage insurance program in an amount sufficient to cover all operating expenses and pay anticipated losses for at least the first two years. The government's investment could be repaid out of future income. The amount of this initial capitalization will depend on the anticipated volume of insured mortgages and the projected default and loss rates. A simple example can illustrate the computation of the minimum initial capitalization which would be required. For purposes of this illustration, let us assume that borrowers pay an up-front mortgage insurance premium of 5% and an annual premium of 1% of the outstanding amount of the mortgage and that the ratio of loss reserves to the next year's anticipated losses is 1.25/1. It would be advisable to fund a mortgage insurance program at well above the minimum level initially to avoid future claims on budget resources.

Computation of the Initial Capital Required for a Mortgage Insurance Program

Projected Volume of Insured Mortgages for Years 1-2			100,000,000
Projected Premium Income for Years 1-2:			
Up-Front Fees @ 5%	10,000,000		
Annual Fees @ 1%		2,000,000	
Total 2-Year Premium Income			12,000,000 Projected
2-Years of Operating Expenses			30,000,000
Projected Losses in Years 1-2			20,000,000
Projected Losses in Year 3			20,000,000
Loss Reserve Ratio			1.25

Computation of Minimum Initial Capitalization from Budget:

Initial Loss Reserve	25,000,000	
Funding to Cover Operating Expenses	30,000,000	
Funding of Loss Reserve, End of Year 2	20,000,000	
Less: Premium Income	- 12,000,000	
Minimum Initial Capital from Budget Resources		63,000,000
Prudent Initial Capital from Budget Resources		100,000,000

After the start-up period, mortgage insurance premiums should be charged which will provide adequate funding for a mortgage insurance program without the need for further budgetary resources. Insurance premiums should be set at a level which will provide a sufficient flow of funds to the mortgage insurer to cover its general and administrative expenses and fund loss reserves and, at the same time, reflect actual loss experience. It is highly likely that in most emerging market economies only three or four institutions will extend mortgage credit and the volume of mortgage credit will be limited for a several years. Therefore, costs will have to be spread over a relatively small base of mortgages. In addition, it will be difficult to establish a fair mortgage insurance premium structure until there have been several years of experience to determine what the stable loss ratio may be. However, if the FHA charges a 2.25% up-front fee and .5% over the life of a mortgage based on U.S. loss experience, the insurance premium in markets involving a lower volume of mortgage credit and greater default risk can be expected to be considerably higher. Without ongoing budget funding, the cost of providing mortgage insurance may be more than the market can support. The mortgage insurance program could be structured to give good borrowers a rebate on a portion of the mortgage insurance premiums paid if the mortgage is paid current over a stated number of years. The promise of a rebate would provide some incentive to borrowers to make their mortgage payments, but would do little to improve mortgage affordability.

Presumably, banks will pass the cost of mortgage insurance through to the borrowers, increasing the cost of mortgage finance and reducing affordability. Lenders can be expected to lower the interest rate charged on mortgage loans to reflect the reduced risk of mortgage lending due to the existence of mortgage insurance, but the rate reduction may be less than the amount of the mortgage insurance premiums. The government should not require that mortgage lenders offer lower interest rates on insured loans because, like any administered interest rate, a rate ceiling will distort the market.

ANNEX C

DRAFT REGULATIONS FOR PROPOSED ZHILSTROIBANK CREDIT AND FUNDS MOBILIZATION PROGRAMS

I. REGULATIONS FOR COMPLETION OF CONSTRUCTION OF RESIDENTIAL BUILDINGS CONVEYED TO ZHILSTROIBANK FROM THE STATE HOUSING FUND, WITH ATTRACTION OF INDIVIDUALS' MONEY TO SAVINGS-AND-LOAN ACCOUNTS AND PROVIDING A GRACE PERIOD FOR REPAYMENT OF THE BUILDING'S VALUE

1. Residential buildings in which at least 50% of the construction has been completed are conveyed from the state housing stock to offices of Zhilstroibank based on a deed of transfer, provided that Zhilstroibank completes construction of the building and sells the finished housing units to the public.

2. Home owners' associations shall be created to attract people's money for completion of construction. An association may be created for each building under construction of for a group of buildings, depending on the conditions of a specific development.

3. Members of the association will be people who are credit worthy and who have sufficient money to complete construction of the acquired housing and make instalment payments for the remaining part of the value with five to ten years.

4. Zhilstroibank shall develop a schedule of funding to complete construction taking into consideration the schedule of completed jobs and payments made to a contractor, as well as a schedule of instalments for the remaining part of the value for the association as a whole and for each association member.

5. Based on these schedules, the bank will conclude an agreement of cooperation with the association of home owners whereby the association commits to provide a specified amount of resources for completion of construction and repayment of the remaining value of houses in instalments. The housing association shall conclude similar agreements with each member.

6. To accumulate resources and fund incomplete construction, the association shall open a savings-and-loan account at the bank. Members of the association shall deposit their money into the association's savings-and-loan account according to the schedule for completion of construction. Money from a member's family, the enterprise or organization where he/she works, gifts and grants from individuals and legal entities, budget resources and proceeds from bank loans may also be deposited into the association's savings-and-loan account. The bank shall use funds deposited in the association's savings-and-loan account to pay contractors for the work performed to complete construction based on the results of inspections of the property.

7. No interest shall be paid on the savings-and-loan account of the home owners' association.

8. The association shall pay the bank an origination and servicing fee in the amount of 1% of the value of the completed building for developing the schedules of funding of unfinished construction, servicing and monitoring the savings-and-loan account, credit underwriting, collection of loan repayments and other transactions.

9. Members of the home owners' association shall make deposits into the savings-and-loan account following the procedures below and the agreement between the bank and the home owners' association.

--- in a lump sum;

--- in equal monthly payments during the construction period; or

--- in a periodic payments in an amount calculated based on the percent of work which has been completed by the contractor.

The procedure for making deposits shall be stipulated in the agreements between the bank, the association and its members.

Those association members who make the full payment required to complete construction in a lump-sum deposit to the association's savings-and-loan account shall be granted a grace period of up to two (2) years before repayment of the remaining value of the house shall be due and payable.

In the event of default, the association members, jointly and severally, shall pay interest on the amount in arrears at the market rate of interest for each day the default continues.

10. If it is determined that the cost of construction will be greater than originally estimated by the bank, the bank, the association and its members shall agree to either amend the existing agreements to adjust for the increase in construction costs or enter into new agreements.

11. After completion of construction, the contractor shall convey the residential buildings to the bank according to the deed of completion.

12. The bank shall enter into a master lease-purchase agreement with the home owners' association which, in turn shall enter into individual lease-purchase agreements with its members. A specified portion of each monthly payment shall be applied to pay the interest and principal repayment established in accordance with a schedule to repay the entire remaining balance of the purchase price of the apartments acquired over the term of the lease-purchase agreement. Ownership rights in the apartments acquired shall not be conveyed to the association of any individual member until the entire amount due to the bank has been paid in full.

13. The term of the master lease-purchase agreement to the association and the underlying lease-purchases of apartments to association members shall be from 5 to 10 years. The term of a lease-purchase agreement to an association member for his/her

apartment may not be longer than the term of the master lease-purchase agreement. The term of the lease-purchase shall be established based on the credit worthiness of each individual member of the association. Association members shall conclude contracts of obligation, including a schedule of payments, with the association which, in turn shall submit to the bank a summary schedule for the association's repayment of the amount due, including interest.

14. The bank shall establish the interest rate for repayment of the remaining balance of the purchase price of the apartments according to the following schedule:

- 9% per annual if the member has made a lump sum payment of the cost to complete construction and the balance of the purchase price will be repaid in instalments within 5 years; or
- 11% per annum if the member has made instalment payments of the amount to complete construction and the balance of the purchase price will be repaid in instalments within 5 to 10 years.

Payment of the principal and interest due shall be made by the association and association members in tenge at the dollar equivalent on the date payment is due.

15. The association or association members may prepay the outstanding balance in full at any time during the life of the lease-purchase agreement

16. The bank shall convey ownership rights to the association members at the time that the entire purchase price of the apartments, together with all interest due, has been paid in full. The right of ownership shall be established in the lease-purchase agreement between the bank and the association, which shall be registered by a notary public.

17. The bank considers repayments of principal and interest as its own credit resources and shall employ these resources in the housing sector.

II. REGULATIONS FOR BILLS OF EXCHANGE OF ZHILSTROIBANK [1]

These regulations determine the conditions and procedures for the circulation of ordinary bills of exchange of Zhilstroibank. The regulations establish the rights and liabilities of the parties and the requirements for an ordinary bill of exchange.

In these regulations the following terms are used:

Bill of Exchange means a document that is made according to the format established by legislation and includes an unconditional financial liability.

Bill issuer (drawee) means a person that issued a bill of exchange for which he/she is liable.

Bill holder (drawer) means a person that is entitled to draw a stated amount of money.

Endorsement means a signature that validates transfer of the rights to another person. In the event of such a transfer, both parties (endorser and endorsee) do not have to inform the bill issuer about the transfer.

Endorser means a person that transfers the ownership right in a bill of exchange to another person by endorsement.

Cession means giving up of a liability and transfer of the rights to another person. Cession includes notification of the bill holder about each transfer of the bill and registration of new bill holder in a special registry maintained by the bill issuer.

Cedent means a person who gives up his/her rights by cession.

Cessionary means a person to whom a cession is made.

1. GENERAL PROVISIONS

1.1 Zhilstroibank issues bills of exchange to facilitate transactions, prevent defaults and attract free resources. Bills of exchange of Zhilstroibank are issued in accordance with current legislation of the Republic of Kazakhstan.

1.2 An ordinary bill of exchange of Zhilstroibank is a written document that includes an unconditional liability of the issuer - Zhilstroibank - to pay a certain amount of money on a certain day in a specified place to a holder of the bill or his order.

1.3 Under established terms for the use of bills of exchange, an ordinary bill of exchange of Zhilstroibank may be used as:

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[1] A bill of exchange is an order in writing addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay on demand or at a fixed date, a specified sum of money. The bill is made our by the signatory (the *drawer*), always with the consent of the person to whom it is addressed (the *drawee*), who signs or *accepts* it. Bills of exchange are used mainly in transactions involving the sale of goods or produce. Bills are negotiable in the money market, enabling drawers to obtain their money immediately.

A means of payment

A pledge.

1.4 A bill of exchange of Zhilstroibank is made in one copy.

1.5 Holders of bills of exchange may be legal entities that are registered in the Republic of Kazakhstan and outside its boundaries, as well as physical persons.

2. FORM OF AN ORDINARY BILL OF EXCHANGE

2.1 An ordinary bill of exchange of Zhilstroibank includes:

1) the title "bill of exchange" that is also used in the text;

2) a simple and unconditional liability of the bill issuer to pay a certain amount of money which is stated in numbers and in words;

3) the terms of payment;

4) the place of payment;

5) the name of the legal entity or person to whom payment shall be made;

6) the date and place of signing of the bill; and

7) the signatures of the Chairperson of the Board and a Chief Accountant, which are sealed by the bank.

2.2 In addition, the bill of exchange has:

8) a series number; and

9) a note "without the right to endorse" on the front page of the bill providing that the bill may be transferred only by cession.

2.3 If the bill of exchange has signatures of persons that are unable to be liable for the bill of Zhilstroibank, or forged signatures, or signatures that for some reason may not make those who put them (or on whose behalf they were put) fulfill their liabilities, signatures of other persons are nonetheless considered valid.

3. SUM OF THE BILL OF EXCHANGE

3.1 A bill of exchange of Zhilstroibank is a financial liability and it must include a sum in numbers and in words.

3.2 In the case of a descrepancy between the sum written in numbers and the amount written in words, the sum in words shall be considered valid.

3.3 If the sum is stated in numbers or in words severaltimes, the lesser sum is considered valid.

3.4 No corrections of the sum on the bill are allowed.

4. TRANSFER OF THE BILL TO A THIRD PARTY

4.1 Any bill of exchange may be transferred to a third party by endorsement.

4.2 If the bill issuer puts the words "no right to endorse" or other word combinations with the same meaning on the bill, then the document may be transferred only by cession. Cession means giving up of the right to demand payment, which must be registered by Zhilstroibank. A cedent (one who transfers the bill of exchange) has to be present at registration in Zhilstroibank.

4.3 As a result of cession, all rights are transferred to a new holder of the bill.

4.4 If the endorsement includes a clause "currency to receive", "order for collection", or any other qualification that means other than an ordinary order, the bill holder may enjoy all the rights of an owner of the bill, but he may not endorse it.

4.5 Transfers of a bill of exchange must be continuous. Otherwise a person who has the bill is not considered a legal holder of the bill.

4.6 If a mistake was made in the text of an endorsement, this record must be crossed our and a new record made. The stamp must be legible.

5. TERMS OF PAYMENT

5.1 Bills of exchange of Zhilstroibank may be paid in any of the following manners:

-- on demand;

-- within a stated period after demand;

-- within a stated period after registration; or

-- on a stated date.

5.2 The terms of payment are determined by the bank.

5.3 In the bills of exchange that are paid on demand or within a stated period after demand, the bill issuer -- Zhilstroibank -- may provide that it will charge in terest on the amount stated in the bill.

5.4 The bill isser may also provide that the bill which has to be paid "on demand" or "within a stated period after demand" may not be paid earlier than the stated period.

5.5 The bill that has to be paid "on demand" or "within a stated period after demand" must be presented for payment within a year since its issuance. The bank has the right to reduce of extend the period, at its sole discretion. The "period after demand" is determined after the day when demand has been recorded.

6. PAYMENT

6.1 A bill of exchange must be presented for payment to Zhilstroibank ar any other bank that is authorized to pay the obligations of Zhilstroibank.

6.2 Payment will be made upon presentment of the bill at the bank.

6.3 According to current legislation of the Republic of Kazakhstan, tax on income from securities must be paid to the tax inspectorate upon redemption of the bills of Zhilstroibank.

6.4 Bills of exchange may be redeemed prior to the stated date if Zhilstroibank and its agent banks agree to such early payment. All issues concerning such payment shall be resolved by a special committee of Zhilstroibank.

6.5 After paying taxes, Zhlstroibank shall transfer the money, including principal and interest, to the bill holder's account.

6.6 Upon payment, the bank may require a signature from the bill holder which certifies that he has received the money.

III. THE TERMS OF ISSUANCE, CIRCULATION AND WITHDRAWAL OF THE FIRST HOUSING LOTTERY LOAN OF ZHILSTROIBANK

Draft Confirmed by the Minister of Finance of the Republic of Kazakhstan

These terms are issued in accordance with the Presidential Decress # _____, dated ______, 1995.

1. The first housing lottery loan of Zhilstroibank (hereinafter the "Targeted Loan") is issued for a one year period in bonds with a face value of Tg 5,000 each. The issuance and redemption dates of all bonds issued as well as the volume of the issue shall be determined by Zhilstroibank (hereinafter the "Issuer") and coordinated with the Minister of Finance of the Republic of Kazakhstan.

2. The main objective of the issuance of Targeted Loans is to attract the financial resources of the population to the housing sector.

3. Bonds issued in a Targeted Loan issuance shall be bearer bonds and shall be sold at the face value.

4. Bonds shall be sold to individuals and legal entities through offices of the Issuer or its agents on a cash or non-cash (money transfer) basis.

5. The purchase of a bond automatically gives the bond holder the right to participate in the drawings for prizes equal to the current market value of a one-room flat.

6. The dates and frequency of drawings shall be determined by the Issuer, but shall be no less frequently that two times each year.

7. The number and amount of the prizes to be paid at each drawing shall be determined by the Issuer based on the amount of bonds outstanding in the month prior to the month of the drawing.

8. Lottery bonds may be redeemed for cash prior to maturity, but the bond holder shall have no further right to participate in future drawings.

9. The interest rate paid on the bonds shall be determined by the Issuer.

10. The date of issuance of the bond shall be stated on the face of the bond.

11. Interest shall be paid by the Issuer. In the case of early redemption of the bond, the bearer shall forfeit all interest due and unpaid at the time of such early redemption.

12. The bond holder has the right to sell or otherwise convey the bond to any individual or legal entity.

13. The bond holder has the right to present, devise or pledge the bond on legislative order.

14. At the maturity of the bond, the bond holder shall receive the face value, plus all interest due and payable.

15. In the event of the loaa, theft or damage of a bond, new bonds are not available.

16. After the maturity fixed by the Issuer, the bonds are not payable.

17. The Issuer has the following rights, obligations and privileges:

    1) implement the work of organizing the Targeted Loan program, issuance and primary allocation of the bonds, advertisement and promotion of the bond issue;

    2) use the funds received from the issuance of bonds for housing finance;

    3) redeem the bonds presented prior to the maturity date at the face value of the bonds;

    4) issue all necessary normative documents;

    5) Guarantee the timely redemption of the face value of the bonds and all interest due and payable.