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

An ICMA Report

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**ASSESSMENT OF THE PROSPECTS FOR  
HOUSING FINANCE SECTOR REFORM  
IN KYRGYZSTAN**

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

## ABSTRACT

The U.S. Agency for International Development (USAID), through its housing sector consultant, International City/County Management Association (ICMA), is working in Kyrgyzstan to assist the Government of the Republic of Kyrgyzstan in implementing the legal, structural and operational reforms necessary to create an effective private housing and real estate market in the country. The housing sector reform project in Kyrgyzstan is organized around three substantive areas: 1) land privatization and real estate development; 2) privatization of housing and communal services; and 3) housing and construction finance.

The first step in the process is to assist Kyrgyz government authorities to develop and implement a comprehensive set of housing sector reform initiatives to establish the legislative foundation for market-based private housing and housing finance markets. At the same time, ICMA is working with private and public entities to identify financially feasible housing systems demonstration projects which will apply market principles of housing construction, finance and marketing. The housing systems demonstration component of the housing sector reform project is an integral part of the overall housing sector policy reform initiative.

This report is based on a short initial visit to Kyrgyzstan by ICMA housing finance advisor Weis from April 22 to 26, 1995 and various documents, draft legislative proposals and publications obtained by the advisor during her visit. During her visit, the advisor met with Kyrgyz and City of Bishkek officials, representatives of U.S. and international donor agencies, Kyrgyz banking officials and the members of the ad hoc planning committee for an Inter-Ministerial Housing Policy Working Group. A list of the consultant's contacts is provided in Annex A. The report describes the current legal and financial situation in Kyrgyzstan relating to housing finance, the structure of the banking system, the draft reform proposals which have been prepared by Gosstroj, and the potential for apartment completion and self-help housing systems demonstration projects.

## EXECUTIVE SUMMARY

### A. BACKGROUND

The housing sector is being given a high priority in Kyrgyzstan today due to a number of factors:

1. The rural to urban migration of the population, particularly in the City of Bishkek, is placing pressure on the housing stock.
2. Housing construction has virtually ceased because of the recent sharp economic decline, budget constraints, rising construction costs and lack of affordability of housing for a large portion of the population.
3. Stimulating the construction sector could generate needed employment to counter recent increases in unemployment.
4. The thousands of unfinished apartments in Kyrgyzstan represent a significant wasted capital investment. Unfinished apartments represent a potentially attractive investment opportunity for entrepreneurs, investors and banks.
5. Several thousand families were granted ownership rights to building lots on the outskirts of Bishkek in so-called "zones of individual construction", but have no financial capacity to build their homes. There are strong political and social incentives to design a means by which these families can build their homes.

There are numerous obstacles to the implementation of the reforms which will be required to transform the housing sector into a productive segment of the economy. Some of these impediments can be removed or mitigated by housing sector reform initiatives, but others will depend on the success of overall economic reform in the country.

1. *Economic and financial instability*
2. *Absence of laws and regulations establishing a clearly defined and enforceable system of property rights*
3. *Lack of an effective institutional framework for the housing and housing finance sectors*
4. *Lack of funding sources for the housing sector*

## B. SUMMARY AND CONCLUSIONS

Although some progress has been made to introduce market-based housing systems in Kyrgyzstan, much remains to be accomplished. Development of an effective and efficient housing market will be difficult, considering the limited level of institutional development and the uncertain prospects for inflation, interest rates and real incomes in Kyrgyzstan. The government will have to design its housing policies and housing sector reform proposals to address the adverse fiscal, economic and market conditions in Kyrgyzstan today. The housing sector initiatives undertaken by the Kyrgyz government should address the fundamental requirements for a well functioning housing system.

1. A mortgage law and other laws and regulations governing secured transactions should be enacted as soon as possible so that enterprises, entrepreneurs and financial institutions can begin to consider entering the housing market. The rights of secured creditors when real property is pledged as security for a loan, particularly loans to individuals, must be clarified.
2. Problems of housing affordability and lack of effective demand will require involvement of the government at least during the transition period. Any subsidy system which is adopted should be cost effective and targeted to those most in need. Scarce budget resources should be leveraged through public-private partnerships, financial and regulatory incentives, credit guarantees and similar techniques.
3. Government and the National Bank should identify and remove any legal, regulatory, tax and procedural impediments to entry into the housing finance market by Kyrgyz banks. For example, the current laws prohibiting disclosure of information regarding bank clients' deposit and loan accounts to other creditors should be reevaluated to permit sharing of confidential information with credit bureaus and other creditors to facilitate the development of sound credit analysis and loan underwriting.
4. The development of the housing sector should be coordinated with other economic and financial sector reform efforts.
5. The draft housing laws and regulations prepared by Gosstroi in 1994 may be used as the basis for discussion of the optimal structure, financing and operations of a market-based housing sector. However, many of the provisions of these draft laws and regulations should be carefully evaluated and appropriate revisions made to ensure that the laws and regulations which are adopted further the objective of creation of a competitive and efficient housing sector.
6. Completion of unfinished apartment buildings appears to be the most cost effective means of creating affordable housing. A financially feasible apartment completion project, probably involving a public/private partnership, should be undertaken as part of the housing finance systems demonstration project.

Financing the completion and purchase of these units may involve a lease-purchase financing structure similar to that being developed in Russia.

7. Individual ownership of rights to building lots by thousands of Kyrgyz families in the "zones of individual construction" on the outskirts of Bishkek offers a promising opportunity for the introduction of self-help construction projects as a second component of the housing finance systems demonstration project. The City of Bishkek has indicated that it is willing to support a self-help demonstration project. It may be possible to access World Bank social safety net funding for a demonstration project. Successful development of these areas may prevent the creation of squatter settlements in the environs of Bishkek
8. Domestic funds mobilization programs and international funding programs should be evaluated to determine their appropriateness for housing sector development in Kyrgyzstan. The current law exempting interest earned on bank deposits from income taxes should be effective in stimulating the growth of household and commercial deposits in the banking system. However, high required reserves on bank deposits increase the cost of deposits and make deposits less attractive as a source of funding for bank loans. Non-deposit domestic funds mobilization programs could include public-private partnerships, tax and other financial incentives and debt and equity capital market financing for housing construction and purchase. Funds may be available through EBRD, CAAEF or World Bank financing programs for construction companies, real estate developers and building materials manufacturers.
9. In 1994, seven "healthy" banks organized the Association of Banks of Kyrgyzstan. The Association could play an important role in establishing standards for bank management, training, adoption of legislation and initiating cooperative efforts, such as mutual deposit insurance, establishment of a credit bureau, maintenance of a list of qualified appraisers and organization of community development programs, including financing self-help housing. ICMA should explore the possibility of offering housing finance and appraiser training through the Association of Banks and developing other joint efforts which would facilitate the entry of sound Kyrgyz banks into the housing finance market.
10. The proposed Inter-Ministerial Housing Policy Working Group could provide the appropriate high-level forum for the discussion and resolution of the issues facing the Kyrgyz housing sector. The recent experience of other emerging marketing economies in addressing housing policy issues suggests that rather than attempting to craft a comprehensive national housing policy, the Inter-Ministerial Housing Policy Working Group would be more effective as an initiating and coordinating body. The Working Group should identify housing sector reform priorities, develop an action plan for enactment of the legislation and regulations required to implement these reforms, assign principal responsibility to specific ministries or other governmental agencies for preparing

the legislation and regulations, coordinate housing reform with reform initiatives in other sectors and make recommendations to government.

## C. HOUSING SECTOR DEVELOPMENT

### 1. Housing Policy

Kyrgyz officials at the government and city levels have taken the initial steps to establish the legal and institutional framework essential to the development of a private housing sector in Kyrgyzstan. As of April, 1995, laws and regulations had been adopted governing land rights in Kyrgyzstan. A bankruptcy law and banking laws and regulations based on western banking principles also have been adopted. Initiatives are being instituted to formulate a broad national housing policy and specific implementing decrees and regulations to govern the transition to a market-based housing sector. An ad hoc planning committee has been organized to develop a mission statement and work plan for an Inter-Ministerial Housing Policy Working Group to develop a national housing policy based on market principles. There is some question whether the best approach to housing sector reform is to adopt a comprehensive national housing policy or discrete laws and regulations addressing various policy considerations affecting the housing sector. The experience of other countries argues for the latter approach.

### 2. Housing Systems Demonstration Projects

Initiating one or more housing systems demonstration projects incorporating market principles and practices will be an essential element of the implementation of housing reforms. All of the people interviewed during the consultant's brief visit to Kyrgyzstan regarded housing as a serious problem and also a potential opportunity for profitable investment. The Chief Architect of the City of Bishkek was very concerned about the need for decisive action to resolve the deteriorating housing situation in the city, particularly apartment completions and enabling individual families to build homes on lots given to them by the city in the "zones of individual construction". The Chairman of Orient Bank, a private commercial bank with German participation, indicated that his institution was considering forming a real estate services subsidiary to acquire and complete unfinished apartments in Bishkek and other cities as part of its business development plan. Kurulus Bank also expressed interest in offering real estate financial services to its customers. Kyrgyzstan appears to be at the stage of economic and financial development where investment in the housing sector could be a sound business prospect.

There appear to be two types of housing systems demonstration projects which may be feasible in the context of the current economic and financial conditions in Kyrgyzstan:

1. Completion and sale of unfinished apartments
2. Self-help housing development in the "zones of individual construction" on the outskirts of Bishkek.

Developing feasible methods to complete the thousands of unfinished housing units in Kyrgyzstan is a high priority of the Kyrgyz government and ICMA. Resident advisor ("RA") Duane Beard and consultant Ronald MacLachlan have evaluated the feasibility of several unfinished apartment and multi-use projects in the City of Bishkek. Based on these evaluations, it appears that several projects may be commercially viable. Discussions with officials from Orient Bank and Kurulus Bank during the consultant's visit indicated that banks and private investors consider the completion and sale of unfinished apartments a potentially attractive investment opportunity. The banks probably would be willing to become involved in these projects as investors, not merely lenders, because there is greater profit potential from the sale of the units.

In order to attract banks, developers and other investors, Kyrgyz government and local authorities must simplify the procedures for conveying state property and granting the required permits to complete the units and provide utilities and other public services to the projects. The Chief Architect of the City of Bishkek indicated that the city would consider contributing unfinished buildings at no cost or on a deferred payment basis to investors and waiving certain requirements and fees as an incentive to private companies to invest in housing projects.

As economic conditions have deteriorated in Kyrgyzstan, the country has begun to experience the rural to urban migration patterns typical for most developing countries. This migration has led to a deterioration in housing conditions in Bishkek and other urban areas. Rising unemployment resulting from economic restructuring has contributed to the problem and the country is facing the challenge of dealing with increasing poverty. Squatter settlements are not in evidence in Bishkek, but there is a risk that if the housing problem is not addressed, families living in overcrowded and substandard housing will develop their own housing solutions. The challenge to housing policy-makers is to assure that these solutions result in safe, sound housing, not urban blight.

The City of Bishkek has responded to the need for housing by granting property rights to individual building lots in undeveloped areas surrounding Bishkek. These "zones of individual construction" are contiguous to existing developed areas and have access to transportation, utilities and other public services. The City of Bishkek is anxious to devise some means by which families can be helped to build their homes. The zones of individual construction offer an opportunity to apply innovative housing solutions through self-help types of development. Self-help housing development would build on the Kyrgyz tradition of "ashar", or mutual aid. In villages throughout Kyrgyzstan neighbors work together to build their houses. Building a house is a community event in which young and old participate. Each member of the community has a duty to help his neighbor build his house. This informal housing construction process could be institutionalized in an urban environment through home owners associations or community-based NGOs. Successful self-help housing programs in the U.S. and other countries should be evaluated for their appropriateness for Kyrgyzstan.

## D. THE HOUSING AND FINANCIAL MARKETS IN KYRGYZSTAN

### 1. The Bishkek Housing Market

The ICMA office in Bishkek has been collecting housing cost and sales data for the City of Bishkek as part of its housing sector indicators program. As of April, 1995, ICMA had compiled data on 2,266 homes sold in the City of Bishkek from June 30, 1994 through March 31, 1995. There are a variety of types of housing in the Bishkek metropolitan area ranging from barracks with no utilities to brick single family detached homes. The most common type of housing unit is an apartment in a multifamily building. According to the ICMA house sales data, barrack style housing units sold for an average price of \$2,350, the average price for an apartment in a multifamily structure ranged from \$4,000 to \$7,600 and individual houses sold for a \$12,000 to \$13,000 average price. Houses in the City Center 1 and 2 Districts sold for the highest prices and houses located on the periphery of the city for the lowest prices.

### 2. Banking and Housing Finance

Central to the creation of a market-based housing sector will be the development of institutions and instruments to mobilize financial resources for the construction, completion and purchase of housing. Participation by the emerging private banking system in Kyrgyzstan will be essential to the success of any housing sector reform. The transformation of the housing sector will require major changes in business operations at existing construction enterprises and the creation of new real estate development, construction and brokerage firms. These changes can occur only if there is an adequate flow of credit to the sector.

The high interest rates in Kyrgyzstan today make traditional housing finance difficult. Few housing projects can support commercial lending rates of over 100% and Kyrgyz families do not have the financial capability to afford mortgages in the current interest rate environment. As the Kyrgyz economy stabilizes, traditional forms of housing finance will become more feasible. In the interim, alternative financial structures must be considered.

As in the other former republics of the Soviet Union, the banking system in Kyrgyzstan has just begun to develop. The legacies of the mono-bank Soviet system in which banks functioned merely as distribution networks for state subsidies have left the Kyrgyz banking system poorly suited to finance an emerging market economy. However, progress is being made. Banking legislation and regulations have been enacted to establish a sound private banking system. As of April, 1995, 18 banks with 178 offices were operating in Kyrgyzstan. Although many of these institutions lack sufficient financial size and strength to make a significant contribution to the development of a housing finance system, there are several banks which could become leaders in a new housing finance industry. Inflation and high interest rates have impeded the development of the banking sector, but as the economy is stabilized financial intermediation will play an increasingly important role in the economic growth and development, including the housing sector.

## E. INTERNATIONAL DONOR AGENCY FUNDING PROGRAMS

The World Bank, EBRD and CAAEF offer financing programs for small and medium enterprises and the World Bank has a social safety net loan program. These financing programs may be viable as sources of longer term funding for housing development. The terms and conditions of most of the loan programs for small and medium enterprises may not allow for direct financing of real estate construction. However, representatives of the donor organizations indicated that loans to construction companies and building materials manufacturers could be designed to meet the program criteria. If a construction company could obtain financing for the purchase of equipment and working capital, the company's own funds could be made available for equity investment in real estate development.

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## ASSESSMENT OF THE PROSPECTS FOR HOUSING FINANCE SECTOR REFORM IN KYRGYZSTAN

### A. BACKGROUND

#### 1. Importance of the Housing Sector to Economic Reform and Development

The housing sector is being given a high priority in Kyrgyzstan today because of a number of factors:

a. The rural to urban migration of the population, particularly in the City of Bishkek, is placing pressure on the housing stock. Overcrowding and substandard housing conditions are worsening and there is a risk that if the housing situation is not addressed, Bishkek could experience the problems of unregulated squatter settlements which plague many urban centers in other developing countries.

b. Housing construction has virtually ceased because of the recent sharp economic decline, budget constraints, rising construction costs and lack of affordability of housing for a large portion of the population.

c. Stimulating the construction sector could generate needed employment to counter the recent increase in the unemployment rate. Construction can be an important factor in economic development because it is labor intensive, is one of the few industries capable of employing relatively low skilled labor and has a comparatively high employment and income multiplier. The construction, completion, repair and modernization of housing stimulates demand in supporting industries such as building materials and furniture and fixtures, which results in two to four times the number of jobs created within the construction industry itself.

d. The thousands of unfinished apartments in Kyrgyzstan represent a significant wasted capital investment. Unfinished apartments could be an attractive investment opportunity for entrepreneurs, investors and banks if the government is willing to facilitate private sector investment by lowering and/or deferring payment of the purchase price of the unfinished structures, expediting permit approvals and reducing or waiving regulatory fees.

e. Several thousand families were granted ownership rights to building lots on the outskirts of Bishkek in so-called "zones of individual construction", but have no financial capacity to build their homes. There are strong political and social incentives to design a means by which these families can build their homes. The Kyrgyz tradition of "ashar", or mutual aid among members of a village or community, provides the basis for successful self-help construction projects. The families participating in such a program also could learn construction skills which would enable them to secure employment in the construction sector.

#### 2. Impediments to Housing Sector Reform

Kyrgyzstan has only recently begun the process of reforming the housing sector. There are numerous obstacles to the implementation of the reforms which will be required to transform the housing sector into a productive segment of the economy.

Some of these impediments can be removed or mitigated by housing sector reform initiatives, but others will depend on the success of overall economic reform in the country.

a. *Economic and Financial Instability*: The current economic and financial instability in Kyrgyzstan discourages the mobilization of domestic and foreign financial resources for investment in the housing sector. Economic conditions in Kazakhstan in 1994 and early 1995 have made housing investment and financing difficult, if not impossible. Inflation has pushed housing construction costs to the point where new housing construction is not affordable. As of March 1, 1995, interest rates on 3-month bank credits ranged from 60% to 180%, making most housing investments not financially feasible if any significant amount of bank financing is required. Fledgling commercial real estate developers cannot absorb the financing costs at the current high levels of interest rates. 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.

b. *Absence of Laws and Regulations Establishing a Clearly Defined and Enforceable System of Property Rights*: Kyrgyzstan has enacted laws governing land rights and collateral, but has not yet enacted a mortgage law and other laws relating to property conveyancing, security of tenure and the rights of secured creditors. Without clearly defined and enforceable laws and regulations governing real estate transactions, including laws establishing a creditor's right to take possession of mortgaged houses and realize on the collateral, no workable housing finance system will develop in Kyrgyzstan.

c. *Lack of an Effective Institutional Framework for the Housing and Housing Finance Sectors*: The institutional structure for the housing and housing finance systems has not yet been organized. The institutions which governed the housing sector under the former central planning system still exist, but their role in a market-based economic system has not been determined. No new, market-based institutions have evolved to take the place of the central housing authorities in the administration of housing programs.

The institutional structure for a market-based housing finance sector 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 Kyrgyzstan because the banking system is in transition, the public lacks confidence in the financial and managerial integrity of Kyrgyz financial institutions, consumer finance of any type is just being introduced in Kyrgyzstan and the government and the National Bank of the Kyrgyz Republic (NBKR) do not have a clear and coherent vision of how development of the housing finance sector should be coordinated with broader economic and financial sector reforms.

A related issue is the banks' and banking authorities' lack of experience with market-based real estate lending. 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 USAID and other foreign-sponsored technical assistance agencies, but it will be some time before local bankers develop the financial and managerial expertise to effectively manage a sound housing finance function.

d. *Lack of Funding Sources for the Housing Sector.* The traditional state budget sources of financing for housing must be replaced by private sector or public/private financing at a time when the banking system is weak, interest rates are prohibitively high and there are no sources of intermediate or long term financing. A lack of even intermediate maturity funding is one of the major impediments to progress in creating a housing finance system in Kyrgyzstan. Funding housing finance is and will continue to be one of the greatest challenges to government, the central bank and financial institutions.

The Kyrgyz government is anxious to explore all possible alternatives to secure longer term funding from international donor agencies. At the present time, the World Bank, EBRD, the Central-Asian American Enterprise Fund ("CAAEF") and other donors are focusing on financing commercial enterprises and privatization. Funding real estate projects may not be within the scope of the financing programs currently being offered in Kyrgyzstan. However, financing for construction and building materials companies may meet the criteria established by the various donor agencies. In addition, funding for self-help housing construction may be available through the World Bank social safety net financing programs.

Kyrgyz banks cannot be expected to solve the problem of funding housing construction and mortgage loan portfolios without government support, at least during the transition stage of economic development. The issue is to design housing and housing finance subsidy programs which are effective in providing financial incentives to encourage entrepreneurs and banks to enter the market and in expanding access to housing credit for the people in a manner which is cost effective and results in the least market distortions. The funding situation may improve as the financial markets develop and new debt instruments are introduced. A treasury bills market is emerging 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 which may provide a stable source of funds for the housing sector.

### 3. Housing Sector Policy Development

Kyrgyz officials at the government and city levels have taken the initial steps to establish the legal and institutional framework essential to the development of a private housing sector in Kyrgyzstan. As of April, 1995, laws and regulations had been adopted governing land rights in Kyrgyzstan. Laws governing the rights of secured creditors have been enacted (See Annex B for the rights of secured creditors in a bankruptcy). Banking laws and regulations based on western banking principles also have been adopted (See Annex C). Initiatives are being instituted to formulate a broad national housing policy and specific implementing decrees and regulations to govern the transition to a market-based housing sector. An ad hoc planning committee has been organized to develop a mission statement and work plan for an Inter-Ministerial Housing

Policy Working Group. Kyrgyz housing authorities have evaluated national housing policy statements from Russia and Kazakhstan, as articulated in the Presidential Decree "On a New Housing Policy", as possible models for a national housing policy for Kyrgyzstan. The draft housing sector reform proposals prepared by Gosstroi in October, 1994, also are being reconsidered in light of current economic, legal and financial conditions in Kyrgyzstan.

Kyrgyz officials intend to base national housing policy, laws and regulations on market principles which will facilitate the emergence of a private housing sector. At the same time, they are concerned about the negative social implications of deteriorating housing conditions. Policy-makers will have to create market-based housing and housing finance systems which will be effective within the reality of the practical problems faced by Kyrgyz entrepreneurs and institutions in producing and financing a range of safe, sound housing which is acceptable to and affordable by the population. Therefore, during the transition phase, government support will be required to compensate for market failures and to provide access to affordable housing credit for the majority of the population.

#### 4. The Housing Market in Bishkek

The ICMA office in Bishkek has been collecting housing cost and sales data for the City of Bishkek as part of its housing sector indicators program. As of April, 1995, ICMA had compiled data on 2,266 homes sold in the City of Bishkek from June 30, 1994 through March 31, 1995. There were a variety of types of housing sold in the Bishkek metropolitan area ranging from barracks with no utilities to brick single family detached homes. The most common type of housing unit sold was an apartment in a multifamily building. According to the ICMA house sales data, barrack style housing units sold for an average price of \$2,350, the average price for an apartment in a multifamily structure ranged from \$4,000 to \$7,600 and individual houses sold for a \$12,000 to \$13,000 average price.

The quality and price of housing units varied according to the location of the house as well as the type of construction. Houses in the City Center 1 and 2 Districts sold for the highest prices and houses located on the periphery of the city for the lowest prices. The following table shows the range and average price by district for the 2,266 houses which were included in the ICMA housing data base.

TABLE 1  
 PRICES OF HOUSING IN BISHKEK, KYRGYZSTAN  
 BY DISTRICT  
 House Sales from 6/30/94 through 3/31/95

DISTRICT	UNITS SOLD	LOWEST PRICE	HIGHEST PRICE	AVERAGE PRICE
City of Bishkek	2,266	\$1,000	\$45,000	\$7,658
Alamedin	206	\$2,000	\$20,000	\$5,568
Center 1	98	\$3,000	\$45,000	\$13,609
Center 2	915	\$1,500	\$39,000	\$9,284
New District	82	\$1,800	\$35,000	\$6,349
South	831	\$1,000	\$25,000	\$6,422
Suburban	134	\$1,300	\$9,000	\$6,897

The prices of houses sold in Bishkek remained relatively constant in dollar terms over the nine month period for which house sales data were available. In some districts house prices declined slightly in dollar terms. The lack of appreciation in house prices is somewhat surprising in light of the high rate of inflation in the country during the same time period. However, worsening economic conditions have resulted in negative growth in real household incomes. The effective demand for housing may have been dampened as people began to find housing less affordable. A softening of effective demand would tend to slow the rate of appreciation in home prices.

5. Housing Finance and Financial Sector Development

Central to the creation of a market-based housing sector will be the development of institutions and instruments to mobilize financial resources for the construction, completion and purchase of housing. Participation by the emerging private banking system in Kyrgyzstan will be essential to the success of any housing sector reform. The transformation of the housing sector will require major changes in business operations at existing construction enterprises and the creation of new real estate development, construction and brokerage firms. These changes can occur only if there is an adequate flow of credit to the sector. Such financing may take the form of bank lending, direct investment, capital market funding or a combination of funding mechanisms. Regardless of the sources and forms of financing, it is clear that credit at market interest rates must be available to ventures with reasonable

risks and returns through a competitive banking system consisting of independent firms operated as sound financial businesses. Credit rationing and administered interest rates will have to be gradually phased out if the financial markets are to function effectively.

The high interest rates in Kyrgyzstan today make traditional housing finance difficult. Few housing projects can support commercial lending rates of over 100%. Kyrgyz families do not have the financial capability to afford mortgages in the current interest rate environment. As the Kyrgyz economy stabilizes, traditional forms of housing finance will become more feasible. In the interim, alternative financial structures must be considered.

As in the other former republics of the Soviet Union, the banking system in Kyrgyzstan has just begun to develop. The legacies of the mono-bank Soviet system in which banks functioned merely as distribution networks for state subsidies have left the Kyrgyz banking system poorly suited to finance an emerging market economy. However, progress is being made. Banking legislation and regulations have been enacted (See Annex C), a Kyrgyz Bankers Association has been organized (See Annex E), banker training programs have been initiated, bank operating systems are being modernized and the banks are beginning to expand the financial services and products they offer to their customers. Inflation and high interest rates have impeded the development of the banking sector, but as the economy is stabilized financial intermediation will play an increasingly important role in the economic growth and development, including the housing sector.

#### 6. International Donor Agency Funding Programs

The World Bank, EBRD and the Central Asian-American Enterprise Fund ("CAAEF") offer financing programs for small and medium enterprises and the World Bank has a social safety net loan program. These financing programs may be viable as sources of longer term funding for housing development. The terms and conditions of most of the loan programs for small and medium enterprises may not allow for direct financing of real estate construction. However, representatives of these donor organizations indicated that loans to construction companies and building materials manufacturers could be designed to meet the program criteria. If a construction company could obtain financing for the purchase of equipment and working capital, the company's own funds could be made available for equity investment in real estate development.

#### B. SUMMARY AND CONCLUSIONS

Although some progress has been made to introduce market-based housing systems in Kyrgyzstan, much remains to be accomplished. Development of an effective and efficient housing market will be difficult, considering the limited level of institutional development and the uncertain prospects for inflation, interest rates and real incomes in Kyrgyzstan. The government will have to design its housing policies and housing sector reform proposals to address the adverse fiscal, economic and market conditions in Kyrgyzstan today. The housing sector

initiatives undertaken by the Kyrgyz government should address the fundamental requirements for a well functioning housing system:

1. A mortgage law and other laws and regulations governing secured transactions should be enacted as soon as possible so that enterprises, entrepreneurs and financial institutions can begin to consider entering the housing market. The rights of secured creditors when real property is pledged as security for a loan, particularly loans to individuals, must be clarified.
2. Problems of housing affordability and lack of effective demand will require involvement of the government at least during the transition period. Any subsidy system which is adopted should be cost effective and targeted to those most in need. Scarce budget resources should be leveraged through public-private partnerships, financial and regulatory incentives, credit guarantees and similar techniques.
3. Government and the National Bank should identify and remove any legal, regulatory, tax and procedural impediments to entry into the housing finance market by Kyrgyzstani banks. For example, the current laws prohibiting disclosure of information regarding bank clients' deposit and loan accounts to other creditors should be reevaluated to permit sharing of confidential information with credit bureaus and other creditors to facilitate the development of sound credit analysis and loan underwriting.
4. The development of the housing sector should be coordinated with other economic and financial sector reform efforts.
5. The draft housing laws and regulations prepared by Gosstroi in 1994 may be used as the basis for discussion of the optimal structure, financing and operations of a market-based housing sector. However, many of the provisions of these draft laws and regulations should be carefully evaluated and appropriate revisions made to ensure that the laws and regulations which are adopted further the objective of creation of a competitive and efficient housing sector.
6. Completion of unfinished apartment buildings appears to be the most cost effective means of creating affordable housing. A financially feasible apartment completion project, probably involving a public/private partnership, should be undertaken as part of the housing finance systems demonstration project. Financing the completion and purchase of these units may involve a lease-purchase financing structure similar to that being developed in Russia.
7. Individual ownership of rights to building lots by thousands of Kyrgyz families in the "zones of individual construction" on the outskirts of Bishkek offers a promising opportunity for the introduction of self-help construction projects as a second component of the housing finance systems demonstration project. The City of Bishkek has indicated that it is willing to support a self-help demonstration project. It may be possible to access World Bank social safety net funding for a demonstration project. Successful development of these

areas may prevent the creation of squatter settlements in the environs of Bishkek

8. Domestic funds mobilization programs and international funding programs should be evaluated to determine their appropriateness for housing sector development in Kyrgyzstan. The current law exempting interest earned on bank deposits from income taxes should be effective in stimulating the growth of household and commercial deposits in the banking system. However, high required reserves on bank deposits increase the cost of deposits and make deposits less attractive as a source of funding for bank loans. Non-deposit domestic funds mobilization programs could include public-private partnerships, tax and other financial incentives and debt and equity capital market financing for housing construction and purchase. Funds may be available through EBRD, CAAEF or World Bank financing programs for construction companies, real estate developers and building materials manufacturers.
9. In 1994, seven "healthy" banks organized the Association of Banks of Kyrgyzstan. The Association could play an important role in establishing standards for bank management, training, adoption of legislation and initiating cooperative efforts, such as mutual deposit insurance, establishment of a credit bureau, maintenance of a list of qualified appraisers and organization of community development programs, including financing self-help housing. ICMA should explore the possibility of offering housing finance and appraiser training through the Association of Banks and developing other joint efforts which would facilitate the entry of sound Kyrgyz banks into the housing finance market.
10. The proposed Inter-Ministerial Housing Policy Working Group could provide the appropriate high-level forum for the discussion and resolution of the issues facing the Kyrgyz housing sector. The recent experience of other emerging marketing economies in addressing housing policy issues suggests that rather than attempting to craft a comprehensive national housing policy, the Inter-Ministerial Housing Policy Working Group would be more effective as an initiating and coordinating body. The Working Group should identify housing sector reform priorities, develop an action plan for enactment of the legislation and regulations required to implement these reforms, assign principal responsibility to specific ministries or other governmental agencies for preparing the legislation and regulations, coordinate housing reform with reform initiatives in other sectors and make recommendations to government.

A U.S. study tour is planned for late summer, 1995, to familiarize members of the working group with methods being used in the U.S. to address housing concerns. The objective of this study tour is to provide the working group with examples of legislation, regulation and practical solutions to housing issues which could be adapted to the Kyrgyz situation. A major conference is planned for the fall in Kyrgyzstan where representatives of government, local administrations, the

construction sector and the financial community can discuss housing policy issues and, hopefully, arrive at a consensus about the optimal housing sector reform program for Kyrgyzstan.

C. IMPLEMENTATION OF HOUSING SECTOR REFORM

1. Existing Laws and Regulations

Over the last two years, the Kyrgyz government has enacted several of the fundamental laws and regulations required for a functioning housing market. Among these have been the Land Code of the Kyrgyz Republic and laws "On Land Reform", "On Pledge", "On Bankruptcy" and "On Banks and Banking". Various banking regulations also have been issued. The Land Code and the law "On Land Reform" established private property rights in land for individuals and legal entities. Land rights include the right to a life estate in land, but not fee simple ownership, the right to inherit land ownership rights and the right to use land, including the right to lease. When real property rights for completed or unfinished buildings are conveyed, the rights of ownership and/or use of the underlying land are included in the transfer.

a. *Rights of Secured Creditors.* The law "On Pledge" permits real property rights to be pledged as security for loans. The consultant requested a translation of the law "On Pledge", but had not received a copy by the time this report was completed. The laws "On Pledge" and "On Bankruptcy" established the rights of secured creditors and the priority of creditors in the case of the bankruptcy of companies and other legal ("juridical") persons (See Annex B). Until a specific mortgage law is enacted in Kyrgyzstan, a bank lending to a commercial developer or other commercial enterprise which declared or was placed into bankruptcy would have to follow the bankruptcy law in order to realize on the mortgaged property. The bankruptcy law provides for the appointment of a conservator for a period of six months to three years before a bankrupt company would be liquidated. Secured creditors have the right to recover the amount due, including principal and interest, by taking possession of and selling the collateral so long as the creditor initiates repossession or foreclosure action prior to the liquidation of the company. However, if a secured creditor has not initiated repossession or foreclosure actions prior to liquidation, the secured creditor would lose his rights in the collateral. In this case, the liquidator would have responsibility for repossession and sale of a bankrupt company's mortgaged assets and the proceeds of the sale would be distributed according to the priority of creditors in the bankruptcy law.

The priority of claims in the case of the bankruptcy of a company or other juridical person is established in Article 41 of the bankruptcy law as follows:

#### *Article 41. Priority of Claims*

*Repayment of debts is performed according to the priority of creditors in the following sequence:*

- 1) First, the claims secured by collateral, to the extent of the sum received from realization of collateral. In addition to the principal debt and liabilities, secured creditors can claim the interest which would have been received during the time spent on the liquidation of the enterprise. If the sum received from realization of collateral is not sufficient to satisfy the claims of a secured creditor, the unpaid balance will be paid in the fourth priority under the procedure and conditions described in item 4 of the present Article;*
- 2) Second, the expenses of the court, liquidator and temporary liquidator, expenses of the persons hired by them and possible expenses of the liquidating enterprise during the period of liquidation which the liquidator considered necessary to continue its operations;*
- 3) Third, claims of enterprise employees who have not receive payment of their salaries during the six month before the beginning of liquidation and employees' disability claims, including the loss of the breadwinner. Disability and loss of breadwinner claims are satisfied in the order and amount established by the Law of the Kyrgyz Republic "On Labor Protection." Payment of the salaries unpaid during six months is limited to a sum equal to six times the minimum salary established at the enterprise or, if a minimum salary is not set at the enterprise, then to six times the minimum salary established in the Kyrgyz Republic;*
- 4) Fourth, claims of ordinary unsecured creditors, including enterprise personnel, workers, staff employees;*
- 5) Fifth, claims of state institutions for taxes and other payments to the Republican and local budget, and also the claims of state insurance and social security institutions;*
- 6) Sixth, other claims, including claims of the creditors, who waived their priority rights and notified in writing the insolvent enterprise or the liquidator that they agree to receive payment of the debt after creditors mentioned in the present article;*
- 7) In the last turn, after satisfying all the above mentioned claims of creditors and paying all interest due during the period of liquidation, the residual balance is paid to the owners of the enterprise.*

*Interest, which the creditors should receive during the period of liquidation, is paid together with the debt on the equal right basis to the creditors in one category according to the priority of claims. Interest is determined according to the established instructions.*

*All creditors can claim their right to compensation for the profit not received or lost as a result of the insolvency of the enterprise insolvency, including such foregone or lost profits as part of the unpaid debt.*

Article 41 grants secured creditors a higher priority than other creditors to the extent of the value of the collateral pledged. If the collateral is pledged as security on several loans, the priority of claim is established based the order in which the secured loans were granted. In other words, the first creditor who recorded the collateral as security for a loan would have priority over all other creditors which have a claim against the same collateral unless there are specific subordination provisions in the loan contract. Senior creditors would be paid in full before any payment is made to junior creditors.

If the proceeds from the sale of the collateral are not sufficient to repay the secured credit in full, together with all interest due, the unpaid amount due is treated as an unsecured debt which would be paid as a fourth priority of claim, after payment of the costs of liquidation and the claims of enterprise employees

b. *Banking Laws and Regulations.* The laws and regulations on banking (See Annex C) authorize banks licensed in the Kyrgyz Republic to accept deposits and invest these funds and the banks' own funds in loans and securities. The banking law authorizes banks to "own, use and possess monetary assets, buildings, constructions and other material assets" according to the banking law and the bank's charter. The banking law does not explicitly authorize a bank to invest deposit and other financial resources in real property. If a bank intends to engage in the business of owning, developing and trading in real property, this activity would have to be included in the list of authorized activities in the bank's license. Banks can invest in "commercial and other institutions" up to a maximum of 15% of the bank's equity capital in each non-bank entity and 60% of the bank's equity capital in all non-bank entities. Banks may also perform "consulting and brokerage services associated with banking activity." The National Bank of the Kyrgyz Republic (NBKR) would have to determine whether real estate brokerage would be considered a service "associated with banking activity."

The banking law encourages deposits in banks by making interest earned on bank deposits exempt from income taxes. As the collection of income taxes is improved, the tax exempt status of bank deposits should increase the flow of funds to the banking sector. Funds mobilization by Kyrgyz banks will be critical to any effort to create a housing finance market.

One provision of the banking law could impede the development of market-based lending practices. Article 26 of the banking law appears to prohibit disclosure of information about a bank client and his/her accounts to another bank to which the client has applied for a loan and to any credit bureau which might be organized in Kyrgyzstan:

3. *Banks (including the Bank of Kyrgyzstan) in the Kyrgyz Republic guarantee the privacy of operations, accounts and deposits of their clients and correspondents including the former ones, except in the cases described in item 4 of the present article.*

4. *Records about operations, accounts and deposits of juridical and physical persons may be given to:*

1) *account holders and their legitimate representatives;*

- 2) *investigative institutions and courts about the cases, taken in their jurisdiction, upon official request from the institution or court;*
- 3) *tax institutions in respect of taxation problems.*
5. *All juridical persons and their staff employees mentioned in items 3 and 4 of the present article are responsible for the confidentiality of information received when performing official duties, according to the current legislation.*

Although it is important to establish a financial right to privacy, banks should be authorized to disclose information regarding a depositor or borrower to other banks and credit bureaus upon the written authorization of the client. It will be critical to the development of sound credit analysis and loan underwriting procedures and practices for the banking laws and regulations to facilitate the establishment of credit bureaus or similar organizations which provide credit histories on borrowers. One of the contributions which the newly organized Association of Banks of the Kyrgyz Republic could make to improving banking practices in the Kyrgyz Republic would be to organize a credit bureau through which association members could share information about bank clients to facilitate sound credit underwriting.

Banking regulations also establish required reserves against deposits and other liabilities of commercial banks. Reserve requirements are a powerful tool of monetary policy and until the Kyrgyz capital markets have developed to the point where the National Bank of the Kyrgyz Republic can implement monetary policy effectively through open market operations, adjustments in reserve requirements may be the principal means of controlling the volume and growth of bank credit. High reserve requirements increase the cost of funds for a bank and restrict growth in bank lending. In addition, if reserve requirements are adjusted frequently, banks must protect themselves against a potential shortfall in required reserves by maintaining additional liquidity and reducing their investment in loans.

## 2. Status of Implementation of Housing Sector Reform

Laws and regulations relating specifically to real estate and real estate secured transactions will be required before a housing market can develop. The Kyrgyz government has begun the process of formulating housing policy and housing sector reform proposals to facilitate the creation of a market-based housing sector in Kyrgyzstan. Several housing sector reform initiatives were drafted in the fall of 1994, but no further action has been taken. The government has had higher priorities over the last six months, including a protracted election process. In recent months, housing has assumed a higher priority as a social and economic issue. With ICMA's assistance, government has supported the organization of an ad hoc planning committee to prepare a mission statement and plan for the creation of an Inter-Ministerial Housing Policy Working Group which would recommend proposed laws and implementing regulations to government to reform the housing sector.

a. *Housing Policy:* There is some question whether the best approach to housing sector reform is to adopt a comprehensive national housing policy or develop an action plan to enact discrete laws and regulations addressing various policy considerations affecting the housing sector. The experience of other

countries argues for the latter approach. Kazakhstan adopted a comprehensive housing policy in September, 1993, but few of the provisions mandated in the housing policy have been implemented. The President of Kazakhstan has requested that new legislative proposals be prepared by the ministries involved in the housing sector to address specific issues. Presumably these proposals would supersede the 1993 national housing policy. A similar situation has occurred in Russia, where a draft comprehensive housing law has been abandoned in favor of separate laws dealing with different housing sector reforms. Armenia appears to have had success in implementing housing reforms by adopting legislation addressing specific issues, such as a condominium law and a mortgage law. In Hungary, where an inter-ministerial housing policy working group was created to address housing policy issues, specific Ministers were given primary responsibility for submitting reports and legislative proposals to the committee on 19 separate housing sector issues.

b. *Housing Systems Demonstration Projects:* During the consultant's brief visit to Kyrgyzstan from April 22 to April 16, 1995, she met with various public officials, representatives of international donor agencies and the ad hoc planning committee to discuss the prospects and problems of housing sector reform and the feasibility of financing several housing systems demonstration projects to implement market-based principles of housing construction and financing. All of the people interviewed regarded housing as a serious problem and also a potential opportunity for profitable investment. The Chief Architect of the City of Bishkek, Tolobay Keneshev, was very concerned about the need for decisive action to resolve the deteriorating housing situation in the city, particularly apartment completions and enabling individual families to build homes on lots given to them by the city in the "zones of individual construction". The Chairman of Orient Bank, a private commercial bank with German participation, indicated that his institution was considering forming a real estate services subsidiary to acquire and complete unfinished apartments in Bishkek and other cities as part of its business development plan. Kurulus Bank also expressed interest in offering real estate financial services to its customers. Kyrgyzstan appears to be at the stage of economic and financial development where investment in the housing sector could be a sound business prospect. The main obstacles are the absence of the laws and regulations regarding mortgages and secured financial transactions, uncertainty about government housing policies, persistent high interest rates and the lack of stable sources of funding for a real estate portfolio.

#### D. DRAFT HOUSING POLICY PROPOSALS

In the fourth quarter of 1994, draft laws, decrees and regulations were prepared by the State Committee for Architecture and Construction ("Gosstro") which proposed institutional, structural and policy reforms for several aspects of the housing sector. Specifically, these draft proposals dealt with:

- Housing Subsidies;

- Creation of a Specialized Housing Construction Fund and Committee on Housing Construction;
- Issuance of Housing Bonds;
- Regulations Regarding Housing Credits; and
- Completion of Unfinished Apartments.

These draft proposals were circulated to the appropriate Ministries and the NBKR and comments were received, but no further action was taken. The proposals addressed several of the fundamental elements of a market-based housing sector, such as a rationalized housing subsidy system, incentives to private financial institutions to provide housing finance and market-based funds mobilization mechanisms, but did not deal with other essential elements, such as private property rights, mortgage law, land privatization, land registration, privatization of housing and housing maintenance and development of housing infrastructure and municipal service programs.

#### 1. Housing Subsidies

The draft resolution "On State Support of Housing Construction" proposed that local administrations pay at least 70% of the increase in the cost of construction due to the V.A.T. and inflation for housing construction begun before January 1, 1994. This subsidy would have been limited to "people with low incomes and in need of improvement of housing conditions." After January 1, 1995, 100% of the funding required for this subsidy would have been paid from the State Budget.

This draft resolution limited the subsidy to the increase in construction costs of housing for those most in need. Although the resolution was brief and general, the essential concept of targeting subsidies was incorporated. If a national housing policy is prepared, housing subsidies funded from the State Budget will be a central consideration. All countries provide subsidies in some form to the housing sector. The challenge which will face housing policy-makers will be to design a limited, rational and cost effective housing subsidy system which will target scarce resources and utilize non-financial incentives.

#### 2. Institutional Structure

The draft regulation "On the State Committee of the Kyrgyz Republic on Development of Housing Construction" would create a special State organization chaired by the Vice Prime Minister of the Kyrgyz Republic which would have the primary authority for developing non-budget forms of financing and investment for the housing sector ("Gosskomzhilistche") and a self-financing "Fund of Development of Housing Construction of the Kyrgyz Republic ("Fund of Housing"). The principal purposes of Gosskomzhilistche would be the "creation and implementation of a single state policy in the field of development and implementation of non-budget forms of investments in the housing sphere, attraction/involvement of foreign financial supply and technical assistance to the Republic and support of the participation of foreign investors in housing reform in the Kyrgyz Republic."

Specifically, Gosskomzhilistche would be responsible for:

- coordination of the activities of all public and private organizations involved in the provision of housing finance;

- creation of conditions which would facilitate housing investment;
- assistance to mobilize funds from enterprises and organizations for housing construction;
- adoption of effective means to stimulate the development of a housing market to provide for labor mobility from regions with a high level of unemployment;
- assistance in the development of housing infrastructure;
- development of a competitive housing finance sector; and
- issuance of decrees and resolutions to implement the decisions made and programs adopted.

The Fund of Housing would function as the administrative body of Gosskomzhillistche and would be responsible for:

- drafting programs and implementing laws, regulations and decrees under the new housing policy for the republic;
- providing funds for the construction of housing and communal services facilities and social infrastructure;
- creating and supporting private organizations involved in the real estate market;
- managing the transfer of unfinished apartments from the State to private investors;
- participating in the budgeting process in the area of housing allowances and subsidies for the construction or purchase of housing;
- implementing proposals for mobilizing foreign investment capital for the housing sector;
- carrying out the decisions made by Gosskomzhillistche; and
- performing other functions to implement the State Housing Program.

The draft resolution provided that the Fund of Housing would be funded from several sources, including voluntary contributions of enterprises, organizations, public bodies, foreign organizations and individuals, directed government guaranteed credits, the sale of housing bonds, State subsidies and grants, profits from its investments and fees for technical and expert services. The resolution appeared to have conceived of the Fund of Housing as an apex institution through which financial resources for the housing sector would flow. However, it did not make clear how the Fund would be able to attract investment from enterprises, organizations and households.

The Fund would be authorized to extend housing credit directly to developers and construction companies for housing construction and to households for housing construction or purchase. The Fund also would administer housing subsidies and finance housing infrastructure. The proposal would give the Fund the right to be a founder or co founder of commercial banks, insurance companies and joint ventures.

The creation of a new State bureaucracy and a specialized state financing agency which would have a virtual monopoly in the housing finance sector raises several fundamental policy issues. These issues are similar to those raised in

Kazakhstan by Presidential Decree #1344 "On a New Housing Policy", which created the state housing bank (Zhilstroibank) and gave the Ministry of Construction, Housing and Land Development (Minstroj) the authority to establish State appraisal and commercial development companies.

Housing sector reform must take the broader objectives of economic and financial sector reform into account. The creation of a government agency which would have control over the entire housing market and a specialized financial institution which would deal directly with the public and could own banks appears inconsistent with the goals of financial sector development in Kyrgyzstan. Concentrating housing finance in a single institution would not further the objective of fostering a competitive and efficient housing finance system, but would merely serve to perpetuate the state monopoly in the housing sector. Instead, housing finance should be delivered through the banking sector. Although only the government has the ability to effect the sweeping reforms needed to transform the Kyrgyz housing system to an efficient market capable of providing housing and housing credit to the majority of the Republic's citizens, the appropriate role of government is to support the private sector, not stifle it.

### 3. Housing Bonds

The draft decree and regulation "On Issuing and Utilization of Housing Bonds" would establish the legal authority and procedures for the issuance of housing bonds to finance the construction of housing. The housing bonds described in the draft regulations would be similar to those authorized and issued in Irkutsk and Kazakhstan. Housing bonds are debt securities which are redeemable, at the option of the bondholder, for an apartment or for cash. A housing bond is denominated in square meters of apartment housing, with the nominal face value expressed as a number of square meters of housing multiplied by the price per square meter of housing at the time the bond is purchased. The draft housing bond regulation set the minimum face value of the bonds at the market price of 0.1 square meter of living space for the housing units being financed. The face value of the bond in number of square meters of living space would remain constant throughout the life of the bond, but the nominal cash value of the bond would be indexed to the cost of a square meter of living space. The regulation did not specify how housing costs would be determined or the index which should be used to adjust the nominal cash value of the bonds. Instead, the regulations stipulated that the method of indexation would be established in the bond documents for each bond issue.

Ownership of a housing bond would give the bond holder the right of possession of the specified number of square meters of living area in apartments being constructed by the commercial developer which issued the bonds. The redemption value of bonds redeemed for an apartment would be indexed to the market price of apartments in the locality in which the housing units were being constructed. Therefore, if an investor accumulated bonds equal to a specified number of square meters, he could redeem these bonds for that number of square meters regardless of the current market price per square meter of housing at the

time of redemption. By this method, the bond holder/home buyer would be protected against inflation in the housing market.

Only "juridical persons" (companies, joint ventures, partnerships) registered in Kyrgyzstan which have the rights to land for housing construction and which have the necessary plans, permits and other documents required to build houses would be authorized to issue housing bonds. Housing bonds issued by commercial developers could give the developer a less expensive, longer term source of financing than traditional bank loans. Housing bonds might be more attractive to commercial developers than bank borrowing because the commercial developer would not be required to pledge specific collateral to secure the bonds. A housing bond program also could be an effective marketing tool to stimulate apartment sales.

The regulation prohibited banks, other credit institutions and agencies and commodity and stock exchanges from issuing housing bonds. This restriction should be reconsidered, since there does not appear to be a sound reason for creating a new financial instrument outside the system of financial intermediation. In addition, it is likely that one or more Kyrgyz banks may establish real estate development or construction subsidiaries or joint ventures. The ability to issue housing bonds to finance its real estate development operations could be a strong incentive for banks to enter the real estate market. Housing bonds would provide the bank with a source of funds to finance residential construction which would be longer term and more stable than deposits or interbank borrowing. Another advantage could be that the banks might be able to obtain a ruling from the NBKR that its obligations to housing bond holders would not be subject to NBKR reserve requirements. Exemption from reserve requirements would make this source of funds very attractive to Kyrgyz banks.

If housing bonds are authorized under the provisions of a new housing policy or by decree and regulation, authorized issuers should not be limited to developers and other non-bank companies and organizations. Banks, insurance companies and other financial institutions and their subsidiaries and affiliates should be authorized to issue the instruments provided that the proceeds from issuance are used for the construction or completion of housing. Authorizing financial institutions to issue housing bonds would facilitate the mobilization of household savings and other financial resources for housing.

The draft housing bond regulations set out the requirements for the issuance of these securities. Housing bonds would be issued in registered form for a stated term to maturity. The nominal face-value of the housing bonds would be determined by the issuer based on the location and other characteristics of the apartments for which the bonds could be redeemed. The nominal face value of each housing bond would be set at the market value of the amount of square meters of living space represented by the bond as of the date of issuance. The actual size of the issue could not exceed the total quantity of square meters of apartments for which the bonds were redeemable. Each issue of housing bonds would have to be approved by the Ministry of Finance or an appropriate local authority. The issuer or

a designated registrar and transfer agent would maintain the registration records for the bonds and serve as the paying and transfer agent.

Each housing bond would be required to include the following information:

- the full name of the security being issued, including the words "housing bond";
- the date and state registration number of the bond;
- the term to maturity;
- the number of square meters being purchased (i.e. the denomination of the bond in square meters);
- the date the bond was purchased by the first bond holder;
- the issue size;
- the purchase price of the bond;
- the method of indexation which will be utilized;
- preliminary conditions of the contract of purchase and sale of a flat;
- procedures for establishing the conditions of the final purchase and sale agreement;
- redemption provisions;
- the name, signature and seal of the issuer;
- the name of the bond holder;
- the name of the bank which will be the "escrow" and paying agent.

The draft regulation stated that housing bonds could be redeemed by any one of three redemption methods: (1) redemption for an apartment; (1) redemption for cash; or (3) exchange of bonds for an equivalent amount of bonds of a new issue. If a bond holder wanted to redeem his/her bonds for an apartment, the bond holder would present the bonds to the issuer in an amount sufficient to purchase an apartment. A bond holder would have the right to redeem the bond if he/she had accumulated bonds equal to at least 30% of the living area of a flat of a specific type. The balance of the purchase price could be paid in cash or financed. The bond holder's property rights in the apartment purchased would then be registered in the appropriate property records.

Alternatively, bond holders could redeem their bonds for the nominal cash value of the bonds at the time of redemption, provided that they gave 7 banking days' notice to the issuer of their intention to redeem the bonds for cash. The regulations did not specify whether cash redemption would be allowed only at maturity. The problem with allowing unrestricted cash redemption of indexed bonds, is that the issuer would not be able to predict the cash reserves needed to cover cash redemptions. Uncertainty about the rate and amount of cash redemption exposes the bond holders and the issuer to the risk that the issuer would not be able to honor its obligations to the bond holders. If bond holders presented their bonds for cash redemption and the issuer was unable to redeem the bonds because the issuer lacked sufficient cash, there could be a run on the company's bonds which would be devastating.

Several changes in the proposed housing bond regulations would address the potential problems of cash redemption of housing bonds:

- (1) The regulations should specify that bonds redeemed for cash will be redeemed at the face value (i.e. purchase price) plus interest earned to date at an interest rate specified by the issuer and stated on the face of the bond rather than at the indexed nominal value of the bond.
- (2) Until issuers gain sufficient experience to predict the rate of cash redemption of housing bonds, the issuer should maintain a "bond redemption" account equal to at least 20% to 25% of the total amount of principal and interest due on the bonds and/or obtain a demand letter of credit from a bank. The funds held in the bond redemption account should be invested only in short term deposits and highly liquid investments. All interest and dividends earned on funds in the bond redemption account should be retained in the account. It should be recognized that establishment of a bond redemption account will reduce the amount of bond proceeds which the issuer can use to finance the construction of apartments.

The draft housing bond regulations did not require financial disclosure by the issuer. Since housing bonds would be unsecured obligations of the issuer, redemption of the bonds for apartments or cash would depend solely on the financial capacity of the issuer and its ability to continue to build apartments for which bonds could be redeemed. The regulations did authorize the issuer to have a bank or trust company guarantee timely performance or payment on the bonds. All issuers should be required to provide prospective investors with a clear and easy to understand explanation of the risks of investing in the bonds, including the financial capacity of the issuer to meet its obligations and any third party guarantee which may be provided.

#### 4. Housing Credits

A decree and regulations "On Housing Credits" established the framework for granting subsidies and allowances to increase the affordability of bank credit for the construction and purchase of housing. A mortgage with real property as security was specified as the basis for housing credits granted by banks. The regulations authorized three types of housing credits: 1) short or long term credit for land development; 2) short term credit for construction, completion and rehabilitation of housing; and 3) long term credit to finance the purchase of houses. Housing credit authorized under the regulations could be granted to "juridical" or natural persons. For purposes of this regulation, "juridical" persons were defined as: real estate developers and investors, general contractors, subcontractors and other companies and organizations involved in the acquisition, development and construction of housing.

The regulation required that in order to obtain construction financing, a developer would be required to have the rights to the land, all required permits and approvals for housing construction and the plans, specifications and cost estimates for the project. Housing credits would be granted based on sound underwriting principles. The regulation included a mortgage on real estate or the rights to real

estate, including both the property to be developed and other property owned by the borrower, other collateral and third party guarantees as eligible collateral for the housing loans authorized. The regulation did not require that the property being financed be appraised by a qualified independent appraiser.

The procedures for granting construction credit also were set out in the regulations. Construction credits would be disbursed by the bank setting up a line of credit for the developer or contractor and advancing funds, based on inspections of the project performed by the bank or its agent, as construction would be completed.

The draft regulations set the maximum loan-to-value ratio for construction and mortgage financing at 70% of the cost of construction or the purchase price of the house. If a maximum loan-to-value ratio is established by regulation, it should be based on the lesser of the construction cost/purchase price or the appraised value based on an appraisal performed by a qualified independent appraiser. The regulation also permitted the lender to charge a variable interest rate and to index the outstanding balance of a loan to adjust for inflation, so long as the method of adjustment is specified in the credit agreement.

The regulation specified the information and provisions which would have to be included in the credit application and the loan agreement. These requirements were consistent with U.S. standards. The forms of collateral which could be accepted to secure a housing credit also were specified, but the means of realization on collateral pledged was not set out in detail. The regulation merely stated that "In case of the impossibility to repay the credit, the mortgaged real estate should be sold to cover the bank's expenditures according to the order and terms fixed by legislation of the Kyrgyz Republic." Although a "Law on Pledge" is on the books in Kyrgyzstan, a specific mortgage law must be enacted before lenders would be willing to accept houses as security for loans.

It was not clear whether the regulation "On Housing Credits" would apply only to subsidized loans or be more generally applicable to all housing loans. If the regulation was intended to apply to unsubsidized as well as subsidized loans, it raises the question of whether the government should limit the types of credit which are authorized, establish a maximum loan-to-value ratio and control other aspects of real estate transactions which are more properly determined by management decisions of the lender and negotiations between the lender and the borrower. The categories of loans permitted in the draft regulations were too restrictive to permit lenders to respond to market demand for construction and housing credit. For example, the regulation did not specifically authorize equity participation financing or lease-purchase financing. The government also should not specify the terms and conditions of private financial contracts. If it is determined that some prudential regulation governing unsubsidized real estate finance is needed, the regulations should be issued by the NBKR, not the government.

## 5. Completion of Unfinished Construction

The decree and regulation "On the Completion and Sale of Unfinished Construction" set out the requirements and procedures for the conveyance of unfinished construction to real estate developers and investors and the requirements for completion of these projects. Transfer of these properties from the State to private ownership would be managed by the Fund of Development of Housing Construction created as part of Gosskomzhillistche, according to the decisions of the Fund of State Property and Gosstroj. The regulations required that unfinished projects be sold on a competitive bidding basis using the procedures specified in the regulation. The regulations appeared to require that all state-owned unfinished construction would have to be sold outright to the highest bidder. This requirement should be reconsidered in light of the potential for successful public/private partnership arrangements which could facilitate the completion and sale of unfinished apartments.

The regulations did not include provisions whereby the Kyrgyz government or a local administration could negotiate an arrangement with a real estate developer, bank or other investor to contribute or defer payment for the unfinished building as an incentive for the investor to complete construction and sell the units. Requiring that all unfinished projects be sold in a competitive bidding process would limit the options for disposition of unfinished construction and could preclude the type of public/private partnership which may be the most effective means of completing unfinished apartments at a cost which would make the investment attractive to investors and the finished units affordable to home buyers.

The Kyrgyz government should give careful consideration before adopting detailed regulations which would restrict the types of investment and financing structures which could be used to complete unfinished apartments. Competitive bidding with strict rules and requirements and sale to the highest bidder may be appropriate for disposing of unfinished commercial and industrial properties. For housing, however, the government may want to have the flexibility to entertain innovative financing proposals from developers, banks, investors or home owners associations in order to deliver affordable finished housing units. The highest price may not be the sole or even the most appropriate criterion for awarding a bid to a purchaser of an unfinished apartment building. If the government's primary goal is to deliver affordable housing units, the selling price of the apartments when completed may be as important as the price paid for the project. ICMA experts on the privatization of state properties can provide assistance to the government in designing methods of conveying property to private owners which will take the goals of housing policy into account while maintaining the principles of market competition.

## 6. Comments on the Draft Proposals

Gosstroj received comments on its draft proposals from the Ministries of Justice and Finance, the NBKR, the State Committee on Economics, the State Property Fund and the Bishkek City Administration. These organizations, or their successors, should be represented on the proposed Inter-Ministerial Housing Policy

Working Group. Many of the comments criticized the creation of new bureaucracies which overlap, at least in part, with existing government agencies. Several commentators felt that Gosskomzhilistche and the Fund of Housing should not be established, but that housing policy and programs should be administered through existing government entities and local administrations. The consultant has the same doubts about the advisability of creating new government organizations which would have a monopoly position in the housing sector, particularly when it appears that the governmental functions of the new agencies could be performed by Gosstroj, the State Property Committee and the Ministry of Finance.

The Ministry of Justice and the Ministry of Finance questioned the necessity of the regulation "On Housing Credits". Regulations governing financial transactions would be more appropriately issued by the NBKR or the Ministry of Finance. The Ministry of Justice also opposed the regulation on housing bonds because it believed the provisions conflicted with the "Law on Securities and Stock Exchanges." It is very important that any inconsistencies between new regulations and existing law and regulation be resolved before the new regulations are promulgated. Housing policy and the regulations to implement this policy must be integrated into the overall program of economic and financial sector reform.

#### E. HOUSING SYSTEMS DEMONSTRATION PROJECTS

There appear to be two types of housing systems demonstration projects which may be feasible in the context of the current economic and financial conditions in Kyrgyzstan:

1. Completion and sale of unfinished apartments
2. Self-help housing development in the "zones of individual construction" on the outskirts of Bishkek.

##### 1. Completion of Unfinished Apartments

Developing feasible methods to complete the thousands of unfinished housing units in Kyrgyzstan is a high priority of the Kyrgyz government and ICMA. Resident advisor ("RA") Duane Beard and consultant Ronald MacLachlan have evaluated the feasibility of several unfinished apartment and multi-use projects in the City of Bishkek. Based on these evaluations, it appears that several projects may be commercially viable. Discussions with officials from Orient Bank and Kurulush Bank during the consultant's visit indicated that banks and other private investors consider the completion and sale of unfinished apartments a potentially attractive investment opportunity. The banks probably would be willing to become involved in these projects as investors, not merely lenders, because there is greater profit potential from the sale of the units. Orient Bank, which owns an insurance company, also sees real estate development and the completion of unfinished units as a vehicle to cross-sell profitable insurance products. The advantage which banks have over commercial developers is that banks have the ability to finance the

project. Lack of financing on financially feasible terms and conditions is one of the principal constraints on commercial developers.

In order to attract banks, developers and other investors, Kyrgyz government and local authorities must simplify the procedures for conveying state property and granting the required permits to complete the units and provide utilities and other public services to the projects. The Chief Architect of the City of Bishkek indicated that the city was willing to waive certain requirements and fees as an incentive to private companies to invest in housing projects. The cooperation of the state water, gas, electric and telecoms companies also will be necessary. The Chief Architect also indicated that the City would consider contributing unfinished buildings at no cost or on a deferred payment basis as an inducement to investors to submit proposals to provide affordable housing.

There are numerous models of public/private partnership in the U.S. in which the city contributes land as an incentive to the development of affordable housing which could be used as the basis for similar arrangements in Kyrgyzstan. A description of some of these programs is provided in Annex F. Consultant provided a Russian translation of this material to RA Beard for distribution to Kyrgyz officials.

## 2. Self-Help Housing Projects

As economic conditions have deteriorated in Kyrgyzstan, the country has begun to experience the rural to urban migration patterns typical in most developing countries. This migration has led to a deterioration in housing conditions in Bishkek and other urban areas. Rising unemployment resulting from economic restructuring has exacerbated the problem and the country is facing the challenge of dealing with increasing poverty. Squatter settlements are not in evidence in Bishkek, but there is a risk that if the housing problem is not addressed, families living in overcrowded and substandard housing will develop their own housing solutions. The challenge to housing policy-makers is to assure that these solutions result in safe, sound housing, not urban blight.

The City of Bishkek has responded to the need for housing by granting property rights to individual building lots in undeveloped areas surrounding Bishkek. These "zones of individual construction" are contiguous to existing developed areas and have access to transportation, utilities and other public services. The families who received building lots initially were given small grants to help them build their houses. In some cases the families used the money for other purposes, but in many instances, rising construction costs and falling incomes precluded the families from beginning construction. The City of Bishkek is anxious to devise some means by which families can be helped to build their homes.

The zones of individual construction offer an opportunity to apply innovative housing solutions through self-help types of development. Years of experience by USAID and the World Bank in developing countries around the world have demonstrated that the informal housing sector can make a significant contribution to economic growth and development. Although specific housing projects have a limited impact on the overall housing sector, the creation of non-governmental organizations ("NGOs") with the capability to organize communities to provide their

own housing solutions and to train individuals in construction skills builds the institutional capacity of the sector. As we have seen in the United States and other countries, housing initiatives which successfully tap the potential of the informal sector result in viable private sector programs in which the government acts as a facilitator by accelerating the construction process, providing infrastructure and land and funding targeted loan programs through the financial sector. Successful self-help housing programs in the U.S. and other countries should be evaluated for their appropriateness for Kyrgyzstan. Self-help housing programs developed for Bishkek should be able to be replicated in other urban areas and become a permanent part of a diversified market-based housing system.

Self-help housing development would build on the Kyrgyz tradition of "ashar", or mutual aid. In villages throughout Kyrgyzstan neighbors work together to build their houses. Building a house is a community event in which young and old participate. Each member of the community has a duty to help his neighbor build his house. Experienced builders and people with technical expertise direct the construction process. The home owner, in turn, provides food and refreshments. This informal housing construction process could be institutionalized in an urban environment through community-based NGOs.

The NGO could be a home owners association organized for the purpose of overseeing the construction and maintenance of the housing project. The association could contract with architects, engineers, contractors and subcontractors, purchase construction materials and equipment and train home owners who wish to participate in the construction process themselves. The association also could be the borrower for a blanket construction loan. In this type of arrangement, the members of the association would make payments to the association and the association would be responsible for assuring that individual families make their payments in a timely manner. After construction has been completed, the individual families could take out mortgages if they are unable to pay the full cost of the house in cash.

#### F. THE HOUSING SECTOR AND THE BANKING SYSTEM

A financially sound and efficient banking sector will be critical to the success of the efforts of the Kyrgyz Republic to move to a market oriented economic system. However, most banks in Kyrgyzstan are not in sound financial condition and suffer from operating and managerial weaknesses which will impede their ability to perform their intermediation function in a competitive market environment. The Kyrgyz banking system has not reached even a moderate level of sophistication. Kyrgyzstan remains a cash economy, with payments for virtually all household goods and services made in cash. Checks are not in general use since the payments system is barely functional. There is no intermediate or long term capital market in Kyrgyzstan and the government securities market is in its infancy. The majority of bank loans are made for maturities no longer than three months. Bankers have limited experience in credit underwriting and credit standards, procedures and loan documentation are not uniform even within the same bank. Systems are

inefficient, and financial accounting and reporting are questionable. Banking personnel, trained in the traditional state bank system, are not oriented towards profitability and risk management.

1. Structure of the Kyrgyz Banking System

The legal and structural framework for the current banking system was established by banking legislation enacted in 1991 and amended in 1992 and 1994. This legislation created a two-tier banking system consisting of the National Bank of the Kyrgyz Republic (NBKR) and a system of commercial banks. At its inception, the Kyrgyz banking system consisted of the NBKR, 10 commercial banks and the State Savings Bank. The three largest banks - Promstroybank, Agroprombank and Kyrgyzstan Bank - dominated the commercial banking sector. Collectively these three banks had 94% of all bank branches and loans outstanding and 90% of total banking deposits in the Kyrgyz banking system.

Over the last 3 years, the Kyrgyz banking system has experienced growth and turmoil. In 1992 and 1993 the number of banks doubled as new banks were licensed. During the year 1994, the NBKR received applications to open 13 new banks, 18 branches, 44 pawnshops, 245 exchange bureaus and 1 branch of a foreign bank. The NBKR approved only one new bank application, denied 10 and, as of the end of the first quarter of 1995, was in the process of evaluating the documents submitted for permission to open 2 new banks. The rapid expansion of the Kyrgyz banking system over the last 2 years has not been without its problems. In 1994 some banks began experiencing serious financial difficulties. The NBKR found it necessary to place 7 banks under supervisory controls and, by the end of the year, had revoked the licenses of 3 banks.

As of March, 1995, 17 Kyrgyz banks and 1 foreign bank operated 178 banking offices in Kyrgyzstan. Banks in Kyrgyzstan are quite small. Aggregate assets of the banking system totaled only 4 billion som (approximately \$377 million at an exchange rate of 10.6 som: US\$1), an asset size equivalent to a medium sized local bank in the U.S. Table 2 shows the name, date of establishment, capitalization and number of offices of the 18 banks operating in Kyrgyzstan as of the end of March, 1995.

TABLE 6  
COMMERCIAL BANKS IN OPERATION IN KYRGYZSTAN  
As of March 31, 1995

BANK	DATE OF REGISTRATION	PAID-IN CAPITAL (Som in 000s)	NUMBER OF OFFICES
AK Kyrgyzpromstroybank	12/91	12,003.3	28
AK Kyrgyzagroprombank	12/91	14,788.2	52
AKB Kyrgyzstan	5/91	27,945.3	26
RAKB Akniet Bank	12/91	3,511.0	2
AKB Kurulusbank	12/91	5,007.0	4
KB Kyrgyzavtobank	12/91	5,588.0	3
KB Maksat Bank	12/91	22,876.0	3
KB Kyrgyz-Zher Bank	12/91	1,234.0	1
AKB Adil International Bank	04/92	1,555.5	2
AK Kyrgyzdyikanbank	05/92	2,095.0	9
AK Kyrgyzvnesheconombank	07/92	15,922.9	3
AK KyrgyzKRAMDSbank	10/92	7,549.0	2
KB Kyrgyzsberbank	12/91	2,723.5	53
AK Kyrgyzenergobank	05/92	4,564.0	3
ChB Mercury LTD	11/92	6,635.0	2
GMKB Hanfan LTD*	03/93	9,284.7	1
IAKB Issic-Kol Bank	05/93	6,469.8	1
KGPB Orient Bank	01/94	10,667.0	1

\* *Foreign Bank*

As the data in Table 2 indicate, the banking system is still dominated by the successors to the Soviet specialized sectoral banks and the commercial banks created from the former mono-bank. The banks which have been licensed since 1991 have been able to capture only a small share of the market because of their limited branch networks. However, these banks are expanding as their financial resources permit and can be expected to attract a larger share of the Kyrgyz banking market as they introduce new financial services and products.

## 2. Banking Activities

Under Kyrgyz banking law (See Annex C), most banks are authorized to engage in a broad range of financial activities. In practice, however, the banks are not true full service banks. The banks specialize in credits to and deposits from specific industries and have not developed a broad customer base. The former specialized sector banks still enjoy virtual monopolies in their respective credit sectors and continue to concentrate their lending in credits to state-owned enterprises. Consumer finance is in its infancy, with only 4.2 million som (less than US\$400,000) of loans to individuals outstanding as of the end of November, 1994. Banks are beginning to consider offering consumer financial services as a means of diversifying their loan portfolios and developing new profit opportunities.

Bank assets consist primarily of investments in commercial loans, government treasury bills and interbank credits. Loans outstanding totaled 2.5 billion som (US\$2.4 million) (52% of bank assets) as of November 30, 1994. As of the end of 1994, 15 banks had invested in treasury bills, more than double the number of banks participating in the government securities market at the beginning of the year. Treasury bill holdings totaled 51 million som (US\$4.8 million) (1.3% of bank assets). Nine banks were involved in the interbank credit market. The total outstanding balance of interbank credits was 32 million som (US\$3 million) at the end of November, 1994, an increase of over 300% during the year. At the end of the year, activity in the interbank market had increased significantly. As the banking system develops, the interbank credit market can be expected to replace NBKR refinancing credits as the primary source of bank liquidity.

Based on statistics reported to the NBKR, there was little bank lending activity in 1994 and the first quarter of 1995. For example, KyrgyzKRAMDSbank, a joint-stock company bank established in 1992 as a subsidiary of a Kazakhstani bank holding company, had only 92 loans on its books with an aggregate outstanding balance of less than 11 million som (about US \$1 million) at the end of 1994. Total lending activity at all Kyrgyz banks during the first 11 months of 1994 was only 1 billion som (US\$94 million). In the first quarter of 1995, one-third of the banks were not even offering credit. Many banks, particularly the banks which were created out of the old mono-bank system, were not granting new extensions of credit because of a lack of loanable funds and credit worthy borrowers. The banks which have been established since the banking system was restructured were being very selective in granting commercial credit in order to avoid the credit risk which has so severely weakened the more established institutions. Loans were being made only to the most credit worthy borrowers on a short term, secured basis.

## 3. Condition of the Kyrgyz Banking Sector

Kyrgyz banks are suffering from the same financial problems which have weakened banks throughout the CIS: high delinquency and default rates in loans to large state enterprises, inadequate capital, poor accounting and internal control systems, insider dealing, inadequate provisioning for loan losses, rapidly escalating operating costs and a rising cost of funds. The banks also were not equipped to operate successfully in a high and volatile interest rate environment. As of the end

of November, 1994, over 1.35 billion som in loans were delinquent. This represented 54% of total loans outstanding. The majority of the delinquent credits consists of accrued and unpaid interest on loans to state enterprises. These credits were granted under the former system of administrative distribution in which the loans were not subjected to even minimal underwriting.

The high rate of non-performing loans adversely affected the capital adequacy, liquidity and profitability of the banks. In early 1995, fewer than half of the banks in Kyrgyzstan met the NBKR's minimum capital and solvency requirements. At the end of 1994, five banks had a negative position on their correspondent accounts at the NBKR. These liquidity problems forced some banks to continue to pay high rates of interest to maintain their deposit base. The squeeze on bank profits led some institutions to lend to excessively risky ventures at high interest rates. Many of these ventures failed because of the worsening economy, increasing the banks' portfolios of non-performing credits and resulting in further deterioration of bank profitability. Only an estimated 25% of bank assets were generating earnings.

Kyrgyz banks continue to rely heavily on NBKR refinancing as the principal source of loanable funds and liquidity. Commercial banks have inadequate funds management systems and procedures and, as a result, frequently are unable to determine their liquidity position. For example, some banks have extended credit without the financial resources to disburse loan funds. The NBKR has been required to provide financing for the bank to meet its commitments to its customers, and sometimes to its depositors. Bank deposits have been increasing and are becoming a more important source of loanable funds. During 1994, commercial deposits grew at a 130% annual rate and household deposits increased by almost 230%. By the end of the year household deposits accounted for over 20% of total bank deposits.

The financial problems of Kyrgyz banks have been compounded by weak bank management. Many bank managers do not understand the requirements to operate profitably in a market economy. They continue to offer Soviet-era financial services and products using the old methods with which they are familiar. Most Kyrgyz bankers lack the technical and managerial skills to enable them to manage a modern banking operation. Training in bank management, real estate finance and investment and risk management is being offered through USAID and other donor technical assistance programs, but it may be some time before local bankers develop the expertise to effectively manage a sound financial services operation.

#### 4. Banking Reform

Kyrgyzstan has taken the first steps in the process of creating a modern, efficient banking system. (See Annex D) The banking laws have been amended twice since their enactment in 1991 and prudential regulations regarding reserve requirements and minimum capital standards have been adopted. The NBKR is attempting to reduce its role as a source of credit to the banking system and move towards functioning as a true central bank.

Strengthening the Kyrgyz banking system is essential to the success of economic reform and the development of an efficient financial market in Kyrgyzstan. The NBKR and the banks themselves have become more concerned about the financial and managerial soundness of Kyrgyz banks. In 1995, the government and the NBKR will focus on recapitalization of the banks, adoption of prudential regulations, creation of a system of deposit insurance, classification and write-off of non-performing assets and development of alternative funding sources to replace NBKR refinancing. USAID is providing technical assistance and training for bankers and bank regulators in safe and sound bank management and prudential regulation.

5. Association of Banks of Kyrgyzstan

In 1994, seven banks organized the Association of Banks of Kyrgyzstan to help develop the banking business in the country and maintain standards of safe and sound bank operation. (See Annex E) Only "healthy" banks which meet NBKR minimum capital and liquidity standards are eligible to become members of the Association. As with other bankers associations, the Association will be funded by entrance and membership fees paid by its members. The Association will have a board of directors and a professional staff.

The Association could play an important role in establishing standards for bank management, training, adoption of legislation and initiating cooperative efforts, such as mutual deposit insurance, establishment of a credit bureau, maintenance of a list of qualified appraisers and organization of community development programs, including financing self-help housing. ICMA should explore the possibility of offering housing finance and appraiser training through the Association of Banks and developing other joint efforts which would facilitate the entry of sound Kyrgyz banks into the housing finance market.

6. Potential for a Competitive Housing Finance System

There are indications that several banks could enter the housing finance market within the next year. Some Kyrgyz banks are considering real estate finance as a viable line of banking business. The participation of senior officers of Kuru!ush Bank and KyrgyzPromStroyBank in ICMA's real estate finance and investment training program is evidence of the potential interest of banks in developing real estate finance capabilities. The Chairman of Orient Bank said that his institution was considering establishing a real estate subsidiary to provide real estate services, possibly including real estate financing.

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.

## G. THE INTEREST RATE ENVIRONMENT

One of the main impediments to the development of a housing finance system in Kyrgyzstan is the high interest rate environment. Interest rates on bank deposits and credits are closely linked to the refinancing interest rate of the NBKR because NBKR refinancing remains the primary funding source for the banking system. The NBKR holds periodic auctions for credit resources. Refinancing credits are for a three month term. Four NBKR refinancing credit auctions were held in February, 1995 for an aggregate 4.5 billion som of refinancing credit. The interest rates bid for these credits increased from 76% to 86% during the month. As shown in Table 3, high and rising interest rates on NBKR refinancing credit were reflected in interest rates for deposits and credits in the banking sector.

TABLE 3  
INTEREST RATES ON BANK DEPOSITS AND LOANS  
As of March 1, 1995

TERM	DEPOSITS	LOANS
0 - 1 month	0.0% - 80.0%	100.0% - 200.0%
1 - 3 months	57.5% - 117.0%	60.0% - 180.0%
3 - 6 months	35.0% - 115.0%	93.0% - 146.0%
6 - 12 months	50.8% - 140.0%	83.0% - 100.0%
Over 12 months	35.0% - 110.0%	N/A

### 1. Interest Rates on Loans

Published statistics on loan interest rates for all eighteen Kyrgyz banks as of March 1, 1995 indicated that seven banks were not quoting som rates on any type of credit and, of the remaining eleven banks, six were som quoting rates on consumer credit. Table 4 shows the interest rates quoted by the twelve Kyrgyz Banks which were making loans during the first quarter of 1995.

**TABLE 4**  
**INTEREST RATES ON SOM LOANS AT KYRGYZ BANKS**  
**BY TYPE OF LOAN**  
as of March 1, 1995

BANK	Interbank Credit	Industrial Development	Commercial	Consumer
Kurulushbank	n/a	n/a	160.0%	n/a
Orient Bank	90.0%	102.0%	120.0%	130%
Kyrgyz-Zher Bank	n/a	n/a	150.0%	n/a
KyrgyzKRAMDSbank	n/a	124.5%	138.3%	n/a
Kyrgyzavtobank	120.0%	137.5%	n/a	108.0%
Mercury LTD	126.7%	n/a	155.0%	109.0%
Maksat Bank	120.0%	n/a	142.0%	180.0%
Kyrgyzsberbank	122.0%	n/a	n/a	60.0%
Kyrgyzpromstroybank	98.0%	n/a	n/a	n/a
Kyrgyzenergobank	n/a	n/a	165.0%	n/a
Issic-Kol Bank	115.0%	90.0%	150.0%	120.0% - 150.0%

Traditional forms of construction and mortgage financing for any significant portion of the purchase price of a home would not be affordable for most Kyrgyz households at the current high interest rates. For example, a 50% loan-to-value ratio adjustable rate mortgage on an apartment in Bishkek selling for US \$8,000 probably would have an interest rate of at least 100%. The monthly payments required for a 10 year mortgage at the initial interest rate would be US\$ 667 per month, a mortgage payment greater than the total household income of many Kyrgyz families.

#### 2. Interest Rates on Deposits

Interest rates on som deposits vary by type of depositor, i.e. an individual or a legal entity, and by maturity. Deposit interest rates are quoted for deposits on current account and for deposits with stated maturities of 1, 3, 6, or 9 months and one year or more. As of March 1, 1995, three banks were not quoting deposit interest rates for household deposits and six banks were not accepting commercial deposits. Tables 5 and 6 present deposit interest rate data for Kyrgyz Banks as of March 1, 1995.

**TABLE 5**  
**INTEREST RATES ON SOM HOUSEHOLD DEPOSITS BY MATURITY**  
as of March 1, 1995

Bank	Current Account	1 Month	3 Months	6 Months	9 Months	1 Year or More
Kurulushbank	50%	n/a	60%	70%	n/a	75% - 80%
Orient Bank	n/a	50%	50%	60%	60%	60%
Kyrgyz-Zher Bank	60%	n/a	n/a	70%	75%	70%
KyrgyzKRAMDSbank	60%	n/a	72%	90%	n/a	n/a
Kyrgyzavtobank	65%	n/a	n/a	n/a	n/a	n/a
Mercury LTD	20%	n/a	70%	70%	70%	n/a
Maksat Bank	n/a	50%	55%	60%	n/a	85% - 90%
Hanfan LTD	35%	n/a	60%	80%	n/a	n/a
Kyrgyzpromstroybank	70%	n/a	n/a	80%	n/a	100%
Kyrgyzenergobank	60%	n/a	n/a	60%	n/a	60%
Issic-Kol Bank	65%	n/a	65%	65%	65%	95% - 135%
Kyrgyzvneshbank	40%	n/a	60%	n/a	n/a	80%
Adil International Bank	8%	n/a	48%	48%	n/a	n/a
Kyrgyzagroprombank	60%	n/a	50%	60%	n/a	70%
Bank Kyrgyzstan	60% - 70%	n/a	n/a	n/a	n/a	n/a

Table 5 shows the som interest rates being offered for household deposits and Table 6, the som interest rates offered on commercial deposits. About half of the Kyrgyz banks are licensed to accept dollar deposits and quoted dollar interest rates during the first quarter of 1995 ranging from 6% for current accounts to 25% for longer term and large balance dollar accounts.

TABLE 6

INTEREST RATES ON SOM COMMERCIAL DEPOSITS BY MATURITY  
as of March 1, 1995

Bank	Current Account	1 Month	3 Months	6 Months	9 Months	1 Year or More
Kurulushbank	n/a	50% - 55%	50% - 65%	50% - 70%	50% - 75%	50% - 100%
Orient Bank	n/a	60%	60%	60%	60%	60%
Kyrgyz-Zher Bank	n/a	n/a	n/a	n/a	100%	n/a
KyrgyzKRAMDSbank	n/a	65%	70%	n/a	n/a	75% - 90%
Mercury LTD	n/a	n/a	72%	n/a	87.5%	n/a
Maksat Bank	14.6%	70.2%	70.7%	60%	70.6%	80% - 90%
Hanfan LTD	35%	60%	80%	n/a	n/a	n/a
Kyrgyzpromstroybank	n/a	n/a	60%	n/a	n/a	n/a
Issic-Kol	65%	65%	70%	80%	80%	100%
Kyrgyzvneshbank	60%	65%	n/a	n/a	89%	78%
Kyrgyzagroprombank	n/a	n/a	60% - 85%	n/a	100%	n/a
Bank Kyrgyzstan	n/a	60%	n/a	n/a	n/a	n/a

As the data in Tables 5 and 6 show, many Kyrgyz banks did not offer a full range of maturities for deposits. For those institutions which did offer deposits with different maturities, the term structure of deposit interest rates was comparatively flat. A flat term structure is not unexpected since inflation and interest rates are expected to decline over the next year.

The deposit rate data also reveal that most of the deposit interest rates offered by Kyrgyz banks provided depositors with a negative real rate of return on a before tax basis. Assuming that the income tax is actually collected, the after tax real rate of return on bank deposits may have been slightly positive. Negative real rates of return

on deposits discourage the flow of funds into the banking system. Households and businesses will seek alternative investments which at least hold the promise of a positive real rate of return.

#### H. PROSPECTS FOR EXTERNAL FINANCING OF HOUSING CONSTRUCTION

The long term success of housing sector reform will depend on the mobilization of domestic financial resources for housing. However, given the limited development and weakness of Kyrgyz banks today, it is unlikely that the banks alone will be able to provide sufficient funding to support growth in the housing sector. The housing reform process could be accelerated if intermediate or long term funding were available from external sources. The most common sources of external financing for the housing sector are World Bank and USAID housing loans. However, Kyrgyzstan is not scheduled to receive a housing loan from either donor agency. The possibility of obtaining external financing for the sector from other multi-lateral and bi-lateral donor agencies is being explored by Kyrgyz authorities. During the consultant's visit she and RA Beard met with representatives of the World Bank and the Central Asian-American Enterprise Fund ("CAAEF") to discuss the possibility of these agencies financing housing construction. It was not possible for the consultant to meet with EBRD representatives during her visit because the EBRD office in Bishkek had not yet been opened. However, RA Beard and other ICMA representatives have met with the EBRD about accessing the Small and Medium Enterprise ("SME") loan program for the completion of unfinished apartments and the consultant has reviewed the published EBRD guidelines for SME financing.

Housing construction does not appear to fit within the guidelines of any of the current donor agency financing programs in Kyrgyzstan. The CAAEF and EBRD programs are intended to fund businesses which will increase the productive capacity of industry, particularly export industries which will generate hard currency. The World Bank loan programs are focused on rural development, SME financing and the social safety net. There is a possibility that a self-help housing program, particularly one which involves training people in construction skills, could be crafted to meet the criteria of the World Bank social safety net loan program.

The criteria for the SME loan programs offered through the three donor agencies are very similar. In order to be eligible, a prospective borrower must be a private or privatizing enterprise which has a viable project to create a new business or expand its existing business. The project should contribute the economic development of Kyrgyzstan by creating new jobs, providing new and better products for the market and improving the balance of payments. The project must have a business plan which establishes its market and financial viability and the borrower must have capable management and staff to implement the plan. The EBRD also requires that a project generate hard currency, which would preclude funding for residential construction.

The CAAEF's equity and loan investment program will provide credit or direct investment for qualifying companies of \$100,000 to \$5 million. However, housing construction does not appear to meet the investment objectives of the agency. The stated goal of the CAAEF is to "invest in enterprises active in fulfilling the demand for infrastructural development such as food processing, distribution and transportation, as well as in companies producing consumer goods and services."

The CAAEF small business loan program appears to accommodate lending to commercial developers for housing construction. The mission of the program is to develop the capacity within the banks which participate in the program to underwrite commercial credits to small businesses on a sound basis and to encourage the extension of small business loans to support the development of entrepreneurial activity. The CAAEF loan program will not extend credit to start-up businesses, so newly organized commercial developers would not be eligible for financing. In order to qualify for a loan, the borrower must be an established business with a history of profitable operations. A commercial development subsidiary of an established diversified company might qualify for credit, but it would not have a track record in residential construction. However, the CAAEF's maximum lending limit of \$50,000 would be too low to provide a meaningful amount of financing for most residential construction projects.

ICMA RA Beard and consultant MacLachlan are working with several commercial developers to prepare business plans which meet EBRD and CAAEF criteria. Although these efforts may not be successful in securing donor agency financed credit, they will improve the skills and expertise of the developers in analyzing construction projects and may result in the companies obtaining financing from Kyrgyz banks using the bank's own credit resources. Developing the capabilities of Kyrgyz commercial developers and banks to evaluate the feasibility of construction projects will have a greater long term benefit to the housing sector than obtaining financing for a specific project.