

A. HOUSING DEMAND AND AVAILABILITY OF HOUSING FINANCE

Private investment in housing production has been constantly increasing over recent years with a 5.1 billion soms (98% of total investment) peak in 2006.⁸⁸ However, public investment in housing at the national and local levels has practically ceased in the same period without having put in place alternative mechanisms to support the development of the housing sector. A lack of mechanisms available to facilitate the construction of affordable housing, including the availability of housing finance, has resulted in a small increase in the housing stock in the recent past. Apartment construction in the shrinking market has been mostly concentrated in the three largest cities (Bishkek, Osh and Jalalabad) and primarily targeted towards the luxury end of the market. As estimated by the International Finance Corporation (IFC), in 2006 in the capital city Bishkek alone, new housing construction was 44.3% of the overall new housing output.

In such a situation, self-built housing becomes the easiest and most affordable way for the population to improve their housing situation. In 2007, individual housing built by tenants made up 87% of the total housing output.

According to market price dynamics and experts' estimates, there is an overwhelming demand for new and affordable multi-storey housing, but the supply of such housing stock is insufficient due to a lack of financial mechanisms to support construction companies. According to the National Statistical

Committee,⁸⁹ in 2006 the construction sector was represented by 673 construction companies, of which more than 84% had fewer than 50 workers. As also noted by the IFC in 2006,⁹⁰ nowadays at least two schemes for housing financing are possible. One approach is when companies operate on a joint stock basis, setting up partnerships with Turkish and Korean construction companies and are well capitalized by the latter. Another approach is adopted by companies without foreign shares; in this case, housing construction is usually implemented with pre-financing by future home owners.⁹¹

Lower housing prices at the beginning of construction (usually 50–60% of the price of a completed apartment) are more attractive to buyers, despite the fact that no legal protection of their rights is provided. The registration of rights to unfinished buildings is not possible. In theory, such a situation puts the buyer in a position to be “double sold” an apartment, but in practice, there have been no such cases yet. In order to make the registration of rights to unfinished buildings possible, the Gosregister is now preparing instructions and methodology to estimate the level of completeness of buildings under construction.

⁸⁸ Government of the Kyrgyz Republic (2008), National Statistical Committee. Construction of Housing and Social Building in January-December, 2007, Express Information on 15 January 2008, National Statistical Committee of the Kyrgyz Republic, Bishkek.

⁸⁹ Government of the Kyrgyz Republic (2007) National Statistical Committee. Kyrgyzstan in Figures Annual Statistical Publication, Kyrgyz Republic, National Statistical Committee, Bishkek, p. 127.

⁹⁰ International Finance Corporation (IFC) (2006), Central Asia Housing Finance Gap Analysis (p. 74), *World Bank Group Working Paper Vol.1*, Washington, D.C.

⁹¹ Roseman, G. (2004), Residential Real Estate Market in Bishkek, Kyrgyzstan. Current Conditions and Prospects, *The Real Estate Issues*, June 2004.

Table 11. Number and volume of housing construction by public and private sectors

Years	Public Sector		Private Sector	
	Number of apartments	Volume of construction	Number of apartments	Volume of construction (in 1,000 m ²)
2002	200	9,000	4,300	425
2003	50	4,000	4,600	444
2004	90	5,000	5,000	492
2005	0	0	5,000	539
2006	200	8,000	4,900	572
2007	0	0	6,300	688

Source: Government of the Kyrgyz Republic (2007) National Statistical Committee. *Kyrgyzstan in Figures Annual Statistical Publication, Kyrgyz Republic, National Statistical Committee, Bishkek, p. 127.*

B. HOUSING FINANCE PROGRAMMES

The 2007 *National Programme on Housing Construction in Kyrgyzstan for 2008–2010* defines the main direction of public investment in housing, which is focused mainly on subsidies for low- and middle-income households. Under the programme, local authorities are made responsible for preparing and adopting local housing programmes and co-financing activities. The programme expects that financing for the first stage (2008–2010) will be 58.2 billion soms (of which 3.9 billion soms or 6.7% should come from budget or public organizations). The volume of housing construction is planned to reach 1.9 million m² per year in 2010, of which only 64% will be individual (self-built) dwellings. Both Government and independent experts say it is very ambitious but due to the lack of financing both at the State and local levels the implementation of the programme is almost frozen.

Other State programmes which have State and local financing, (Young Teacher Deposit and Young Doctor Deposit) provide assistance for young members of these professions in rural areas under special savings and loan schemes subsidized by the government (see *Housing programmes* in chap. IV, sect. A). In 2007 the

volume of such financing was about 14 million soms. Victims of natural disasters are also eligible for State support and can receive a 20-year interest-free loan of 200,000 soms for housing repair, construction or purchase or a subsidy of 50,000 soms (US\$ 1,130).⁹²

At the local level, the Bishkek city administration provides interest-free loans for low- and middle-income households to finance a 30% down payment in selected construction projects; the administration also provides land plots for housing construction in exchange for 10% of housing (units or square metres as agreed between the administration and developer) constructed on such plots for provision to low-income households in housing need.

C. GENERATING HOUSING FINANCE AT THE LOCAL LEVEL

Particularly at the level of local government, where the main responsibilities for

⁹² Government of the Kyrgyz Republic (2007), On the Approval of the Regulations on the Issue of State Mortgage Certificates for State Subsidies Provision for Construction, Reconstruction of Individual Dwellings by Victims of Natural Disasters in the Kyrgyz Republic, approved by Government Decree No. 155 on 8 May 2007.

the implementation of housing policies are located, financial resources are very tight and often only sufficient for performing basic administrative duties. Local budgets are prepared locally, but only 25% of all municipalities have a surplus. The ongoing reform of the local administration system intends to reduce financial transfers between the State and local authority budgets; it delegates power to local authorities to collect and keep all taxes that depend upon local policies. The budgets are usually designed one financial year ahead using a cost-based approach without any subsequent monitoring. In 2009 the State expects to start drafting the budget for three years ahead, which should improve the predictability and soundness of the State and local budgets. This is of crucial importance, as local government gains access to sufficient financial resources of its own to exercise responsibilities for implementing housing policies.

Regarding land tax, the Ministry of Finance estimates that the revenue from the tax amounts to 80–90% of local budgets. However, the lack of a cadastral valuation system is an obvious drawback. Land tax is calculated in accordance with zoning regulations. The Government establishes a normative value for different types of land by using a number of coefficients established for a zone of the city where a land plot under consideration is located. The local government could vary tax rates for agriculture land within a 30% range depending on land fertility. An independent appraisal of land value is undertaken only when it is necessary to determine starting prices for auctions or tender for sale of land plots.

Property tax can be another source of revenue for the local government; the tax was expected to be effective from 1 January 2009 with the adoption of a new Tax Code. Tax rates are determined by the Tax Code at the rate of 0.35% of the normative value for housing and 1% of the normative value for commercial property. Normative values are determined in the

Tax Code⁹³ according to the property's location, size, construction material and type of usage. It is the responsibility of the citizen to calculate the correct tax value of his/her property.

Previously, housing transactions were subject to taxation based on the value of the purchase agreement. Such a non-transparent tax encouraged parties to declare lower dwelling values in the agreement. In 2007, stamp duty based only on the size and location of property was introduced. It is collected upon the notarization of the purchase agreement and distributed between the State and local budgets.

Earnings generated by selling land plots for construction could provide sufficient funds for housing policy. However, no obligation has been placed on local government to use income generated from sales of land for housing purposes.

Another way for local authorities to finance housing policy is to issue securities up to 20% of total budget revenues. The issuance should be proved by the Ministry of Finance, but still there is no clear procedure. External borrowings are prohibited for municipalities.

D. BANKING SYSTEM OF KYRGYZSTAN AND MORTGAGE MARKET

The Kyrgyz banking system comprises 22 commercial banks. A number of banks have ratings from international agencies such as Moody's and Fitch⁹⁴ but the country does not have a sovereign credit rating. The banking sector of Kyrgyzstan has experienced healthy growth over the past years. Total assets increased from 7.9 billion soms in 2002 to 44 billion soms in 2008.⁹⁵ However, it is important

⁹³ Government of the Kyrgyz Republic (2008) Tax Code, Article. 327, Bishkek.

⁹⁴ International Finance Corporation (IFC) (2006), Central Asia Housing Finance Gap Analysis (p. 74), *World Bank Group Working Paper Vol.1*, Washington, D.C.

⁹⁵ National Bank of the Kyrgyz Republic (2008), Trends of Development of Commercial Banks System on 31 March

to note that 60% of total assets belong to foreigners, of which 35% to investors from Kazakhstan. Mortgage loans currently comprise approximately 7.7% of total banking assets.⁹⁶ The banking sector is fairly profitable with an average return on equity (ROE) of 17.2%.⁹⁷

The depth of the banking sector has likewise increased. As a percentage of GDP, total banking sector assets almost tripled in six years (from 10.4% in 2002 to 30% in 2008). Bank deposits as a percentage of GDP increased almost three times, indicating an increase in confidence in the banking system. Moreover, in 2008 a State deposit insurance system was created with the guarantee of 20,000 soms per deposit.⁹⁸ However, only a tiny share of the population uses banking services: 8% of adults have bank accounts, 1% use credit and debit cards and banking services are hardly accessible for the rural population.⁹⁹ Long-term funding, especially from local sources, is limited: domestic deposits do not usually exceed 1 year, only about 40% of all assets and 15% of all liabilities are long-term (more than one year).¹⁰⁰ Without sources of long-term capital, growing capitalization still remains insufficient to fund mortgage lending.¹⁰¹

In 2007, the average interest rate on bank loans was 25% for local currency loans and 19% for United States dollar loans.¹⁰²

There are about 300 credit unions and 200 microfinance organizations operating in the country.¹⁰³ Unlike banks, credit unions generally do not have the right to accept deposits, so they refinance loans through shareholders' equity or the refinancing facility offered by the Financial Company for Support and Development of Credit Unions organized by the National Bank of Kyrgyzstan.

The development of the mortgage market in Kyrgyzstan started in 1999, when the *Law on Mortgages* was adopted.¹⁰⁴ The Law establishes a legal framework not only for mortgage lending, but also for loan and saving schemes. The Law also allows municipalities to create agencies for the development of mortgage lending and issue housing certificates — securities, which could be accumulated and exchanged for housing. A separate chapter of the Law is devoted to the creation of a State mortgage agency responsible for the development of the mortgage market and provision of a refinancing vehicle through issuing mortgage-backed securities with a State guarantee. Unfortunately, all these initiatives were not realized due to a lack of finance.

2008, National Bank of the Kyrgyz Republic Publications www.nbkr.kg/ubn/tendencia_razvitia.htm.

⁹⁶ Data provided by the National Bank of the Kyrgyz Republic on June 2008.

⁹⁷ National Bank of the Kyrgyz Republic (2008), Trends of Development of Commercial Banks System on 31 March 2008, National Bank of the Kyrgyz Republic Publications www.nbkr.kg/ubn/tendencia_razvitia.htm.

⁹⁸ Government of the Kyrgyz Republic (2008), the Law of the Kyrgyz Republic on Protection of Deposits adopted by Government Decree No.78 on 7 May 2008.

⁹⁹ Government of the Kyrgyz Republic (2007) Concept of Social-Economic Development of the Kyrgyz Republic until 2015, Economic Strategies Centre of the Ministry of Economic Development and Trade, Bishkek

¹⁰⁰ Data provided by the National Bank of the Kyrgyz Republic on June 2008

¹⁰¹ The average price for a two-bedroom apartment in Bishkek is US\$ 40,000. Thus, the total bank equity of US\$ 248 million could hypothetically finance a maximum of about 9,000 apartment units.

¹⁰² Data provided by the National Bank of the Kyrgyz Republic on June 2008.

¹⁰³ National Bank of the Kyrgyz Republic (2007), Trends of Development of Non-Banking Finance-Credit Institutions in 1st half of 2007. National Bank of the Kyrgyz Republic Publications on website: www.nbkr.kg.

¹⁰⁴ Adopted by Government Decree No. 41 on 29 May 1999, changes made on 28 June 2001, 2 March 2002. In 2005 was replaced by the Law on Pledge adopted by Government Decree No. 49 on 12 March 2005, changes made by Government Decree No. 133 on 6 August 2007.

Table 12. Assets and deposits of the Kyrgyz banking sector

	2002	2003	2004	2005	2006	2007	2008
Assets (millions of soms)	7,860	11,385	17,703	21,904	28,269	42,153	43,898
GDP (%)	10	14	19	22	25	30	30
Deposits (millions of soms)	3,529	4,781	7,976	12,091	14,976	19,332	18,971
GDP (%)	5	6	8	12	13	14	13
Share of deposits in foreign currency (%)	63.2	65.7	70.7	76.4	69.5	58.1	53.1

Source: National Bank of the Kyrgyz Republic — www.nbkr.kg.

The mortgage market has grown significantly since 2002, albeit from a low base. Currently, mortgage loans outstanding in the banking system are approximately 3.4 billion soms (2.3% of GDP and 15% of the total loan portfolio). New mortgage issuance is about 16% of all loans (in 2002, 1%),¹⁰⁵ but the market is quite heavily concentrated.¹⁰⁶ IFC estimates there is substantial room for further growth of the market.¹⁰⁷ Mortgages are offered by all banks mainly in United States dollars for up to 10 years at a fixed rate of 20–24%.¹⁰⁸ The maximum loan to value ratio is set at approximately 50–60% of purchase price while it used to be up to 75–80% before the United States subprime mortgage crisis. Banks prefer to issue mortgages to the borrowers with verified incomes. The average size of a mortgage issued by a bank is about US\$ 30,000.¹⁰⁹ Home improvement loans are also very popular in the

country, but loans for construction are rarely known because of high risks and absence of adequate pledges (banks require to mortgage existing dwellings because unfinished buildings cannot be registered). Moreover, banks rarely provide financing to developers to assist construction projects.¹¹⁰

At this stage of development in the mortgage market, mortgages are affordable only for a small share of high-income households. According to the National Statistical Committee,¹¹¹ in 2006 about 40% of people in Kyrgyzstan lived below the poverty line (i.e., their annual per capita income was less than 10,325 soms), of whom more than three quarters lived in rural areas. Today, less than 2% of workers can afford monthly payments for a typical mortgage. They are mainly employed in the financial sector. A huge challenge for banks and borrowers is a significant share of hidden or underreported incomes, which makes the underwriting process more difficult and reduces the maximum size of loan available.

¹⁰⁵ Data provided by the National Bank of the Kyrgyz Republic on June 2008.

¹⁰⁶ In 2005 two largest mortgage originators accounted for 41% of the market, while five largest — for 71% (see Struyk, R. and Roy, F. (2006), Pre-Feasibility Study on Housing Finance in the Kyrgyz Republic, KFW, Frankfurt).

¹⁰⁷ International Finance Corporation (IFC) (2006), Central Asia Housing Finance Gap Analysis (p. 74), *World Bank Group Working Paper Vol.1*, Washington, D.C.

¹⁰⁸ Some banks, like KICB, offers 12–18% rate to their employees or most valued clients.

¹⁰⁹ IFC estimates the average size to be 25–30 thousand US dollars, while Kyrgyz Investment and Credit Bank reports it is about US\$ 30,000–40,000.

¹¹⁰ Struyk, R. and Roy, F. (2006), Pre-Feasibility Study on Housing Finance in the Kyrgyz Republic, KFW, Frankfurt.

¹¹¹ Government of the Kyrgyz Republic (2008), National Statistical Committee. Kyrgyzstan: Short Statistical Publication. National Statistical Committee of the Kyrgyz Republic, Bishkek.

A number of non-bank financial institutions also offer mortgage loans, but for smaller amounts.¹¹² The microfinance sector has a potential to offer housing microfinance loans as in India, but is focused mainly on trade and agriculture lending.

One of the biggest problems that Kyrgyz banks face in originating mortgages and expanding their mortgage portfolios is the lack of cheap long-term capital.¹¹³ Given that the banks with a short-term deposit base constantly operate without an appropriate match in the maturity of assets and liabilities, this leads to high interest rates and liquidity risks. Another problem is the absence of sound risk-management policies, methods and tools. It is encouraging to note that some Kyrgyz banks are beginning to implement these systems (e.g., EBRD minimum quality standards) but most banks still do not actively use insurance as a tool to mitigate mortgage risks. The insurance sector is undercapitalized¹¹⁴ and lacks the necessary links with the developing residential mortgage industry (standardized insurance policy documentation related to residential mortgages is lacking). Insurance companies working with banks engaged in mortgage lending offer mainly two insurance products: one-year life and property insurance. This carries additional risks to the lender since there is no mechanism to ensure that insurance policies are renewed yearly. Most banks require property insurance, but life insurance is viewed as excessively expensive. Moreover, some of the products necessary to support the developing mortgage industry do not exist, such as title insurance and primary mortgage insurance (insurance against bank losses on defaulted mortgages).

The insurance legislation does not contain specific provisions regarding primary mortgage

insurance. This product mitigates the mortgage lender's risk by insuring against default by the borrower, often where the borrower is highly in debt. The value of this insurance product is that it makes mortgages more accessible. Currently, Kyrgyz banks usually require a down payment of at least 30%. Given the relatively low level of personal savings and high real estate prices, only very few people can afford such a large down payment. With primary mortgage insurance, banks may be willing to offer financing with a lower down payment, making mortgages accessible to a substantially larger segment of the population.

There are no regulations with respect to title insurance. This product mitigates the banks' risk associated with a third-party claim against the property. It ensures that banks have sound collateral and that borrowers have adequate compensation for termination in their ownership rights. Thus, title insurance would lower the overall financial risk for both mortgage lenders and borrowers. Title insurance is also important for the development of the secondary mortgage market, since it would provide comfort to potential investors in secured mortgage portfolios by protecting them from the consequences of possible title disputes.

Currently, the National Bank of Kyrgyzstan is preparing a credit register system while the first credit bureau "Ishenim" (Trust) in the country has been in operation since 2003 within a general legal framework because no special law for credit bureaus exists. It was created as a for-profit company with the support of EuropeAID and now 15 banks, 11 microfinance organizations and 3 credit unions are members.

Though the appraisal sector is developing quite actively in Kyrgyzstan, mortgage-lending banks still employ special staff to appraise residential property as part of the process of mortgage origination and underwriting. This creates a potential conflict of interest, raises the question about quality and objectivity of the appraisals and makes investment less appealing to third parties. Periodical re-evaluation of pledged property is not obligatory so banks do it

¹¹² According to the National Statistics Committee, in 2006 micro loans were mainly short-term (up to 12 month) and did not exceed 25 thousand soms.

¹¹³ Currently banks are able to attract foreign funding at about LIBOR + 5%.

¹¹⁴ As of January 2008, the aggregate reserves of insurance companies were about 41 million Soms.

only in cases of foreclosure, which is very rare now.

Although realtors are quite active in the housing market, banks do not cooperate with them in promoting mortgages. The main reason is lack of confidence in realtors because anybody could start such a business. To address these issues, the Parliament has already adopted amendments to the *Law on Realtors' Activities* introducing a licensing system.

Although the mortgage sector of the financial market is expanding rapidly, a number of legal concerns limit further development. A crucial problem is that foreclosure reportedly may take up to several years in practice, especially when court decisions are involved. This arises from the ability of the borrower in default to exercise the option of having the bank's claim adjudicated in court at any time, even when an out-of-court settlement is near completion. Moreover, because almost no defaulted mortgages have been reported, there is no clear practical experience of foreclosure and eviction. The main issues of concern are related to the *Civil Code* and they were carefully identified in IFC and International Business Council studies in 2006.¹¹⁵

Another important problem is a time lag between title transfer and mortgage registration. Under the current legislation, registering a residential real estate transaction involving a mortgage must be done in two stages. A mortgage agreement can be registered only if the buyer has already registered the purchased property. The time lag between title transfer and mortgage registration, which can be approximately 11 to 12 days, is therefore the biggest risk in the existing registration process.

Mandatory notarization of the mortgage agreement as well as the purchase and sale agreement is also a challenge. The *Law on Pledges* requires obligatory notarization of the

pledge agreement if it is necessary to notarize an underlying agreement (e.g., agreement of purchase and sale). Moreover, the Gosregister will not register a pledge agreement until it has been notarized. Notarizing the mortgage agreement is redundant because the notary's function at that stage (to verify the seller's ownership) is fully duplicated in the subsequent registration of the purchase and sale agreement and prohibits simultaneous registration of the mortgage agreement and the purchase and sale agreement.

The existing ban on the sale of agricultural land to town dwellers and the moratorium on the transactions of plots of land, imposed after 2004, seriously limit market liquidity and the possibility to use such land plots as the pledges for mortgages.

Currently, two key tax elements in the development of mortgage lending are missing, including mortgage interest deductibility and the tax treatment of capital gains on the sale of residential property. The new draft *Tax Code* will introduce these features: it will be allowed to deduct the mortgage interest of up to 230,000 soms per year from the tax base while capital gains will be taxable for property owned less than two years.

Despite these obstacles, the mortgage market has a good potential for growth but it is limited by a lack of affordable financing. The German Development Bank KfW (*Kreditanstalt für Wiederaufbau*) is preparing to launch a mortgage-refinancing programme for commercial banks and microfinance companies. The programme will target low- and moderate-income households, who need small mortgages for home repair and improvement. The country's capital markets are underdeveloped. The total capitalization of Kyrgyz companies traded on local stock exchanges is about 5.3 billion soms or less than 3.8% of GDP.¹¹⁶ There is no large institutional investor, the menu of available financial instruments is very limited and lacks

¹¹⁵ International Finance Corporation (IFC) (2006), Central Asia Housing Finance Gap Analysis (p. 74), *World Bank Group Working Paper Vol.1*, Washington, D.C.

¹¹⁶ Data of the Kyrgyz Stock Exchange. Published on www.kse.kg.

corporate debt securities. Outstanding Government securities (1.6 billion soms) are short term (two years maximum).¹¹⁷ However, it is not certain whether there is sufficient liquidity or appetite among potential bond purchasers for large issues with longer maturity periods, as the assets of non-governmental pension funds are 14.3 million soms and unit investment trusts are just being created, but demand exists for instruments that have a positive yield and are affordable for households.

The draft *Law on Mortgage Securities* was prepared in 2005, but it is still under discussion in Parliament. The main problem, which is very hard to overcome, is a lack of budget resources for the implementation of this law.



Picture 7. Residential buildings in Bishkek

Source: UNECE

¹¹⁷ Government of the Kyrgyz Republic (2007), Concept of Social-Economic Development of the Kyrgyz Republic until 2015, Economic Strategies Centre of the Ministry of Economic Development and Trade, Bishkek.