

Central Asia Housing Finance Gap Analysis



September, 2006

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FOREWORD

This report, presented by the International Finance Corporation (IFC), is based on the results of IFC's comprehensive review of housing finance systems in five countries in Central Asia: Azerbaijan, Kazakhstan, Kyrgyzstan, Tajikistan and Uzbekistan. The primary aim of the review was to identify capacity, regulatory and other gaps in the housing finance systems of each of these countries and to develop an appropriate action plan for each of the country focusing on efforts needed to improve overall conditions for housing finance system to develop and to allow low and medium income groups of population access to financial resources being allocated for housing finance. This report will also be beneficial for all stakeholders in the mortgage industry in these countries. This project was made possible through the generous financial support of the State Secretariat for Economic Affairs of Switzerland (SECO).

The country reviews were conducted by local professionals with in-depth expertise in local finance, banking, and legislative matters. The overall review process was coordinated by the IFC Project Manager and Deputy Project Manager in the field, who provided guidance and served as a central resource for the country teams. Overall strategic direction and support was provided by the Senior Operations Manager in charge of IFC housing finance technical assistance (TA) programs for CIS countries and her team, based in Moscow.

This report consists of an Executive Summary, Country Sections and Country Action Plans. The Executive Summary gives a brief overview of the main problems and issues, at the regional and country levels, in developing efficient housing finance systems. The Country Sections start with an economic and housing sector overview for each country, continue with an analysis of the institutional capacity for mortgage lending and the relevant legal, environmental, and governmental policies, and finally, offer recommendations. The Country Action Plan section provides governments with a broad implementation strategy for promoting robust housing finance markets. The appendix contains a table outlining the status of land ownership and land lease rights in the project countries.

The results of the review were extensively discussed with stakeholders in the project countries (please refer to Acknowledgements section). Additional feedback and commentary were also provided by our colleagues from the IFC Regional Department and respective country offices of the World Bank.

This Report was prepared in Russian and translated into English.

ACKNOWLEDGEMENTS

The project team was fortunate to have received considerable assistance and support in the course of its work. The team thanks the government agencies, international financial institutions, donor organizations, and companies that rendered support to the project in each country. The team held over 150 meetings with government officials, almost 190 meetings with representatives of commercial banks, realtors, appraisers, and insurance companies, and attended eleven seminars and roundtables to obtain information and insight about the workings of the mortgage sector in the project countries. The project team also participated in the work of intra-ministerial working groups in drafting the Law “*On Mortgage*” in Uzbekistan and assisted in developing housing policy in Kyrgyzstan. Taking this opportunity, we would like to extend our gratitude to all state agencies, international and donor organizations, firms and companies that rendered their support to the Project staff in each country. The acknowledgement list below is by no means an exhaustive one, and we, beforehand, bring our apology for any unintentional omission of anyone’s name or name of any organization.

Azerbaijan

The National Bank of Azerbaijan Republic, the Azerbaijan Mortgage Fund, the State Committee for Securities, the State Statistical Committee of Azerbaijan Republic, the Association of Property Market Participants, Bank of Baku, Bank Standard, Azerigazbank, UniBank, Texnika Bank, Caspian Property Services (construction company), Bashak Inam (insurance company), Standard-Insurance (insurance company), Mbanks (insurance company), Azerbaijan Intellect Service (consulting and appraisal).

Kazakhstan

Bank TuranAlem, BTA- Ipoteka, CenterCredit Bank, Temir Bank, Lariba Bank, Agency for Financial Control, Kazakhstan Mortgage Company, Kazakh Mortgage Credit Guarantee Fund, Association of Realtors of Kazakhstan, Institute of Professional Appraisers, Financial Institutions Association of Kazakhstan, Mr. Rustam Dospalinov (Appraiser for Eurasia Bank).

Kyrgyzstan

Ministry of Justice, Ministry of Economy and Finance, the National Bank of the Kyrgyz Republic, the State Agency for Architecture and Construction, the State Tax Inspection, the National Statistical Committee, the State Agency for Registration of Rights on Immovable Property, the State Agency for Financial Supervision and Reporting, KyrgyzKreditBank, Halyk Bank Kyrgyzstan, Demir Kyrgyz International Bank, Association of Real Estate Agencies, Association of Appraisal Companies, Coalition of Kyrgyz Appraisers, Kyrgyzinstrakh Insurance Company, Al Star Appraisal Center, Urban Institute, Bankakademie International, Kyrgyz Stock Exchange, KfW.

Tajikistan

Ministry of Justice, Ministry of Finance, the National Bank of Tajikistan, the State Enterprise “Khochagii Manzilii Kommunalii” (communal housing services), the State Committee of the Republic of Tajikistan on Organization of the Use of Land, the State Committee on Construction and Architecture of the Republic of Tajikistan, Khukumat of the City of Dushanbe (Office of the Mayor of Dushanbe City), commercial banks, insurance and construction companies, representatives and foreign experts and consultants working for EBRD, ARD/Checchi (USAID), SWEDESURVEY (Foreign Agency of the National Land Service of Sweden).

Uzbekistan

Information-Analytical Department on Economic Issues and Foreign Economic Affairs under the Cabinet of Ministers of the Republic of Uzbekistan, Ministry of Justice, Ministry of Finance, the Central Bank of the Republic of Uzbekistan, the State Committee for Statistics, National Center for Cartography under the State Committee of the Republic of Uzbekistan on Land Resources, Geodesy, Cartography and the State Land Registry, the State Mortgage Lending Support Fund, Uzbekistan Banking Association, Ipoteka Bank, Kredit-Standart Bank, KfW, LFS.

1. EXECUTIVE SUMMARY

1.1 INTRODUCTION

International Finance Corporation's Private Enterprise Partnership (IFC-PEP) carried out this analysis of current conditions in the housing finance markets in Central Asia. The project was made possible by financing from the State Secretariat for Economic Affairs of Switzerland (SECO).

The project involved a detailed study and gap analysis of the legal, business and operating environments in the residential mortgage lending sectors in Azerbaijan, Kazakhstan, Kyrgyzstan, Tajikistan, and Uzbekistan. This report presents a broad overview of the residential mortgage lending market in Central Asia, identifies gaps hindering the development of the primary mortgage markets, and provides recommendations to correct the deficiencies identified. In addition, country-specific plans for implementing the recommendations are proposed.

This report is arranged in three broad sections:

- An executive summary introducing main issues facing the region.
- Country-specific gap analysis of the regulatory environment, institutional capacity and state policy with respect to housing finance.
- Country-specific action plans for implementing recommendations proposed by the Project.

In addition, detailed country baseline reports were produced (in Russian), which include statistical data on the housing market and an in-depth explanation of the relevant legislation.

1.2 REGIONAL OVERVIEW

Size of the Residential Mortgage Market

The residential mortgage lending industry throughout the region is in the very early stages of development, with the possible exception of Kazakhstan. In the other four countries, as shown in the table below, the current mortgage market is less than 0.7% of GDP.¹ A typical residential mortgage loan currently offered in the region (with the exception of Kazakhstan) is short-term (three to five years), requires a considerable down payment (30% to 40%) and carries a high annual interest rate (up to 25%, fixed) for both US\$ and local currency loans. Only a small number of banks in the region offer mortgages. Kazakhstan is the only country in the region in which lenders offer longer-term mortgages (up to 20 years) to the public.²

Financial institutions in the region are constrained by the lack of longer-term resources necessary to fund long-term mortgage products. Moreover, there is a lack of the necessary competencies in residential mortgage lending operations, including a lack of standardized mortgage lending policies and procedures.

The *Table 1* below illustrates some characteristics of primary residential mortgage markets in the region, including the current and potential size of residential mortgage markets, the availability and cost of related services (appraisal and insurance), additional costs in purchasing a typical residential property with mortgage loan proceeds (closing costs) and typical residential real estate prices.

¹ As measured by a ratio of mortgage debt outstanding to GDP. The ratio for Kazakhstan is 3%.

² Kazakhstan's mortgage-lending banks can sell/refinance their mortgages through the Kazakhstan Mortgage Company, the country's secondary mortgage market operator. Such refinancing opportunities have enabled banks to offer mortgages on a longer-term basis.

Table 1: Comparison of Mortgage Markets in Central Asia (December 2005)

	Azerbaijan	Kazakhstan	Kyrgyzstan	Tajikistan	Uzbekistan
Number of financial institutions offering residential mortgages	16	27 (1)	16	3	2
Number of banks in the country	44	35	21	11	29
Current mortgage market (US\$, millions)	76	1,660	16	0.44	1
Current mortgage market (% of GDP)	0.60%	3%	0.63%	0.03%	0
Potential mortgage market by 2010 (US\$, millions) (2)	540	3,000	80	93	100
Cost of property insurance (% of property sale price)	0.3% - 0.4%	0.2% - 1.5%	0.3%-0.8%	2% - 8%	0.2% - 0.5%
Cost of life insurance (% of mortgage loan)	0.25%-0.8%	0.26% - 4%	0.5%-1.1%	2%	1% - 11%
Cost of title insurance (% of property sale price)	n/a	0.07% - 0.3%	n/a	n/a	n/a
Cost of property appraisal (3)	\$50 - \$100	\$22 - \$37	\$25-\$50	n/a	\$20 - \$100
Estimated closing costs for apartment valued at US\$ 50,000 (4)	\$135	\$100	\$300	\$770	\$30 (after Jul/2006)
Closing costs (% of sales cost)	0.27%	0.2%	0.6%	1.54%	0.06%
Longest mortgage term available (5)	7 years	25 years	10 years	3 years	10 years
Annual interest rate (US\$ loans)	9% - 20%	12% - 18%	15% - 24%	18% - 20%	n/a
Annual interest rate (local currency loans)	12% - 30%	7% - 18%	16% - 24%	20% - 25%	14% - 20%
Maximum loan amount (6)	no limit	no limit	no limit	\$ 70,000	\$ 20,000
Official GDP/capita (US\$, 2005)	\$1,518	\$3,703	\$444	\$334	\$520
Average price/sq. meter for property in largest city (centre) (US\$)	Baku \$1,500– \$2,000	Almaty \$1,500– \$2,000	Bishkek \$250–\$700	Dushanbe- \$550– \$1,350	Tashkent \$350–\$500
Affordability Index (price per sq.m/GDP per capita) (7)	1.15	0.47	1.06	2.84	0.82

Notes:

- (1) Banks and non-bank financial institutions (mortgage portfolio mainly concentrated with Halyk Bank, BTA Bank/BTA Ipoteka and Kazkommertzbank).
- (2) Estimated by the Project team as the ratio of amount of mortgage debt outstanding to GDP. Estimate of GDP in 2010 was based on growth rate projected by the governments or central banks of the Project countries. Mortgage penetration was estimated at 2.5% of GDP.
- (3) Varies by type and size of the property. Apartment units in major urban areas are generally cheaper to appraise than single family dwellings outside urban areas.
- (4) In general, the buyer incurs costs associated with closing the property purchase transaction using mortgage financing. Such costs include, among other items, property appraisal fees and notary and registration fees. Closing cost is the highest in Tajikistan owing to the high cost of notarization. Property, title and borrower's life insurance, as well as any commissions/fees charged by the lending bank under mortgage transaction are not included into estimated closing costs.
- (5) Starting in 2006, the maximum residential mortgage loan term in Azerbaijan increased to 15 years.
- (6) The Azerbaijan Mortgage Fund limits loans under its program to US\$ 27,000.
- (7) Based on the average price per square meter, as indicated in the table.

Regulatory Environment

In general, legislation with respect to financial markets in the region is underdeveloped. Adequate laws and/or regulations with respect to such sectors as pensions, insurance, and real estate appraisals are absent. In most of the project countries, legislation related to residential mortgages is also poorly developed and structured and cannot be considered supportive of the development of residential mortgage lending. Securitization legislation has not even appeared on the policy agenda. Even in Kazakhstan, where mortgage-related legislation is better developed than in other project countries, additional improvements in certain areas

are needed. These specific legislative and regulatory gaps are thoroughly reviewed in country sections of the report.

Existing banking legislation with respect to residential mortgage lending does not contain specific provisions to clarify the legal mechanisms for conducting mortgage lending operations, effectively and reliably at every level of the mortgage lending process (origination, underwriting, loan accounting, servicing, and risk management). These issues are also reviewed in country sections of the report.

The analysis indicates that key regulatory deficiencies, directly related to residential mortgage lending, are common across the region. These include:

- Fragmented housing finance legislation.
- Unclear, cumbersome and costly procedures for registering ownership in real estate property (including title transfer).
- Time-consuming and costly procedures for registering liens on property.
- Underdeveloped procedures for repossession of mortgaged property.

Problems with registration and transfer of ownership/title are present in all project countries (although to a lesser extent in Kyrgyzstan and Tajikistan). These include the absence of clearly-defined, workable procedures, lengthy wait times, and, until recently, high costs.

In addition to the time it takes to register a change of title, mortgage liens (when applicable) can only be placed on a property after title has passed from seller to purchaser. This is a problem because sellers generally wish to receive their money immediately, but banks may be unwilling to disburse loan proceeds to the buyer until a lien is in place. Some banks are disbursing loan funds before a lien has been registered, but there can be a lag of more than one month between the time of the sale and the time when the bank perfects a lien on the property and the seller is paid.

Title transfer costs vary across the region, as shown in the table above. Until recently, they were prohibitively high in some of the project countries. In Kyrgyzstan, the cost of title transfer was only recently reduced from 5% of the sale price to approximately US \$250. In Uzbekistan, the cost was extremely high at 10% of the sale price, but a recent Resolution of the Uzbek Cabinet of Ministers reduced it to a cost per square meter equal to 2% of the minimum monthly salary.³ In most Project countries, the high cost has led to the underrepresentation of the sale price on purchase/sale contracts. Where the purchase is to be financed with a mortgage, the purchaser/borrower must also pay appraisal fees and bank fees and commissions related to obtaining the mortgage financing.

The enforcement of liens on residential property remains largely untested in most Project countries. In a number of jurisdictions, the law having to do with collateral contradicts the country's civil code. Thus, attempting to repossess residential property in the event of the borrower's default can lead to drawn-out court cases.

Clear procedures with respect to registration and notarization are lacking throughout the project countries. The purposes, processes and mechanisms of the two functions are not clearly differentiated and set out in legislation and/or regulations.⁴ Specific issues related to the registration process and notarization are discussed in country chapters below.

³ Resolution of the Cabinet of Ministers of the Republic of Uzbekistan No.109 dated June 7, 2006.

⁴ Registration and notarization issues with respect to land are not covered in this report. Nevertheless, the annex contains a table outlining the status of land ownership and land lease rights in the Project countries.

Institutional Capacity

Weak institutional capacity is a common problem in all Project countries. A functioning banking sector exists in all of the Project countries, but banks throughout the region lack the institutional capacity to develop a vibrant primary residential mortgage market. The following are their primary needs:

- Adequate sources of longer-term capital for funding residential mortgage lending.
- Basic standard operating procedures for mortgage origination, underwriting, accounting, reporting, and servicing.⁵
- An appropriate line of standard mortgage loan products to address a variety of housing needs.
- A standard package of residential mortgage documents, such as the agreement of purchase and sale, and mortgage and credit agreements.
- Risk management policies, methods, and tools under the residential mortgage lending transactions.
- Adequate base of statistical data (such as real sales/purchase data, early repayment and data on mortgage loan defaults) necessary to develop risk management policies.
- Adequately trained bank staff, capable of performing primary mortgage lending.

Transparency in the banking sector over all continues to be inadequate across the region. In many instances, the ownership structure of banks is opaque and the principals are involved in related party transactions. (These banks are often referred to as “pocket banks”.) However, in each of the project countries, a small number of banks have worked successfully with multilateral organizations and, in some cases, have received funding facilities or equity investment from them. These banks are attempting to operate in a fair and open manner and quite often have experience working with smaller (retail) clients. This bodes well for potential residential mortgage lending operations.

The residential real estate sector is non-transparent throughout the region, with some services directly related to the mortgage industry (such as real estate companies, appraisers, and registration and notarization agencies) operating in a fraudulent and corrupt manner along the entire mortgage lending chain. Lack of government regulation over these sectors has led to an environment of mistrust and has hindered development of residential mortgage markets.

In Azerbaijan, Kyrgyzstan, Tajikistan, and Uzbekistan, there are no financial institutions specializing in residential mortgage lending. Although not a prerequisite for the development of residential mortgage markets, these institutions can lead the industry through best practices, especially in the early stages of growth.

The insurance sector in the region is undercapitalized and has not yet developed and offered insurance products necessary to support residential mortgage lending. Certain insurance products desirable for mortgage lending, such as life insurance, are prohibitively expensive. (See *Table 1: Comparison of Mortgage Markets in Central Asia*.) Title insurance is not available in any jurisdiction except Kazakhstan, where mortgage-related insurance standards nevertheless require further improvement. Primary mortgage insurance, which protects against non-payment by a mortgage client, is also available only in Kazakhstan.

Residential appraisal companies operate without uniform standards in all of the project countries and with lack of expertise in most of them. Banks have been forced to employ appraisers directly because of the lack of trust in appraisal companies. This creates the potential for conflict of interest in the banks. Such appraisals could be seen to lack impartiality, especially by potential investors who might provide financing or re-financing of residential mortgage portfolios.

There is no centralized source of residential mortgage market data. Historical data, especially with respect to real estate sale prices and mortgage portfolio performance figures, are important for developing and deriving

⁵ Standardization of mortgage lending policies and procedures will be the next necessary step in improving mortgage lending operations at the industry level.

mortgage pricing trends. This, in turn, is critical for further development of the mortgage industry in the region.

Most of the Project countries do not have self-regulating industry organizations, such as mortgage lender or real estate appraiser associations, which can be effective in driving mortgage regulation and housing policy. These associations can also be instrumental in promoting and developing unified industry standards.

Capital markets in the Project countries (with the exception of Kazakhstan) are weak and underdeveloped and are not a viable source of long-term financing. This is characterized by the lack of potential investors, such as insurance companies or pension funds, which are generally the primary investors in capital markets and in the secondary mortgage market in particular. The potential for direct foreign investment is also low, given the high risk profile of the region. Thus, banks are limited in potential sources of funding for mortgage lending. Their own capital may not be sufficient to fund large-scale residential mortgage lending, and using deposits for this purpose, which are short term in nature, will result in asset/liability gaps.

Government Policy

Governments in the Project countries all place a high priority on the development of residential mortgage financing in the belief that it will help solve housing problems, which are still very significant in all of the countries. However, they have not yet developed market-oriented concepts and/or integrated national housing policies. Moreover, key principles of mortgage markets and ways in which national residential mortgage systems can be built successfully have not yet been fully inculcated by the relevant officials as well as market players themselves. This lack of understanding may have negative consequences when government agencies attempt to create social housing programs, because these programs may distort the development of a fledgling market-driven mortgage sector.

Such programs are currently being considered by the governments of Azerbaijan, Kyrgyzstan, Tajikistan, and Uzbekistan⁶. The risk of market distortion under these programs is further exacerbated by lack of local experience in structuring social housing programs efficiently and transparently. Further, it may become difficult to sustain funding for the programs when government budgets are strapped for cash. The potential liabilities associated with such programs can be open ended and thus difficult to measure.

Mortgage Awareness

A lack of understanding of what constitutes a residential mortgage loan and an effective mortgage-lending system is widespread across social segments throughout the region. Mortgage loans are often confused with construction loans, and with government-subsidized housing programs that attempt to meet the basic housing needs of the poorest segment of the population.

1.3 COUNTRY OVERVIEW

Azerbaijan

Regulatory Environment

Residential mortgage operations in the country are governed by the new “*On Mortgage*” law. However, implementation of the law has been hindered by the lack of supporting normative acts.

The most important legal and regulatory issues related to the development of residential mortgage financing are:

⁶ Refer to country sections for detailed description of these programs.

- The law “*On Mortgage*” contains provisions that are in conflict with provisions of the existing *Civil Code*.
- The registration process for residential real estate is cumbersome and requires further clarification.
- Repossession provisions lack practical, clearly-defined implementation mechanisms.
- Title transfer and lien registration is time-consuming with a number of regulatory contradictions and lacks adequate regulation.

Institutional Capacity

Residential mortgage lending is limited in scope, both in terms of the size of the portfolios and the number of banks involved. Most housing loans are currently construction related.

The key issues in the development of institutional capacity for residential mortgage lending include the following:

- Most banks do not have established residential mortgage lending policies, procedures and products, nor do they have adequately trained staff.
- Adequate risk management policies, methods and tools for residential mortgage lending are lacking.
- There is no standard documentation for residential real estate transactions involving mortgages.
- There is no functional specialization in mortgage lending operations (origination, underwriting, balance keeping, servicing).
- There are no standardized insurance products related to residential mortgage lending, and therefore no standardized policies and procedures related to such products.
- Property and life insurance are commonly available, but title insurance and mortgage risk insurance are not.
- Appraisal of residential property is not subject to licensing/certification. Appraisal is therefore largely unregulated and non-transparent, and appraisers operate under many different sets of standards.
- The policies necessary to create sustainable funding mechanisms in local financial markets (such as pension policies and insurance sector reform) are not in place.

Government Policy

The government is in the process of establishing a State Mortgage Fund to provide longer-term resources to the banking system for mortgage lending. However, early results have not been encouraging, mainly because the underwriting procedures are not suitable to a developing market. Furthermore, market-driven mortgage refinancing mechanisms (such as mortgage-backed bonds or securities) have not been developed and government financing of this fund may be economically unsustainable in the long term.

Mortgage Awareness

Awareness of mortgage financing is generally low, but some specific age and income groups (younger professionals) in the capital city are aware of mortgage opportunities. In smaller cities, and especially in rural areas, mortgage financing is generally unknown.

Kazakhstan

Regulatory Environment

Among the project countries, Kazakhstan has the most advanced legislation related to residential mortgage lending. However, although foreclosure procedures for residential properties have been tested, eviction procedures remain generally untested. In addition, certain practical aspects of mortgage lending and the regulatory environment are still to be addressed. The following are some of the most important issues:

- Lack of coordination between state cadastres systems.

- Varying documentation requirements in the registration process due to unlawful operating practices in registration offices.
- Title registration problems for non-registered private houses.
- Concurrently registering title transfer and placing a lien on properties is impossible.
- Lack of adequate regulation of real estate appraisal.
- Lack of reliability in notarized letters of attorney and other documents.

Institutional Capacity

The residential mortgage market in Kazakhstan has been developing rapidly over the last five years and currently exceeds US \$1.65 billion in loans outstanding. The country is currently at a crossroads in choosing the right course for further development of the residential mortgage industry. However, neither the government nor the industry appears to be making a concerted effort to plan that course.

Banks have well-developed lending policies and procedures, generally in line with international standards. A typical mortgage lending product is well standardized in the banking system, and most banks refinance significant portions of their portfolios through the government-controlled Kazakhstan Mortgage Company. However, the following barriers to the further development of the residential mortgage market still exist:

- The concentration of the secondary mortgage market owing to the dominant position of the Kazakhstan Mortgage Company is potentially dangerous. This will be further exacerbated if fixed-rate mortgages are introduced and they gain a significant share of the primary market.
- The recently created, government-funded Mortgage Loans Guarantee Fund will provide guarantees to banks against default by individual borrowers. However, no relevant mechanisms, policies or procedures have been developed.
- The mortgage product line continues to be underdeveloped, with no fixed-rate mortgages offered.
- There are no standards for property, life and title insurance.
- There are no standards for real estate appraisals.
- There are no risk management standards or mechanisms for residential mortgage lending, and no standards for portfolio analysis.

Government Policy

The Kazakh government's main instrument in the development of the housing sector has been the Kazakhstan Mortgage Company and the Kazakhstan Mortgage Loans Guarantee Fund. The government has been reluctant to privatize the Kazakhstan Mortgage Company, which a number of experts consider necessary in order to diffuse concentration, avoid a monopoly and introduce market competition to the secondary market.

Mortgage Awareness

Awareness of residential mortgages is high in major cities. However, people in smaller cities and rural areas remain largely unaware of the benefits of mortgage financing.

Kyrgyzstan

Regulatory Environment

The legislative and regulatory framework with respect to residential mortgage lending is fragmented and underdeveloped. For example, mortgage operations are governed by the *Civil Code* and a separate section in the law "On Pledge," while registration of ownership and liens on real property are governed by a separate registration law. It would be more effective to combine the legislation with respect to mortgages in a single piece of legislation (such as a law on mortgage).

The following are the most important issues:

- The extrajudicial eviction procedure with respect to mortgaged property contains a number of contradictory provisions.
- Title transfer and lien registration can be time-consuming.
- Eviction in the event of foreclosure can be carried out only with special permission from the state prosecutor's office, and the legal acts regulating the process are conflicting.

Institutional Capacity

Institutional capacity to develop the residential mortgage industry is likewise fragmented and underdeveloped. Key issues include the following:

- Without a base for longer-term funding, banks carry on mortgage lending without an appropriate asset/liability balance.
- There are no standards, policies and procedures for the entire chain of mortgage lending operations.
- Banks do not have adequate facilities for training staff in residential mortgage financing.
- There are no adequate risk management policies, methods or tools associated with residential mortgage lending.
- Standards for mortgage-related insurance products are not developed.
- There is no uniformity in residential property appraisals.
- Title insurance is not available.

Government Policy

The government is currently creating a mortgage program focused on addressing social housing needs rather than on developing market-driven mechanisms for mortgage financing. The program contemplates an interest rate subsidy for professionals, such as doctors and teachers, who are also low wage-earners. If not structured appropriately, this measure may distort the market by crowding out non-subsidized, commercial providers of residential mortgages. This policy is risky, ineffective, and inefficient, and may hinder growth in the availability of commercial residential mortgages.

Mortgage Awareness

Knowledge of residential mortgage lending is relatively high in the cities of Osh and Bishkek, but low elsewhere.

Tajikistan

Regulatory Environment

The legislative and regulatory framework with respect to residential mortgage lending is underdeveloped. According to the *Civil Code*, mortgages are to be regulated by a separate law, "*On Mortgage*", which has not yet been adopted. At present, mortgages are governed by a relevant section in the existing law "*On Pledge*."

The following are the most important regulatory problems associated with residential mortgage lending:

- The legal framework for mortgages is insufficient, in that there is no specific law governing mortgages.
- There is no unified registration system for title transfer and liens. The current system distributes these functions among several government bodies, without coordination among them.
- Access to information in the real estate registry is limited to the property owner or an appointed agent.

- Procedures for repossession of mortgaged property have not been developed. The current legislation makes it almost impossible for a lien-holder to enforce eviction from primary residential property in the event of default.

Institutional Capacities

Overall, the development of mortgage lending in Tajikistan is limited by extremely weak institutional capacity. The mortgage lending exposure of Tajik banks consists of only a small number of loans. The following are the key issues that need to be addressed:

- Credit organizations currently lack access to the long-term resources necessary to fund longer-term residential mortgages.
- There are no standards, policies and procedures for the entire chain of mortgage lending operations.
- Banking staff are not adequately trained in residential mortgage lending techniques, nor do they have access to such training.
- There are no adequate risk management policies, methods and tools related to residential mortgage lending.
- There are no standardized insurance products to reduce the risk to mortgage lenders, such as title and credit risk insurance.
- There are no professional appraisal companies in operation.

Government Policy

The government is aware of the importance of mortgage financing, but has not yet developed the strategic vision and understanding necessary to create meaningful programs for the development of the mortgage market. The drafting of an integrated government housing policy could be greatly enhanced by assistance from experts with experience in framing such policies in developing countries.

Mortgage Awareness

Generally, awareness of mortgage financing is very low and is usually confused with construction lending.

Uzbekistan

Regulatory Environment

The legal framework for residential mortgage operations is fragmented and mostly insufficient. The existing legislation sets out fundamental provisions, but contains a number of legal impediments that must be resolved. The government is in the final stages of developing a specialized mortgage law ("*On Mortgages*") and introducing other related regulations aimed at streamlining title transfer, lien registration, foreclosure and eviction procedures.

The following are the key areas for improvement in the legal and regulatory bases for residential mortgage lending:

- Registration of agreements of purchase and sale for real estate is cumbersome, requiring additional post-registration of new title with a specialized state agency.
- The lien registration procedure is not clear. There are numerous contradictions as between lien registration procedures and procedures for the registration of pledge agreements under the law "*On Pledge*".
- It is currently impossible to enforce eviction from a primary residence in the event of default and foreclosure.
- There are no provisions for the priority of claims secured by mortgages over unsecured claims.

Institutional Capacity

The existing residential mortgage market infrastructure is insufficient in the following areas:

- Banks do not have experience in developing mortgage lending products and lack the related policies and procedures.
- Banking staff are not adequately trained to originate, underwrite and service mortgage loans.
- There is a lack of adequate risk management policies, methods and tools for residential mortgage lending.
- The residential real estate market is not transparent. The actual sale price in most transactions is not appropriately disclosed.
- Property insurance is available, but insurance companies do not offer title insurance and life insurance can be prohibitively expensive.
- Appraisal services are available from specialized companies, but appraisals are infrequently carried out and there are no uniform standards⁷.

Government Policy

The government is establishing the Mortgage Lending Support Fund to provide longer-term resources to the banks for mortgage lending. However, vision is needed as to how such an organization should be structured, financed, and operated on a market basis. Furthermore, market-driven mortgage refinancing mechanisms have not been developed and there is a danger that government financing of the fund will not be economically sustainable in the long term.

Mortgage Awareness

Awareness of mortgages is quite high in major cities. However, people in smaller cities and rural areas remain largely unaware of mortgage financing.

⁷ At the time of completing this gaps analysis report the Uzbek authorities adopted National Standard for Property Appraisal “Appraisal for the Purpose of Placing Collateral Against the Credits, Deeds of Pledge and Debt Obligations” (approved by the Resolution of the State Committee of the Republic of Uzbekistan on Managing the State Property on June 14, 2006, came into force on August 3, 2006).

2. AZERBAIJAN

Azerbaijan Republic does not belong to Central Asia in geographical terms. However, its long-standing cultural and historic links with countries of the region can facilitate closer integration. Therefore, the country was included into the analysis carried out by Project.

Per official statistics, the population of Azerbaijan Republic in 2005 was 8.4 million. With 2 million inhabitants, Baku is the capital and largest city of the country.

2.1 Economic Overview

Azerbaijan's social and economic development after independence can be divided into two periods. The first, from 1991 to 1995, was a period of significant economic decline and protracted social instability. The second, from 1996 to the present, has been characterized by increasing macroeconomic stability and robust economic growth. Current economic growth is mainly driven by development of the oil and gas industries and construction of transit oil and gas pipelines through the country.

A moderate inflation rate and an increase in economic indicators such as real incomes, industrial production and efficiency, and higher agricultural output during recent years are evidence of overall economic stabilization and development. Positive macroeconomic trends and the continued pace of economic growth are necessary conditions for the successful establishment and development of a primary residential mortgage market. The following table shows main economic trends in Azerbaijan for the 2000– 2005 period:

Table 1: Main Macroeconomic Indicators for Azerbaijan, 2000 through 2005:

	2000	2001	2002	2003	2004	2005
GDP (US\$, millions)	5,273	5,708	6,236	7,276	8,522	12,537
GDP growth (%)	11.1	9.9	10.6	11.2	10.2	26.4
GDP per capita (US\$)	665	714	774	896	1,041	1,518
Inflation (%)	1.8	1.5	2.8	2.2	6.7	9.6
Unemployment (%)	1.2	1.3	1.4	1.4	1.4	1.4
Foreign Direct Investment (US\$, millions)	664	900	2,012	3,018	4,192	3,887
Exchange rate (Manat/ US\$)	4,474	4,654	4,861	4,911	4,914	4,730

Source: The State Statistical Committee of the Azerbaijan Republic

From 1996 to 2004, GDP growth remained high, averaging 10% per annum. Significant increases in the price of oil, coupled with increasing volumes of oil exports, resulted in an astounding 26.4% growth in GDP during 2005. Non-oil sectors such as agriculture, the chemical industry, and the construction and transportation sectors also significantly contributed to GDP increases. GDP per capita was US \$1,518 at the end of 2005, which is almost three times higher than in 2000.

Until recently, tight government monetary policy facilitated economic growth and helped to keep inflation at check. However, rapid economic growth in the last few years, combined with a considerable increase in personal incomes and consumer demand, caused the inflation rate to increase to 9.6% at the end of 2005.

According to Azerbaijan's State Statistical Committee, monthly individual wages averaged US \$125 in 2005, which was 250% higher than in 2000. This increase has meant a decrease in the poverty level from 40% of the population in 2004 to 29% of the population in 2005.⁸

Foreign direct investment (FDI) in Azerbaijan in 2005 totaled US \$3.9 billion, which was lower than that in the previous year. The main reason for this decline is that the large oil and gas infrastructure projects are nearing completion, requiring less investment. Almost 97.7% of FDI has been directed to the oil sector.

Azerbaijan's economy is currently growing quite rapidly, but the pace of economic growth will decelerate once world oil prices stabilize or decline. However, growing government revenue, coupled with government plans to use a significant portion of this revenue for social and economic development, including the priority task of creating suitable conditions for the construction of affordable housing, can be considered a positive factor in creating a sustainable housing finance system.

2.2 Overview of the Housing Sector

Housing Stock⁹

As at the end of 2005, total housing stock was approximately 103 million square meters, or roughly 1.85 million residential units. Single family homes make up 1 million of the total and are located mainly in rural areas. Over 850,000 residential units (predominantly apartments) are located in urban areas.

Privatization of the housing stock commenced with the adoption of the Housing Stock Privatization Law in 1992. From 1992 to 2005, 62.5% of Azerbaijan's housing stock was privatized. This included 378,100 individual apartments totaling 20.3 million square meters of living space. During 2005, an additional 16,200 apartments were privatized, totaling 1 million square meters of living space, which was 16.5% more than in 2004.

About 58% of residential dwellings were built more than thirty years ago, and 24% of the housing stock is in urgent need of replacement or immediate major repairs. At present, 18% of the housing stock (6,500 apartment buildings) consists of "Khrushchekas," so called because they were built in 1950s and 1960s (when Nikita Khrushchev was the leader of the USSR). The quality of these structures was quite poor to begin with, and they became obsolete twenty-three years ago. Nevertheless, up to 200,000 families still live in these buildings.

As in other project countries, the poor condition of a large portion of the housing stock is attributable to two factors. First, since privatization, the state authorities have not been responsible for the maintenance of individual apartment units, which has contributed to a decline in the condition of these buildings. Although state organizations are still responsible for maintaining the common areas in these buildings, they have limited financial resources and lack sufficient capacity for repairs and maintenance. Second, families cannot afford renovations and/or maintenance themselves, which has meant that these repairs have been left undone.

Despite these circumstances, in addition to current brisk pace of new housing construction, housing cooperatives engaged in the maintenance of the common areas of multi-family dwellings are emerging. Under existing housing legislation, apartment unit owners can create organizations to provide for maintenance and renovation of common areas in the building, or sign a contract with existing state or private firms to provide those services. However, experience is doing so is still quite limited. Further, it is not known whether such organizations use new financial instruments (or if there are financial instruments available) to fund the maintenance and renovation of common areas in apartment buildings.

⁸ Source: The Secretariat of the government program on poverty reduction and economic development under Ministry of Economic Development of the Azerbaijan Republic.

⁹ Source: Association of Property Market Participants.

Despite the low quality of a significant portion of the housing stock, banks generally use residential real estate as collateral, though not necessarily in conjunction with mortgage loans. This indicates that financial institutions view real estate, even if not in good condition, as one of the most reliable forms of collateral.

Residential construction grew steadily during the period from 1997 to 2002, but has increased substantially since the beginning of 2003. New housing construction has increased from 560,000 square meters in 2001 to about 1.4 million square meters in 2005. In 2005 alone, new housing completions led to an increase of 1.5% in the housing stock. New apartment construction has been concentrated mainly in the largest three cities: Baku, Sumgait and Ganja, with approximately 50% of new construction occurring in Baku. Nevertheless, over the past four years, only 5% of the population has moved into newly constructed premises.

It should be noted that increases in the housing stock have kept pace with growth in the population. According to data provided by the Association of Real Estate Market Participants, during the period from 1998 to 2005, the cumulative rate of population growth was 12%, which corresponded to the rate of growth in new residential dwellings. The table below illustrates housing construction trends for the period 1998 to 2005.

Table 2: Housing Construction and Housing Stock Trends in Azerbaijan, 1998 to 2005

	1998	1999	2000	2001	2002	2003	2004	2005
Total Housing Stock, (m ² , millions)	94.2	94.7	97.1	97.7	99.2	100.4	101.6	103
New Housing Construction, (m ² , thousands)	533	416	487	560	803	1,302	1,156	1,381
Housing Stock per Capita (m ²)	12.1	12	12.1	12.1	12.1	12.2	12.3	12.3

Source: the State Statistical Committee of the Azerbaijan Republic

Almost all housing construction in Azerbaijan is carried on by private construction companies, which have built approximately 98% of the new housing stock. There are practically no government programs related to housing construction. However, some government organizations do finance housing construction for their employees. In general, residential construction companies in Azerbaijan are organized as either cooperative societies or operate as private developers. In practice, the operations of the two forms are similar. Construction companies are often organized as cooperatives but still sell the units, which is not a permitted activity for housing construction cooperatives under the current law. Under the guise of non-commercial activity, unscrupulous construction companies thus evade income tax and VAT.

Residential construction is financed mainly from the savings of the future unit owners, which is the main source of funding for housing construction cooperatives. Individuals, mainly in rural areas, also build single family dwellings themselves, usually financed from their savings. Residential construction financing by commercial banks to private developers remains at a low level (US \$87.5 million 2005), reportedly due to significant risks involved.

Under current legislation, land for housing construction is allocated from municipal reserves.¹⁰ The rules for the transfer of land from the state to private purchasers are rather cumbersome, non-transparent and subject to unofficial payments. The purchaser must obtain permission for the allocation of land for construction purposes from two different authorities: the municipality and the State Land and Cartography Committee.¹¹ (Land allocation issues are discussed in depth in the legal section of this report.)

¹⁰ Based on data from the Land and Cartography Committee, there are three categories of land: government-owned (56.9%), municipally owned (23.5%) and privately owned (19.6%).

¹¹ The functions of the State Land and Cartography Committee include carrying out surveys, determining a minimal normative price for land plots, granting rights with respect to land plots, and issuing the relevant documents. The last two functions were abolished upon adoption of the Law "On Amendments to the Land Legislation" on July 25, 2006. Accordingly, those functions passed to the State Real Estate Registry Service.

The procedures for obtaining land from the municipality are established in the Land Code and the Regulation on Allocation of Land Plots by Municipalities. There are two ways to obtain land from municipalities:

- Municipal land zoned for residential use in the municipality’s plan must be allocated by auction.
- Other municipal lands must be allocated through official application by the interested party.

In practice, however, all transfers of municipal land take place through official applications. (Unfortunately, there is no information on municipal land auctions, probably because of the non-transparency of this process.) According to the land legislation, an application for land allocation must be submitted to the relevant municipality and include the following information:

- proposed land use
- how the applicant proposes to hold the land: private ownership, lease, or free-of-charge tenure (the latter is most common for construction companies and other developers)
- history of previous land purchases by the applicant
- land holdings of the applicant’s family members
- list of family members
- location of land plots
- design of the building(s) to be built on the plot requested
- applicant’s domicile

The documentation described above is only required of individuals and does not apply to legal entities. Thus, the allocation process is not transparent and subject to misuse. In order to make proposals for improvement in this area, therefore, existing practices would have to be studied in detail.

Municipalities must consider land allocation applications within five days of receipt. If the municipality decides that an application may go forward, it must, within five days of that decision, forward a copy of the application to the State Land and Cartography Committee. By law, the municipality must also request for each application a written opinion from local authorities on the suitability of the land allocation. In practice, the necessity for this opinion complicates all of the procedures related to land allocation. It can compel the applicant to resort to making unofficial payments to local officials in order to ensure a favorable opinion.

Municipalities may reject an application for a plot of land for the following reasons:

1. Failure to meet the requirements of
 - the official territorial development plan
 - the local general plan
 - other construction and development plans of the territory
2. The land plot requested is owned by someone else.
3. Water, gas, electric and other services on the land requested are not available.
4. The area is susceptible to landslides.

The applicant may appeal the decision of the municipality to the Ministry of Justice (the authority controlling the activities of municipalities) or to the courts.

The State Land and Cartography Committee must, within ten days, make the plot available on the spot, with the applicant and representatives of municipality present, and prepare a survey map. The survey is carried out at the applicant’s expense. The Committee forwards the survey map to the municipality, along with a document establishing a minimum price for the land. The municipality then establishes a final price based on the market, but it may not be less than the minimum set by the State Land and Cartography Committee.

Then, within five days, the municipality must make a decision on the application and, if granted, enter into an agreement with the applicant. The municipality gives the applicant a copy of the decision and survey map. With these and other required documents, the applicant must apply to the State Real Estate Registry Service to register ownership. The procedures for registering ownership of land are similar to those for registering ownership of other real property (the registration process is explained in more detail in the legal section of this report).

Housing Demand

Demand for housing in Azerbaijan has surged, especially in Baku, as a result of population growth and internal migration. During the late 1980s, the population of Baku was 1.1 million. This increased rapidly to 1.7 million by 1993 due to internal displacements caused by the conflict with Armenia over Nagorno-Karabakh. Currently, the population in Baku is officially 1.87 million, but some unofficial estimates claim that it is over 3 million.

In spite of the 3.8 million square meters of residential construction during the past three years, housing prices are still increasing -- a sign that demand is currently not being met. Annual price increases in the recent past have been in the range of 10-20%. Depending on the location, the price of newly constructed apartment units in Baku ranges from US \$293 to \$1,297 per square meter.

The demand for housing remains high, and is likely to continue to grow for the following reasons:

- Personal incomes continue to grow at a fast pace. Many people view real estate as a way to store wealth or as long-term investment. The lack of alternative financial instruments and the low level of faith in the banking system contribute to this view.
- Construction has not kept pace with residential housing demand, especially in Baku where there has been an influx of people from the regions.

Expected Demand for Residential Mortgages¹²

Because of difficulties associated with carrying out a survey to determine the number of individuals who would wish to purchase or renovate a house with mortgage proceeds and have sufficient income to support a mortgage, an alternative method was used to calculate potential demand. A precise estimate cannot be made without such a survey, but an approximate figure can be calculated by considering aggregate residential mortgages as a percentage of projected GDP, as IFC has done in estimates for other countries. Assuming GDP of US \$47 billion¹³ by 2010, and aggregate residential mortgage loans of 2.5% of GDP, the aggregate value of residential mortgages will be approximately US \$1.17 billion by 2010.

2.3 Institutional Capacity for Residential Mortgage Lending

The conventional participants in the housing finance market (financial institutions, insurance companies, realtors and appraisers) exist in Azerbaijan, but these institutions all have little or no experience in housing finance. For example, banks do not have standardized mortgage lending policies and procedures, insurance companies do not offer the insurance products that are quite often necessary in mortgage lending, and appraisal companies do not have uniform valuation standards for mortgage purposes.

Further, although sixteen banks in the country claim to offer mortgages, the aggregate amount of mortgage loans outstanding in the country was only US \$75.5 million at the end of 2005. The low mortgage volume illustrates that the institutional infrastructure needed to facilitate an efficient mortgage lending industry has yet to appear in Azerbaijan.

Banking Sector¹⁴

As of January 1, 2006, there were forty-four commercial banks operating in Azerbaijan. Non-bank financial sector included eighty-five credit unions and seventeen microfinance organizations.

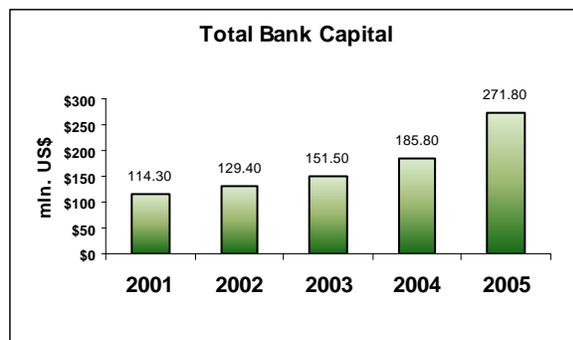
¹² Source: the State Statistical Committee of the Azerbaijan Republic.

¹³ As estimated by the Ministry of Economic Development of the Azerbaijan Republic.

¹⁴ Source: National Bank of Azerbaijan

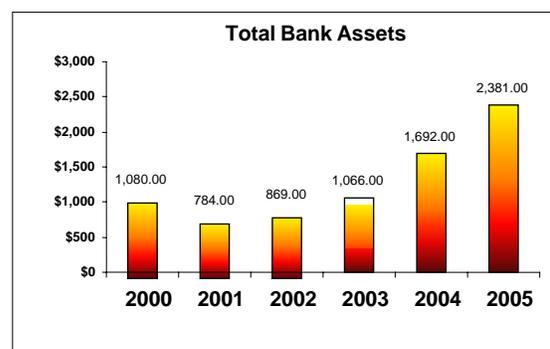
The banking sector has experienced dynamic growth recently, mainly due to favorable macroeconomic conditions. This has provided a stable base for the steady development of Azerbaijan’s financial sector. The strengthening and development of the banking system during the recent past is clearly indicated in the growth of bank capital, deposits including household deposits and volumes of lending to the real sector.

Chart 1



Source: National Bank of Azerbaijan

Chart 2



Source: National Bank of Azerbaijan

Total capital in the banking sector increased by 238% between 2001 and 2005 and totaled US \$ 271.8 million by the end 2005. This growth resulted from a combination of increased retained earnings and an increase in the minimum capital requirements stipulated by the National Bank of Azerbaijan, which took effect on January 1, 2006. In recent years, the National Bank of Azerbaijan has made strong efforts to strengthen and consolidate the banking sector through increasing the minimum capital requirements. As a result of these efforts, the number of commercial banks has decreased from fifty-three in 2001 to the present forty-four. Further strengthening of the banking sector is expected over the next few years. It is assumed that the increase in bank capital will make more long-term funds available for mortgage lending purposes.

Total bank asset have more than doubled since 2000 to US \$2.38 billion and currently represent approximately 20% of GDP. However, approximately 60% of assets and deposits of the banking sector are controlled by two state-run banks. This level of concentration may translate into increased systemic risk.

As a resulted of increased business activity, aggregate portfolio of bank loans outstanding grew by 45.6% to about US \$1.5 billion in the space of one year. The bulk of these loans were to the entrepreneurs, but 29% was classified as consumer loans to individuals.

Table 3: Distribution of Bank Loans in Azerbaijan, as of January 1, 2006

Economic Sector	Loans Outstanding (US\$, millions)	Share of Overall Portfolio (%)	Change since January 1, 2005 (%)
Trade and Services	381.7	26.3	65.9
Power and Natural Resources	191.7	13.2	740.0
Agriculture	103.2	7.1	73.2
Construction and Real Estate	87.0	6.0	77.3
Industry and Manufacturing	88.1	6.1	26.8
Transportation and Communication	135.5	9.3	-14.3
Individuals	422.2	29.1	44.2
State Construction	8.7	0.6	42.3
Other Credit Operations	33.0	2.3	7.5
Total	1,451.1	100	55.9

Source: National Bank of Azerbaijan.

As illustrated in Table 3, individuals account for the largest single segment of loans. In general, this has been the result of increased personal incomes, which has in turn led to increased ability to service debt, coupled with an increase in the range of loan products offered by banks to individual borrowers.

The table below shows the average annual interest rates on loans of various terms offered by banks in over the past two years.

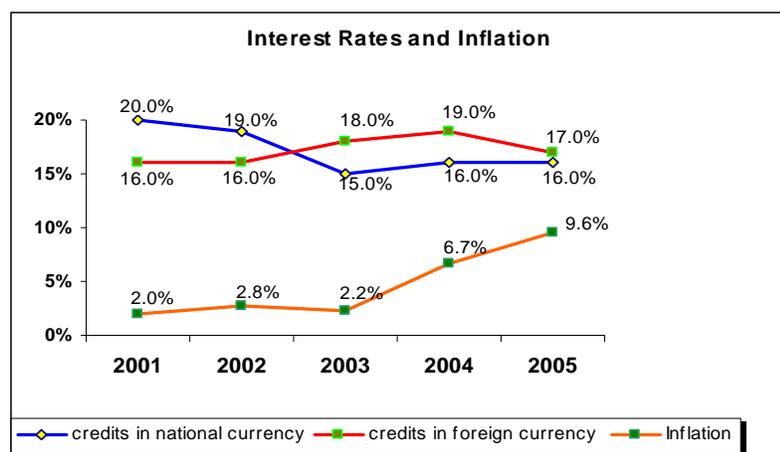
Table 4: Average Interest Rates on Bank Loans in Azerbaijan

Loan Term	January 1, 2005		January 1, 2006	
	Manat	US\$	Manat	US\$
3 to 6 months	12%	10.3%	-	9.7%
6 months to 1 year	11.9%	13.3%	18.4%	10.3%
Over 1 year	20%	15%	20%	14%

Source: National Bank of Azerbaijan

The diagram below illustrates trends in local and foreign currency interest rates on loans compared to inflation rates.

Chart 3



Source: National Bank of Azerbaijan

Despite an increase in the rate of inflation over the past three years, interest rate levels on bank loans have remained stable. It is important to note that a low and stable inflation rate is necessary (from a macroeconomic point of view) for the development of an efficient residential mortgage market.

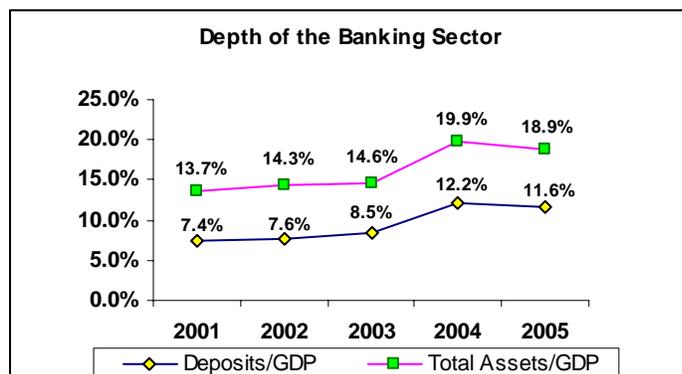
Total bank deposits reached US \$1.5 billion at the end 2005, including approximately US \$500 million in personal deposits. Deposits by legal entities grew by 30.2%, outpacing the growth of personal deposits for the same period. The increase in the deposit base of the banking sector was facilitated by increased consumer confidence in the banking system, partly owing to a set of comprehensive actions taken by the National Bank of Azerbaijan to support the development of the banking sector. One significant step was the development of a law on deposit insurance, which will be adopted in the near future.

At the same time, it is important to note that in 2005, term deposits (more than one year) increased to 29% of total deposits. Historically, long-term deposits have represented 10% to 15% of total deposits, and this recent growth trend can be viewed as quite positive. Nevertheless, it does not contribute significantly to solving the problem of accessing to long-term funding for the development of residential mortgage lending. Because of that problem, most local banks provide shorter-term mortgage loans (or fund longer-term loans from capital). The exceptions are institutions with access to long-term funding. For example, Shore Overseas Azerbaijan (the subsidiary of an American non-bank financial and credit organization) has access to a seven-year credit

facility from the Overseas Private Investment Corporation.¹⁵ As a result, the standard mortgage product offered by Shore Overseas Azerbaijan has a seven-year term.

The diagram below illustrates trends in the depth of the banking sector by comparing deposits and assets to GDP. (The higher the value of that indicator, the greater the role the banking sector plays in the economy of a country.)

Chart 4



Both deposits and assets increased as a percentage of GDP, from 7.4% and 13.7% respectively in 2001 to 11.6% and 18.9% in 2005. A small decrease in each occurred in 2005. However, this is attributed to the extremely large increase in GDP that year (owing to increased world oil prices coupled with increased oil exports) rather than to a slowdown in growth in the banking sector.

Source: National Bank of Azerbaijan

Interest rates for USD loans for terms of between one and three years decreased from an average of 18.4% in May 2005 to 17% in May 2006. However, interest margins remained unchanged, which indicates that the decrease was not the result of increased competition decreased lending risk. During the same period, mortgage interest rates remained largely unchanged, at 20.1% per annum on average.¹⁶

The table below shows interest rate margins on local currency (Manat) and US dollar loans from 2002 through 2005, illustrating that they changed insignificantly over that period.

Table 5: Interest Rate Margins on Loans in Azerbaijan (%)

2002		2003		2004		2005	
US\$	Manat	US\$	Manat	US\$	Manat	US\$	Manat
7.32	9.2	8.4	8.3	8.5	9.5	8.2	9.3

Source: National Bank of Azerbaijan

Non-Bank Financial Institutions

At the end of 2005, eighty-five non-bank financial institutions were operating in Azerbaijan, of which sixty-eight were credit unions and seventeen were microfinance organizations. Total capital in the sector was approximately US \$44 million, and assets totaled close to US \$80 million. It must be noted that the source of the capital for these organizations was either grants from international organizations (such as USAID) or the founders themselves.

Shore Overseas Azerbaijan is one of the largest non-bank financial institutions in the country. It is owned by US-based ShoreBank and supported by Overseas Private Investment Corporation and USAID.¹⁷ Along with loans to entrepreneurs and small businesses, the organization offers residential mortgage products in the

¹⁵ Overseas Private Investment Corporation is a specialized investment agency of the United States government.

¹⁶ Based on interviews with representatives of commercial banks.

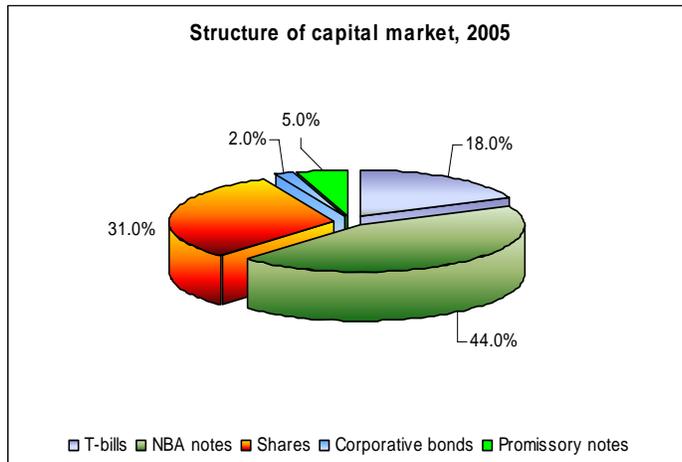
¹⁷ Source: United States Agency for International Development (USAID).

Baku area. It is the only non-bank financial institution engaged in residential mortgage lending in the country. The mortgage loan portfolio of Shore Overseas Azerbaijan exceeded US \$2.5 million at the end of 2005.

Capital Markets¹⁸

Capital markets are in early stages of development and cannot currently support the funding of long-term mortgages. The development of the capital markets started in 1998 with the conversion of state enterprises into joint-stock companies, the adoption of the Law “On Securities” (no longer in force), and the establishment of the Securities Committee, the National Depository Center and the Baku Stock Exchange (BSE). Despite the necessary infrastructure is in place, the capital markets still do not have sufficient liquidity and depth.

Chart 5

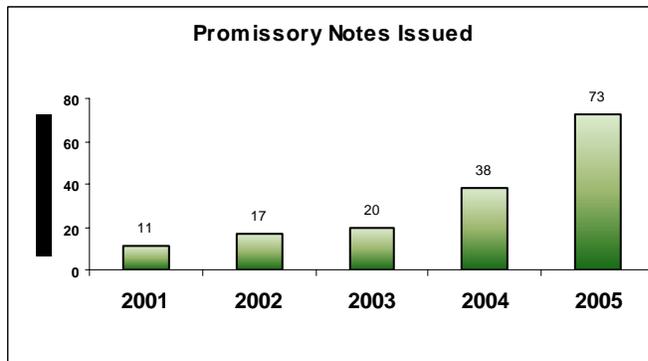


Source: The Securities Committee of the Azerbaijan Republic

Capital market liquidity has improved in the past year. For example, in 2005, thirty-eight financial institutions (thirty-two banks, two leasing companies and four insurance companies) issued securities for a total of US \$240 million, an increase of 61% over 2004. Securities transactions mainly take place on debt market, where the majority of instruments are shorter term treasury bills and notes. In addition, the government issued treasury bills totaling US \$136 million (88% higher than in 2004), and the National Bank of Azerbaijan issued notes totaling US \$344 million (86% higher than 2004).

Yields in 2005 increased over 2004 from 4.56% to 11.7% on treasury bills and from 4.47% to 9.15% on notes. This was the result of increasing inflation and higher National Bank of Azerbaijan refinancing rates (increased from 7% to 9% during the period). Average maturity for treasury-bills was forty-five days. For National Bank of Azerbaijan notes, maturity ranged from one to three months.

Chart 6



Source: The Securities Committee of the Azerbaijan Republic

Over the last five years, the number of promissory notes on the securities market has increased considerably. At the beginning of 2005, promissory notes for AZN 6 million (nearly US\$ 6.5 million), US \$17.8 million and EUR 10.6 million were issued. The increase in volume was related to an Agency for Credit Unions issue to fund credit union lending.

¹⁸ Source: The Securities Committee of the Azerbaijan Republic.

The State Securities Committee registers each securities issue. Eighty-six issues were registered in 2005, 19.4% more than in the previous year.

The following are the main issues related to further development of the securities market:

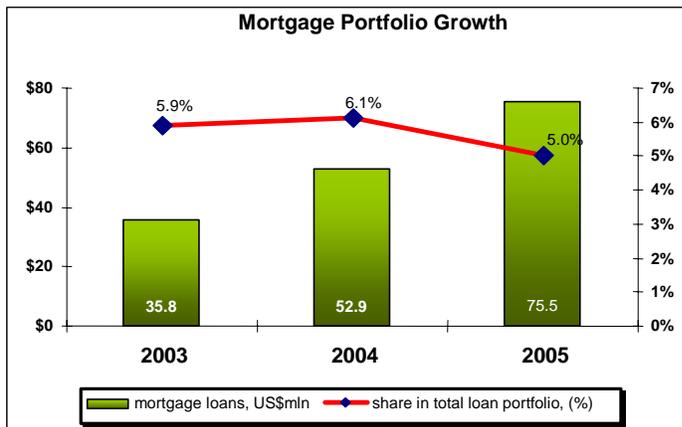
- There is a lack of qualified investors in the securities market (pension funds, insurance companies and other entities with significant cash to invest).
- The level of transparency in joint stock companies is low. Access to information about them is difficult, and the information provided on the financial condition of these companies is usually incomplete.

The development of capital markets, functioning effectively as an intermediary between investors and borrowers for long-term resources, is a key factor in the development of a nationwide system of housing finance. It also serves to diversify risks, not only in housing finance, but also in the economy as a whole.

Residential Mortgage Lending Market and Bank Operations in Azerbaijan

Mortgage lending market in Azerbaijan is in the initial stages of development: the volume of mortgage debt outstanding as a percentage of GDP is approximately 0.6%. Sixteen banks currently claim to offer residential mortgages funded through equity and deposits. Total mortgage loans currently represent approximately 3.2% of aggregate bank assets, or roughly US \$75.5 million.

Chart 7



Typically, these loans are extended at high interest due to longer repayment and untested mechanism for the assessment of mortgage lending risks.

The following are the main problems associated with residential mortgage lending by banks:

- Lack of long-term financing sources to fund mortgage loans
- Incomplete or non-existent internal standard procedures for the complete mortgage lending process
- Limited residential mortgage product line
- Lack of effective mechanisms to assess risk related to mortgage lending
- Bank staff lacks skills in this area

The following are the typical conditions for the mortgage loans provided by banks, usually financed from equity:

- Amount: US \$5,000 to \$200,000
- Period: usually one to three years (seven years is possible through Shore Overseas Azerbaijan)
- Interest rate: 9% to 30% per annum (US\$ and AZN)¹⁹
- Blended principal and interest repayment: monthly

¹⁹ A low rate (9-12%) may be available for loans on certain residential construction projects, but market interest rates range from 20 to 30%.

- Loan to value ratio: not to exceed 50% of the appraised value of the underlying residential property
- Monthly payment: not to exceed 50% of monthly income

Banks currently face the following main risks in residential mortgage lending:

- Risk of borrower failing to pay back the loan due to banks inability to assess his income and ability to service debt.²⁰
- A decline in real estate prices may leave banks under-collateralized (given the absence of adequate appraisal skills).
- Foreign exchange risk since the bulk of mortgage loans are in US dollars, while salaries are usually paid in Manat and not indexed to the US dollar.
- Funding mortgages from short-term deposits has inherent liquidity risks. (This will become a problem once aggregate mortgage loans surpass bank capital, which is not yet the case.)

The government established the Azerbaijan Mortgage Fund at the end of 2005 to ensure that banks had access to longer-term resources and to stimulate residential mortgage lending. Approximately US \$27.8 million is being allocated to partner financial institutions from the 2006 budget, for a fifteen-year term, with a 6% annual interest rate, for the purpose of on-lending at 12%. However, it is premature to gauge whether the Azerbaijan Mortgage Fund will be effective in providing subsidized residential mortgage loans with 12% annual interest rates to the end borrower over a period of 15 years. By early summer 2006, only fifty individuals had applied for mortgages under this scheme, with only five of those meeting the preliminary qualification criteria. Only four mortgage loans had been disbursed by that date.

Table 6: Azerbaijan Mortgage Fund Mortgages

Maximum Loan Amount (US\$)	Downpayment	Interest rate	Term	Maximum Monthly Payment	Early Repayment Penalty
33,000	30%	12%	15 years	50% of gross income	None

Source: National Bank of Azerbaijan

Pension System

Legislation provides for both state and private pension funds. However, there are currently no private pension funds in existence. The state pension fund is mainly based on mandatory employee contributions of 3% of salary and mandatory employer contributions of 22% of salaries paid. In 2005, the pension fund accumulated approximately US \$533 million and paid out approximately US \$529 million. Fund did not carry out any investment activity because there is no legal framework regulating the investment of pension savings.

Insurance Market

Twenty-eight insurance companies and five insurance brokerages are currently operating. The total authorized capital in the industry at the beginning of 2005 was US \$24.6 million.

Under the Law “On Mortgage”, borrowers are not required to obtain property insurance, unless it is a requirement of the lender and set out in the mortgage contract. In such cases, the costs range from 0.3% to 0.4% of the appraised property value per annum.

Life insurance is not widely available and is not mandatory to obtain a mortgage loan. Annual premiums range from 0.25% to 0.8% of mortgage loan amount.

²⁰ Entrepreneurs with unpredictable income represent 40-50% of mortgage borrowers.

Title insurance is not available. There is no demand from either borrowers or lenders, and there is no actuarial data to correctly price this product.

Appraisal Companies

According to Azerbaijan Ministry of Economic Development data, there are presently twenty appraisal companies operating. Prior to 2002, real estate appraisers were licensed. However, in September 2002, the government abolished the licensing requirement without giving a clear reason. Uniform qualification standards for real estate appraisers have not yet been established, and the quality of these services varies. Further, there are no industry standards for residential appraisals at present.

The following are the most common deficiencies in appraisal reports:

- No real estate market analysis
- Lack of competence in application the appraisal methods
- Improper use of methods and approaches in the appraisal and lack of reasoning as to rationale for using them
- No ratios or multipliers used to fine-tune the calculation of the real estate value

Credit Bureau

The National Bank of Azerbaijan launched a centralized credit bureau on January 1, 2005, with technical assistance from the World Bank. The National Bank of Azerbaijan requires commercial banks to provide the bureau with information on outstanding business loans of more than approximately US \$1,000 and outstanding personal loans of more than approximately US \$5,000. The information is submitted electronically, kept on file by the bureau for three years, and then archived in electronic form.

Banks that provide information to the credit bureau have the right to obtain information from the bureau on the status of their clients with respect to loans at other banks. The fee is US \$2. The credit bureau charges borrowers US \$1 to view their credit reports. Requests for credit reports are made on line.

The credit bureau system is still quite rudimentary, especially with respect to credit information on individuals. Thus, it has, at best, limited usefulness in determining the creditworthiness of potential mortgage borrowers.

Real Estate Agents/Agencies²¹

At present over 800 realtors are active in Azerbaijan, but the majority of real estate transactions flow through 120 firms. Large realtors processed approximately 30,000 property sales in 2005, an increase of about 10% to 12% from 2004.

Significantly, there is no legislation specifically regulating realtors, and the business is characterized by a lack of transparency and an absence of coordination. Realtors lack the technology, standards and methods necessary for real estate transactions involving mortgages, which certainly does not promote the development of mortgage lending. To develop an effective and transparent realtor sector, and to improve professional capabilities and accountability, it will be necessary to implement a certification process for realtors. This could be accomplished by a self-regulating industry association, which does not currently exist and which could play a leading role in the development of this sector.

²¹ Source: Association of Property Market Participants.

2.4 The Legal & Regulatory Environment

In 2005, the government introduced significant measures to improve the housing conditions of the population through remove barriers to the development of the residential mortgage market. The Law “On Mortgage” was passed, and a number of housing and mortgage-related presidential decrees and resolutions of the Cabinet of Ministers were adopted, including the following:

- Presidential Decree “On the Establishment of the Mortgage Lending System in the Azerbaijan Republic,” dated September 17, 2005
- Presidential Decree approving the Regulations of the Azerbaijan Mortgage Fund under the National Bank of the Azerbaijan and the Rules of Mortgage Lending through the Azerbaijan Mortgage Fund under the National Bank of the Azerbaijan, dated December 22, 2005
- Resolution of the Cabinet of Ministers of the Azerbaijan Republic No. 144 “On Approval of the Rules of the State Registration of Mortgage Notes,” dated February 13, 2005

These were advancements, but a number of critical legislative issues remain to be addressed in order to further develop the primary residential mortgage market. One is the cumbersome and lengthy process for registering title and mortgages. Another is contradictory provisions as between the Law “On Mortgage,” the Civil Code and the Law “On the State Real Estate Registry.” Moreover, legislation governing other areas related to mortgage lending and securities market requires further refinement.

Banks and non-bank financial institutions already provide loans, including housing loans, using residential property as collateral. However, there are a number of substantial risks in purchasing a house with mortgage loan proceeds. The main risk arises from gaps in the existing legislation with respect to the process of registering ownership upon the purchase of a property. The greatest concern is the time lag between transfer of title and registering a mortgage on the property. The period can exceed thirty days. As a result, mortgage lenders often require temporary collateral sufficient to secure the mortgage loan until the mortgage on the underlying property is registered.

The following section provides details on key gaps in the process for state registration of title and mortgage, identifies key risks related to the purchase of residential real estate with a mortgage, and explains how financial institutions are mitigating the risks at present.

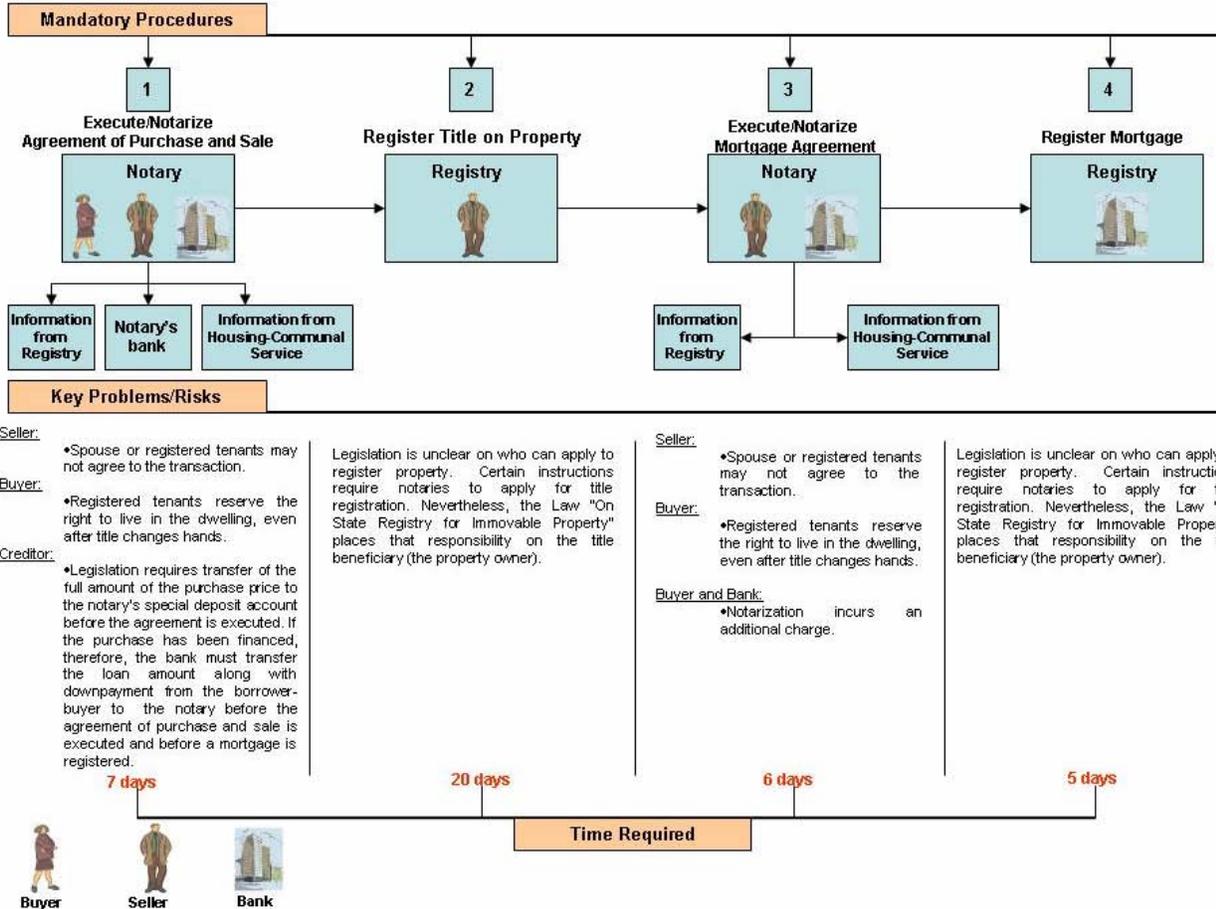
Title Registration Process

Registering title with the state registering body (the Service of the State Register for Real Estate the Republic of Azerbaijan or the State Registry Service), including ownership rights and mortgage rights, is mandatory. Failure to do so may nullify those rights.

The State Registry Service is an independent state organ responsible for registration of ownership and mortgage rights with respect to real estate. Since its establishment in early 2005, and continuing to the present, the State Registry Service has been beset with organizational problems, such as the lack of permanent premises and insufficient staffing.

The entire process for title transfer and mortgage registration on a residential property can take up to thirty-eight days. The diagram below shows the process, the time required for each step, and the problems and risks for the parties to the transaction.

Process for Title and Mortgage Registration in Azerbaijan



Key Issues in the Title Transfer and Mortgage Registration Processes

1. Risks Associated with Title Transfer

Legislation requires a purchaser to deposit the whole property purchase amount to a notary's special account, at a bank appointed by the Ministry of Justice, prior to notarization of the agreement of purchase and sale. Thus, one of the risks for mortgage lenders, at the very beginning of the registration process, arises from the requirement to deposit mortgage loan proceeds before the new owner registers title and before a mortgage is in place. The following are the problems with this procedure:

- There are no regulations in place governing the operation of the deposit accounts of notaries. Commercial banks therefore view the payment deposit procedure as an unreliable form of settlement. In fact, nothing in the legislation prohibits the seller and buyer from agreeing between themselves as to disposition of the loan proceeds after the bank has transferred funds to the deposit account. The lender has no means by which to block payments from these accounts or to cancel the loan and call back the funds.
- The bank must transfer funds to the deposit account in the absence of due collateral that backs up the loan. The mortgage can only be registered once title transfer has taken place, which can be up to thirty-eight days after loan proceeds are deposited. Lenders are exposed to the risk of having no collateral for the disbursed mortgage loan for this period.

- Control over the disposition of the loan proceeds passes to the notary and the designated bank upon deposit. The bank granting the mortgage thus loses control over the proper use of the mortgage proceeds.

Even after the seller has received the proceeds of the sale from the notary's deposit account, the buyer cannot assert ownership until title has been registered with the State Register Service, and the lender cannot begin the process to register a mortgage on the property until the purchaser has registered title.

2. Time and Costs Involved in Registering Title to Residential Real Estate

Under current legislation, the State Register Service must carry out the registration of title associated with a transfer of ownership within twenty days of receiving the application.

The following documents are required in order to transfer title:

- Application form, completed as required by State Register Service
- Notarized agreement of purchase and sale
- Floor plan or (known as a "technical passport") for the property
- Survey map of the property
- Receipt for payment of the state fee

Before the registration process can begin, the agreement of purchase and sale must be notarized, which can take up to a further seven days. The notary requires the following documents:

- Information ("Form 2") from the State Register Service regarding any encumbrances on the property
- Certificate from the housing-communal service confirming that the seller lives at the address indicated with the family members named (if any)
- Notarized statement from the seller's spouse (if any) indicating no objection to the sale of the property
- Notarized statement of any family members living with the seller (if any) indicating no objection to the sale of the property
- Statement from an appointed guardian indicating no objection to the sale of the property if anyone residing at the property is under guardianship²²

State fees involved in registering title include the following:

- For notarizing the agreement of purchase and sale in Baku:²³ AZN 110 (approximately US \$120)
- For registering title: AZN 11 (approximately US \$13)

3. Mortgage Registration

Under the Law "On State Registry for Real Estate," the documents required for state registration of any rights with respect to real estate, including but not limited to mortgages, are to be submitted by the beneficiary. The following documents are required to register a mortgage with the state:

- Application form, completed as required
- Documents attesting to the identity of the beneficiary, and where the beneficiary is a legal entity, the certificate of incorporation
- Notarized mortgage agreement between the borrower (or property owner) and the lender

²² Guardians are appointed by the Guardianship Department of the local authority with respect to persons judicially recognized as legally incapacitated, in whole or in part. Under the Civil Code, legal incapacity can include children under the age of 18, the mentally disabled, and persons addicted to alcohol, drugs or gambling.

²³ Fees vary by region and are highest in Baku.

- Floor plan/technical passport of the property
- Survey map of the property
- Receipt for payment of the state fee

The State Registry Service may refuse to register a mortgage on a property on the following grounds:

- Failure to comply with the form and content of the documents required
- The applicant (such as a minor or a legally incapacitated person) does not have the authority, under the Civil Code, to enter into the contract, or is barred by the courts or any registration body from registering a mortgage

Who has Access to Information from the State Register Service?

The law permits access to information only for holders of rights (and their legal representatives and successors) and municipalities and relevant public authorities.

The State Register Service must provide the information, in writing, within five days of an application. The fee for this service is 30% of the state fee for registering title.

The mortgage registration process usually takes twelve days after title has been registered. In order to notarize the mortgage agreement, the parties (borrower and lender) must submit the same documents as required to notarize the agreement of purchase and sale, redundantly collecting the same documents on the same property.

The following are the state fees involved in registering a mortgage:

- For notarizing the mortgage agreement: AZN 27.50 (approximately US \$30)
- For registering mortgage rights: AZN 8.8 (approximately US \$10)

The present mortgage registration system creates incentives for making unofficial payments to accelerate the title and mortgage registration processes.

4. Additional Registration of Mortgages

Legislation requires additional mortgage registration in cases where there is (i) a change in the nature, amount and terms of the principal obligation; (ii) alienation from and material change to the mortgaged property; and (iii) assignment of rights.

Although the procedures are straightforward, they present a number of difficulties, especially where assignment of rights is involved. The most significant problem arises because additional registration is not accomplished by simple notification, but rather involves certain administrative procedures and decisions at the discretion of the registering authority. In particular, if the State Register Service rejects the additional registration, any changes to the loan agreement may not be enforceable. For this reason, banks may be unwilling to make changes, which can preclude the possibility of refinancing mortgage loans.

Additional Registration of Mortgage upon Assignment of Rights

Legislation permits the assignment of rights under a loan agreement. This triggers automatic assignment of lien rights, but only if the additional registration of the mortgage has been completed.

Additional registration is carried out by the State Register Service within three days of receipt of an application. The applicant must present the following documents:

- notarized copy of the assignment agreement
- notarized changes to mortgage agreement
- receipt for payment of the state fee in the amount of AZN 1.10 (approximately US \$1.30)

In addition, current legislation provides for mortgages to be financed through mortgage notes,²⁴ an optional arrangement based on agreement between the borrower and the lender. In such cases, the mortgage note must be registered with the State Committee

²⁴ Although this mechanism is set out in legislation, it has yet to be tested.

for Securities as a security, rather than with the State Register Service, which may result in additional time and expense.

5. Mandatory Notarization of the Mortgage Agreement

By law, the documents related to a real estate transaction must be notarized. Notarization of the agreement of purchase and sale may play an important role in ensuring the legal validity of that agreement. However, the mandatory notarization of mortgage agreements requires additional analysis to gauge its effectiveness and it may be eliminated altogether. Notarizing a mortgage agreement takes up to ten days. Notaries strictly require the presence of all persons involved in the mortgage transaction, or their proxies.

Mandatory notarization is also required for any changes to a mortgage agreement or the assignment of rights. Again, notaries require the parties to be present. This requirement may become a barrier to the development of secondary mortgage markets because of the inconvenience to the parties.

6. Assignment of Rights

Under the Law “On Mortgage,” a person who has acquired a secured claim also acquires the mortgage rights.

Under the Civil Code, the lender must obtain prior consent from the borrower to assign rights only in circumstances that affect the “reasonable interests” of the borrower. However, what constitutes “reasonable interests” is not defined.

The requirement for the lender to notify the borrower of assignment of rights is mentioned obliquely in the Civil Code, which provides that the borrower must fulfill his/her obligation to the lender until notified that the lender’s rights have been assigned to another lender. If a lender assigns rights to several parties without determining priority, the rights pass to the first party to notify the borrower.

The law does not oblige the original lender to notify the borrower of an assignment of rights.

Under Article 28 of the Law “On Mortgage,” the following formalities are required for assignment of rights in a mortgage:

- The mortgage agreement must be amended
- The amended mortgage must be registered with the State Register Service²⁵

Given that the legislation does not provide mechanisms for valuation of the assignment of rights transfer, this matter becomes subject to an agreement by the parties.

7. Assignment of Mortgage Notes

The procedure for assignment of rights in mortgages financed through mortgage notes is set out in the Law “On Mortgage.” The mortgage note is to be endorsed in favor of the assignee and the note transferred to assignee along with the mortgage agreement. The endorsement must contain the full name of the new holder of the mortgage note and the amount of the outstanding balance. If an individual is endorsing the note, the endorsement must be notarized.

The requirement to notify the borrower is the same as for the conventional assignment of rights, except that the law “On Mortgage” requires the assignor to notify the borrower in writing. The law states that the consequences for failure to do so are set out in the Civil Code. As mentioned above, under the Civil Code the borrower must fulfill his obligations to the previous lender until notified of an assignment. If a lender assigns rights to several parties without determining priority, the rights pass to the first party to notify the borrower.

²⁵ Transfer of mortgage becomes valid upon the additional registration.

The Law “On Mortgage” also requires additional registration of the mortgage in the event of assignment of rights in a mortgage note.

8. Land Right Issues

Under land legislation, the three categories of ownership in land are (i) private (ii) municipal, and (iii) state.

Land for residential construction is mostly allotted from the municipal land resources. Municipal land may be allocated for housing construction in three ways:

1. privately-owned land for construction of a residence by an individual
2. free-of-charge term-limited tenure for construction of multi-unit dwellings by private commercial companies²⁶
3. free-of-charge permanent tenure for construction of multi-unit dwellings by housing construction cooperatives²⁷

Land legislation permits expropriation of land for government, municipal or common needs.²⁸ A court order is required if the landowner does not consent. Under the Land Code, the expropriating party must pay the landowner for the expropriated land at fair market value as of the time of expropriation. With the landowner’s consent, the expropriating party may offer a comparable plot of land in lieu of payment.

Foreclosure and Eviction Process

The current system of foreclosure was set out in the Law “On Mortgage.” The procedure appears detailed and seems to solve the problems that existed before the law was passed. However, the effectiveness of the law has not yet been thoroughly tested since the few judicial foreclosure cases initiated during 2005-2006 have yet to be settled. Moreover, the courts have been very reluctant to follow the procedural requirements of the Law “On Mortgage” in the few cases that have gone to court.

Under the law, banks can foreclose in the following cases:

- The borrower fails to repay the obligation, in whole or in part, on the terms stipulated in the loan agreement
- The borrower fails to make interest payments on the loan on two or more consecutive occasions
- The borrower fails to fulfill any of the provisions of the mortgage agreement, if the mortgage agreement provides for foreclosure on these grounds.

The Law “On Mortgage” provides for the following ways to foreclose on mortgaged property:

- Court order (judicial procedure)
- Executive note by a notary (out-of-court procedure, where the notary informs the law enforcement officer that sufficient legally document grounds exist for foreclosure)
- Notarized agreement between the parties (out-of-court procedure, known as a “work-out” in many western jurisdictions)

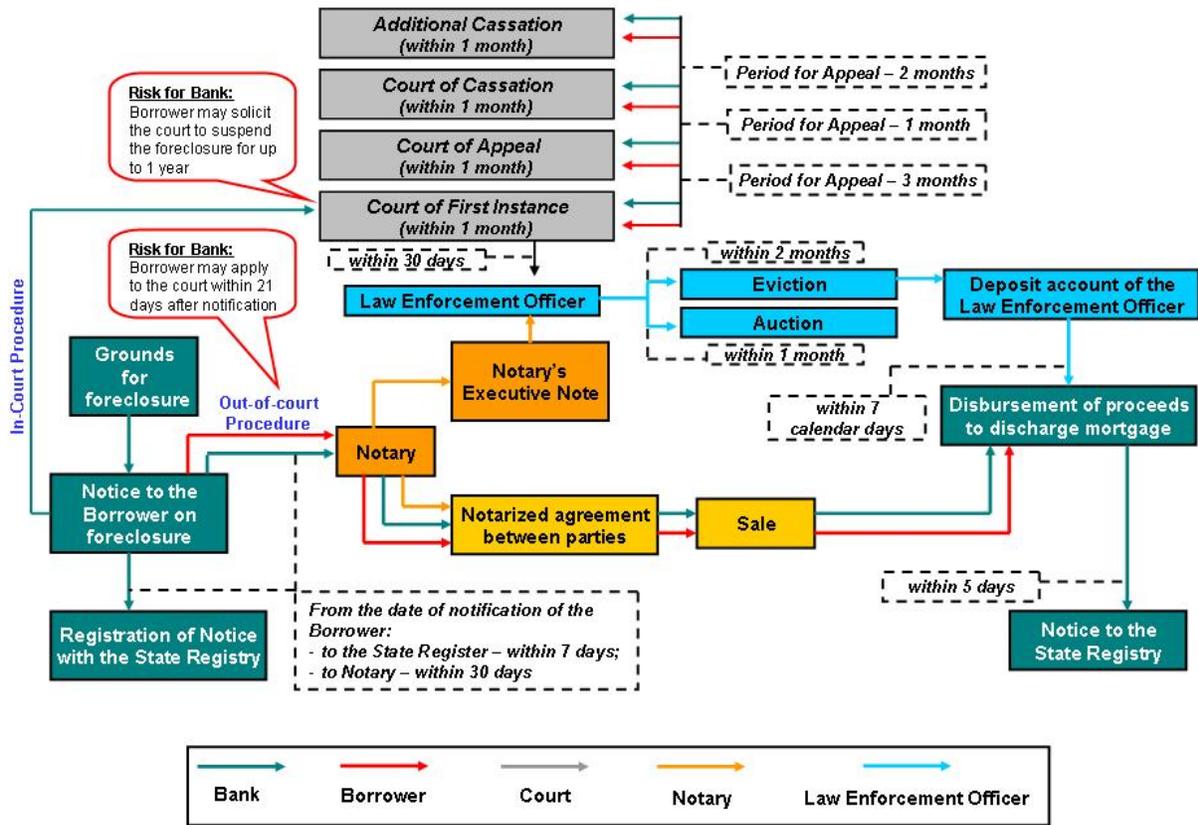
The diagram below illustrates foreclosure procedures under current legislation.

²⁶ After the sale of all units in the dwelling, ownership of the land passes to permanent common ownership by the unit-owners.

²⁷ Non-profit housing societies remain the owners the building and retain title to the land.

²⁸ The details are set out in the Land Code.

Foreclosure Process in Azerbaijan



Out-of-Court Foreclosure Procedure

The existing procedures appear to be balanced as to the interests of the lender and the borrower. The law acknowledges the borrower’s right to apply to the court to settle a dispute over mortgaged property, but sets a strict time limit for the application (twenty-one days from receipt of notice of foreclosure).²⁹ A bank forfeits the right to foreclose through an out-of-court procedure if it fails to initiate the process within thirty days of providing notice of foreclosure to the borrower.

Although out-of-court foreclosure procedures are clearly defined, banks continue to consider judicial foreclosure their best option. In general, banks do not trust the out-of-court procedure. They believe that it favors the borrower, because the borrower may find legal grounds, at any stage in the out-of-court procedure, to force the bank into court for a lengthy and expensive proceeding. It is clear that the viability of the out-of-court settlement process needs to be more thoroughly put to the test by local banks.

²⁹ The law does not provide guidance for the lender in the event that the borrower is absent or evades service of notice.

Borrower Recourse in Judicial Foreclosure

The law provides the borrower with legal means to delay foreclosure:

- The borrower may apply to the court within twenty-one days of receipt of notice of foreclosure and petition the court to suspend foreclosure pending a decision by the court.
- The borrower may appeal the decision of the court of first instance to the court of appeal. If the appeal court rules in favor of the bank, the case must be directed to the law enforcement officer within thirty days. However, the borrower has the right to appeal further. The entire judicial process typically takes up to five months, and it takes up to nine months to repossess the property.
- The borrower may ask the court to suspend foreclosure for up to one year if the mortgaged home is the borrower's only residence.

High Cost of Law Enforcement Services

The law enforcement officer plays a very important role in both out-of court and judicial settlements. The fees for these services are 7% of the total outstanding debt to be collected through the court. The cost can be reclaimed by the lender from the proceeds of sale of the property, but is a substantial burden for both lender and borrower. As a result, both parties often look for ways to avoid recourse to these services. For example, the borrower may grant power of attorney to the bank in the sale of the property.

Issues with respect to Foreclosing the Residential Properties

Under the Law "On Mortgage," foreclosure and repossession are not grounds for evicting the registered residents of the property in question. However, this rule does not apply to a mortgaged residence. Upon foreclosure of mortgaged property, the borrower and residents registered at the time the mortgage agreement was executed must vacate the property no later than one month after it is sold, provided that all adult residents cohabiting with the borrower gave notarized consent to leave the house in the event of foreclosure. Residents registered after the mortgage agreement was executed are deemed to have given consent.

If the borrower and residents do not vacate the property within one month of the sale of the foreclosed property, they can be forcibly evicted under a notary's executive note (in the case of an out-of-court foreclosure) or a court order (in a judicial procedure). The eviction is carried out by a law enforcement officer in accordance with procedures set out in the Law "On Enforcement of Court Orders."

It would be prudent to amend the legislation to enable unconditional eviction of the borrower and all residents in the event of foreclosure. This would materially reduce the risk to the lender in the event that a forced sale of a mortgaged property becomes necessary. At the same time, the reduced risk to lenders would give potential borrowers who live with other registered residents better access to mortgage loans.

OTHER LEGAL ISSUES

Regulation of the Mortgage Operations of Banks

The existing banking legislation does not fully meet the requirements of effective regulation of residential mortgage financing.

National Bank of Azerbaijan directives contain only the following rules that could be seen to be applicable to the residential mortgage lending:

- Internal Procedures for, and Accounting of, Loans Issued by Banks, approved by the Board of the National Bank of Azerbaijan as of April 3, 2001

- Rules governing the Classification of Assets and the Creation of Loan Loss Reserves, approved by the Board of the National Bank of Azerbaijan as of June 17, 2003

In addition to the two directives mentioned above, the National Bank of Azerbaijan has also established additional standards for banks engaged in mortgage lending as partner institutions of the Azerbaijan Mortgage Fund.

Lack of Legislation or Regulations on Escrow Accounts

Currently, there is no mechanism established in law regarding third-party control and disposition mortgage proceeds intended for the settlement of real estate transactions, or for mortgage payments held in escrow. The parties have no protection from misappropriation of these funds, particularly during the time lag between registration of title and registration of a mortgage. This could be solved by amending the legislation to include provisions governing the operation of escrow accounts. With such an amendment, a third party (an escrow account holder) could control the disposal of money from within the escrow account.

Conflicting Legislation

Certain provisions in the recently adopted Law “On Mortgage” and Law “On State Register for Real Estate” do not conform to the related provisions of the earlier Civil Code with respect to residential mortgage lending. In particular, the definitions are not consistent, and there are contradictions in the regulations governing the issuance and sale of mortgage notes and the registration process. The discrepancies present significant risks for parties involved in the residential mortgage lending process.

Securities Legislation

The Law “On Mortgage” contains provisions governing the issuance of mortgage notes, but it would be beneficial if the government were to provide a more solid foundation for the introduction and development of mortgage-backed securities. The current legislation lacks provisions related to securitization and the creation of special-purpose instruments necessary to develop efficient refinancing mechanisms for the mortgage industry.

Insurance Legislation

Insurance-related legislation provides a large list of items that may be insured. Title and the potential insolvency of a borrower are not on the list, and therefore title and primary mortgage insurance may not be available from insurance companies until it is included in the list.

Taxation

The tax legislation does not contain incentives for the major participants in the mortgage market, such as lenders, borrowers and holders of mortgage-backed securities. A possible exception is insurance companies, which are currently exempt from VAT.

Since the tax legislation has not fully kept pace with developments in the mortgage lending market, the taxation of events such as assignment of rights needs further analysis.

The VAT rules are vague with respect to the exemptions available. For example, it is not clear whether property sold through foreclosure is exempt from VAT. The lack of clarity in the VAT legislation has led to contested interpretations and has contributed to the lack of transparency in the housing industry. Moreover, the high VAT payable (currently 18%) clearly pushes banks to a lower their loan-to-value ratios to mitigate the high cost of potential repossession. Again, this makes mortgage loans less affordable for the consumer.

2.5 Government Policy in Housing Finance

During 2004 and 2005, the government has instituted a set of important measures intended to improve housing conditions for a wide spectrum of the population. The main results of the policy are the Law “On Mortgage” and establishment of the Azerbaijan Mortgage Fund in 2005.

The Azerbaijan Mortgage Fund was established by the National Bank of Azerbaijan for the purpose of promoting the development of mortgage lending. The following are its main functions:

- Refinance residential mortgage loans disbursed by commercial banks
- Impose standards on the residential mortgages it refines
- Issue mortgage-backed securities to attract additional long-term funds for mortgage lending
- Manage financial risk in residential mortgage lending through the provision of long-term funding to achieve stability and liquidity

The Azerbaijan Mortgage Fund was established recently and therefore has some internal problems, the main one being a lack of qualified personnel. In addition, the Azerbaijan Mortgage Fund has not yet developed a full set of policies and procedures for banks regarding disbursement and servicing of mortgages, including loans refinanced with the Azerbaijan Mortgage Fund. The Azerbaijan Mortgage Fund plans to work closely with international organizations to rectify these issues.

Based on its own criteria, the Azerbaijan Mortgage Fund has concluded agency agreements with fifteen banks, seven appraisers and eight insurance companies. Procedure and criteria for the selection of partner banks, appraisers and insurance companies was developed by NBA who handled the selection process as well.

Cooperation between the Azerbaijan Mortgage Fund and partner banks is currently governed by individual agreements with each partner bank. The general agreement also governs the mechanisms by which partner banks may refinance residential mortgage loans disbursed under the program.

By June 2006, partner banks had submitted 113 applications to the Azerbaijan Mortgage Fund for obtaining funds for mortgage on-lending of which thirty-seven were granted. The working relationship between the Azerbaijan Mortgage Fund and the partner banks is quite new, and it is premature to gauge the effectiveness of the model. It is also important to note that the model can only operate effectively once professional skills in this area have been developed.

In addition to the Azerbaijan Mortgage Fund program, the government, through the Ministry of Youth and Sport, is currently developing a program to support young families and provide better living conditions for the poorest segment of the population. It is expected that this program will be financed directly from the state budget. The details of the program details have yet to be worked out and it is still in the development stage. Approval for this program is expected early in 2007.

2.6 Recommendations

The recommendations for the development of a national system of residential mortgage lending fall into three general categories:

- Strengthening the regulatory environment to encourage the development of system of housing finance
- Creating the conditions necessary for strengthening the capacity of key participants in the mortgage market and furthering the development of their institutional potential
- Improving state housing policy

Key recommendations for each proposed area of reforming are described below.

Strengthening the Legal Environment

- Introduce legislation necessary for the further development of the residential financing system.
- Remove the legal barriers to registering title and mortgage simultaneously.
- Introduce the concept of “mortgage by operation of law” for houses purchased through a mortgage loan.
- Review the requirement for mandatory notarization of mortgage contracts, focusing on eliminating duplicate procedures.
- Amend the legislation related to notaries, as regards to escrow accounts, to provide creditors with the right to block the use of mortgage proceeds until the mortgage is registered.
- Amend the Law “On State Registry of Real Estate” to reduce the time involved in registering title.
- Revise the provisions of the Law “On State Registry for Real Property” to enable mandatory registration of buildings under construction.
- Revise the provisions of the Law “On Mortgage” related to additional mortgage registration requirements. In particular,
 - replace the existing procedure with registration by notice, including a provision to allow notice by mail
 - eliminate duplicative procedures for registering mortgages arranged through a mortgage note
- Eliminate the requirement to notarize mortgage contracts and introduce a comparable function at the registry office.
- Harmonize the Civil Code and the Law “On State Registry for Real Estate” with respect to provisions related to the process of registering title.
- Bring the mortgage-related provisions of the Civil Code into conformity with the Law “On Mortgage.”
- Harmonize the Civil Code and the Law “On Mortgage” with respect to provisions related to issuing mortgage notes.
- Adopt legislation regulating the use of Escrow accounts
- Introduce specific legislation regarding securitization and mortgage-backed securities.

Development of Mortgage Market Infrastructure and Strengthening Institutional Capacity

Create an Effective Mortgage Lending Model for the Banking Sector:

- Develop uniform standards and procedures to be used in the residential mortgage lending process.
- Develop standard documentation for residential mortgage lending operations, including a standard package for concluding mortgage lending transactions.
- Improve the professional skills of bank staff engaged in residential mortgage lending.

Strengthen Independent Appraiser’s Capabilities:

- Develop an effective system to certify and monitor professional residential real estate appraisers and introduce mandatory certification.
- Develop standard methods and procedures for residential appraisals, including a standard residential appraisal form.
- Create an association of professional appraisers.

Strengthen Linkages between the Insurance and Residential Mortgage Sectors:

- Expand the range of insurance products necessary for the further development of residential mortgage lending.
- Improve the existing life insurance products.
- Develop standard insurance products for use in residential mortgage lending, including standard documentation, contracts, and policies with respect to mortgage loan insurance.

Improve Capacity of the Azerbaijan Mortgage Fund

- Develop and update the standards and procedures for the structuring and disbursement of residential mortgage loans, for use by partner banks in obtaining refinancing through the Azerbaijan Mortgage Fund.
- Develop effective mechanisms for cooperation with partner banks.
- Develop effective mechanisms for attracting long-term financing of the fund.
- Develop training programs to improve professional skill in residential mortgage lending for employees of both the Azerbaijan Mortgage Fund and partner banks.

Assistance in Developing Government Policy

- Prepare and submit to the government a comprehensive policy framework for the structure and development of a national housing financing system.
- Identify and draft the laws required to develop a housing financing system.
- Develop mechanisms to provide state support for improving the living conditions of vulnerable sectors of the population.
- Analyze opportunities to create tax incentives to support the development of residential mortgage lending.
- Reform the housing construction sector by introducing stricter quality standards for building materials to encourage higher construction quality.
- Develop programs to promote consumer awareness of residential mortgage lending.

3. KAZAKHSTAN

3.1 Economic Overview

The Kazakhstan's economy is the most advanced among all Project countries. High levels of economic development conditioned by the active extraction and export of the mineral resources and the favorable price situation in the world's energy markets facilitated significant growth in the country's aggregate income³⁰. From 2000 to 2005 GDP per capita has risen significantly from US\$ 1,229 to US\$ 3,703. In 2005 the country's GDP was US\$ 57.1 billion. The following chart indicates trends in main macroeconomic indicators over the past five years.

Table 1. Key Macroeconomic Indicators for Kazakhstan

	2000	2001	2002	2003	2004	2005
GDP, USD (million)	18 292.4	22 152.1	24 636.4	30 832.8	43 149.4	57 123,6
Unemployment Rate, %	12.8%	10.4%	9.3%	8.8%	8.4%	8.1%
Inflation Rate, %	9.8%	6.4%	6.6%	6.8%	6.7%	7.5%
Foreign Direct Investment, USD million	2 781.2	4 556.6	4 106.4	4 607.6	8 423.7	6 416.4
GDP per capita, USD	1 229.0	1 490.9	1 658.1	2 068.1	2 716.3	3 703*
Weighted av. credit interest rate for period	17.0%	14.2%	14.4%	13.7%	13.1%	13.3%
Exports, USD million	8 812.2	8 928	10 027	13 233	20 603	28 301
Imports, USD million	6 848	7 944	8 040	9 554	13 818	17 979
Average official exchange rate	142.13	146.74	153.28	149.58	136.04	132.88

Source: The National Bank of the Republic of Kazakhstan, Agency of the Republic of Kazakhstan for Statistics;

*preliminary data

Real wages increased by 17.4% during 2005. Wage growth, however, has been uneven with wages in Almaty increasing by 20% compared to 13% in Astana. The real wage growth has led to an increase in the population's purchasing power and an increase in the demand for real estate. This, coupled with the growing availability of mortgage financing, has led to increases in residential real estate prices which will be discussed in the next section of this chapter.

Overall, macroeconomic trends observed over the last five years point to a stable environment conducive to further development of the residential real estate and mortgage sectors.

3.2 Overview of the Housing Sector

As of the 2005 year-end, there were 1.73 million residential dwellings in Kazakhstan of which 395.1 thousand were multiple family dwellings and 1,331.1 (77% of the overall housing stock) were single family dwellings.³¹ Occupied living space per person in 2005 was equal to 17.5 m², compared to 17.3 m² in 2004. In Almaty the indicator registered at 18.5 m² and at 15.4 m² in Astana. The following chart illustrates some of the main trends in the Kazakh housing sector during the past seven years:

³⁰ Aggregate income of all the economic agents of the economy (e.g. producers, consumers) of the country

³¹ According to data from the Agency of the Republic of Kazakhstan for Statistics

Table 2. Housing Trends in Kazakhstan 1999 - 2005

	1999	2000	2001	2002	2003	2004	2005
Total Housing Stock, mm.m2	244.5	239.4	241	238.3	243	252.7	254.6
New Housing Construction, mm. m2	1.1	1.2	1.5	1.55	2.1	2.6	5
Housing Stock per capita, m2	16.4	16.5	16.3	16.6	17	17.3	17.5

Source: Agency of the Republic of Kazakhstan for Statistics

At the end of 2005 the housing stock in Kazakhstan was 97.1% privately owned. Information with respect to the overall conditions of the housing stock is unavailable. However, independent experts estimate that between 65% and 85% of the country's housing stock is in need of improvement.

In Astana, according to the 2003-2005 program of intensive demolition of dilapidated houses and individual cottages, it was planned to develop 1.8 million m² of the city area. In Almaty, according to the city's general development plan, by 2020 an estimated 1.15 million m² of dilapidated housing stock will be demolished and replaced by 1.41 million m² of earthquake proof buildings.

The current conditions of housing stock are largely a result of inefficient system of condominium maintenance (CAO)³² (condominium property maintenance costs are paid for by the individual owners of the apartments commensurate to their share in the total property of the condominium), lack of transparency of the CAO management, non-purpose use of funds by CAO management, high costs of the building materials and builders' services.

Despite a considerable tear of the housing stock, banks nevertheless take private residences as collateral for mortgage loans on a condition that a given property is no older than fifty years. Along with this criterion, mortgage lenders also take into account other factors such as marketability and liquidity of a given real estate property, which primarily depend on its location and conditions.

Population's pent up demand³³ for housing, a limited resale market for housing, and a large amount of substandard housing stock lead to a significant development of housing construction market. New construction is primarily taking place in Kazakhstan's big cities. In this context, it is important to point out to a relatively low quality of new buildings, a significant number of which does not meet international standards.

Housing construction in Kazakhstan is also taking place as part of the 2005-2007 state program of housing construction. The program aims to resolve the whole complex of issues, including creating a balanced housing market, attracting private investments in the residential housing construction, stimulating the development of individual housing construction, formation of the effective construction industry as well as increasing affordability of mortgage financing and savings program for housing for the wider segments of the population. The program targets constructing 12 million m² of the residential housing in the country. Furthermore, as part of the above-mentioned program, the government is financing affordable housing (construction projects that are agreed upon with the state Ministry of Industry and Trade) that is characterized by certain technical and pricing parameters (USD 350 per m²)

At the 2005 year-end, there were 4,842 contract-based construction companies in the country of which 96% are private.³⁴ In general, this points to a high degree of competition in the market, absence of state monopolies, and a sufficiently high potential for this sector of the economy.

The major construction companies in Almaty are "Basis – A" corporation (with nine residential complexes under construction), "Kuat" (six construction sites), "EliteStroi", "Silk Way Construction", and

³² CAO – Cooperative of the apartment owners.

³³ Payable demand, that is not met due to the absence of the commodity supply.

³⁴ Agency of the Republic of Kazakhstan for Statistics.

“AstanaStroiInvest” (three residential construction sites each).³⁵ These companies primarily build residential housing of the “de Luxe”, “Elite”, and “Business” class. “AstanaStroiInvest” builds mainly housing of the “Econom” class.

As a rule, major construction companies and corporations work closely with major financial organizations, banks and mortgage companies, and finance their construction projects with banks’ mortgage loans. Meanwhile, as part of their mortgage lending programs, banks have a list of construction companies and types of housing which they are ready to finance.³⁶

New housing construction is generally performed via the project-finance scheme. A construction company defines the funding source, which can be debt (e.g. bank loans) or a company’s own capital (e.g. equity). Another frequently used source of funding for new residential construction is funds from individuals who collectively fund the construction (the law of the Republic of Kazakhstan “On the share construction participation” was not adopted at a time when this analysis was being performed).

In 2004 new construction volumes in Kazakhstan reached 2.7 million square meters. In 2005, this figure almost doubled to 5.04 million square meters. Astana’s share of the new construction in 2005 was 22% while that for Almaty was 12%. The share of individuals and non-state legal entities in the total housing construction investment in 2005 was 74% and that for the government was 26%.

Land allocation is the topic of the day as there is an acute deficit of available land in major cities (Almaty especially). The deficit preconditions the price uptrend in the recent years. The land price per 100 square m² (sotka) can range from US\$ 1,550 to US\$ 80,000 within the city and US\$ 200 to US\$ 22, 900 outside of it (Almaty).

The process for private parties to obtain land is mainly through land auctions. The rules and procedures of the auction are regulated by the enactment of the Government of the Republic of Kazakhstan as of 13 of November 2003 N 1140 “The organization and realization rules of the land auctions sales or land renting rights”. The auction information is publicized, usually through local newspapers, no later than 15 days before the auction. Individuals and corporations are both allowed to bid but must post a deposit (the amount is defined by special methods included in the Rules) and complete a brief application form in order to participate in the auction. The minimum offering price of a land plot may not be less than the value of that plot stated in the land registry.

Residential Price Dynamics

New housing constructed in Kazakhstan by the end of 2005 can be nominally divided into three major price segments:

- social housing, up to US\$ 600 per square meter
- middle class housing segment, US\$ 600-1,200 per square meter
- elite housing, over US\$ 1,200 per square meter as

Depending on price and type of class, independent experts segment the newly constructed housing into the following categories: “de Luxe”, “Elite”, “Business”, “Econom”³⁷.

The resale market segmentation is less intricate as Soviet standards of construction were not diversified. There are so called improved standard and ordinary standard apartments. The price of improved standard apartments is higher than and may range 25%-75% above the price of ordinary standard apartments, depending on location and a floor on which an apartment is located.

³⁵ Many of these companies operate throughout Kazakhstan.

³⁶ By pre-selecting construction companies, partner banks minimize the construction risks.

³⁷ LLP “CCRE Consulting”.

As elsewhere in the former Soviet Union, the demand for residential housing is driven by a number of factors. Recent increases in prices have been driven by:

- *Excessive Liquidity Problem*
Capital markets in the former USSR countries have not yet developed and therefore, cannot serve as an efficient mechanism for managing excessive liquidity, which may have a high speculative component. The sky-rocketing of residential prices in Kazakhstan can be largely conditioned by a relatively high speculative demand, which in turn is conditioned by the influx of liquidity from the commodity markets and the country's "shadow" economy. High returns on investments in residential property, in comparison with returns in the capital market, along with growing prices of residential property and accessibility of mortgage finance fueled the demand, thus creating a multiplicative effect on the price of housing supply.
- *Internal migration of the population*
There has been a large influx of people from rural areas and smaller cities to large urban areas of the country. The migration takes place because of several major reasons: optimization of the regional villages³⁸ to major regional centers, lack of working opportunities and low standards of life in the rural areas. Although there is no trustworthy statistics on migration, reality demonstrates that a considerable volume of migration (particularly from rural areas to the major cities) as well as migration of the economically-active population from the neighboring countries are the additional sources of the residential property price growth and serve as an impetus to new construction.
- *Money laundering practice*
Real estate transactions in the country are still predominantly conducted in cash –in US dollars – with no verification performed with respect to the sources of funds. Thus, individuals and companies that have earned undeclared income may purchase real estate as a means to bring their money out of the shadow economy.
- *Shifts in the asset structure of the population*
Due to high dollarization of Kazakhstan's economy, especially during 1991-2003, the majority of economic agents formed their savings in US dollars. The dollar depreciation observed in recent years emerged as a problem for people and prompted them to convert their dollar assets into assets which are less susceptible to devaluation. Real estate has become such an asset.
- *Insufficient supply and price of residential housing construction*
The state program of residential construction of the former USSR could not provide most of the population with the required housing, thus forming the pent-up demand for the residential property already at that time. After the collapse of the USSR the growing price of constructing residential property became the major barrier for meeting the demand of the population. Insufficient savings and absence of mortgage finance further increased the demand for residential housing.

Demand for Residential Housing

The period of 2000–2005 was characterized by significant changes in qualitative and quantitative factors of supply and demand in the resale market. In 2000 the demand for residential housing was not high and resulted in housing prices ranging from US\$ 100 to US\$ 150 per m². With real wages increasing and mortgage lending becoming available during 2002-2003 housing prices in Almaty leapt to US\$ 500-700 per m². By 2004-2005 prices in Almaty reached US\$ 1,500-2,500 per square meter.³⁹

³⁸ The State Program of the Republic of Kazakhstan on Development of Rural Territories for 2004-2010.

³⁹ Local experts estimate a housing supply deficit in Almaty of about six million square meters, driving price dynamics in the city.

The last two years have witnessed a shift in the demand structure for housing in favor of newly-built housing. The observed tendency is pre-conditioned by the limited supply in the resale market and by changes in preferences of the population in favor of modern residential housing. The housing supply structure is predominated by residential housing of the “de Luxe”, “Elite”, “Business” class the price of which ranges between US\$ 600-2,500. The supply structure is also becoming more diversified (in 2000 it was limited to residential housing of “Elite” class).

Regional pricing trends are mainly preconditioned by the implementation of the State program of the residential construction 2005-2007. Regional average resale prices were US\$ 150 to US\$ 250 per m², which is less than US\$ 350 per m² offered by the State program.

Affordability⁴⁰

Affordability ranges greatly within the country. Recent large increases in residential real estate prices in Almaty and Astana have made residential real estate less affordable in these cities. Affordability ratio ranges greatly within the country and major cities⁴¹. The housing affordability ratio in Almaty has increased from 4.6 years in 2003 to 6.8 years in 2004 (in the resale market). Such an increase has been driven by substantial growth in housing prices, which in turn, has been mainly driven by a speculative demand component, high concentration of excess liquidity, and an increased purchasing power of the city’s population. According to experts’ estimates, the affordability ratio in Almaty in 2005 was 6.7 years for a one-room apartment, 8.7 years for a two-room apartment, and 12.7 years for a three-room apartment.⁴²

At the country level, the affordability ration in the resale market has increased from 3.6 years in 2003 to 4.8 years in 2004. This increase was conditioned by price increases in the new residential construction market prices in which serve as price targets in the resale market. Moreover, real wage growth in the country’s regions and mortgage lending that started to spread across the regions also contributed to rising real estate prices.

In Astana the affordability ratio has trended downward from 6 years in 2003 to 5.2 years in 2004. The decrease is a result of housing market saturation (oversupply): as a result of intensive residential construction supply of housing has somewhat outstripped the demand for it.

3.3 Institutional Capacity for Residential Mortgage Lending

The mortgage market in Kazakhstan is one of the best functioning and most sophisticated in the former Soviet Union. Mortgage lending in the country is performed by both bank and non-bank financial organizations. The largest bank mortgage lenders are JSC “Kazkommertzbank”, JSC “Narodnyi Saving Bank of Kazakhstan” (Halyk bank), JSC “Bank TuranAlem”, JSC “ATF Bank”, JSC “Bank Centercredit”, and JSC “Alliance Bank”. Non-bank financial organizations involved in mortgage lending are the mortgage companies foremost of which is the JSC “Kazakhstan Mortgage Company” (KMC) – the state-owned, secondary mortgage market operator.

Furthermore, mortgage companies such as JSC “BTA Ipoteka”, JSC “The First Mortgage Company”, LLP “Almatinskaia Regional Mortgage Company”(Kaskelen), JSC “Mortgage Company Astana Finance” (Astana), LLP “Kurylis Ipoteka” and JSC “Mortgage Company “Damu”⁴³ also operate in the mortgage market.

⁴⁰ The data is offered by the State Agency of Statistics and can differ given that it is gathered and processed differently in other analytical reports in the market.

⁴¹ The affordability ratio calculated as the average price of a 3-room apartment versus the annual average income of the household. The measurement unit is the number of years. The choice of the 3-room apartments is preconditioned by the prevalence of them in the country.

⁴² LLP “CCE- consulting” estimation.

⁴³ Depending on the license issued, mortgage companies can grant mortgage loans in foreign currency or national currency. Foreign currency lending requires a separate license. Along with lending, mortgage companies may perform trust management (provided that the relevant license).

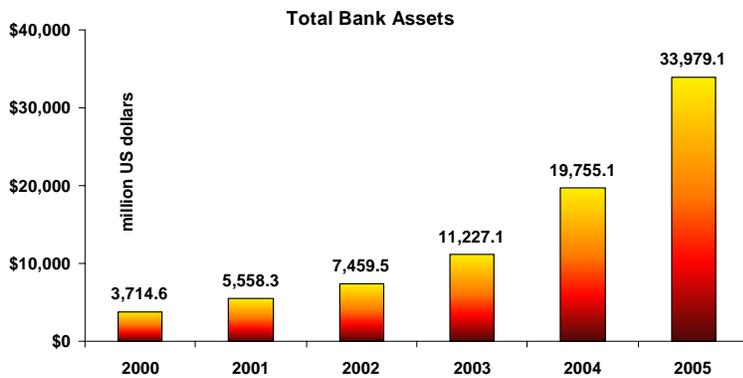
Banking Sector

As the end 2005 there were 35 banks, including one state-owned bank and 34 banks with foreign participation. The banking sector in Kazakhstan is highly concentrated. Approximately 62% of total banking assets are held by the three largest banks: JSC “Kazkommertzbank”, JSC “Narodnyi Saving Bank of Kazakhstan” (Halyk bank), and JSC “Bank TuranAlem”. A further 16% of total assets are held by JSC “ATF Bank”, JSC “Bank CenterCredit”, and JSC “Alliance Bank”.

Over the past couple of years, the country’s banking sector has been going through consolidation. The consolidation process is characterized by a liquidation of unviable banks and by an increase in the capitalization of existent banks.

Asset growth has been significant. During 2003 and 2004 this growth reached 50% and 76% respectively. Yearly growth accelerated to 72% during 2005 as total banking sector assets reached US\$ 34 billion.

Chart 1



Source: The National Bank of the Republic of Kazakhstan

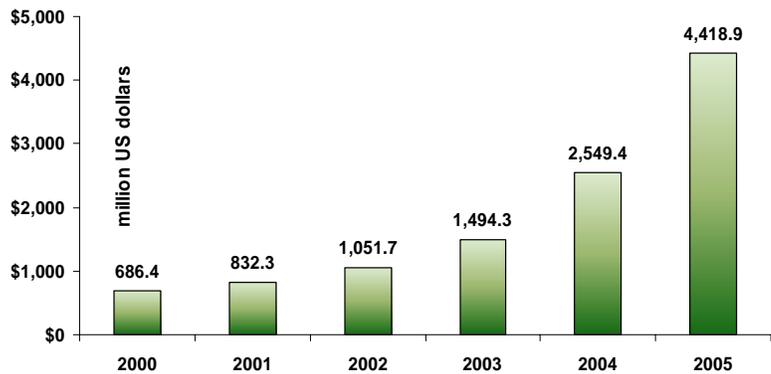
The banking system also includes the following foreign banks: ABN AMRO, Citibank, and HSBC. These banks, however, serve primarily corporate clientele.

Kazakh banks have also been aggressively expanding in the countries of the former USSR by purchasing banks or establishing representative offices there, including in Ukraine, Russia, Azerbaijan, Georgia, Uzbekistan, and Kyrgyzstan. This has also led to a transfer of technologies and skills in mortgage lending to newly purchased/established branches. For example, JSC Halyk Bank in Kyrgyzstan (owned by Halyk Bank Kazakhstan) has been offering mortgage products based on their Kazakh products.

Banking Sector Capitalization

Banking sector capital has also increased significantly since the turn of the century and stood at US\$ 4.4 billion at the beginning of 2006, up from US\$ 686 million five years ago. These increases have mainly been through retained earnings but there are a number of instances where new

Chart 2
Bank's Equity



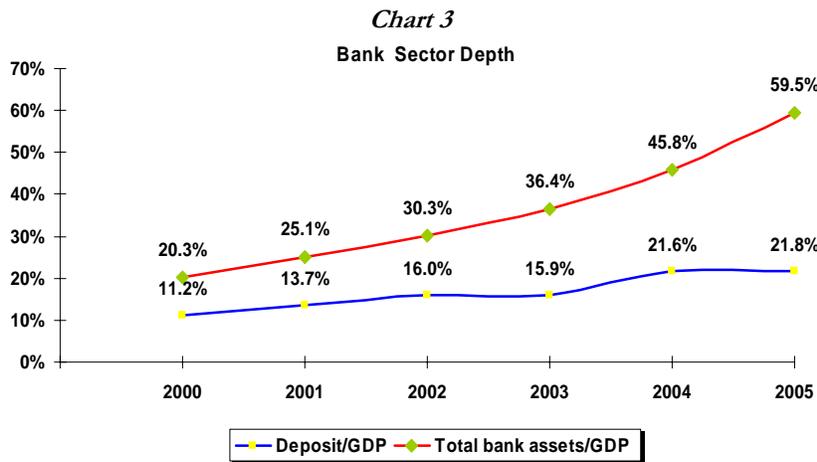
Source: The National Bank of the Republic of Kazakhstan

equity issuances contributed to capital growth. Trends in the banking sector continue to indicate an ongoing consolidation, which will result in further reductions in the number of banks in the country.

Today’s banking environment in Kazakhstan is characterized by liquidation of some banks (13 banks were under the liquidation at the end of 2005), and by growing capitalization of other banks via additional stock issuance (preferred and common stock issuances) and issuance of subordinated bonds. Some of the large banks announce plans to perform IPOs in the next 2-3 years on the international capital markets. For example, JSC “Bank TuranAlem” has announced plans to perform an IPO and list shares on the London Stock Exchange (LSE) in 2009 while JSC “ATF bank” is set to perform an IPO in 2007.

Bank Sector Dynamics

As the end 2005, total banking sector assets were 60% of GDP. One of the major tendencies of the banking sector development over the past five years has been a change in the structure of bank crediting with respect to a real sector of the economy. Lending to the industrial sector decreased from 30.5% of bank assets at the end of 2000 to 17% at the end of 2005. At the same time, construction lending has expanded significantly from 4.3% of total bank assets in 2000 to 10.7% in 2004 and to 12% at the end of 2005.



Source: The National Bank of the Republic of Kazakhstan

Expansion in deposits lagged asset growth throughout the same period. Nevertheless, the ratio of deposits to GDP has increased from 11.2% in 2000 to 21.8% at the end of 2005.

Deposit growth of the country’s banking sector is conditioned by an increase in people’s confidence with respect to the banking system in general, an increase in general welfare of the population, and the lack of other financial instruments to invest savings. The creation of the Kazakhstan Guarantee Fund of deposits for individuals has become an additional factor in the increase people’s confidence in the country’s banking sector.

It is interesting to note that over 70% of deposits in the banking sphere are with the three largest banks. At the end of 2005, total of deposits within the banking system amounted to US\$ 12.4 billion of which 58% were deposits in national currency. Deposits of legal entities amounted to 65% of total deposits. Deposit terms offered by banks range from 1 month to five years, and further. Term deposits were 79% (term less than one year) of total deposits.

The table below indicates average interest rates on deposits for 2005:

Table 3. Average weighted deposit rates: 2005

	Legal non-bank entities		Individuals	
	National currency	Foreign currency	National currency	Foreign currency
Demand Deposits	2.3%	1.1%	0.7%	0.3
Term Deposits	3.1%	3.3%	9.4%	5.9%
Escrow deposits ⁴⁴	2.2%	2.7%	6.8%	0.7%

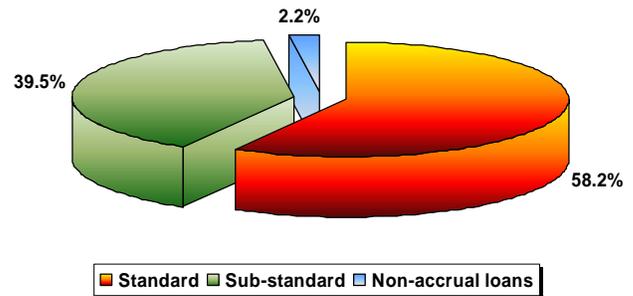
Banks' Loan Portfolio Quality

The diagram below illustrates the quality of total loan portfolio of banks at the end 2005. The 2005 loan portfolio shows improvement in terms of standard (performing) loans that increased to 58.2% from 56% in 2004. Non-accrual (non-performing) loans dropped from 2.9% in 2004 to 2.2% in 2005. Despite positive tendencies, the share of sub-standard loans has remained high at 39.5% at the 2005 year-end. Within the sub-standard loan structure 81.4% were the loans of the 1st category with payments 30 days overdue.

The improvement of banks' loan portfolio quality is a result of banks' improved ability to perform an assessment of borrowers in the last couple of years. However, the high dynamics of crediting, taking place against the background of fierce competition among banks, continue to influence negatively the loan portfolio quality.

Chart 4

Loan Portfolio Quality of the Banks, as the end of 2005



Source: The National Bank of the Republic of Kazakhstan

Kazakhstan Deposit Guarantee Fund

The Kazakhstan Deposit Guarantee Fund of consumer deposits was established in 1999 with the National Bank of Kazakhstan being the sole equity holder. The fund's capital is 1 billion tenge (about US\$ 8 million). The major purpose of the Fund is to guarantee consumer deposits (in foreign or national currency) in case of a bank's liquidation. Term deposits, demand deposits, escrow deposits, current account balance, card-account balance are all subject of a collective obligatory guarantee system. According to regulations with respect to the guarantee system (with amendments made by the rule of the Agency of the financial Supervision of Kazakhstan dated 12.07.04 №204), in case of a bank's bankruptcy, the Fund will compensate a depositor for an amount not exceeding 400,000 tenge (approximately US\$ 3,200) without accrued interest. The Fund receives obligatory annual premiums from participating banks. Obligatory premiums range from 0.25% of the total amount of insurable deposits of individuals during the first two years of participation and 0.16% in subsequent years. Participating banks pay premiums on a quarterly basis.

Sources of Funding for Mortgage Programs

Financial institutions fund their lending activity according to the scale and the profile of their operations. The banks mostly use the deposits (by individuals with the term more than 3 years), place subordinate and ordinary bonds in local currency, raise funds from international markets through interbank and syndicated loans or by placing bonds. Choosing the sources of funding and the subsequent utilization of funds are largely dependent on the internal credit policy of the banks and non-bank organizations.

⁴⁴ Money acceptance without the notification

The most popular way of funding the lending activity for larger banks is to place bonds on foreign markets (Eurobonds). For example, in the beginning of 2005 JSC “Bank TuranAlem” placed the 10 year Eurobond in the amount of 350 million US dollars with the fixed interest rate of 8.5%. JSC “Kazkommertzbank” in December of 2005 placed the first three issues of the securitized 5 year bonds (2005A, 2005B, 2005C) in the amount of 300 million US dollars with the floating rate of Libor-3+29 basic points. In the first quarter of 2005 JSC “Bank CenterCredit” placed its 3 year Eurobonds in the amount of 200 million US dollars at 8% annual interest rate. In the middle of 2005 JSC “Alliance bank” placed 3 year Eurobonds in the amount of 150 million US dollars at the interest rate of 9%. In 2005 JSC “ATF bank” placed two Eurobond issues for 5 and 7 years in the amount of 200 million US dollars bearing interest rates of 8,875% and 8,125% respectively.

Subordinate (not collateralized) bonds and ordinary bonds issues in the local market are another source of the source to fund the mortgage lending programs by banks. Issued for 5 to 15 years, these bonds are the subordinate to other debt of financial organizations. The annual interest rates of subordinate bonds range from 7.75% to 12% and usually indexed to the inflation rate. The banks also fund the particular programs through international financial institutions such as FMO, EBRD, ABRD, IBRD and others⁴⁵.

The mortgage companies raise funds through borrowing at the local interbank market and collateralize those loans by pools of mortgage loans. The term of those interbank loans does not exceed 5 years and funds are provided either as single facility or credit lines.

Unlike banks, the mortgage companies cannot use deposits to fund their lending programs. Therefore, mortgage companies tend to source most of funding in a form of the credit lines from their parent holding companies.

International financial institutions are an important source of funding for mortgage companies'. For example, in 2003, the EBRD provided JSC “BTA Ipoteka” the 7 year credit facility of 5 million US dollars at the interest rate of 8.81%. In 2005, EBRD extended 10 year credit line in the amount of 10 million US dollars at the floating interest rate of Libor-3 +5%.

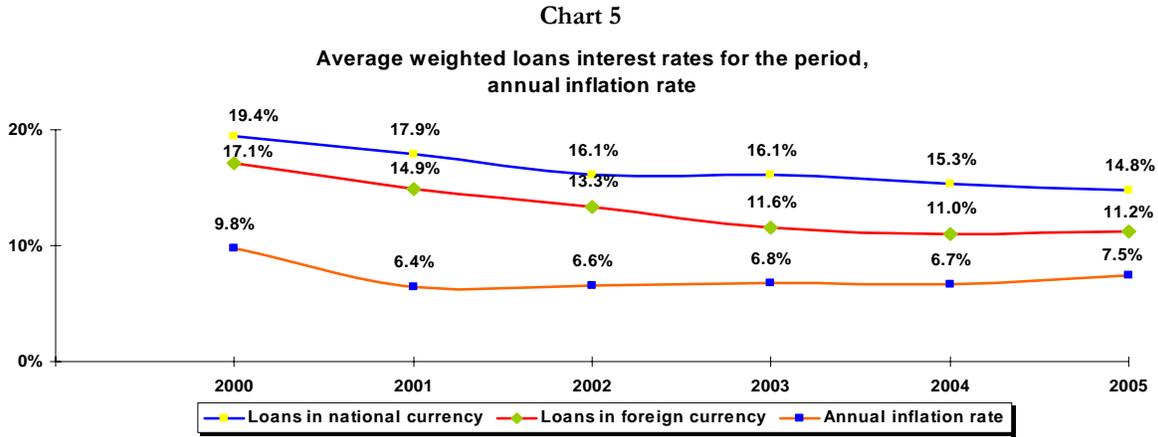
In 2002-2003, the mortgage companies tried a few issues of the mortgage bonds. In 2004, the number of mortgage lenders registered their bond issues at the local stock market to fund their long-term lending programs. For example, the volume of the first bond issue program of JSC “BTA Ipoteka” was 10 billion tenge. Within this program, “BTA Ipoteka” placed four bonds issues. Under the second bond issue program, the company plans to raise 15 billion tenge. As of late of 2005, company placed two issues. The annual interest rates on bonds issued within the second emission ranged from 8.5% to 10%. (See the Capital market section).

Recently, another financial instrument commonly used on developed markets to fund mortgage lending operations was tested in Kazakhstan as well. In 2005, JSC “BTA Ipoteka” became the first mortgage company in Kazakhstan to securitize its mortgage portfolio. ABN AMRO BANK N.V was the manager of this US \$150 million transaction.

⁴⁵ According to the NBK most recent data 35.5% of the country's external debt is formed by the commercial banks. The accrued debt of the commercial banks amounted to US\$ 13.9 billion as of the end of the 2005.

Loan interest rates of the commercial banks

As mentioned earlier, inflation was kept at check over four years (2000-2004), ranging from 6.4% to 6.7% per annum. However, in 2005 rate of inflation grew to 7.6%. To ease the inflationary pressure, in 2005 the National Bank of the Republic of Kazakhstan twice increased its refinancing rate, to 7.5% in February and to 8% in July.



Source: The National Bank of the Republic of Kazakhstan

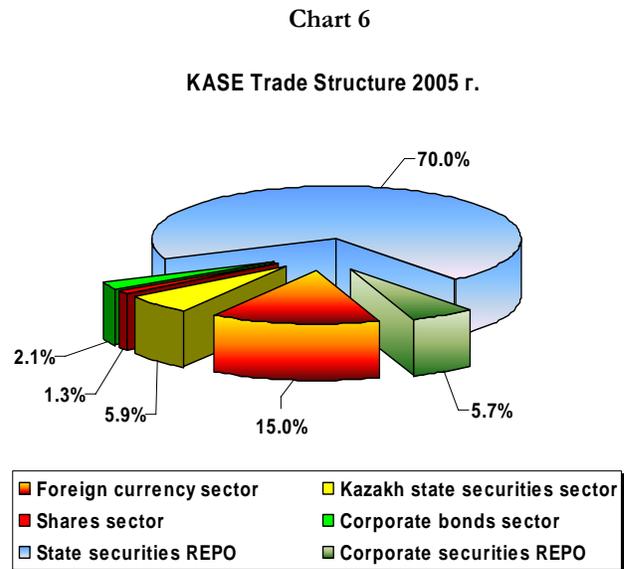
The above chart illustrates trends in inflation and bank interest rates for both US dollars and local currency loans. Despite the inflation, interest rates for bank loans in 2005 remained relatively low thereby stimulating the demand of the population for the commercial bank loan products.

Capital Markets

Kazakhstan’s capital market is by far the most advanced amongst all Project countries. The total turnover of Kazakhstan Stock Exchange (KASE) in 2005 was US\$ 80.4 billion or 36% higher than in the previous year.

The following chart demonstrates the structure of stock exchange trades in terms of key instruments traded.

REPO is the largest market segment and account for 76% of the total turnover. In US dollar terms, this segment in 2005 grew 45% to US \$60.8 billion. The REPO with government securities accounted for 70% of the total stock market turnover. The REPO with corporate securities accounted for 6%. The KASE trades for foreign currency in 2005 increased 27.5% and reached 12 billion US dollars or 15% of the KASE’s total turnover. The same year, corporate bonds trading grew 101.1% or 2.1% of the total stock market trading. Equity trading increased 6.5% and accounted for 1.3% of the total trade volume.



Source: KASE

The essential segment of the KASE - trading in government securities shrank 14.5% to 4.75 billion US dollars or 5.9% of total market trading. Low yields, appreciation of Kazakh Tenge (KZT) and increasing inflation make investment in securities issued by Ministry of Finance less attractive. Moreover, lately the Ministry of Finance did not require additional resources as budgetary funds were not fully utilized by programs what has an adverse effect on government securities trading. Notes of the National Bank of the Republic of Kazakhstan account for the bulk of the volume of government securities since they are used as the money market management instrument. The National Bank of Kazakhstan accounted for the majority in foreign exchange trading segment as it had to absorb the large volumes of USD liquidity to prevent rapid appreciation of KZT.

Overall, analysis of the investment instruments traded at KASE brings to conclusion that Kazakhstan’s stock market is primarily the source of the short-term financial resources (REPO trading accounts for 76%). At the same time, the KASE serves as an efficient monetary instrument for country’s National Bank.

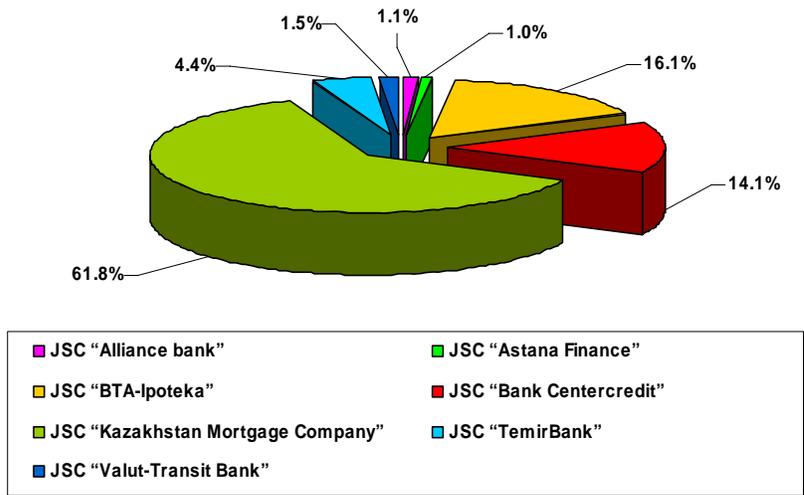
Mortgage Bonds

Mortgage Backed Bonds (MBBs) of the commercial banks and mortgage companies were also represented at KASE. As of late 2005, there were seven major issuers of the mortgage bonds: JSC “Kazakhstan Mortgage Company”⁴⁶, JSC “BTA Ipoteka”⁴⁷, JSC “Bank Centercredit”, JSC “Valut Transit Bank”, JSC “Alliance bank”, JSC “Astana Finance”, JSC “TemirBank”. In the same year, capitalization of mortgage bond market was 706.6 million US dollars⁴⁸ while total corporate bond market capitalization reached US \$8.25 billion.

In total, there are 26 mortgage bond issues currently traded at the market including 12 issues by JSC “Kazakhstan Mortgage Company”. In late 2005, JSC “Kazakhstan Mortgage Company” accounted for 62%, JSC “BTA Ipoteka”- 16%, JSC “Bank Centercredit” - 14% of total emission of mortgage bonds. The market dominance of these issuers is driven by their business specialization, i.e. mortgage lending (JSC “BTA Ipoteka”), refinancing mortgage loans (JSC “Kazakhstan Mortgage Company”) or strategic interest in this area (JSC “Bank Centercredit”). Another factor could be diversification of sources of funding for mortgage lending operations like it is a case with “BTA Ipoteka” and JSC “Bank Centercredit”. Three issuers of MBB account for 92% of the mortgage bond market. This level of market concentration is partly caused by the timing of when issuers decided to enter the market. JSC “Kazakhstan Mortgage Company” was issuing MBBs since 2002, JSC “BTA Ipoteka” since 2003 and JSC “Bank Centercredit” have issued its first MBBs in 2004.

Bonds issued by mortgage lenders are listed on the KASE and targeted at institutional investors. Pension funds were the major investors into MMBs. In 2005, the total assets of pension funds reached 936 million US

Chart 7
Mortgage Backed Bonds Market, as the end 2005 r.



Source: KASE

⁴⁶ State owned specialized mortgage company.
⁴⁷ Privately own specialized mortgage company.
⁴⁸ According the KASE.

dollars and the MMB's accounted for 3.6% of their investment portfolio. For comparison, corporate bonds accounted for 30.7% of pension funds portfolio.

The most general parameters of the MBB issues placed in the domestic stock market are as follows:

1. MBB are issued in electronic form;
2. MBS pay the floating coupon indexed to inflation rate or to the KZT/USD devaluation rate. Some MBS issuers set the range for coupon rate fluctuation (4%-10%) and some issue fixed coupon MBBs;
3. MBB maturities range from 5 to 12 years;
4. Coupon paid semi-annually.
5. Mortgage backed bonds are secured the pledge of the rights under mortgage loan agreements (including the mortgage certificates)

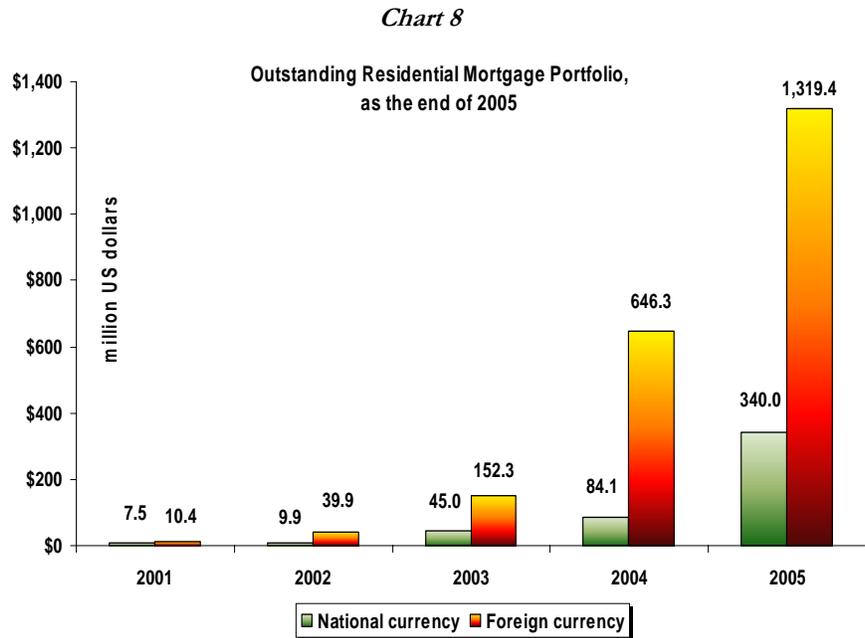
Mortgage Market in Kazakhstan

Development of residential mortgage lending in Kazakhstan started in 1998. The establishment of JSC "Kazakhstan Mortgage Company" in late 2000 further increased the interest of banks in residential mortgage lending.

Mortgage portfolio of banks grew 386% in 2003 and 336% in 2004. In 2005 the growth rate slowed down to 222%. At the end of 2005, total portfolio of outstanding mortgage loans stood at US\$ 1.66 billion or about 2.9% of GDP. The following chart illustrates the dynamics of mortgage portfolio since 2001 and provides a breakdown by currency.

At the end of 2005, the US Dollar denominated loans accounted for 79.5% of the total portfolio of residential mortgage loans. Trends indicate that in recent years local currency loans have grown at much faster pace than US Dollar loans.

Lately, banks tend to apply more relaxed underwriting requirements, for example granting, since 2003, loans to borrowers without official confirmation of their incomes or simplifying overall internal underwriting and approval procedures and requiring fewer documents from clients. Apart from the strong demand for mortgage from growing number of low-doc clients, this trend is a result of severe competition between banks for the new clients and new market segments. Kazakhstan Mortgage Credit Guarantee Fund has also contributed into the general relaxation of underwriting requirements by giving an opportunity to borrowers to reduce down-payment to 7-10% of the property value.



Source: The National Bank of the Republic of Kazakhstan

The following is the list of documents usually required by banks to grant the residential mortgage loan to full-doc clients:

The List of Documents for Mortgage Loan Application

1. Identification card, passport of the borrower and his/her spouse.
2. Tax identification number certificate of the borrower and his/her spouse (upon request).
3. The documents identifying the civil status of the borrower (Marriage certificate, Divorce certificate, Death certificate).
4. The documents certifying information about the dependents of the potential borrower (Children Birth certificate, if grown up children – children ID).
5. Fix abode certificate of the potential borrower.
6. Reference from the place of employment about position, salary for the last 6 months stamped and signed by the chief accountant and the director of the company.
7. Pension fund account abstract proving the pension fund monthly deductions to the account within the last 6 months.
8. Employment book copy or work contract copy , acknowledged by the stamp and signed by the HR-department.
9. Other documents to prove the potential borrowers income.
10. Spouse Income Reference document see the item 6 (upon request).

Under express mortgage lending programs⁴⁹ run by some banks, required documents are limited to an identification card or passport and tax identification number. As this information is generally insufficient for assessing the creditworthiness of the client, his file is passed on to the security department as well.

So far, aggressive mortgage lending policy of banks did not result in deterioration of quality of mortgage portfolio. However, it may still come under pressure should macroeconomic situation in the country deteriorate.

Regional Mortgage Lending Structure

The current mortgage portfolio is highly concentrated in two cities, Almaty and Astana. At the end of 2005, they accounted respectively for 40% and 16% of total amount of outstanding mortgage loans (in terms of population they account for just 16%).

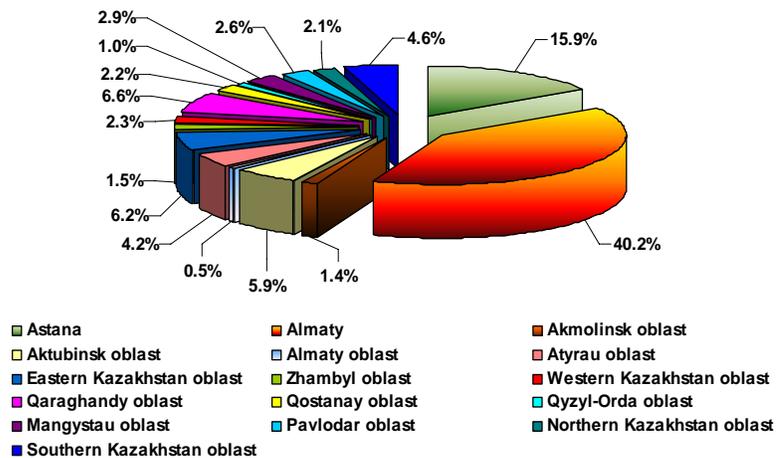
Analysis of the regional structure also shows the gradual decline in the market share of these two cities in 2003 and 2004. In 2003 and 2004 they accounted for 61.6% and 59.5% of the market respectively.

Banks’ policies are in general aimed at broadening the regional client base. However, the practical

implementation of this policy is constrained first of all by undeveloped branch infrastructure outside the country’s two main cities. Secondly, household incomes in regions are substantially lower than those in two biggest cities. Third, regions lack appraisal companies capable to carry out quality work. Very few independent appraisal companies can perform the trustworthy appraisal. Overstatements of the value of the collateral are common what increases risks if mortgaged property is to be sold to recover the loan.

Chart 9

Regional Structure of Mortgage Lending, as of the end of 2005



Source: The National Bank of the Republic of Kazakhstan

⁴⁹ Mortgage lending programs without the official income proof.

It is obvious, that the regional mortgage lending dynamics will depend upon the real wage growth of the population in regions, differentiated approach (considering the regional specificity) of the mortgage lenders in positioning and marketing of their mortgage products as well as development of the branch network of banks.

Interest Rates, Terms and Currencies of Mortgage Loans

On the earlier stage of mortgage market development, interest rates could reach 20 % per annum with down payments ranging from 40 to 50% and loans term from 5 to 10 years. Significant changes in the market took place in 2001, when the Kazakhstan Mortgage Company (KMC), established in 2000, began its providing the liquidity to the growing residential mortgage market.

JSC “Kazkommertzbank” was the first bank who in 2001 launched its mortgage lending program. In 2002, two more commercial banks entered this market, JSC “Bank CenterCredit” and JSC “Alliance Bank”. In 2003, JSC “Narodnyi Saving Bank of Kazakhstan” (Halyk bank) launched its own mortgage lending program (called ‘Mortgages Light’). By the end of 2003, when almost all banks started offering mortgage loans, the annual interest rates went down from 15-17% in 2002 to 14-15% in 2003. In 2005, the interest rates for mortgage loans (based on annuity payments) further reduced to 13-14% (for US Dollar denominated mortgage loans). The interest rates for mortgage loans secured by deposits were 7%⁵⁰.

The terms of mortgage loan grew from 10-15 years in 2002-2003 to 20-25 years in 2005. JSC “Kazkommertzbank”, JSC “Bank TuranAlem”, JSC “BTA Ipoteka”, and JSC “Narodnyi Saving Bank of Kazakhstan” (Halyk bank) were the first banks to offer longer term loans. As of late 2005, the maximum term for mortgage loan was 25 years.

Table № 4. Key Mortgage loans parameters

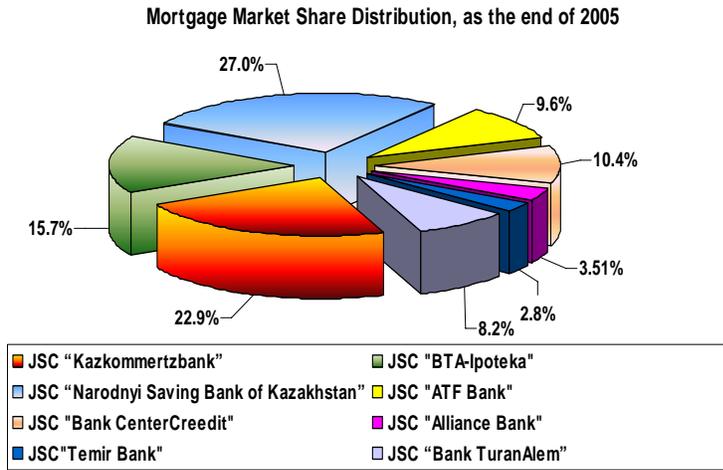
	Max Loan Amount	Min. Down Payment amount	Interest rate	Tenor, years	Monthly payment/ Income Ratio	Repayment penalty	Fixed period*****
Commercial Bank and mortgage companies	unlimited*	10%-50%**	7%-20%***	>3 20 25	35%-60%	yes	Yes, 3-6 mnth
Kazakh Mortgage Company	<390 thousand USD	10%-30%**	11.8%-13.2% (10%****)	20 25	35%-45%	yes (<1%)	6 month 3 years (State program)

**JSC “BTA Ipoteka” 500 thousand USD, amount that exceeds the sum is reviewed individually.
 **LTV ratio more than 70% is secured by civil liability insurance or by Kazakh Mortgage Credit Guarantee Fund
 ***depends upon indexed or fixed type of product or deposit covered
 **** State program of the residential construction 2005-2007.
 ***** the period within which the repayment is forbidden*

Along with the commercial banks that offer mortgage loans there are savings based mortgage schemes similar to German *Bausparkasse*. The law of the Republic of Kazakhstan “On the housing construction savings” was adopted in 2002 to create a legal basis for this type of operations. Currently, such product is offered by JSC “Zhilstroisbergbank”. Savings are deposited accruing the interest of 2% to 5.5% per annum until the required desired down-payment amount of 25% of the property value is accumulated. Then, a 20 year mortgage loan is granted at 3.5-6% per annum.

⁵⁰ As an example, “mortgage – Lights” of “Narodnyi Saving Bank of Kazakhstan” had the deposit coverage.

Chart 10



Source: IFC assessment

The following chart estimates the market shares of the major mortgage lenders of the country⁵¹. The largest mortgage portfolio of US \$447 million or about 27% of the whole market was held by JSC “Narodnyi Saving Bank of Kazakhstan” (Halyk bank). The aggregate mortgage portfolio of JSC “Bank TuranAlem” and JSC “BTA Ipoteka” amounted to US \$390 million or 24% of the market. The market share of JSC “Kazkommertzbank” was approximately 23% or US \$380 million.

The mortgage portfolio amount of the other lenders was about US \$435 million.

Quality of the Loan Portfolio of Mortgage Companies

Classification of mortgage assets for both bank and non-bank financial institutions in Kazakhstan is ruled by the norms set by the National bank of Kazakhstan. There are no separate asset classification rules for mortgage companies.

So far, the quality of mortgage portfolio remained high. In 2005, the standard loans accounted for 98.6%, sub-standard - 1.1% and non-performing loans (the ones put on non-accrual basis) were about 0.2% of the total portfolio of mortgage companies. Overall, the quality of portfolio is not expected to deteriorate as long as country’s economy continues to grow.

Mortgage Lending Risks

The risk management concept is still relatively new to the majority of banks and they require assistance to implement the best international practices in that area. However, banks are more advance compared to non-banking financial institutions in terms of introducing the risk management systems. Lacking the proper risk management methodologies, the many non-banking institutions developed in-house risk management policies. Along with methodologies, financial institutions experience the lack of efficient risk management technologies. Employed scoring systems are often flawed due to non-representative client sampling which is insufficient for stress-testing. Efficient risk management software is missing as well.

The Kazakhstan Mortgage Company (KMC)

The Kazakhstan Mortgage Company (KMC) was established in December 2000 as the secondary mortgage market operator that refinances mortgage lenders that, in turn, provide long-term residential mortgages to the population of the country. The company attracts long-term funds by placing mortgage backed bonds (MBBs) in the stock exchange and directs cash flows to participating banks by buying their mortgages. Thus, the KMC facilitates mortgage refinancing and assists banks in further expanding their mortgage lending activities.

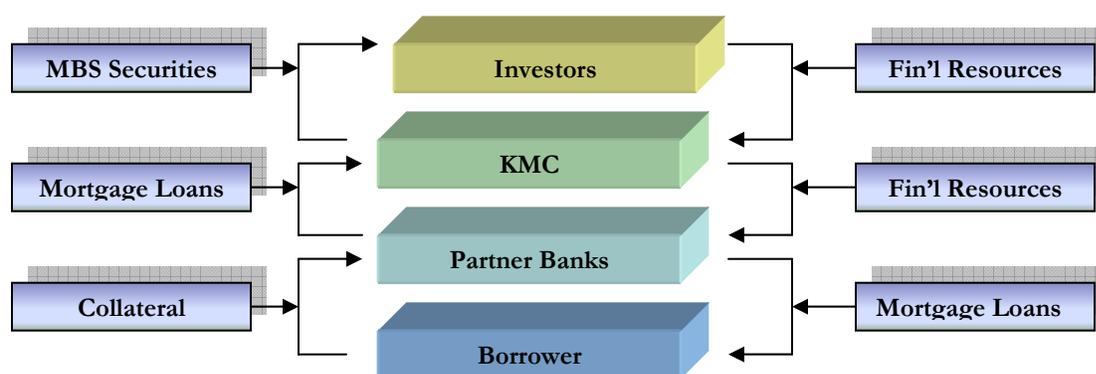
As a rule, banks extend mortgage loans that are compliant with the KMC requirements with respect to client type and underwriting criteria as well as KMC’s program criteria. The mortgages are sold to the KMC

⁵¹ The information has been obtained through a variety of sources, including: mortgage counterpart market share assessment, the local press and data offered by the banks.

(refinanced) on a recourse basis. If a mortgage loan fails to comply with KMC requirements or a payment default occurs, a partner bank retracts a mortgage loan that is in default and provides a substitute loan. In this case, all risks reside with the partner bank.

Loan servicing is also performed by the partner bank that originated the loan within the framework of the trust management agreement with the KMC. Within the State Program of residential construction for 2005-2007 banks are allowed to sell mortgages without recourse and in this case, all risks are transferred to the KMC.

Chart 11
Model of KMC Facility



The KMC pools mortgage loans and uses them as collateral for issuing mortgage backed bonds (MBB) in capital markets. To date KMC has made 12 bond issues. The table below illustrates main parameters of recent MBS issues.

Table 5

Basic Parameters of KMC Bonds (6 issuances out of 12)						
Issuance	1	2	3	4	5	6
Amount, USD⁵²	9,721,322 1,5 billion tenge	18,302,727 3 billion tenge	28,130,977 5 billion tenge	35,924,701 5 billion tenge	36,662,267 5 billion tenge	36,662,267 5 billion tenge
Issue Date	10.11.2002	11.08.2003	01.12.2003	01.02.2004	01.06.2004	01.06.2004
Tenor	3 years	10 years&51 days	10 years&121 days	10 years&59 days	4 years&304 days	6 years&304 days
Coupon Rate	Inflation + 4.75% = 10.75%	Inflation +1.8% = 6.9%	Inflation + 1.0% = 8.3%	Inflation + 0.5% = 6.9%	Inflation + 0.39% = 7.69%	Inflation + 0.39% = 7.29%

Source: official web site of the Kazakh Mortgage Company

Kazakhstan Mortgage Credit Guarantee Fund (KMCGF or the Fund)

The Kazakhstan Mortgage Credit Guarantee Fund was founded in November 2003 as a financial agency with the purpose of lowering credit risks in the Kazakhstan’s mortgage market. The National Bank of the Republic of the Kazakhstan is the sole owner of the Fund.

⁵² Based on exchange rate calculated by IFC Project staff.

Currently the Fund is the only financial organization in the mortgage guarantee (mortgage insurance) market. The mortgage guarantee system unites 26 participants of the 32 registered financial organizations that offer mortgages and mortgage-related services.

The major objective of KMCGF is the creation of risk sharing mechanisms, thereby increasing mortgage affordability by extending loan terms up to 20 years, lowering interest rates, and lowering the down-payment requirements to 7%-10%.

The core principles of the Fund are a mono-line approach to its product line and non-affiliation with any credit organizations.

The KMCGF's main sources of funding are paid-in capital, investment income, and income earned from operations. Net profits are fully directed to reserve capital, which can be used for guarantee payments.

For the 12 months of 2005 the Fund's share of guaranteed loans in the total mortgage portfolio amounted to 2.45% and has been dynamically trending up. The KMCGF participates in the special program of the KMC that supports the State program of residential construction for 2005-2007. Therefore, a significant growth in the share of guaranteed mortgage credits in the Republic of Kazakhstan can be expected.

KMCGF pricing rates are differentiated based on the type of mortgage programs and the term of mortgage guarantees. The price for obtaining a guarantee may be a one-time, upfront fee, ranging between 0.12% and 0.59% of the amount of mortgage loan outstanding or an annual charge, ranging between 0.55% and 3.73% of the amount of mortgage loan outstanding. A fee for guaranteeing highly leveraged mortgage loans ranges between 0.35%-3.3% of the amount of mortgage loan outstanding and depends on the type of payment (annual or one-time), loan amount and loan term.

Bank Caspian, JSC "BTA Ipoteka", JSC "Valyut Transit Bank", JSC "Tsesna Bank", JSC "Alliance Bank", and JSC "Temirbank" actively work with the KMCGF. JSC "Narodnyi Saving Bank of Kazakhstan" and JSC "Kazkommertzbank" have not yet worked with the Fund but have carried out joint assessments with respect to introducing banks' mortgages loans that could be guaranteed by the Fund.

It is worth to point out that while introducing the system of mortgage loan guarantees, the Government has been able to create an insurance mechanism that enabled to:

- lower the down-payment to 10% of property value;
- increase the mortgage term up to 20 years;
- cancel a borrower's civil liability.

With KMC's special program⁵³ of mortgage financing of affordable housing, the annual interest rate decreased to 10% and life and disability insurance became voluntary, provided that the mortgage lenders applied for 100% guarantee coverage of the loss (KMC program).

In 2005 the Standard & Poor's rating agency, applying the methodology of rating companies that have government support, rated the Kazakhstan Mortgage Credits Guarantee Fund with a "BB" long-term credit rating for foreign currency debts with a stable outlook. On a Kazakhstan's rating scale the rating forecast was «kzA+». In 2006 a stable outlook was changed to a positive outlook. Moreover, the "BB" long-term credit rating for foreign currency debts and «kzA+» rating were reconfirmed.

Credit Bureau

In July 2004 the Law "On Credit Bureau and Formation of Credit Histories in the Republic of Kazakhstan" came into effect. The "First Credit Bureau" LLP was established in August of 2004 at the initiative of the

⁵³ Special program of the KMC that supports the State program of residential construction for 2005-2007

Association of Kazakhstan Financiers (AKF) but in practice, became operational in the beginning of 2006. As of the end of 2005 there was only one credit bureau in the country.

Banks, with a borrower's written consent, register borrower data in the Credit Bureau's database. Previously the information could be obtained from the National Bank of the Republic of Kazakhstan where the banks were obliged to submit information on defaulted credit loans. In the existing bureau's database all available information about a borrower is being registered as well as his/her credit story.

The major issue with the credit bureau is the lack of a direct, multi-user access to databases from remote office locations (for example, from bank premises). Besides, the bureau cannot yet provide comprehensive information as it is currently being actively built up.

Appraisal Companies

Currently, there are about 2,000 appraisers in Kazakhstan. The largest associations of appraisers include the Kazakhstan Appraisers' Association, the Chamber of Professional Appraisers of Kazakhstan, and the Southern-Kazakhstan Appraisers' Union. There are 36 professional public unions of appraisers in the country, five of which work at the national level and 27 at the regional level.

The main objective of these associations is the dissemination of uniform appraisal standards and conducting professional training for further industry improvements. As of the end of 2005, such standards did not exist.

Appraisal activities are licensed. Although licensing of appraisers has been aimed at keeping statistical accounts and providing the industry with qualified appraisers, it can not fully provide a high quality appraisal practice.

At the end of the 2005, a meeting between the Ministry of Justice and large unions of national appraisers took place. The main topics of the discussion were the development of national standards of appraisal, stiffening the system of licensing, and improving appraiser's professional qualifications. A set of deadlines and main directions of joint work were defined at the meeting. Furthermore, the essential question that was touched upon was funding of the development of national standards of appraisal and their translation in the national language.

Three methods of residential property appraisal are currently used in the country. The method selection depends on type of property being appraised. The comparative sales method is widely used for apartment appraisal. The comparative sales and the replacement cost methods are primarily used for individual houses and cottages. For commercial real estate, the income generating method is used along with the two methods mentioned previously. Newspapers that print real estate advertisements serve as a main source for the comparative method (there is no database of actual sales records). Some realtors and appraisers create their own databases.

The lack of standards and classification norms increases the risk of an inaccurate property appraisal. To minimize risks of inaccurate appraisal or fraudulent appraisal, banks and commercial mortgage companies use in-house appraisers or affiliated companies to perform appraisals on residential properties. The costs of these appraisals range from US\$ 20 to US\$ 60 and depend on the appraised property.

Insurance Companies

At the end of 2005, Kazakhstan counted 37 insurance companies and 129 affiliates of these companies. However, according to the National Bank of the Republic of Kazakhstan, only three insurance companies have licenses for underwriting life insurance. As of the end of 2005 the total assets of insurance companies amounted to US\$ 551 million and total equity amounted to US\$ 270 million.

Many of the insurance companies are affiliated or partially owned by big banks. Insurance companies that are part of banking financial groups offer insurance products claiming to hedge the risks under the mortgage

lending programs of their parent banks, but, in fact, substantially increase systemic risk exposure. The range of insurance products offered is largely preconditioned by insurance companies' product line and by their possession of certain types of insurance licenses.

To facilitate the oversight and state licensing of the insurance industry, the insurance practice is divided into branches (e.g. property, civil liability insurance etc), classes (e.g. life, disability insurance etc) and types (voluntary and compulsory insurance). The insurance practice encompasses the "Life insurance" and "General Insurance" branches. Each type of the obligatory insurance represents a separate class of insurance and is subject to licensing. For example, "Life insurance" includes the following classes of voluntary insurance: life insurance and annuity insurance.

Bank clients generally have a free choice of picking up an insurance company though banks will sometimes direct clients to a particular insurance company by promising more favorable loan conditions.

A practice of obtaining insurance as part of a mortgage program includes insuring real estate property against damage and against title loss. Some banks use borrower's life and disability insurance. Furthermore, in case of an insurable incident, a mortgage lender or mortgagor becomes the insurance beneficiary.

The life and disability insurance⁵⁴ and property insurance⁵⁵ are mandatory for obtaining a mortgage loan. Title insurance⁵⁶ is a relatively new product and is not extensively offered by mortgage lenders. The risk associated with title loss is minimized by bank lawyers thoroughly conducting a legal examination of documents confirming property rights.

The minimum life or property insurance coverage period is one year, preconditioned by renewal for the next year. A bank's credit agreement defines borrower's responsibility with respect to not renewing the required insurance. If a borrower fails to renew insurance, a mortgage lender reserves the right to demand full mortgage repayment. The external monitoring of an insurance renewal is performed by an insurance company via a bi-lateral agreement between a mortgage lender and an insurance company. Along with an external insurance monitoring, an internal monitoring is performed by specialists from a credit organization.

In practice, the cost of title insurance ranges from 0.07% to 0.3% of the mortgage loan amount per annum. Property insurance premiums range from 0.25% to 1.5% per annum while life insurance costs range from 0.26% to 0.45% per annum (the annual rates might reach 4% according to the classification tables of the insurance companies).

Banks may also provide highly leveraged mortgage loans (those with an LTV exceeding 70% to 90%) by tapping into the mortgage guarantee system. This risk can be also hedged by civil liability insurance⁵⁷. Previously, before the creation of the Kazakh Mortgage Guarantee Fund, mortgage lenders used this insurance product to minimize this type of risk.

Real Estate Companies

There are several realtors' associations in Kazakhstan: the Association of Realtors of Kazakhstan and the National Association of Realtors. However, at a time of writing of this report there was no multiple listing services in the country. Realtors create their own data bases.

⁵⁴ The annual amount of life insurance or work capacity loss insurance is calculated as the multiple of the tariff rate set by the insurance company and the loan amount (outstanding principal amount).

⁵⁵ The annual amount of property insurance is the multiple of the tariff rate and the appraised value of the collateral.

⁵⁶ The amount of title insurance depends upon the loan amount.

⁵⁷ Within the civil liability insurance scheme the amount, that exceeds LTV = 70% is being insured. On the outstanding principal amount decrease to LTV=70% the mortgage lender does not require this type of the insurance any more. Some of the mortgage lenders set the max amount of this risk not less than 15% of the property value.

The absence of professional realtors creates certain difficulty with respect to the demand side of the market. If a potential client wants to see a wider variety of properties, he/she would have to use a number of real estate agents.

The realtor market is not regulated by the government with estimates of unlicensed or unregulated realtors ranging upwards of 80%. Aiming at organizing and further improving realtors' activities, the Association of Realtors of Kazakhstan drafted the law "On Realtors Activity". In it, the Association offers to certify realtors and attest their professional qualifications. The committee, responsible for certification and attestation, will consist of top managers of real estate companies and official representatives from state bodies. Moreover, a realtor's professional experience should be not less than two years.

Realtors' commissions range, on average, between 1% and 3% of the real estate value. If a realtor company assists in obtaining a mortgage loan, the commission can be as high as 9% of the real estate value.

Mortgage Brokers

There are mortgage brokers present in the market. This type of activity is not licensed, nor is it registered. Therefore, the exact number of mortgage brokers is not known. The practice of mortgage brokers has been initiated by mortgage lenders as a way to expand their mortgage sales channels in the market. Moreover, independent mortgage brokers were provided with training and were certified upon successfully passing banks' mortgage program tests.

The mortgage brokers' commission varies from US\$ 300 to US\$ 700, is paid for by the borrower, and largely depends upon mutual agreement of the parties.

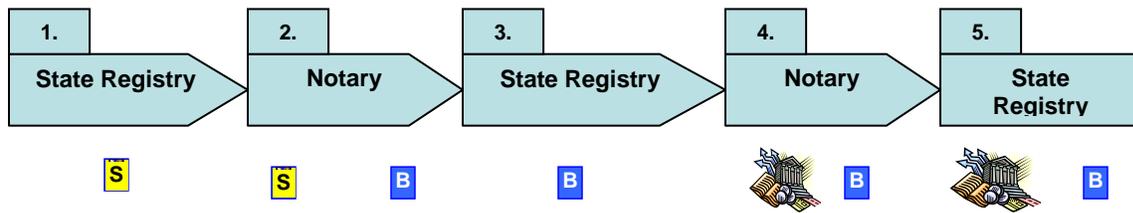
3.4 The Legal & Regulatory Environment

Registration of Mortgage and Property Rights

On the whole, the analysis of current legislation indicates that laws related to the registration of a lien on property, as well as property rights in general are adequately regulated. However, there are still some areas potentially risky for parties of mortgage housing lending. In accordance with existing legislation financial institutions have a right to and therefore take residential real estate as collateral for both business loans and mortgage loans. Current legislation stipulates that all rights associated with immovable property, including property and mortgage rights, are subject to obligatory state registration.

A flow chart below provides a graphical depiction of the title transfer process for a mortgage-financed residential property and outlines main potential issues and risks of every stage of such process:

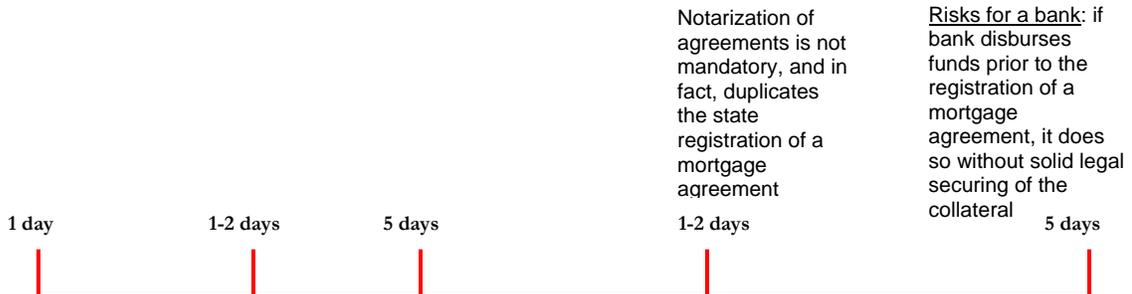
Property Title Mortgage Registration Process in Kazakhstan



REQUIRED ACTIONS

- Documents which confirm:
- Ownership rights of a seller on real estate
 - Absence of outstanding liens and other encumbrances attached to the residential property
 - Notarization of agreement of purchase and sale (optional)
 - Payment of the state duty for notarization
 - Registration of buyer’s ownership title based on an agreement of purchase and sale
 - An agreement of purchase and sale comes into force from the moment of the state registration
 - Notarization of a mortgage agreement
 - Checking of outstanding encumbrances on collateral
 - Payment of the state duty for notarization
 - Registration of a lien with a local Registry office
 - Mortgage agreement comes into force from the moment of the state registration

ISSUES/RISKS



Currently, state registration of property title and related transactions on immovable property is performed by specialized registration offices under the Ministry of Justice (further: the registry offices). According to the legislation, state registration of immovable property rights (including property title transfer, mortgage lien and etc.) must be done within five working days from the date of submitting all required documents to the registry office. The registration is a paid service. The state fee is established based on a percentage ratio to “a monthly index” (MI), and is varied from 50% of MI to 800% of MI depending on the type of residential property (e.g. apartment, single-family house). Currently the state registration of the title on an apartment costs 515 tenge (around US\$4)⁵⁸.

Prior to the title transfer registration, buyer and seller conclude an agreement on residential property purchase and sale. Depending on the parties’ will, the agreement may be notarized. In that case parties pay the state duty in the amount of about 7 000 tenge (around US\$56)⁵⁹. Furthermore, in order to see the transaction through the end, and in accordance with the existing regulation, technical plan on residential property to be acquired must be updated at the registry office. This step takes about a month and costs about 3 000 - 5 000 tenge (or US\$25-40). The review of the technical plan depends on total area space of the subject property, and also on the fact, whether owner-seller reconstructed a property and received all necessary permits for that. When the technical plan is being renewed the subject property is checked for compliance with the original technical plan. In accordance with the legislation applicants have a right to expedite the process of updating property’s technical plan by paying additional fee of about 15 000 tenge (or US\$120). In such case registration time reduces to 2 days.

Another important step in the process of acquiring a residential property through mortgage financing is an independent appraisal of the property, which is required by commercial banks offering mortgage loans, in accordance with the legislation. In general, an independent appraiser (appraisal company or individual, possessing a license to provide appraisal services) use comparative sales method (for appraising apartments) or combine comparative sales and replacement costs method (for appraising single-family house) to make a proper assessment of the residential property value. An independent appraisal costs about 3500 tenge (or US\$25) and is in addition to the formal appraisal done by the registry offices for perspective taxation purposes. The cost of such formal appraisal depends on the type of the property being appraised, materials used during construction, number of storeys, wear and tear of the building, and also based on regulating coefficient of secondary property market, which is being developed by local authorities for each territorial-economic administrative unit.

In sum, all expenses associated with mortgaged apartment title transfer (including notarization of an agreement of purchase and sale) total to about 15000 to 17500 tenge (or US\$120 – US\$140). In case parties to the residential property sales-purchase deal expedite the update of a technical plan on a property, the amount of costs associated with residential property title transfer is doubled.

Costs of transfer of title on land plots and private houses on them are much higher than those for apartments and cost about 80000 – 100000 tenge (or US\$640- US\$800). High cost is a result of a lack of “single property object” definition in the country’s legislation. The legislation views a residential property and the land plot

⁵⁸ According to the Resolution #454 of the Government of the Republic of Kazakhstan dated May 16, 2003 “On Approving Fees for the State Registration of Title on Immovable Property and for Other Associated Deals With It” (amendments introduced on September 1, 2005), registration fees are calculated based on: (i) percentage ratio to “a monthly index” (MI) – index is formed for the fiscal year along with the work on a new state budget; index can be reviewed once or twice per year; (ii) a type of residential property (e.g. apartment - 50% of MI in effect on the date of payment, single-family house - 800% of MI). On January 1, 2006 MI was equivalent of 1030 tenge.

⁵⁹ At present, the cost of notarization of an agreement of purchase and sale of a residential property is fixed depending on parties involved into transaction and method of financing. An individual buying residential property in urban area will have to pay 700% of “a monthly index” (MI) for notarization of an agreement of purchase and sale. In case when a buyer is a legal entity - 1000% of MI will apply. Children, spouses, parents, brothers and sisters, as well as grandchildren of a property seller entering into residential property purchase and sale transaction as buyers will have to pay 500% of MI. If property purchase and sale transaction is being conducted through mortgage financing, than notarization will cost 200% of MI. (According to Article #497 of the Tax Code of the Republic of Kazakhstan).

under it as separate objects of proprietary rights. This leads to existing practice when title on land plot is registered separately from the title on residential property built on that land. Such a separation leads not only to the substantial increase in costs for the parties to the property sales-purchase transaction, but also prolongs the time required for complete title registration procedure. Parties to property sales-purchase transaction where the subject is a land plot, need to complete more documents not only on the land plot itself, but also on the residential premises built on that land plot (measurement of a land plot and development of a technical plan on that land plot and any building on it). Thus, a lot more time is required to transfer and register land rights in compare with an apartment transfer. High financial costs and time considerations associated with registration of deals involving land plots and private houses on them leads to excessive number of non-registered private houses on the country's market.

In accordance with Kazakh legislation an interested party may have access to registration information which is available upon the party's written request concerning a specific immovable property object. Such information is provided for a fee to an applicant within one working day from the moment of in-writing application. The cost of such a service is 500 tenge (around US\$4).

When the sales-purchase transaction on residential property is being concluded, under the mortgage financing, the lender, usually, appoints the third party (e.g. realtor firm) as an agent to represent interests of the borrower based on the notarized power of attorney. After the signing of an agreement of purchase and sale by the seller and the buyer, an agent registers residential property title transfer and further mortgage lien with the register office.

The following documents are also required to register a lien on a residential property:

- Application form.
- Documents confirming residential property title rights of mortgager (e.g. agreement of purchase and sales).
- Receipt confirming the payment of the state duty for registration.
- Credit Agreement.
- Mortgage Agreement.
- Technical plan of residential property.
- Applicant's identification document.
- Notarized shareholder's documents if the applicant is a legal entity.

Taking into consideration the significant number of documents required for residential property mortgage deal registration, it is necessary to focus attention on optimizing a list of such documents. This should be done in order to save time and reduce costs of residential property mortgage registration procedure. However, protection of rights of parties involved in residential property mortgage deals should not be damaged.

The analysis of the current legislation and practice pertaining to residential property registration revealed at least some challenging aspects that complicate the process of registering residential property deals; these aspects are elaborated upon further in the next chapter of this report.

Absence of the Unified System for Registering Real Estate and Associated Deals

At present, in the Republic of Kazakhstan two cadastres containing data on immovable property are in use: the Legal Cadastre (run by the Ministry of Justice) and Land Cadastre (run by Land Committee). Data in these cadastres often differ which creates significant problems in determining actual legal (ownership) status of real estate. In particular, this concerns land plots accommodating private houses. In practice, there are

cases when land plots and houses on them often have different ownership status and they are often formally owned by different people. According to some estimates, about one third of the country's immovable property assets are not properly registered in the Legal Cadastre. As a result, such property cannot be accepted as collateral in mortgage lending, as lenders prefer to deal with the property registered in the Legal Cadastre in due course. Creation of a unified registration will help streamline the property registration mechanism, and establish more confidence in the title registry system.

Absence of Uniformity in Requirements to Documentation Associated with Registering Title Rights and Mortgage

Currently, registry offices located in different regions of the Republic have different requirements with respect to the documents needed for property and residential property lien registration, including requirements to various documents related to extrajudicial mortgaged property sales procedure. This is an issue not related to absence of legislative regulatory mechanisms; it can be rather explained by executive discipline in applying the norm of the law. The law clearly stipulates the procedure for registering title rights and mortgage as well as the requirements to the list of documents to be provided to registry offices while registering title rights and residential property deals. However, in practice respective provisions of the law are often interpreted varyingly by not only different registry offices but also by individual officials within the same registry offices.

For instance, registry offices in different locations of the Republic have their own different requirements with respect to lists of documents needed for the registration of property rights and encumbrances. Also, registry offices often provide contradictory responses to applicants; registry officials frequently do not accept documents that were submitted in accordance with their recommendations. Moreover registry offices commonly do not provide written justification of their refusal to register property, therefore not abiding existing provision of the law covering provision of such formal explanations or simply delay such procedure (which is required by the law to be done within five working days from the moment of application). In addition, they often request additional documents that are not required by the law. In practice, applicants have to comply with non-conforming requirements of registry offices, as they simply do not have any other options to get their property transactions properly registered and that takes considerable time and requires extra expenses.

As another example directly related to collateral sales, registry offices have different requirements with respect to extrajudicial proceedings. In particular, they demand from the banks to file extra documents which are not required by the law:

- An application on extrajudicial property foreclosure for a benefit of a bank.
- A document confirming the registration of notification on default of the borrower (notification #1) and tender notification (notification #2) with the state entity where mortgage agreement was registered (i.e. registry office).

Primarily the situations described take place due to the lack of training of registry officials and also due to the lack of control over the registry offices' execution of their functions. In addition, the law does not set any responsibility for registry officials for improper implementation of their functions and non-compliance with the formal registration procedures.

It should be noted that a new concept and a corresponding draft law on state registration of the property rights is presently being developed in Kazakhstan. According to the draft law, data contained in all existing cadastres (land, water, town-planning and forest) will be brought together into one unified cadastre, and affected agencies will be required to submit related cadastral data within their competence to the offices of the Ministry of Justice.

Title Registration Problems for Non-Registered Private Houses

In spite of the existing requirement for the obligatory registration of property title, some private houses built before the introduction of obligatory state property registration have not been properly registered. In addition, there are private houses that were built without authorization and were not registered properly. A person willing to register his/her rights to such properties must go through the whole procedure of registration both of a land plot and a house. Thus, an actual owner of a property must submit an application to a respective land committee for receiving a document (confirming allotment of a land plot) that grants and certifies land rights to a certain land plot. After receiving such a document, the actual owner submits an application to the respective territorial architectural and town-planning body for receiving a document (confirming that residential property is put into operation) that allows use of a house. The actual owner then submits the mentioned documents to the respective registry office, to formalize his/her ownership rights. The described mechanism is prescribed for newly built houses as well as for the houses previously built without permission. The described procedures may take a lot of time for a number of reasons. First, the law does not set any deadlines for land officials for granting rights to a land plot. Second, the actual owner must obtain a number of documents from different public institutions such as, for instance, the fire department in order to get a document allowing use of a house.

As a result, many houses are still not properly registered and, consequently, do not participate in market transactions and, as such, do not participate in mortgage lending. A simplified legalization process for such homes that were not properly registered in the Legal Cadastre would considerably help resolve the existing problem.

Impossibility to Concurrently Register Title Transfer and Lien on a Property

Current legislation does not provide for a mechanism of simultaneous title and lien registration in conjunction with the purchase of a property with mortgage proceeds. In practice this considerably increases the risks of a potential mortgage lender, which is interested in simultaneous registration of the pledge and property rights, in order to avoid potential property claims from any third parties, as well as unfair actions on the borrower's part.

Presently this risk is partially eliminated by banks through the use of third parties that are trusted by the bank as an authorized agent. A bank assigns a person (usually from a real-estate company) that will serve as an authorized agent on behalf of a borrower (based on a notarized power of attorney.) Such an agent will be authorized to submit an agreement of purchase and sale and mortgage agreement for registration to the registry office. After an agreement of purchase and sale is signed by the parties (between the seller and the borrower), it is the authorized agent's turn to get involved to appropriately register the documents. Since that moment the borrower does not have any further access to these documents. Such measures help prevent potential unfair actions on the part of a borrower.

Absence of Ranking of Encumbrances

The legislation of the Republic of Kazakhstan does not provide for the prioritization of encumbrances imposed on collateral by courts and other law-enforcement authorities, based on different creditors' claims and requests. Although the law excludes collateral from the list of property which may be claimed against based on other creditors' claims, it does not preclude courts and other law-enforcement authorities from putting an encumbrance on such collateral. This means that although collateral cannot be used to satisfy other creditors' (not related to mortgage lending) claims, this must be confirmed by a court in case different/other property claims arise with respect to the same property. This, in practice, may result in the impossibility of timely collateral sales by a lender, which must wait until collateral is discharged from such (not related to mortgage agreement) encumbrances by a court. Such lender's rights should be maximally protected by the legislation.

Notarization

Requirements for obligatory notary certification of immovable property transactions were eliminated from the legislation several years ago, which was certainly a step forward. This has led to reduced time and expenses for the registration of immovable property rights and associated transactions. Notarization of such rights and transactions is now made at the parties' discretion in one or two days, and costs approximately US\$56. In particular, in mortgage lending many banks do require notarization of sale-purchase contracts, although such notarization is simply a duplication of the functions of the registry offices. However, the elimination of obligatory notarization is one key component to reducing the time and costs associated with closing mortgage deals.

Notaries require consent from the property seller's spouse in cases where property was bought during marriage and, consequently is considered the spouse's joint property, unless otherwise provided in a marriage contract. In case where spouses have a marriage contract, according to which the property is in seller's sole ownership, the seller must submit the marriage contract to a notary, and then spouse's consent is not required. As to protection of children's rights, notaries do require permits from special guardianship authorities. In case an agreement of purchase and sale was not notarized, the consents described above may be required by registration authorities, in case parties do not notarize sales-purchase agreements.

Mortgage Loan Transfer

It is possible to sell a mortgage loan to the third party by making a respective endorsement on the mortgage certificate/deed (transfer of right to claim). Such transfer of a mortgage certificate is subject to the state registration. Initial registration of a mortgage certificate, as well as registration of its subsequent transfer/s to third parties, cost 25% of "a monthly index", for each action. This amount equals to approximately 250 tenge (about US\$2). State registration on the right to claim transfer must be done within five working days.

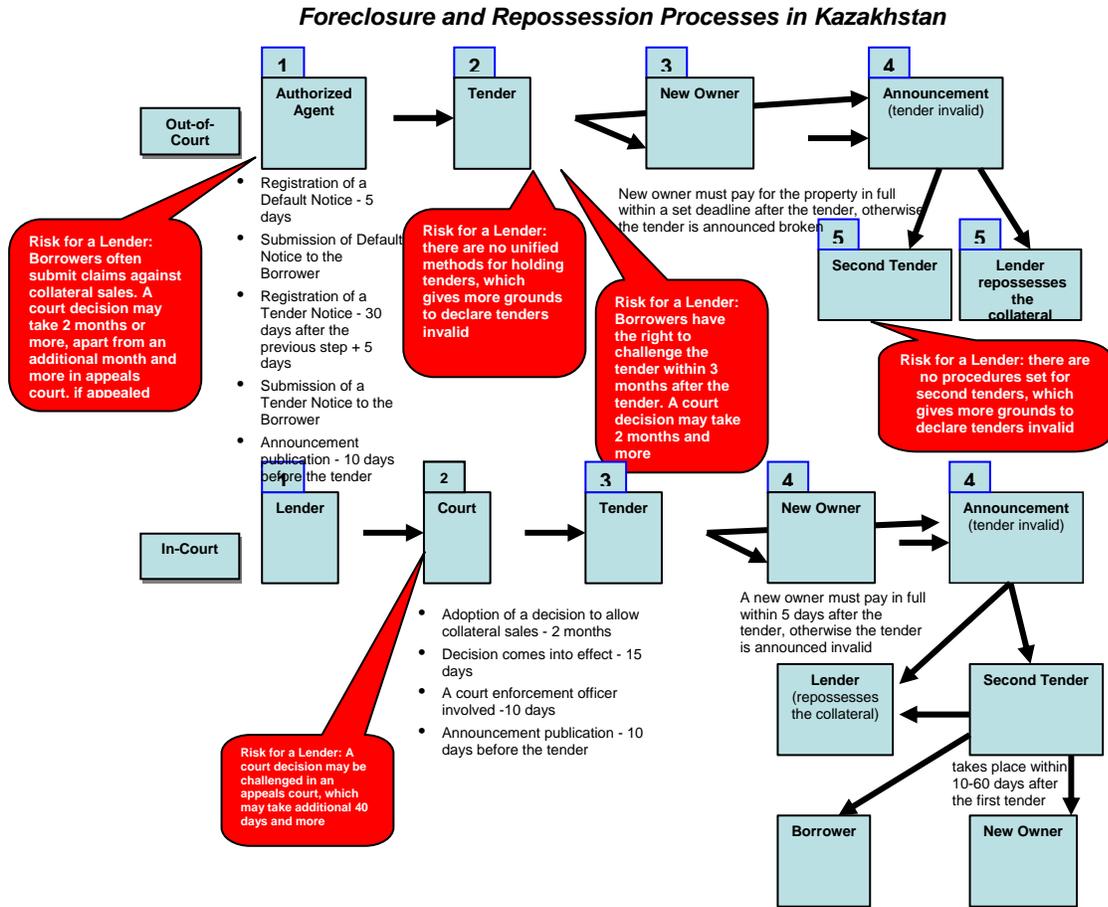
Notwithstanding the fact that the current legislation provides for the issue and circulation of mortgage securities (mortgage certificates), many provisions regarding mortgage certificates have not been developed. In particular, the law does not establish procedures for introduction of changes and amendments into mortgage certificates. Also, the legislation is ambiguous in relation to an issuer of a mortgage certificate. In addition, the law says nothing about effective periods of mortgage agreements and mortgage certificates, including correlation of such effective periods between mortgage agreements and mortgage certificates. A shorter effective period of a mortgage certificate than the one of a mortgage agreement is not established in the law either. The law does not require indicating the effective periods of mortgage agreements and mortgaging certificate in such documents, although this should be included among other obligatory requirements to the contents of mortgage agreements and mortgage certificates. At present, separate "legal existence" of loan agreements and respective mortgage certificates is possible.

In practice such situation can lead to distortion of fair value of mortgage backed securities because the latter securities do not reflect changes in terms of mortgage agreement, i.e. amended terms of payment, decrease of the principal debt, revision of the credit amortization. Mortgage certificate indicates initial information of the transaction only (rate, principal debt amount, etc.), thus rights and interests of owners of such securities are not insured. In the light of the above mentioned, mortgage certificate can not serve as a reliable instrument for mortgage lending.

Foreclosure and Repossession

Legislation of Kazakhstan provides for judicial and extrajudicial proceedings in regard of mortgaged property foreclosure. Foreclosure procedure specified by legislation seems to be sufficiently effective, with the exception of issues in regard of duration of such procedure. Active legislation leaves a room for possible alienation of mortgaged property in creditor’s (mortgagee’s) favor.

The flow charts below provide a graphical depiction of foreclosure by way of both judicial and extra-judicial proceedings and outlines the main steps of each:



Judicial (in- court) proceedings

Judicial realization of mortgaged property is carried out on the basis of court decision by public sale (auction) organized in accordance with procedural legislation. Norms of procedural legislation regulate following matters regarding mortgaged property realization: bidding process and dates, opening price of mortgaged property, bid participation terms, other essential conditions. According to such provisions of legislation mortgaged property judicial foreclosure takes up to 4 months. In case of borrower’s appeal to upstairs dates mentioned above might increase to another 40 days. Thus dates of enforcement of the court decision on mortgage foreclosure can be delayed up to 6 months and more. Moreover legislation provides for a court writ to suspend mortgaged property realization for a 1 year and by that suspend court proceedings for even longer dates. Such long terms of mortgage property judicial foreclosure procedure and creditor’s respective losses increase have an overall negative impact on mortgage housing finance development.

Extrajudicial (out-of-court) Proceedings

The sale of collateral through extrajudicial proceedings is possible in case such sale is provided for by the legislative acts or in the mortgage contract (or in a subsequent agreement by parties). Such a sale is made via a tender that is conducted by an authorized agent. An authorized agent is determined by the parties to the mortgage contract. It must be noted that in the following cases the sale of collateral through extrajudicial proceedings is not allowed:

- For the conclusion of a mortgage contract a consent from a third party or state body was required, but not received in due course.
- Collateral has a significant historic, artistic or other cultural value for the society.
- Collateral is in joint ownership, and some of its owners do not provide a written consent for out-of-court proceedings.

In the cases listed above the sale of collateral is possible only through in-court proceedings.

Acting legislation is well expanded in regard of extrajudicial proceedings of mortgaged property sales. The borrower's rights in extrajudicial proceedings are protected by the possibility to submit a claim against the sale of the property. Judicial hearing of such cases may take an additional couple of months in court, with an additional month in appeals court if required. This increases the period of extrajudicial proceedings, correspondingly. The borrower, as a rule, uses this legal option, even if there are no legal grounds for a claim. In addition, the mortgagor/borrower has the right to challenge a tender in case the tender procedures did not conform to the rules, within 3 months after the tender took place.

In practice there are certain problems concerning second tenders. In accordance with the Civil Code of the RK, a default notice and announcement regarding a tender (presumably, initial tender) are subject to obligatory state registration with the respective registry office, where collateral was registered. The law does not set similar procedures for the second tender (drafting and registration of notices, etc.). In other words, it is not clear whether notices should be made and registered during second tenders. This gap gives more room for judges to consider second tenders illegal, in case of disputes.

The legislation does not currently provide for unified methods for holding tenders in extrajudicial proceedings. This causes different implementation practices, and, consequently, gives more grounds for judges to declare tenders invalid or illegal.

Forced Eviction

In cases, when a debtor refuses to voluntarily leave the premises sold at a tender during extrajudicial or judicial proceedings, such a debtor is subject to a forced eviction, in accordance with a special court decision. It will take about 2 months for a person to receive such a court decision. Apart from that, an additional 2 months are required for a court enforcement officer to execute such court decision. In sum, a forced eviction will take (theoretically) approximately 4 months.

A court enforcement officer formally notifies a debtor about the time of eviction (sends an eviction notice.) The absence of a debtor does not impede the eviction process. A forced eviction is made with the participation of attesting witnesses. During the eviction process a court enforcement officer makes an inventory of the debtor's property, the storing of which will be covered by a debtor. To date, there are no eviction cases, and no problem issues identified therein.

Private Ownership of Land

Kazakh legislation allows private ownership of land, including such of agricultural land. Those willing to build a private house must obtain ownership rights to land in residential areas, for housing construction purposes. Land plots that are owned by the state and that are not leased to third parties may be sold at auctions. The list of such land plots is determined by local governments and is approved by local representative bodies.

In order to obtain land from the land stock owned by the state (other than sold at auctions) the applicant submits an application to respective local authorities. The local authorities consider the application and tentatively select a land plot and approve developed land project document. Then local authorities take a decision concerning granting rights to a certain land plot, demarcation of the land plot is done as well as preparation and issuance of documents confirming rights to land. This procedure is finalized by state registration of rights to the land plot.

In practice it is difficult to get land allocated for housing construction due to non-transparency and effort consuming of approval and project documentation issue. Moreover, as the law does not set any deadlines for land officials for granting rights to a land plot this process can be delayed thus positive outcome can not be guaranteed to applicants.

According to the Land Code, a privately owned land plot may be withdrawn for state needs, through either purchase of such land plot, or, based on the owner's consent, granting another equivalent land plot. In case of purchase from the owner, the purchase price and other terms are jointly determined by parties. The purchase price must include market value of the land plot and other immovable property located on it, as well as compensation for any damages that such purchase may cause to the owner (income from lease, etc). In practice this rule is not always followed by municipalities (they tend to underestimate land plots), as they do not allocate funds in their budgets for these purposes. Therefore, withdrawal of land plots for state needs often lead to judicial hearing of such cases.

OTHER LEGAL ISSUES RELATED TO HOUSING MORTGAGE LENDING

Inadequate Appraisal Legislation

Professional training and qualifications of appraisers is not sufficient in Kazakhstan. Although the Law "On Appraisal Activities" provides for appraisers' responsibility for the appraisal authenticity, and insurance of their civil liability, in practice this norm does not work due to the lack of any legally established appraisal standards and supervision over appraisers' activities. All these result in unfair and subjective appraisal of property objects. Distorted property values may imply additional risks and losses to creditor in case of collateral sales due to mortgage contracts.

Protection of a Good Faith Purchaser

In accordance with the civil legislation of the Republic of Kazakhstan, the grounds, according to which a property may be taken away from a good faith purchaser, are not sufficiently determined. In other words, the legislation does not protect a good faith purchaser from the restoration of a property to its owner, and endangers the lenders' interests in cases where such good faith purchasers are borrowers under mortgage lending contracts.

For instance, in accordance with the Civil Code, if a property was purchased from a person that did not have the right to sell it, the purchaser is considered a good faith purchaser in case he/she did not and could not know that a seller was an improper party to an agreement of purchase and sale (or, in other words, did not have the right to sell the property.) In such cases the proper owner of the property has the right to repossess his/her property if it was transferred to a third party without his/her will. The wording "transfer of a property without the owner's will" in practice leads to the situation that a good faith purchaser's rights are completely not protected by the law, as the grounds for the restoration of a property to its owner are not limited by the law.

For instance, there are cases where property is transferred to a good-faith purchaser by "an authorized person", based on a forged letter of attorney with a forged owner's signature. This may happen when an owner lost a document confirming his/her title and does not reside in his/her property. Although a good faith purchaser did not know about such fraud actions at the moment of purchasing the property, the property will be restored to its former owner. In order to reduce this risk for a good faith purchaser (borrower), the law should set more specific and limited grounds for restoration of a property to its owner, to

provide protection of a good faith purchaser's rights. Although title insurance is an effective way to reduce a lender's risk in cases of losing property title by a borrower (a good faith purchaser), protection of a good faith purchaser's rights by the law would reduce number of occasions when this remedy would be called for.

Notaries' Responsibility for Non-Lawful Actions/Legitimacy of Notarized Letters of Attorney and Other Documents

Existing legislation sets civil and criminal responsibility of the notaries to increase notaries' responsibility for their non-lawful actions and prevent possibility of power abuse by them. Thus in accordance with article 11 of the RK Law "On Notariat", the ground to recall a notary's license is a repeated violation of the law by a notary, during execution by him/her of notaries actions, or a single violation of the law that caused damages to the state, entities or individuals. Legislation sets criminal responsibility for the cases involving intentional actions by notaries and, in addition, caused significant damages to third parties. Other types of responsibility (civil and disciplinary) are set for cases of a notary's negligence or when a notary's actions (regardless of guilt) cause non-significant damages to third parties. In addition notaries are required to insure their civil responsibility.

In practice it's difficult to prove the guilty intent of notaries illegal actions resulted in significant damages to the individuals or entities to bring them to account. That, in its turn, results in abuse of powers and violating the law by notaries. As a rule, they simply reject any claims of their illegal actions (reject their signatures on forged documents, claim that their seals were withdrawn for some time and that respective improper documents are not registered in their registers).

Moreover, swindlers widely use cancelled letters of attorney and letters of attorney "issued" by dead people. That is possible due to the lack of the registry system for letters of attorney. Also, there are cases of use of forged documents (certified on behalf of non-existing notaries and/or with the use of forged seals) take place. In particular, this often concerns transactions with immovable property, including those associated with mortgage lending. In practice in most cases where transactions are afterwards recognized as being invalid by courts, such transactions were made with the use of forged letters of attorney

Thus, the existing legislation does not sufficiently protect participants of housing market from fraudulent offences thanks in no small part to absence of clear legislative rules in regard of notaries' accountability.

Lack of Information on Borrowers' Marital Status

Legislation establishes a requirement to verify a person's marital status for the conclusion of a transaction with immovable property. Such information is critical for the assessment of a person's solvency, as well as for the determination of the legal status of the property, which is the subject of the transaction (in mortgage lending). Generally, if a person is married, his/her spouse's consent is required for the conclusion of any property transactions. As no mechanisms of efficient confirmation of such information on marital status exist, in practice this can lead to the situation when a married person signs a statement that he/she is not married. Such a situation may increase risks for a lender in the future, in case of any property disputes between spouses. To minimize risks associated with the abovementioned a lender can request such information from civil registration offices. However, creation of a centralized database of all marriages across the country can turn as an efficient tool for parties in mortgage operations.

3.5 Government Policy in Housing Finance

For the purposes of creating necessary housing construction financing mechanisms, solving the housing problems of wide groups of Kazakhstan population, increasing affordability of the housing and stimulating housing construction, the Government of the Republic of Kazakhstan approved Decree No.1290 dated 21st of August 2000, which introduced "The Concept for Long-Term Financing of Housing Construction and Development of the Mortgage Lending System in the Republic of Kazakhstan".

In accordance with the approved Concept, the National Bank of the Republic of Kazakhstan has taken a decision to establish the secondary mortgage market operator to be engaged in refinancing lenders extending mortgage loans to the general public. The JSC «Kazakhstan Mortgage Company» established in December 2000 by the Kazakh Ministry of Finance, has stepped forward as such an operator.

At the time of the Company establishment there existed preconditions in Kazakhstan to expand the credit-financial sphere and for the growth of public solvent demand in the housing market, owing to the creation of conditions to develop market mechanisms for money mobilization through implementing the long-term housing mortgage crediting system. With the implementation and development of the system the population got an opportunity to purchase in a free market, build and repair housing items at the expense of the funds people are granted as long-term mortgage credits. Housing built under the state program is being financed by KMC through the network of participating financial institutions, which presently includes 14 commercial banks and 4 mortgage companies involved in mortgage lending operations.

Furthermore, establishing Kazakhstan Fund on Guaranteeing Mortgage Loans (KFGML) at the end of 2003 introduced necessary mechanisms to increase affordability of housing for groups of population with medium and low incomes and gave them an opportunity to improve their housing conditions.

Presently, KMC jointly with KFGML put their efforts into fulfilling the social mandate bestowed on them – socially oriented mortgage lending within the framework of the Government Program.

3.6 Recommendations

Republic of Kazakhstan in comparison with other countries of the Central Asian region examined by the Project has the most developed legislation, institutional capacity in mortgage housing finance. Banks use meticulously developed mortgage credit policies and procedures which correspond with international best practice whereas level of standard mortgage housing loan product is high. This is due to the fact that most of banks refinance their mortgage portfolios through the state controlled Kazakhstan Mortgage Company. Nevertheless the challenges regarding practical legislative and regulative aspects of mortgage housing finance are still on the agenda and require tackling, especially those, mentioned below.

Right now the country is facing a choice of further mortgage house lending sector development direction. However, it seems that neither the government nor the sector itself is undertaking any efforts to make such choice.

Streamlining Legal Environment

- Improvement and unification of the registry offices' operations.
- Introduction of unified registration process on simultaneous registration of residential property title transfer and mortgage on property.
- Protection of a mortgagee/lender's rights related to timely repossession of collateral.
- Streamlining procedures in extrajudicial proceedings.
- Establishment of legislative grounds for protection of good faith purchaser rights.
- Strengthened control by the respective authorities over notaries' activities, as well as legally defined responsibility for their non-lawful actions. Registry of letters of attorney issued on the territory of the Republic of Kazakhstan to be established under the Ministry of Justice; all issued letters of attorney to be obligatorily registered. It is also necessary to provide public with direct access to such information.
- Form a unified civil registration database within the Ministry of Justice of the Republic of Kazakhstan, which would be immediately made available to interested parties associated with mortgage lending deals involving purchase and sale of real estate.
- Improvement of the legislation related to mortgage certificates.

Mortgage market infrastructure streamlining and its potential development

Establishment of efficient mortgage business model in banking sector:

- Creation and implementation of unified standards and procedures for the full cycle of mortgage lending process.
- Development and implementation of standardized document set for mortgage lending.
- Development and implementation of enhanced and broadened mortgage products product line.
- Improvement of professional skills of personnel involved into mortgage lending.

Further Development of Risk Management Practices:

- Establishment of better defined approaches for development of more efficient methods and analytical ratios of mortgage housing lending risks management for commercial banks as well as non banking institutions involved into mortgage lending.
- Improvement of professional skills of personnel involved into risk management in the context of rapid mortgage housing finance development.

Improvement of Appraisal Activities:

- Development of efficient monitoring and certification system of professional property appraisers.
- Improvement of appraisal companies' professional level by means of developing of appraisal activity standardization and promoting it through organization and conduct of specialized trainings.

Improvement of Interlinks Between Insurance Sector and Mortgage Lending:

- Widening the range of insurance products, necessary for further development of mortgage housing lending.
- Development of standard insurance products, standard insurance documentation, used in mortgage housing lending operations; drafting standard insurance agreement and insurance for mortgage products.

Improvement of state housing policy:

- Improvement of complex state program on development of national system of housing finance.
- Implementation of preparation plan and adoption of legislation acts necessary for forming housing finance system.
- Establishment of mortgage housing lending stimulating tax regime.
- Development of efficient policy and mechanisms in the sphere of state support to low income population in living standards improvement.
- Reforming housing construction sector to create quality and affordable residential housing supply increase.
- Public awareness rise in regard of housing lending by promotion of mortgage program implementation.

4. KYRGYZSTAN

4.1 Economic Overview

Kyrgyzstan is the second smallest Central Asian country in terms of land mass and the smallest in population. Recent estimates place the population at approximately 5.1 million, of which 35% or 1.8 million live in urban centers. Bishkek, the capital, has a population of approximately 1.1 million and is the country's largest city. Osh is the second largest city, with just over 300,000 inhabitants. No other cities have a population of over 100,000.

In 1998, Kyrgyzstan was one of the first project countries to establish and encourage private ownership of land. As a further sign of its liberal and open economic policies, Kyrgyzstan is the only project country that is a member of the World Trade Organization (WTO).

The political climate has been turbulent in the past year, but the situation has stabilized. The country was rocked by a (mainly peaceful) revolution in March 2005. The "tulip revolution," as it was known, was sparked by irregularities in the parliamentary elections of February and March 2005. The then-President was forced to resign and flee the country. A provisional government was formed, and fresh presidential elections were held in July 2005.

As a result of this political uncertainty, the Kyrgyz economy shrank by 0.6% in 2005. Industrial production slipped by 12% during the year, after 4.6% growth in 2004. Inflation increased to 4.9% during 2005, compared to 2.8% in the prior year.⁶⁰ Given the strong economic ties with neighboring Kazakhstan and Russia (Kyrgyzstan's main trading partners), political uncertainty can be expected to eventually diminish. Furthermore, the strength of these ties will certainly determine the pace of future economic growth in Kyrgyzstan.

Except for 2005, economic indicators have been quite positive in the recent past. The table below shows key economic figures over the past six years:

Table 1: Key Macroeconomic Indicators

	2000	2001	2002	2003	2004	2005
GDP (US\$, billions)	1.37	1.525	1.606	1.919	2.212	2.441
GDP growth (%)	5.4	5.3	0	7	7.1	-0.6
GDP per capita (US\$)	189	308	322	381	434	473
Inflation level (%)	18.7	3.7	2.3	5.6	2.8	4.9
Unemployment (%)	7.5	7.8	8.6	8.9	9	9.5
Foreign direct investment (US\$, millions)	-2.36	5	4.8	45.5	131.4	210.6
US\$/KGS exchange rate	47.7	48.4	46.9	43.7	42.7	41

Source: National Statistical Committee of the Kyrgyz Republic

In general, although the macroeconomic situation deteriorated somewhat in 2005, the overall prognosis for potential primary mortgage market development remains optimistic given that the exchange rate remains stable and inflation remains under control. Furthermore, although the macroeconomic environment may not

⁶⁰ Source: www.stat.kg

be considered optimal, it is more conducive for the mortgage lending development than the macroeconomic environment in Tajikistan or Uzbekistan. Besides, a number of banks in the country are already heavily engaged in SME lending and have also taken first steps toward introducing mortgage loans to the market.

4.2 Overview of the Housing Sector

Housing Stock

Growth in housing stock in Kyrgyzstan has been minimal over the last seven years. From 1997 to 2004, the number of residential dwelling units increased from 1.038 million to 1.08 million (42,100 net new residential housing units came onto the market during this period). This constitutes growth of 4.1% in housing stock over a seven-year period, which has not kept pace with the 8.1% growth in population over the same period. During this period, 73,600 new housing units were constructed, but 31,500 were eliminated from the housing stock—either converted to office or commercial use or demolished.

The overall area of residential housing stock stood at 60.8 million square meters in 2004, which translates to 12.4 square meters per capita. In 2005, residential housing stock increased by 1.2 million square meters to approximately 63 million square meters, according to unverified information supplied by the National Statistical Committee of the Kyrgyz Republic. According to its data, average area per capita remained 12.4 square meters, owing to a population increase of more than 120,000 over the previous year. Average residential dwelling size has increased slightly in recent years, from 53.8 square meters in 1997 to 58.2 square meters in 2005.

Approximately 90% of the housing stock was built during the Soviet era, 2% is pre-Soviet, and the remaining 8% was built after independence. Of that 8%, most has been built in 2004/2005. In 2002/2003, residential construction as a percentage of GDP was approximately 1.4%, as against 2.0% in 2004.

There are two implications associated with the current structure of the housing stock. First, housing stock built during the Soviet era has not been adequately maintained in the recent past. As these buildings age, the lack of upkeep will shorten their useful life, necessitating even more new construction. Second, the small increases in the housing stock in the recent past indicate a lack of mechanisms available to facilitate the construction of new housing stock, including the availability of housing finance.

New apartment construction has been confined mainly to the largest three cities (Bishkek, Osh and Jalalabad) with approximately 44.3% of new construction occurring in Bishkek. Single family home construction has been less concentrated in urban centers. The table below shows new housing construction for the period 1997 to 2005:

Table 2: New Housing Construction in Kyrgyzstan, 1997-2005

	1997	1998	1999	2000	2001	2002	2003	2004	2005
New apartment construction	4,100	6,600	4,400	5,000	4,100	4,700	4,900	5,300	5,230
New single family home construction	3,400	4,700	4,000	4,600	3,900	4,300	4,600	5,000	5,100

Source: National Statistical Committee of the Kyrgyz Republic

The rate of home ownership is high. In 2005, 96.6% of housing units were owner-occupied, versus 73.4% in 1991. High rates of owner occupancy are a result of the massive privatization of the housing stock in the mid-1990s (mostly before 1995).

However, with privatization came some problems as the state withdrew support for housing maintenance and renovation. This has resulted in deterioration of the housing stock in the past decade, as owners often cannot afford basic maintenance for their dwellings.

Factors Affecting Housing

The factors recently affecting housing include:

- Deterioration of the housing stock
- Lack of new construction to meet demand, especially in Bishkek and Osh
- Rural to urban migration.

As mentioned, after residential dwelling units were privatized, the government's obligation to maintain these dwellings ceased. This left a void, firstly because most apartment owners cannot afford to maintain their units, and secondly because new sources and mechanisms for attracting financial resources to the housing sphere have not developed. The legal framework to regulate the creation and functioning of homeowners' associations already exists but they have not gained wide acceptance since apartment-dwellers lack information about their function. Further, vestiges of Soviet mentality interfere with the operations of these associations, as most people still believe that maintenance of common areas should be performed by the state, not by homeowners. As a result, the common areas of apartment buildings (staircases, entrances and roofs) are not maintained, despite the homeowner associations formed to address these issues (in about 25% of buildings).⁶¹

Rural poverty has resulted in the migration of an estimated 150,000 to 200,000 people to Bishkek from the provinces in the past five years.⁶² Osh, the country's second largest city, has seen a similar influx. As a result, substandard housing has sprung up on the outskirts of these cities. These housing units often lack basic necessities, such as sanitation, running water and central heating. This has placed a strain on cities of Bishkek and Osh, as they try to provide basic infrastructure for these areas. The process has been slow, due to lack of funds and the absence of a market mechanism to finance urban infrastructure projects.

The inflow of new residents to Bishkek and Osh has not been offset by an increase in new, affordable housing units to satisfy demand. As the demand for housing has increased since 2004, the overwhelming need for a mechanism to finance construction companies has arisen. According to data from the State Committee on Architecture and Construction, there are 657 construction companies currently operating in Kyrgyzstan. A number of them operate on a joint stock basis with Turkish and Korean construction companies, and they are well capitalized by their foreign partners. Companies without foreign partners finance projects by pre-selling the units.

There are presently two ways of allocating land for housing construction in Kyrgyzstan. Land plots can be offered for sale on the open market, or municipalities can sell land by auction. Kyrgyz citizens and registered companies are eligible to bid in these auctions. Notably, however, despite the provisions of the land code, the actual process in the auction and sale of residential land plots can be considered non-transparent, resulting in a high level of irregularity.

Demand for Housing

The population has grown from 4.7 million in 1997 to 5.1 million in 2005, and this has placed an additional burden on existing housing stock. The largest increase in demand for housing is in Osh and Bishkek as a result of migration from rural areas.

In Bishkek, for example, approximately 32,000 new apartments have been built since 1997, but the population has increased by an estimated 150,000 to 200,000 through migration. Given an average family of

⁶¹ Source: "Pre-Feasibility Study on Housing Finance in the Kyrgyz Republic," The Urban Institute, March 2006

⁶² *Ibid.*

four, this translates to a current deficiency of over 40,000 apartments.⁶³ Overall, according to the Kyrgyz government, more than 166,000 families are in need of new or improved housing.

Thus, demand for housing is high, but potential purchasers are unable to buy housing for one of two reasons:

- They do not have sufficient financial resources to purchase a home outright and do not have sufficient (monthly) income to afford a mortgage currently offered in the market
- They have sufficient income to support mortgage payments but do not have access to mortgage financing for a variety of reasons, including inability to prove their real income.

Affordability

The affordability index developed for the project countries (a ratio of price per square meter of residential housing to annual GDP per capita) gives a median coefficient of 1.06 for Bishkek, (and a range of 0.56 to 1.57 within the city).

This coefficient provides a way to rank the relative affordability of residential real estate in the project countries. A lower coefficient means that residential real estate is more affordable. Kyrgyzstan places at the mid-point among the project countries. However, in Almaty, the capital of Kazakhstan, the affordability index ranges from 0.43 to 0.58, with a median of 0.51. Thus, apartments are approximately half as affordable in Bishkek as they are in Almaty even though apartment prices in Almaty are up to US \$2,000 per square meter, compared with US \$700 per square meter in Bishkek. This is because Kazakhstan has much higher GDP per capita than Kyrgyzstan.

Nevertheless, the recent growth in mortgage lending in Kyrgyzstan and a similar experience in the early stages of development and growth of housing finance markets in other countries indicate that affordable housing and mortgage lending may become a reality for a small but growing part of the population with a medium income.

Demand for Mortgages

No survey of mortgage demand was carried out. However, annual GDP growth is conservatively projected to be 3% per annum over the next four years, to US\$ 2.6 billion by 2010. The mortgage market as a percentage of GDP is projected to grow from the current 0.6% to 3.0%. Thus, a conservative estimate of potential demand by 2010 is US \$80 million (or roughly US \$15.70 per capita based on the current population). This would represent an increase of roughly US \$67 million in aggregate mortgages outstanding in the next four years, and a rate of growth slower than the actual growth rate in the last three years.

Extrapolating from past growth trends, bank assets are conservatively expected to double to US \$800 million by 2010. As a percentage of bank assets, mortgages are expected to increase from 2.8% to 10% in 2010.

Kazakh banks in Kyrgyzstan will play an important role in the rapid growth in mortgage lending by exporting their expertise in this field. Moreover, it is feasible that Kyrgyz subsidiaries of Kazakh banks may also receive the long-term funding needed to fund mortgage portfolio growth.

4.3 Institutional Capacity for Residential Mortgage Lending

The institutional capacity necessary for the development of a vibrant primary mortgage market is currently weak.⁶⁴ There is a functioning banking sector, and a wide range of mortgage market participants (sixteen

⁶³ Source: National Statistical Committee

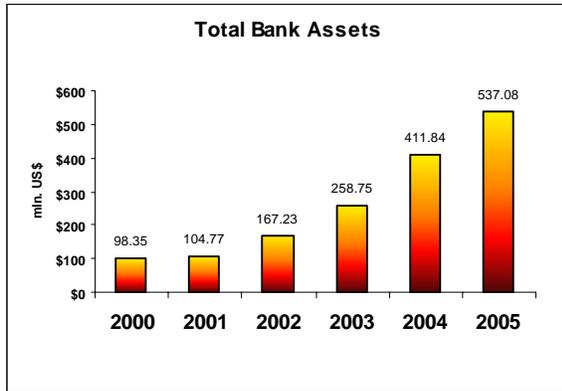
⁶⁴ Institutional capacity means the set of structures within the economy that facilitate mortgage lending. These structures include (but are not limited to) capital markets, commercial banks and other lending institutions, insurance companies, credit bureaus, property appraisal firms and real estate agencies. Institutional capacity also includes various self-regulated bodies and associations that ensure operational efficiencies, information sharing and the overall transparency of the primary mortgage market.

banks and a number of non-bank financial institutions offer both home-purchase and renovation loans). However, their reach has been limited by the factors discussed below.

Banking Sector

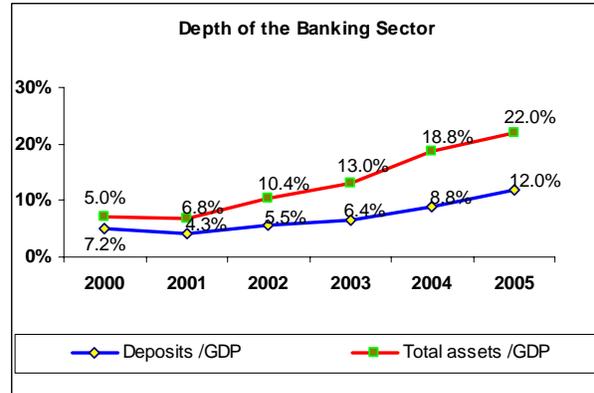
Twenty-one commercial banks comprise the Kyrgyz banking system. However, it is important to note that 70% of Kyrgyz banks are partly or wholly foreign-owned, including five banks with 100% foreign capital. The parent banks are mainly Kazakh and Russian. A number of those banks have ratings from international agencies such as Moody’s and Fitch.

Chart 1



Source: National Bank of the Kyrgyz Republic

Chart 2

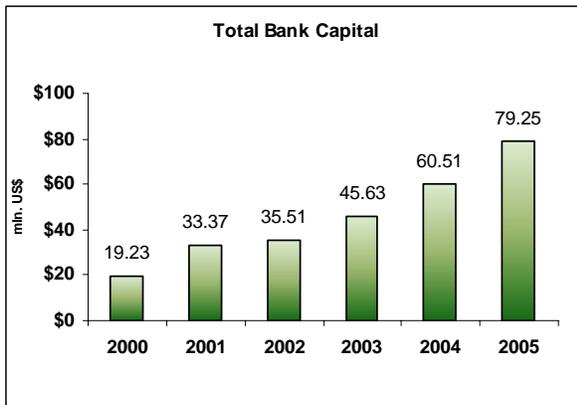


Source: National Bank of the Kyrgyz Republic

The banking sector has experienced healthy growth over the past five years. Total assets in commercial banks increased from roughly \$100 million in 2000 to over \$537 million in 2005. Mortgage loans currently comprise approximately 2.8% of total banking assets.

The depth of the banking sector has likewise increased. As a percentage of GDP, total banking sector assets more than tripled in five years (from 7% in 2001 to 22% in 2005). Bank deposits as a percentage of GDP increased almost two-fold, indicating an increase in confidence in the banking system.

Chart 3



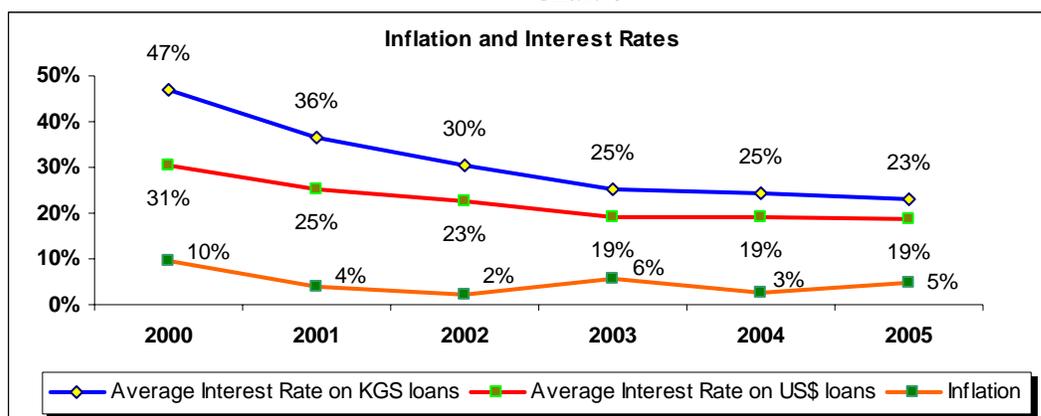
Source: National Bank of Kyrgyz Republic

The capitalization of the banking sector has also been growing. Over the past five years, the total equity of commercial banks has increased from about US \$20 million to about \$80 million.⁶⁵ However, without sources of long-term capital, capitalization remains insufficient to fund mortgage lending, particularly in light of rapidly rising property prices.⁶⁶

Total deposits increased by 51.6% from 2004 to 2005, to US \$295 million. Business deposits were US \$230 million at the end of the first quarter of 2006 (an increase of 78% over the prior year), despite the lack a deposit guarantee program. A state deposit guarantee program was proposed three years ago, but has not yet been approved by parliament. Personal deposits have also increased, by 22% in the past year, and now total US\$ 50.7 million. Most are short-term deposits for up to twelve months.

The macroeconomic environment has stabilized, as inflation has decreased from about 19% in 2000 to about 5% in 2005. Over the same period, driven by a substantially improved inflation climate, the average interest rate on bank loan has decreased from 47% to 25% for local currency loans and from 31% to 19% for US dollar loans. Low and stable inflation, which leads to low interest rates, is a key macroeconomic factor in the development of an efficiently functioning mortgage sector.

Chart 4



Source: National Bank of the Kyrgyz Republic

There are 320 credit unions operating in the country with total loans outstanding of approximately US \$13.7 million⁶⁷. The number of clients of these credit unions has grown to 21.2 thousand. Operational activity of credit unions is financed mainly from shareholders' equity (aggregate US\$7.6 million) and a refinancing facility offered by the Financial Company for Support and Development of Credit Unions organized by the National Bank of the Kyrgyz Republic.⁶⁸

Unlike banks, credit unions generally do not have the right to accept deposits. Last year, however, the Kyrgyz National Bank, as part of a pilot project, did grant ten credit unions licenses to accept deposits. Most credit union lending is agriculture-related. In addition, there are 136 micro-credit institutions, including the state-owned Kyrgyz Agricultural Finance Corporation. This organization offers loans to the agricultural sector with financing by the World Bank.

Capital Markets

The country's capital markets are underdeveloped. The total capitalization of Kyrgyz companies traded on local stock exchanges at the end of 2005 was about US \$50 million, or less than 2.3% of GDP. The bond market has not developed either: about US \$37.6 million in government bonds and less than US \$8.5 million in corporate bonds were issued up to and including 2005, with no significant upward trend noted. For example, only US \$600,000 in corporate bonds were issued in 2004 and two issues totaling US \$2.1 million in

⁶⁵ If the 2005 foreign exchange rate is applied throughout.

⁶⁶ The average price of a two-bedroom apartment in Bishkek is US \$22 thousand. Thus, total bank equity could hypothetically finance a maximum of about four thousand apartment units.

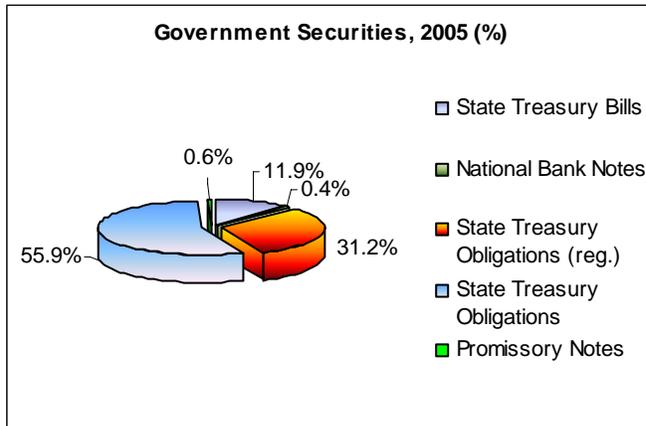
⁶⁷ Legislation governing the activity of credit unions in Kyrgyz Republic is established by the Law #124 "On microfinancing organizations in Kyrgyz Republic" dated July 23, 2002.

⁶⁸ Source: National Bank, 31 December 2005.

2005. All bonds are short-term; government bonds, at eighteen months, have the longest term. Most corporate bonds, meanwhile, have maximum maturities of one year, although two corporate bonds have been issued with two-year terms.

However, it is not certain whether there is sufficient liquidity or appetite among potential bond purchasers for larger issues with longer maturity periods (for example, issues of five to eight years). Acceptance of issues of this magnitude is crucial to expanding the funding sources for financial institutions wishing to engage in mortgage lending, but this is forecast only for the medium term.

Chart 5



Source: the National Bank of the Kyrgyz Republic

Mortgage Market

The mortgage market has grown significantly since 2002, albeit from a low base. Current mortgage loans outstanding in the banking system are approximately US \$15.5 million, with annual growth rates of 372%, 230% and 90% for the past three years respectively.⁶⁹ However small the figure, it places Kyrgyzstan third after Kazakhstan and Azerbaijan of all project countries in terms of the aggregate mortgages outstanding even though it is the smallest in terms of population.

The charts below show the level of residential mortgage lending in Kyrgyzstan and in a selection of other countries. The aggregate mortgage portfolio is approximately 0.6% of GDP, with mortgage debt per capita of just over two Euros.

⁶⁹ Source: "Pre-Feasibility Study on Housing Finance in Kyrgyz Republic," Urban Institute, March 2006.

Chart 6

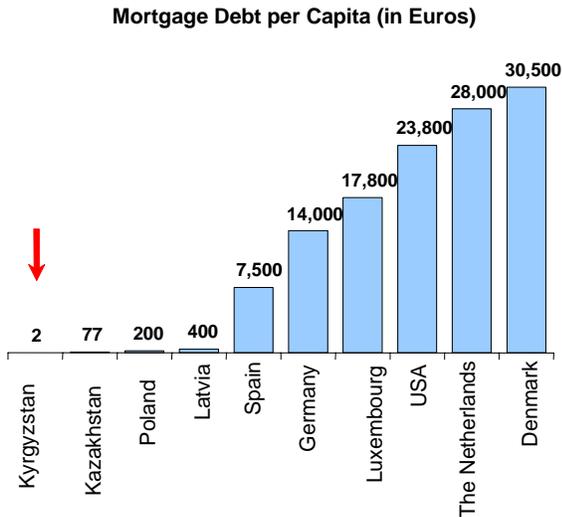
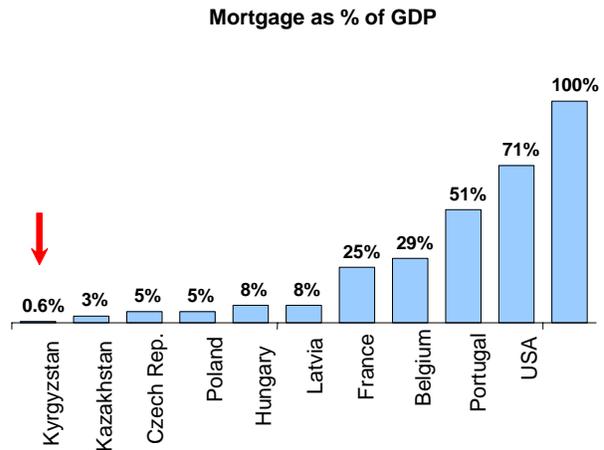


Chart 7



Source: European Mortgage Federation, 2003 (for all countries except Kazakhstan and Kyrgyzstan, for which the most recent data were used).

Kyrgyzstan is clearly in the early stages of growth in residential mortgage lending compared to other developing countries or industrialized countries. Much of the early growth has been driven by four Kazakh banks that undertaken mortgage lending in Kyrgyzstan. There appears to be substantial room for further growth.

Mortgage Lending by Banks and other Financial Institutions

Although sixteen of the twenty-one commercial banks with full banking licences offer (or claim to offer) mortgage loans, five banks (Energobank, Halyk Bank, Kazkommertzbank, Finance Credit Bank and KyrgyzKreditBank) account for 71% of the mortgage loan market. Energobank and Halyk Bank comprise the largest share, and they have been promoting mortgage products most aggressively. Four of them are subsidiaries of Kazakh banks. These banks have built their mortgage operations on experience gained in Kazakhstan. They appear to have the basic underwriting tools in place to assess the risks involved in mortgage lending in Kyrgyzstan, having modeled their operating procedures and policies on their Kazakh parent banks.

A number of non-bank financial institutions also offer mortgage loans, but for smaller amounts. Bai Tushum, a micro-finance organization, offers loans for purchasing homes and home improvement in Bishkek, with average loans of US \$10,000 and US \$5,000 respectively.

One of the biggest problems that Kyrgyz banks face in originating mortgages and expanding their mortgage portfolios is the lack of long-term capital. Functioning capital markets are virtually non-existent, and banks have no long-term deposits and relatively little capital. Consequently, they finance mortgage lending from a combination of shorter-term deposits and equity. This has two principal implications.

First, given the short-term deposit base, banks constantly operate without an appropriate match in the maturity of assets and liabilities.⁷⁰ Moreover, since mortgages are currently offered at fixed rates for longer terms, the interest rate spread presents substantial risk to the profit and solvency of banks if the market were to demand higher interest on deposits. Banks would not be able to raise mortgage interest on existing loans, thus squeezing margins. Furthermore, banks that fund mortgage portfolios largely with short-term deposits could face a liquidity problem in the event of substantial and unexpected withdrawals.

⁷⁰ According to Kyrgyz Central Bank statistics, the average term of bank deposits is about five months.

Second, without access to sources of long-term capital, and a limited equity base, banks are unable to finance growth in their mortgage portfolios reliably, and are thus limited in how quickly and to what extent they can originate mortgages.

Given the fledgling stage of the industry, Kyrgyz banks have not yet developed an adequate mortgage product line. A typical mortgage product, as indicated in the table below, has a fixed-rate, an annual interest rate in the range of 16%-24% and a down payment requirement of up to 50% of the value of the property. In addition, a number of banks extend home improvement loans with terms of up to five years and interest rates similar to home purchase loans.

Table 3: Key Features of Residential Mortgages Offered by a Cross-Section of Kyrgyz Banks

Bank	Down payment required	Annual interest rate (US\$)	Annual Interest Rate (KGS)	Term (Years)	Prepayment Penalty
Energobank	30%	20%	20%	5	Yes
Kyrgyz Kredit	50%	24%	24%	3	No
Halyk Bank	40%	16%	16%	7	Yes
DemirKyrgyzInt'l	30%	20%	N/A	3	Yes
Ineximbank	20%	20%	24%	5	No

Source: Interviews with bank officials, early 2006

All mortgages currently offered are short-term. The maximum term available is seven years, with a prepayment penalty. This is normal at this stage of development in the market, but short-term mortgages are far less affordable or attainable for the general population. The monthly installments would consume too large a portion of monthly income for the average family. (By contrast, the average mortgage term in neighboring Kazakhstan is ten to eleven years, with a down payment requirement as low as 10%.)

Why Are Longer-Term Mortgages Important?

The affordability of mortgages increases substantially with increasing mortgage terms. The chart on the left, below, shows the monthly mortgage payment under various mortgage terms for a mortgage of \$20,000 at an annual 20% interest. As the mortgage term increases toward thirty years, the monthly payment drops drastically. The largest decrease occurs when the term increases from one year to ten. Currently, Kyrgyz banks offer mortgages with an average five-year term. At that term, the monthly payment on the mortgage mentioned above will be about US \$530, making it unaffordable for most people (given the average GDP per capita of \$430). Monthly payments on the same mortgage at a longer term, say fifteen years, would drop to \$390, placing it within reach of a larger segment of the population. However, the risk factors involved in offering longer-term mortgages in Kyrgyzstan need to be assessed.



Kyrgyz banks also face a number of internal challenges in mortgage lending. Foremost among them is the underdeveloped state of basic policies and procedures along the entire chain of mortgage lending operations (origination, underwriting, closing, servicing, and risk management). Particularly worrisome is the absence of sound risk management policies, methods, and tools with respect to mortgage lending. A few banks, especially those with Kazakh or other foreign ownership, have been able to model policies and procedures on those of their parent companies and embed them in their Kyrgyz operations.

Kyrgyz mortgage lenders could substantially improve their residential mortgage operations by implementing basic residential mortgage lending policies and procedures, standardized documentation, and internal structures to encourage larger-scale mortgage lending and servicing. It is encouraging to note that some Kyrgyz banks are beginning to implement these systems. Moreover, SME lending is relatively well developed. Many banks have adequate policies for this type of lending, many of which are transferable to mortgage lending.

Mortgage policy is currently at the individual discretion of each bank. Standardizing policy would be an important step, for a number of reasons. First, Kyrgyz banks could realize operational efficiencies and cost savings, and they would be encouraged to operate in a transparent manner. Second, it is a paramount prerequisite for the future development of the secondary mortgage market (mortgage-backed securities and/or mortgage bonds), which is a major source of long-term capital in many established mortgage markets. Finally, standardization of policy would increase transparency in the mortgage market, levelling the playing field and thereby increasing consumer confidence.

Kyrgyz mortgage lenders currently lack staff adequately trained in independent mortgage underwriting. Senior management in banks make a disproportionate number of the underwriting decisions. Often, the bank's chief executive officer or the head of the credit division will make decisions on individual mortgage loans. This is operationally inefficient, but must be viewed in the context of the relatively small volume of mortgage lending and the consequently cautious approach to it. Once mortgage portfolios begin to grow rapidly, it will no longer be feasible for top management to approve each mortgage.

Insurance Sector

The insurance sector is undercapitalized, and has yet to develop. The sector also lacks necessary links with a developing residential mortgage lending industry⁷¹. Certain insurance products required under residential mortgage lending, such as life insurance and property insurance, are prohibitively expensive. Some of the products necessary to support a developing mortgage industry do not yet exist, such as primary mortgage insurance and title insurance.

Standardized insurance policy documentation related to residential mortgages is also currently lacking. Insurance companies working with banks engaged in mortgage lending offer two insurance products:

- Life insurance, with premiums of up to 0.8% of the insured value per annum.
- Property insurance for mortgaged property, which can be as high as 0.5% of the insured value per annum.

On a US \$30,000 mortgage, this will mean annual payments of an additional \$390 for the borrower. As a rule, banks that offer mortgages require borrowers to obtain insurance policies from insurance companies approved by the bank. Furthermore, insurance policies are generally have a one-year term, while mortgage terms can be considerably longer. This carries additional risk for the lender, since there is currently no mechanism to ensure that insurance policies are renewed yearly.

⁷¹ As of January 2006, the aggregate reserves of insurance companies were about \$0.8 million (31.1 million KGS).

Appraisals

Mortgage-lending banks in Kyrgyzstan employ special staff to appraise residential property as part of the mortgage origination and underwriting process. This creates the potential for conflict of interest, raises questions about the quality and objectivity of the appraisals, and makes investment less appealing to third parties such as potential direct investors or purchasers of residential mortgage portfolios.

The situation is exacerbated by the lack of basic legislation and regulation with respect to appraisals to govern minimum standards of quality and licensing requirements. In April 2006, the government approved a set of appraisal standards for residential real estate, but it has not yet been implemented and its effectiveness cannot yet be evaluated.

In the absence of legislation, binding minimum standards may be agreed upon between an appraisal company and a financial institution, on a contractual basis, under appraisal guidelines established by the financial institution.

Real Estate Agencies

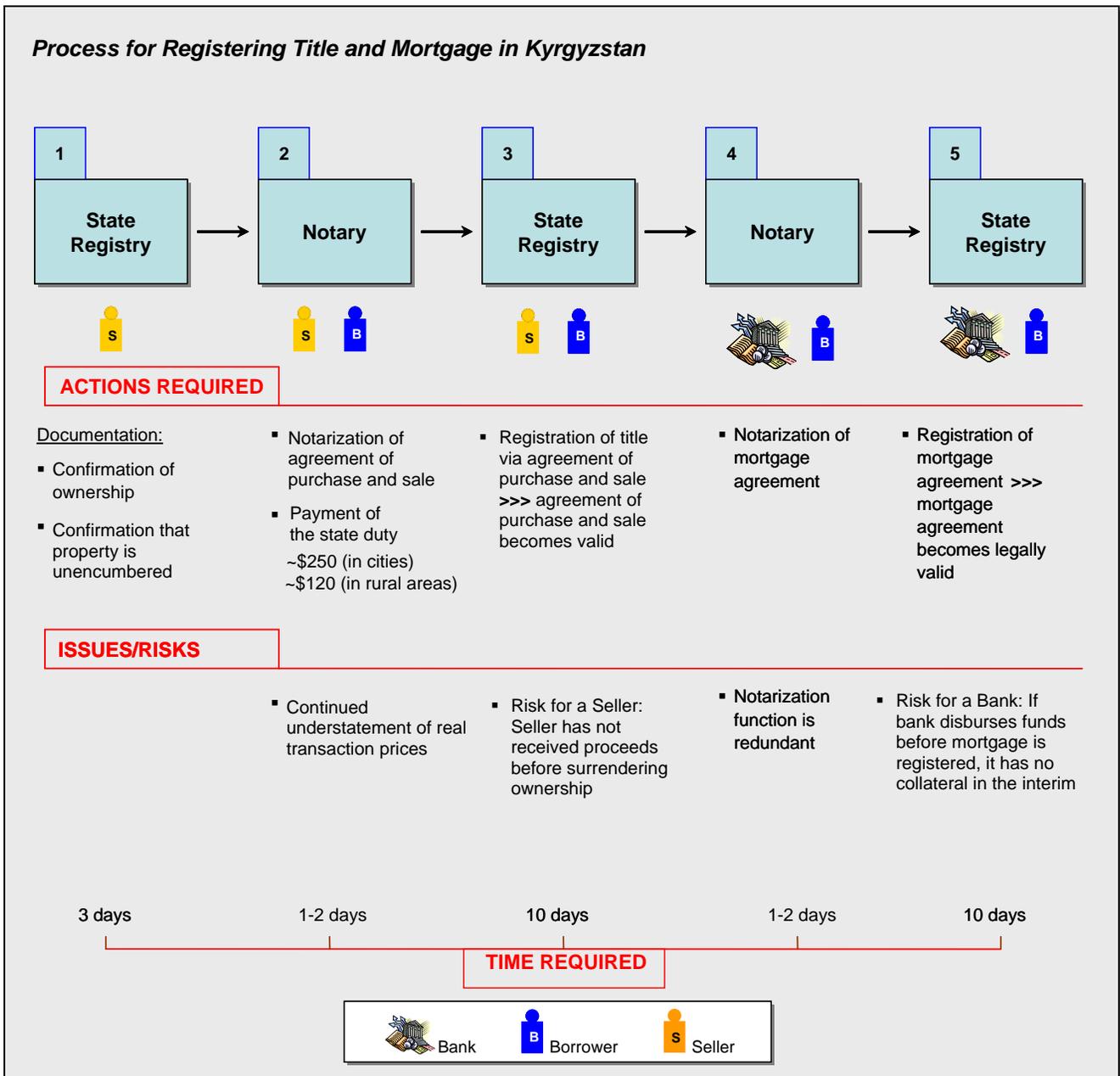
There are presently over 200 real estate agencies operating in Kyrgyzstan. Their main functions include brokering real estate purchase/sales transactions, performing appraisals and providing legal consulting services on real estate matters. Real estate agencies are regulated by the Law “On Realtor Activities” passed in 2003. A number of self-regulating professional organizations currently assist in the establishment and growth of the industry. The largest is the Association of Realtors and Professionals in the Real Estate Industry, established in 2002.

According to the Association, 60% to 70% of real estate transactions go through real estate agencies and the trend indicates their increasing involvement. Average fees range between US \$100 and US \$300, but can be as high as 3% of the sale price. At present, real estate agencies do not have links to mortgage lending services.

4.4 The Legal & Regulatory Environment

Property Title Registration Process

Banks and non-bank financial institutions may accept residential property as collateral under current legislation, and they have been doing so for mortgage and business loans. However, the process for registering mortgaged residential property is not efficient. Until recently, it was expensive, and there are risks for both seller and creditor throughout the process. Some elements of the process are redundant. The Law “On Registration” was intended to consolidate the registration system throughout the country, but the process had not yet been finalized. The chart below shows the current title transfer process for a mortgaged residential property and outlines main issues and risks, followed by a discussion of the problems.



The time needed to both transfer title and register a mortgage on a residential property ranges between twenty-five and twenty-seven days. The current fixed fees (paid in local currency) are approximately US \$10 (for individuals) to register title and an additional \$15 to register the mortgage. The government also charges the state duty for notarizing the agreement of purchase and sale, approximately US \$250 in cities and \$125 in rural areas. The cost to notarize the mortgage agreement is approximately US \$8.

It is possible to reduce the time required to register title and mortgage by five to seven days respectively by paying a surcharge on the registration fees. In this case, the fee for the full title and mortgage registration process will be double (up to US \$50).

Once title has been transferred, registering a mortgage on a property takes approximately ten to twelve days under normal circumstances and five to nine days if the surcharge is paid. Banks can reduce the time further, however, by making an unofficial payment (up to US \$50) to the local State Registry office. In this way, registering a mortgage can be accomplished in as little as one to two days.

Under the Law “On State Registration Rights on Real Property,” the public has access to information in the State Registry. The fee for retrieving information ranges from US \$1.50 to \$4. Both parties to an agreement of purchase and sale or a mortgage agreement have the right to apply to the State Registry office to obtain information.

The state registry may refuse to register a mortgage on a residential property in the following circumstances:

- The documents submitted do not comply with the requirements set out in legislation.
- The applicant is incapacitated or not mentally competent to enter into such an agreement.
- The property is already pledged as collateral and the applicant has failed to disclose that fact.

The state registry must provide written justification to the applicant if registration of a mortgage (or any other registration) is refused. A copy of the letter is placed in the registration file for the property in question. However, the state registry cannot refuse to register a mortgage if all of the following documents are submitted in correct form:

- Application form.
- Three executed copies of the mortgage agreement (one to be kept in the registry file, one to be returned to the lender with the registry office stamp and one to be returned to the borrower with the registry office stamp).
- Technical passport (plan) of the property.
- Documents confirming ownership (agreement of purchase and sale, privatization certificate).
- Applicant’s passport (or notarized shareholder documents if the owner is a legal entity)
- Certificate of registration (if a legal entity)
- Power of attorney from the owner (if the applicant is not the owner)

Escrow Accounts and Safety Deposit Boxes

Escrow accounts are used in established mortgage markets to mitigate risk. A neutral party opens an account on behalf of the purchaser. Access to this account by either the seller or the purchaser/borrower is contingent upon meeting the conditions agreed upon by the parties. When the agreement of purchase and sale is signed, the purchaser deposits the down payment funds to the “*escrow account*”. The lender deposits the mortgage proceeds to the escrow account also. The funds are held in the escrow account until the transaction is final. At closing, if all conditions have been met, the escrow account agent releases the funds to the seller.

Another solution, primarily used for cash transactions, is the safety deposit box. The borrower and the bank place the down payment and mortgage proceeds, respectively, into the safety deposit box, which is then locked. Upon successful completion of the transaction, the seller presents the registered agreement of purchase and sale indicating that the purchaser/borrower is the lawful owner of the property, and a document indicating that the borrower has pledged the property to the bank, whereupon the seller is given access to the safety deposit box.

Legal entities and individuals wishing to register a mortgage are required to provide a somewhat lengthy list of document, some of which can be difficult to obtain. Some of these documents are valid for a limited period, obtaining them can be time-consuming, and there may be additional costs to the borrower to have them notarized. For example, articles of association for legal entities must be notarized. Where the bank undertakes to register the agreement of purchase and sale on behalf of the borrower, a notarized power of attorney from the borrower is also required. To reduce time and expense, the list of documents required for registering real estate transactions could be streamlined, without compromising protections for the parties.

Time Lag between Title Transfer and Mortgage Registration

Under current legislation, registering a residential real estate transaction involving a mortgage must be done in two stages. The lender must wait until title is transferred from seller to buyer (via registration of the agreement of purchase and sale), and until the buyer has pledged the property as collateral for the mortgage (via registration of the mortgage agreement), before registering the mortgage. Only then is the underlying collateral in place to secure the mortgage loan. The time lag between title transfer and mortgage registration, which can be approximately eleven to twelve days, is therefore the biggest risk in the existing registration process. If the lender has disbursed the funds immediately upon the sale, which is most often the case in Kyrgyzstan, the mortgage loan is not secured during this period.

If the lender does not release the funds until the mortgage is registered, the seller is at risk, having surrendered legal ownership of the property without receiving the proceeds of the sale. Owners are therefore reluctant to sell property to purchasers planning to finance the acquisition through a mortgage, and banks generally end up assuming this risk. For this reason, one of the leading Kyrgyz banks knowingly assumes the risk. Another bank has mitigated the risk by requiring borrowers to grant power of attorney to the bank to complete the title transfer.

Land

According to the Constitution and Land Code of the Kyrgyz Republic, citizens and legal entities may have title to land (foreign citizens and foreign legal entities may not).

Under the Land Code, the authorized state body auctions land, or right of use of land, except in the following cases:

- State-owned land on which the buildings are already privately owned.
- Land plots that remain unsold after two auctions.

By government resolution, transfer of ownership or rights in the above-mentioned cases may be carried out through direct sale.

Under the Land Code, the state can expropriate land in certain cases. The expropriation may be based on agreement between the owner and the state. When the owner does not agree to the expropriation terms, the state body can apply for a court order, within two-months. The Land Code provides that, in this case, the state must compensate the owner for the market value of the land, buildings on the property, and all losses. The state may also provide the owner with a replacement land plot. However, this provision has not been tested because of the lack of clear normative acts for the mechanism of expropriation.

Currently, land plots in Bishkek are allocated on short-term lease (up to five years) for residential construction purposes, mainly for apartment buildings in which the units are subsequently sold. The relationship between the land-owner and owners of individual apartment units situated on such land is not clear. This is a potential risk for both the unit owners and land-lease holders.

Mandatory Notarization

By law, the agreement of purchase and sale must be notarized. There is no obligation to notarize the mortgage agreement, but all banks require it. It is important to notarize agreements of purchase and sale, but notarizing mortgage agreements is redundant.

In notarizing an agreement of purchase and sale, the notary certifies the signatures of the seller and buyer and verifies (among other things) consent of the seller's spouse. Under the Law "On Protecting the Interests of Minors," it is necessary to submit a permit obtained from the relevant state body if the owner of the residence is a minor, if the parents of a minor residing in the dwelling are divorced, or if the property to be sold is a privatized apartment.

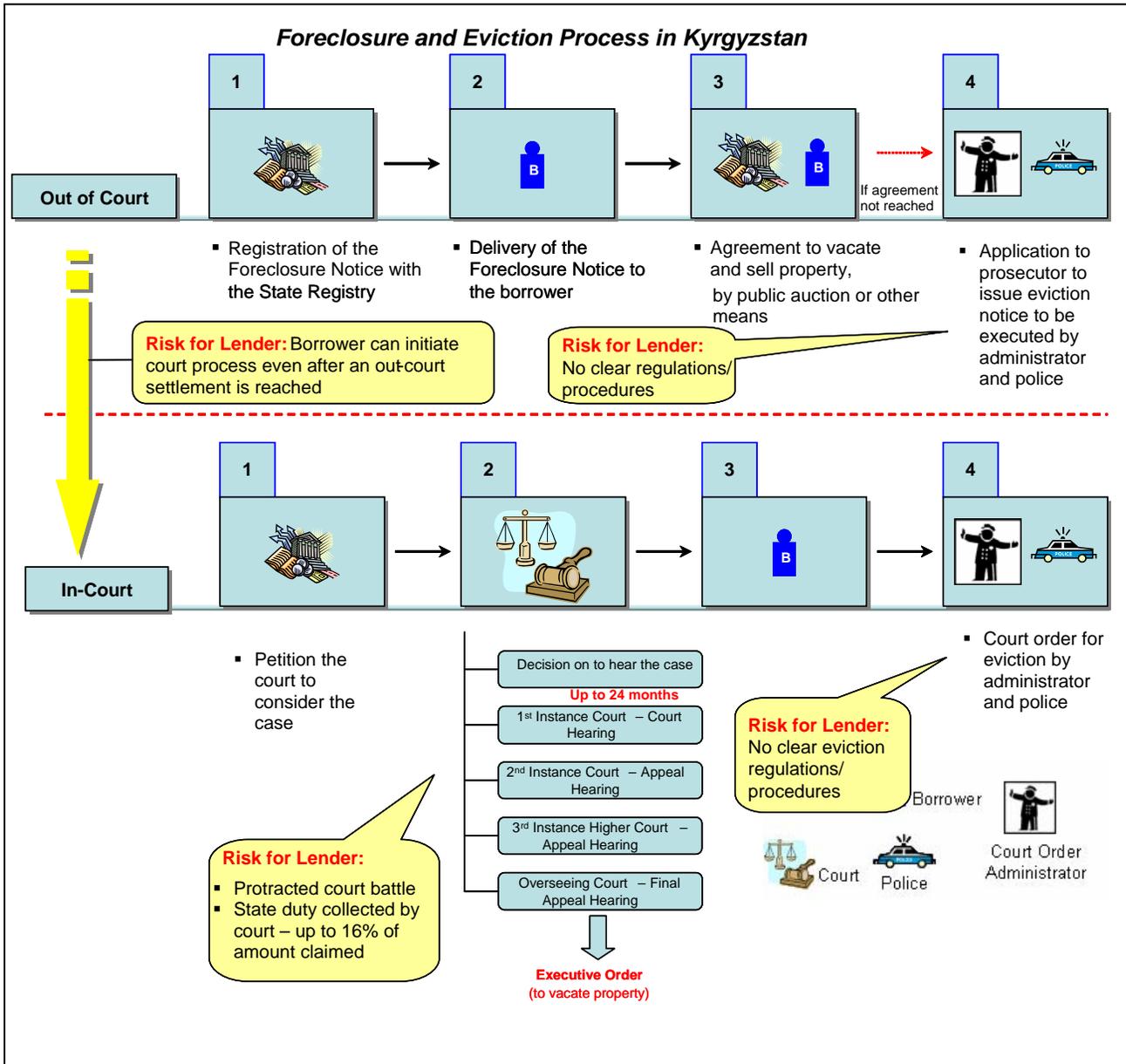
Notarizing the mortgage agreement is redundant because the notary's function at that stage (to verify the seller's ownership) is fully duplicated in the subsequent registration of the agreement of purchase and sale. By that point, the seller's right to sell the property has already been verified, before the purchaser signs the mortgage agreement, through a title search by the bank's lawyer (or through title insurance once it becomes available).

The Civil Code permits the assignment of loans. According to information provided by commercial banks, however, assignment is not common. The reasons include the terms, the costs involved in effecting an assignment, and the necessity to obtain the borrower's approval, all of which require additional detailed analysis.

Foreclosure & Eviction Process

The law provides for foreclosure and eviction, either through the courts or through out-of-court settlements. However, since the Law "On Pledge" was passed only in March 2005, the overall process remains untested and it is too early to draw conclusions as to the effect of this law on the lender's ability to repossess mortgaged property.

The chart below shows the current foreclosure and eviction process and highlights the main risks.



Court Proceeding

Under current legislation, both court and out-of-court foreclosures carry significant risks for a mortgage lender. The main issue with court proceedings, however, is the judge’s objectivity.

A court process can be protracted. If the court upholds the lender’s initial claim, four opportunities for appeal are available to the borrower, and the four possible court hearings can take up to two years. Moreover, if the court orders eviction, neither the court administrator nor the police (who are responsible for carrying out the eviction) have clear rules or procedures to follow in executing the eviction order. As a result, it is impossible to predict how long it will take effect the eviction, or whether they will be able to do it at all. In the interim, the borrower retains possession of property, making it impossible, or at least extremely difficult, for the lender to sell the property to recoup the loss.

A court foreclosure process can be very expensive. Court costs can be as high as 16% of the amount claimed. If default occurs early in the life of the mortgage, adding court costs to the amount outstanding (mortgage principal, interest and penalties) may approach or exceed the market value of the property.

Out-of-Court Settlement

The biggest risk for a lender in an out-of-court settlement stems from the right of the borrower to initiate a court proceeding after the parties have reached a settlement (or at any time during negotiations). The borrower derives this right from the Civil Code, which provides that a foreclosure must be pursued through the court if there is a “disagreement between the parties.”⁷² Although it is important to preserve the general right of either party to recourse to a court, it is also important that the courts acknowledge the legal status of an out-of-court settlement between the borrower and the lender. Otherwise, for the lender, the value of an out-of-court settlement is negated because the borrower can force the lender into a protracted and expensive court battle.

If the defaulting borrower and the lender reach a settlement, but the borrower refuses to honor it and vacate the premises, there are no clear procedures for eviction. The existing legislation allows the lender to request that the local prosecutor issue an eviction notice to be executed by the court administrator. However, the prosecutor may only issue notices where a criminal offence is involved, and not in cases of a civil dispute. Eviction notices fall under civil jurisdiction. Given these legislative contradictions, it is possible that there will be no eviction and the lender will not be able to take vacant possession of the property.

Lack of Banking Regulation with Respect to Mortgage Lending

The banking legislation does not provide specific regulations with respect to residential mortgage lending by banks. For example, banks are not regulated with respect to their mortgage portfolio risk management policies and procedures. This is understandable, given the early stage of the development of mortgage lending in Kyrgyzstan. However, given the specific features of mortgage lending, the lack of regulation is a potential risk for the economy generally, and for the banking sector in particular.

Since banks are not required to report on their mortgage portfolios to the central bank, government authorities may not have sufficient and accurate information to make policy decisions with respect to the development of the mortgage industry.

Deposit Insurance

The current legislation does not provide for government guarantee of deposits. The lack of deposit insurance makes banks less attractive to individuals as a place to keep their savings. Given that Kyrgyz banks are not adequately capitalized to fund wide-scale mortgage lending, a deposit insurance scheme (especially for longer-term deposits) will be a factor in attracting personal and business deposits to the banking system.

Credit Bureau

Introducing legislation with respect to credit bureaus would be a useful step in developing not only mortgage industry, but also consumer finance market generally. In mortgage lending specifically, credit bureaus can play an important role by providing lenders with historical information about a potential borrower’s creditworthiness. Credit bureaus can play a role in educating potential borrowers in ways to maintain a good credit rating and in how to assess their borrowing capacity.

⁷² The Civil Code does not provide the exact definition of a “disagreement” in this context.

Primary Mortgage Insurance

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 leveraged. The value of this insurance product is that it makes mortgages more accessible. Currently, Kyrgyz banks usually require a down payment of at least thirty percent. Given the relatively low level of personal savings and high real estate prices, only a very few people can afford such a large down payment. With primary mortgage insurance, banks may be willing to offer financing with lower down payment, making mortgages accessible to a substantially larger segment of the population.

Title Insurance

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 securitized mortgage portfolios by protecting them from the consequences of possible title disputes.

Appraisal Regulations

Currently there is no legislation or regulations governing residential property appraisals, and there is no licensing requirement for appraisers.⁷³ In April 2006, the government did approve new appraisal standards for real estate, which include three appraisal methods: cost-based, comparative and income-based. The standards have not been in force long enough for a meaningful assessment.

Tax Framework

A tax framework favorable to residential mortgage lending could advance the development of the industry, but Kyrgyzstan currently lacks the legislative foundation for such a framework. Two key tax elements in the development of mortgage lending are the deductibility of mortgage interest and the tax treatment of capital gains on the sale of residential property.

Mortgage interest is currently not deductible. However, a capital gain on residential property is currently not taxable. This may be considered positive, but it can also encourage speculation in the property market, driving prices out of the reach of the average purchaser.

4.5 Government Policy in Housing Finance

The government is attempting various initiatives to solve the housing problem for people with average and low incomes, including three programs being developed by the Ministry of Economy and Finance to support this segment of the population in improving their housing conditions. The fundamental features of these initiatives are that they are funded from the budget and that state bodies are involved in implementing them.

- The first program is designed to provide special financial assistance for young teachers/doctors in rural areas to improve their housing conditions. This will be in the form of a subsidy toward a down payment, to be used in conjunction with housing loans from commercial banks. There are plans to support about 1,000 young specialists through approximately US \$3.6 million in down payment subsidies.
- The second program is a home ownership savings/loan plan to assist in purchasing or building homes funded from current and future wages. Under this program, people accumulating money in an account earmarked for acquiring a home, at an authorized bank will receive state support in a form of bonus

⁷³ The government introduced a Law "On Appraisal Activity" in August 2003, but parliament has not passed it.

contribution to their savings. This method of support is planned to provide more than 3,500 families with housing credits by 2010.

- The third program entails construction of residential properties funded directly by the state. This program will be restricted to poorest segment of the population, those in most urgent need of housing.

These programs are only in the initial stages of development, and there are no clearly defined mechanisms for implementation, financing or distribution of subsidies.

One proposal has been the state subsidization of mortgage interest rates. This approach could lead to distortions in the market and could also pose risks for the government. Interest rates are dictated by market conditions, and it would be difficult to forecast the value of such a subsidy, and therefore the liability to be assumed by the government. If economic conditions were to deteriorate or interest rates increased, the government would face a larger than expected deficit or would be forced to cut expenditure in other areas. Moreover, it is very dangerous to associate open-ended interest rate risk with the proposed subsidy programs. These risks may outweigh the benefits of these programs and have an adverse affect on the developing mortgage system and the economy as a whole.

Clearly, the government is attempting to improve housing conditions and meet the increased demand for housing. However, it is important to do so without distorting the market for mortgage lending by private lenders, particularly at this stage of the development of the market. International experience has shown that housing support programs can be implemented without distorting the market. Moreover, they can contribute to the development of an effectively operating residential housing finance system.

Strategies to promote the residential mortgage market need to be comprehensive. Tackling problems in one area at a time will lead to minimal improvements and hinder the dynamic development of residential mortgage lending in the country. The government needs to implement a comprehensive legislative program to foster the development of the institutional bases for the development of an effective residential housing finance system.

4.6 Recommendations

These recommendations for building a sustainable primary residential mortgage market fall into three broad categories:

- Strengthening the enabling environment to support the development of residential mortgage lending.
- Creating conditions to encourage participants in the residential mortgage market to develop and strengthen their institutional capacity.
- Improving government housing policy.

Specific recommendations for each category are presented below.

Enhancing the Legal Environment

- Eliminate contradictions in existing mortgage legislation.
- Introduce a unified registration process so that title transfers and mortgages may be registered simultaneously.
- Enhance the legislation governing the state registration of title and mortgages on real estate.

- Enhance the normative legal acts of the National Bank of the Kyrgyz Republic regarding the regulation of financial risk in connection with the execution of residential mortgages.
- Develop and adopt a law regulating the operation of credit bureaus.
- Amend existing legislation to provide for functioning of “escrow accounts”.
- Develop and adopt a law or set of regulations on deposit insurance.
- Develop and adopt a law regulating mortgage-backed securities and a law regulating the operation of the secondary residential mortgage market.

Mortgage Market Infrastructure and its Further Development

Establish Effective Mortgage Lending Practices in the Banking Sector

- Develop and introduce unified standards and procedures for residential mortgage underwriting, closing, servicing, and guidelines for risk management.
- Develop and introduce standard residential mortgage documentation.
- Develop and introduce a broader mortgage product line.
- Improve the residential mortgage lending skills of bank staff.

Strengthen Appraisal Activity

- Develop effective monitoring and certification systems for professional residential property appraisers.
- Improve the skills of appraisers, based on standardized appraisal practices, through specialized training courses.

Strengthen Cooperation between the Insurance and Residential Mortgage Lending Sectors

- Broaden the line of insurance products to include those necessary for the further development of residential mortgage lending.
- Develop and introduce standardized insurance products and standardized insurance documentation to be used in residential mortgage lending, including a standard insurance contract and insurance policy.

Encourage Development of the Secondary Mortgage Market

- Consider the possibility of creating a financing agency for secondary residential mortgages.
- Develop and introduce mechanisms to guide the activities and operations of the secondary mortgage market agency, including the introduction of standardized procedures and effective mechanisms for cooperation with partner banks.

Improve Government Housing Policy

- Develop a comprehensive state housing policy to create and develop a national system of housing finance.
- Implement plans to draft and introduce the set of laws and normative acts necessary for the development of the residential mortgage industry.
- Create a tax framework that fosters growth in residential mortgage lending.
- Develop effective policies and mechanisms to guide state support for low-income groups in improving their housing conditions.
- Reform the residential construction sector by introducing minimum acceptable quality standards.
- Increase public awareness of residential mortgage lending through public information programs.

5. TAJIKISTAN

5.1 Economic Overview

Tajikistan has made considerable progress in improving macroeconomic conditions over the last five years. At present, the country is experiencing consistent economic growth. Moderate inflation rates, growth in macroeconomic indicators, real income growth for the population, increases in production volumes and efficiencies in key industries and agriculture in the recent past all these are evidences of economic stabilization and development. Positive changes in the country's macroeconomic profile (rising incomes, low inflation and a stable currency), coupled with continued growth, are crucial prerequisites for the successful structure and development of a residential mortgage lending system.

The table below illustrates trends in key economic figures for the period 2000 to 2005.

Table 1: Key Macroeconomic Indicators for Tajikistan, 2000-2005

	2000	2001	2002	2003	2004	2005
GDP (US\$, billions)	0.99	1.1	1.2	1.6	2.1	2.3
GDP growth (%)	8.3	10.3	9.1	10.2	10.6	8.1
GDP per capita (US\$)	189	203	220	236	310	334
Inflation (%)	60.6	12.5	14.5	13.7	5.6	7.1
Foreign direct investment (US\$, millions)	25.3	29.5	36.07	31.65	22.36	54.5
Somoni/US\$ exchange rate	1.83	2.37	2.76	3.06	2.97	3.12
Inbound money transfers (US\$, millions)	10	50	78.4	253.6	433.4	660
Inbound money transfer as % of GDP	1.0%	4.5%	6.5%	15.9%	20.6%	28.7%

Sources: International Monetary Fund Country Report No. 06/1 Jan. 2006 (*Poverty Reduction Strategy Paper – Second Progress Report*); web site of the National Bank of Tajikistan (www.nbt.tj).

GDP growth has averaged slightly less than 10% per annum for the past five years. Real GDP grew by 8.1% in 2005, a slight drop from 10% in 2004. Economic growth has been driven mainly by the export of raw materials (aluminum and cotton). More than half of the GDP growth is based on the aluminum industry output. Output in other industries comprised approximately 18% to 20% of GDP, with agricultural output making up approximately 17% to 22% of GDP (more than one-quarter of which is comprised of cotton fiber).

Average wages in the country continue to be low, despite notable increase in absolute numbers in recent years (local wages are also augmented, to a great extent, by money transfers from abroad). Official average monthly wages increased from US \$14 in early 2000 to US \$98 as at September 2005.⁷⁴ However, real personal income and consumption growth are even higher than official wage statistics indicate. Several factors play a role in this discrepancy. First, employers engage in certain practices (funds accumulation and insurance schemes) that allow employees to earn income in excess of their official salaries. Second, cash remittances from migrant workers from outside the country also boost family incomes. The volume of remittances from migrant workers in 2005 alone totaled US \$660 million, which represented 28.7% of GDP.

The country is also characterized by low unemployment levels, which average around 2%. This is related to labor migration to neighboring countries by a significant portion of the working population.

The level of foreign investment in the country remains low compared to other CIS countries, with average direct foreign investment inflows not exceeding 2% of GDP from 1998 to 2003. The low level of foreign

⁷⁴ Source: National Bank of Tajikistan. Website: www.nbt.tj.

investment can be attributed to the country's relative isolation and the post-conflict environment. However, the situation has improved in the recent past, with investment activity in the country's energy system (hydroelectric power) and aluminum industries.

Inflation trends in the recent past have shown a marked decline, with the inflation rate standing at 7.1% in 2005. The main factors influencing the inflation rate are external, in that prices for imported foreign manufactured consumer goods, and especially energy, are set outside of the country. Strong domestic demand, coupled with increases in utility tariffs, will force inflation up in 2006. This will mean that the National Bank of Tajikistan (the central bank) will face continued pressure from the IMF to maintain a tight monetary policy, both to keep inflation under control and to ensure currency stability.

Remittances by Migrant Workers⁷⁵

Remittances have become an important source of economic growth for the country, and this element ranks second, just after aluminum production, as a factor in GDP. Although official statistics do not give a complete picture of the volume of remittances, a recent World Bank Report, *Enhancing the Development Impact of Remittances*, indicates that the true value of remittances ranges from 21% to 28% of GDP.

Estimates place the number of migrant workers anywhere from 421,000 to 1.2 million. Remittances exhibit a strong seasonal tendency, reflecting the type of employment migrants have obtained in host countries, which is mainly construction-related.

The World Bank Report states that 15% of remittance recipients used the funds to make home repairs. This use of funds ranks third, behind consumption and education/health, and shows the importance or necessity (or both) of home maintenance. Further, the World Bank Report indicates that the income of the migrants, upon returning to Tajikistan, increased threefold over pre-migration earnings (average post-migration income of US \$91 per month, compared to \$30 pre-migration and \$274 while away). Approximately 40% of income earned while abroad (US\$110 per month) is remitted to family members living in Tajikistan.

Remittances by migrant workers must not be overlooked in considering specific factors that will influence the growth of residential mortgage lending in Tajikistan. This is so for the following reasons:

- Remittance income could play an important role in determining how repayment capacity should be calculated for potential mortgage borrowers. The question is how this income should be taken into consideration (if at all) in determining capacity to repay a mortgage loan where a portion of family income is from remittances. IFC-sponsored mortgage lending programs in a number of other developing countries, such as Cambodia, have faced this issue. As a result, the residential mortgage policies and procedures developed for local banks have included the latitude to use remittance income in the calculation of borrower repayment capacity, as long as these payments were verifiable and likely to continue.
- Even if financial organizations that offer residential mortgage loans decide not to take direct remittance income into consideration for specific clients, they will need to establish risk management policies to minimize the systemic risk of a decline in overall remittances. It is important to note that remittance income plays a large role in driving the increase in consumption in the country.

⁷⁵ Much of the information on remittances was obtained from the World Bank report *Tajikistan Policy Note: Enhancing the Development Impact of Remittances*, January 2006.

5.2 Overview of the Housing Sector

*Housing Stock*⁷⁶

Total housing stock stood at 59.4 million square meters at year-end 2005, of which 42.8% was located in urban areas and 57.2% in rural areas. Population growth has outpaced growth in the construction of new residential housing units, creating an imbalance between housing demand and supply. From 1998 to 2005, the population increased by 16.55%, but growth in housing stock, as measured by floor space, was only 8.92% over the same period.

Dwelling area per capita at the end of 2005 was 8.7 square meters per capita, which is 27.5% less than the norm of 12 square meters per capita established by the state.

The table below illustrates the main trends in housing stock for the period 1998 to 2005.

Table 2: Residential Housing Trends in Tajikistan, 1998-2005

	1998	1999	2000	2001	2002	2003	2004	2005
Total housing stock (m ² , millions)	55.2	55.3	56.1	54.4	55	56.9	57.6	59.4
State-owned housing stock (m ² , millions)	11.1	11.3	9.8	6.7	5.5	5.3	5.1	5.7
Private housing stock (m ² , millions)	44.1	44	46.3	47.7	49.5	51.6	52.5	53.7
State-owned housing (% of total)	20.1%	20.4%	17.5%	12.3%	10.0%	9.3%	8.9%	9.6%
Privately owned housing (% of total)	79.9%	79.6%	82.5%	87.7%	90.0%	90.7%	91.1%	90.4%
Dwelling area per capita (m ²)	9.4	9.1	9.1	8.5	8.5	8.6	8.6	8.7

Source: State Committee on Statistics and Housing Municipal Services

Privately owned housing stock is currently over 90% of the total. For the period of 1991-2005 almost 13 million square meters of housing stock (over 245 thousand units) was privatized. It is important to note that, in 2005, residential construction grew at a rate of 3.1%, which is significant compared to previous years. Nevertheless, as a result of increased demand for new housing and depletion of existing housing stock (much of which was built during the Soviet era) through wear and tear, even greater residential construction volumes are needed in order to correct the supply/demand imbalance.

Housing Dynamics/ Demand for Housing

The trends in Tajikistan are similar to those in other countries in the region:

- Deterioration of the housing stock as the state withdraws from direct ownership and maintenance and leaves the new private owners responsible for upkeep.
- Lack of new construction to meet the demand for housing.
- Increasing internal migration from rural areas to urban centers, creating further pressure on the supply of urban housing.

⁷⁶ Data in this section was obtained from official publications of the State Statistics Committee of the Republic of Tajikistan (Khochagy Manziliyu Kommunal), a state agency.

Almost all (96%) of the Tajik housing stock was built during the Soviet era, and does not correspond to present quality and comfort standards. After the period of massive housing privatization, the government failed to introduce any mechanisms for the continuing repair and maintenance of the common areas of privatized apartment buildings and did not provide funding for it. A limited state budget, coupled with government spending on more essential social services, has left little room to pay for housing rehabilitation. Many new unit-owners do not have the financial means to pay for the repair and maintenance of their own apartments, and they lack awareness of collective mechanisms (such as condominium or housing associations) and the skills necessary to obtain the financing and knowledge to operate them.

This situation is expected to continue for the foreseeable future. However, it may be mitigated by further GDP growth, which will lead to higher individual incomes and increased tax revenues for the state. In addition, the situation may also improve through the introduction and support by the state of new mechanisms to maintain and rehabilitate existing housing stock, including the establishment of housing associations and/or cooperatives, which may help solve problems in obtaining financing for them. Such associations are currently operating as pilot projects only. An absence of the supporting legislation necessary to regulate the establishment and activities of housing associations has so far hampered widespread introduction. It is important to note that housing associations may aid in the development of residential mortgage lending. The risks to the lender can be reduced, as collateral quality would improve through the rehabilitation and regular maintenance of mortgaged properties and their common areas in the presence of such associations.

Lack of funding to finance necessary repairs and supporting infrastructure has resulted in increasingly decrepit housing stock. However, housing in the capital and larger cities is generally in better condition than in rural regions and may be accepted as collateral by local commercial banks. The lack of new residential construction translates into decreasing collateral quality, which means increased risk to residential mortgage lending organizations. Residential mortgage lending institutions will thus mitigate the higher risk through higher interest rates and higher down payment requirements or by declining to fund the purchase of such properties altogether.

New residential construction has not kept pace with the overall population increase or the net internal migration to Dushanbe. One reason for this is the diminishing role of the state in housing construction. The other is a lack of effective mechanisms by which private financial resources can be directed to this sector. At present, available amounts of financing would fall short meeting the financing needs of housing construction sector at such a level, which will satisfy the existing demand from the population.

In the absence of any state programs for stimulating the industry, the sector has just started to rebound. However, over 90% of completed housing construction was accomplished either by private individuals or by a few private construction companies. It is worth noting that current legislation and regulations provide for a relatively straightforward process for allocating land for housing construction and issuing the relevant permits. In practice, however, as is common in most Central Asian countries, there are significant administrative barriers in the procedure for obtaining land for residential development and difficulties in obtaining the documentation required.

In September 2005, the state approved new procedures governing the distribution of land for residential construction purposes. These procedures apply to both individuals and companies who wish to acquire land. According to the new procedures, the overall time needed to transfer land is three months. The associated costs depend on the actual amount of work performed by the relevant state agency in making the assessment as to whether the land plot can be transferred and also on any number of other additional official payments (e.g., certain fees). At present, it is quite difficult to get a land plot for housing construction given the high demand against the limited supply of land for such purpose.

The residential construction market is just starting in Tajikistan, but is showing some early positive trends. The number of residential construction companies has been increasing considerably (three were operating in

Dushanbe last year). However, these companies focus mainly on luxury residential units for the wealthier segment of the market since these projects tend to have the highest profit margins. According to information from these construction companies, the average cost of one square meter of luxury residential space is US \$600, compared to \$400 per square meter for mid-range residential space.

The majority of construction companies engage in residential construction on a small scale, partially because of the lack of funding opportunities to finance the construction of larger, multi-unit apartment buildings. Banks are unable or unwilling to extend credit for such projects because, generally, collateral requirements cannot be met.

Construction companies are licensed by the Tajik State Committee for Construction and Architecture. Rules governing the licensing of construction companies are contained in the Law “On Licensing Activities” passed in 2004 and in licensing regulations passed in August 2005.

Currently, the most residential construction is taking place on a shared financing basis, where future owners co-finance the construction. However, there is no legislation to regulate the relationship between the developer and the future owner, which creates potential risks for future owners, especially related to the possibility of non-performance or fraud on the part of the developer. Risks for the developers may include irregular cash-flows from the future owners or their inability to pay for their apartments.

The lack of the financing required for capital-intensive construction projects is due to the higher risk inherent in construction loans, which, as mentioned earlier, is related to the lack of adequate collateral coverage for such loans. Most construction companies do not have the liquid collateral required by banks. Further, neither the land nor the unfinished apartment units may be used as collateral. At a minimum, the higher risks associated with residential construction loans will result in higher interest rates to the borrower. This problem issues have more of a legislative application and are closely related to a lack of any regulation on these matters in the legislation.

Loan terms for residential construction in Dushanbe average two to three years. Substantial equity funding from the developer is required to start construction, which potential developers generally do not have. Given the potential for better returns on shorter-term commercial lending, and given the lack of experience in the real estate financing (including the lack of efficient risk assessment instruments for real estate lending), commercial banks are reluctant to finance residential housing construction projects. Moreover, the costs in the residential construction business are very difficult to predict, especially in an environment where inflationary pressures may still exist, and the construction business has had a reputation, including in industrialized countries, for being non-transparent.

The table below shows trends in new-home construction from 1998 through 2005.

Table 3: New Residential Construction in Tajikistan (units), 1998-2005

	1998	1999	2000	2001	2002	2003	2004	2005
Private dwelling completions	4,000	4,200	5,400	5,500	5,600	6,700	6,329	6,679
Public (state) dwelling completions	100	300	200	200	300	500	350	377
Total Residential Completions:	4,100	4,500	5,600	5,700	5,900	7,200	6,679	7,056

Source: State Committee on Statistics and Housing Municipal Services.

A total of 2,327 state-owned residential dwellings were completed in the last seven years. This highlights the negligible role of the state in solving housing problems for vulnerable groups of population.

The table below shows the total floor area of residential construction from 1998 through the first half of 2005.

Table 4: New Residential Construction in Tajikistan (floor space), 1998-2005

	1998	1999	2000	2001	2002	2003	2004	2005
Total area completed (m ²)	226,900	224,900	245,500	275,300	331,600	364,900	440,300	441,500

Source: State Committee on Statistics and Housing Municipal Services

Only a small portion of the new home construction was in Dushanbe city limits. The table below shows new apartment construction in Dushanbe over the same period:

Table 5: New Residential Construction in Dushanbe (floor space), 1998-2005

	1998	1999	2000	2001	2002	2003	2004	2005
Total residential completions (m ²)	200	10,900	18,900	14,900	23,000	62,700	103,500	54,900

Source: State Committee on Statistics and Housing Municipal Services

A total of 4,441 residential dwellings were built within Dushanbe from 1998 through 2005. The city's official population was 630,000 at the end of 2004. This figure may be somewhat misleading, however. Unofficial estimates place the population in the region of 1,000,000, owing to internal migration to the city by people seeking higher incomes. In any case, according to the state standard of twelve square meters per capita, 4.8 million square metres of residential dwelling space (or just less than 100,000 apartments) would have to have been built to accommodate the influx. Less than half of that has been built nationwide since independence, which points to a severe housing shortage.

The government does not view housing as the highest priority, and must deal with more pressing needs, including healthcare and education. It has instituted a poverty reduction strategy to deal with these issues, and plans to increase spending in these two areas in 2006 and 2007. However, a separate housing development strategy has not been developed to meet the housing needs of vulnerable segments of the population.

Housing Affordability

Residential real estate prices in Dushanbe have doubled in the last five years. Current prices per square meter range from US \$550 to \$1350, depending on the neighborhood and the number of rooms in the apartment. Two and three-room apartments are the most expensive per square meter, because larger apartments are too expensive to maintain, and one-room apartments are too small for the typical family.

A ratio of price per square meter to GDP per capita was used in the analysis of the project countries to determine and rank the affordability of housing (affordability increases as the coefficient decreases). The average coefficient for Dushanbe is 2.84, ranging from 1.6 to 4.04 depending on the city district. Housing in Dushanbe is the least affordable among the major cities in the project countries.

Affordability is becoming less of an issue for the richest segment of the population. This is evident in the growth in apartment sales in Dushanbe from 2000 to 2004. During this period, apartment sales increased by 43%, from 8,913 units in 2000 to 12,736 units in 2004. This trend points to the development of the residential real estate market in the city and an increase in liquidity in residential real estate. Ultimately, the increased activity will improve living conditions over all, as more housing, adequate to the needs of the general population, will be available for purchase. The table below shows the growth trend in apartment sales:

Table 6: Apartment Sales in Dushanbe

	2000	2001	2002	2003	2004
Apartments sold	8,913	7,744	11,800	11,955	12,736
Turnover*	5.24%	4.56%	6.94%	7.03%	7.49%

* *Apartments sold as a percentage of total existing apartments.*
 Source: *State Committee on Statistics and Housing Municipal Services.*

The turnover of 7.49% in 2004, does indicate that a segment of the population, though perhaps not large but continuously growing, is able to afford an apartment purchase. This is especially noteworthy given the almost complete lack of mortgage lending in the country. The funds for these purchases came from private loans or from the buyer's savings.

Estimate of Demand for Mortgages

Considering the surprisingly healthy turnover of apartments in Dushanbe, and given that the vast majority of these sales were cash transactions, a clear demand for mortgages exists. Further, since a significant portion of remittances is spent on home improvement, a demand for home renovation loans can also be inferred.

The potential demand is difficult to quantify with precision, since there was no any survey data available on potential home buyers and renovators in the country. Moreover, such survey is difficult to organize. However, residential mortgage loan demand can be estimated using GDP figures and the experience in other countries with mortgage markets at a similar (or slightly more advanced) stage of development. Assuming that mortgages are 2% to 3% of GDP, and that GDP will grow to US \$3 billion by 2010, a conservative estimate for the size of the mortgage market in 2010 is US \$60 million to \$90 million (the size of the mortgage markets in the other project countries was estimated in the same manner).

5.3 Institutional Capacity for Residential Mortgage Lending

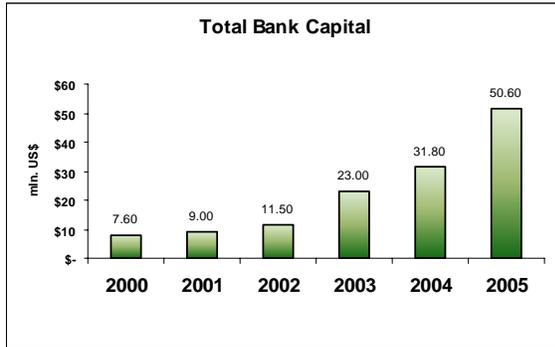
The infrastructure required for a functioning mortgage lending system remains underdeveloped. Despite strengthening and development in the financial services sector in recent years, there are no specialized residential mortgage lending institutions or housing savings schemes, and financial institutions do not yet offer any type of residential mortgage product. Further, other participants in the mortgage lending system, such as appraisers, realtors and credit bureaus, are likewise underdeveloped or nonexistent. The participation of insurance companies in the mortgage system is also insignificant.

Banking Sector

As of January 1, 2006, eleven commercial banks and one branch of a foreign bank were operating in Tajikistan. The non-banking financial sector included seven credit unions, six specialized non-banking financial institutions (thrift associations) and thirty microfinance institutions.

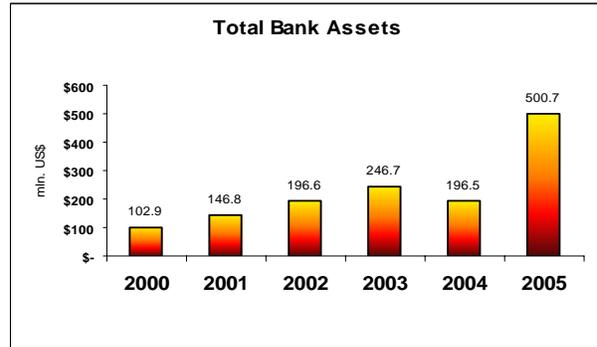
The development of the banking sector is quite dynamic, owing mainly to strong macroeconomic growth. The strengthening and growth in the banking sector in recent years is evident in the increase in banking sector capital, deposits (especially from individuals) and lending volumes.

Chart 1



Source: National Bank of Tajikistan

Chart 2



Source: National Bank of Tajikistan

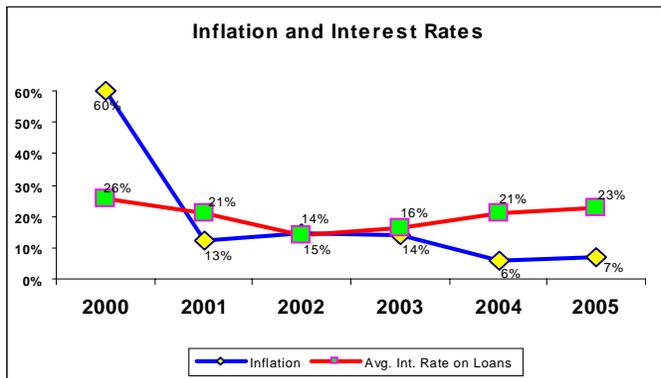
The aggregate paid-in capital of banks has increased more than sixfold since 2000, to US \$50.6 million in 2005. Growth has accelerated in the recently, from almost US \$32 million in 2004 to \$58 million as at February 1, 2006. The last quarter of 2005 alone saw an increase of US \$5.2 million owing to injections of new capital in three banks, including US \$2.2 million in new capital from foreign sources (EBRD and an American investment fund invested in two local banks: Eskhata Bank and First MicroFinance Bank).

Aggregate bank assets dropped in 2004, after strong growth in the four prior years. This was due to a decrease in loans outstanding to the cotton industry. By the end of 2005, however, bank assets had rebounded to exceed US \$500 million. Lending to the private sector has been increasing, and the overall volume of loans outstanding increased from 3.3% of GDP in 2003 to 17.9% of GDP in 2005.⁷⁷

A decrease in inflation in the recent past led to a decrease in loan interest rates, from 26% per annum in 2000 to 21% in 2004.

Low and stable levels of inflation are considered a necessary for the development of an effectively functioning residential mortgage market. The chart below illustrates recent trends in inflation rates and loan interest rates.

Chart 3



Source: National Bank of Tajikistan

Overall growth in population incomes has resulted in an increase in personal savings deposits, which is the main reason for the increase in bank liabilities. The increase in bank deposits is also related to increased consumer confidence in the banking system and the introduction of deposit insurance for individuals in 2003. Following a presidential decree establishing the terms for legalizing undeclared funds accumulated by

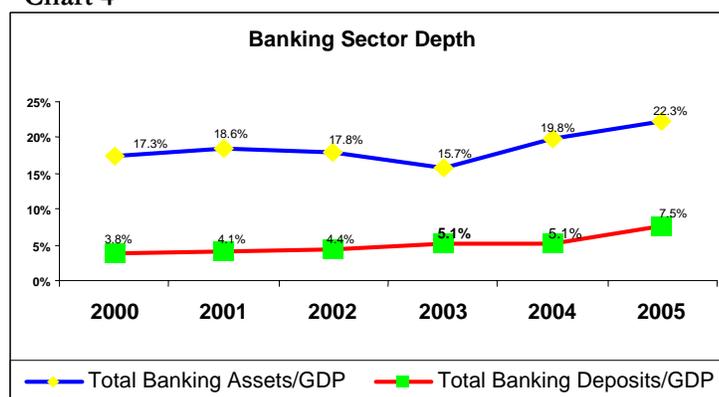
⁷⁷ Source: National Bank of Tajikistan. Credit volumes include futures contracts.

individuals, and the passage of the law granting amnesty to citizens with respect to these funds, almost US \$50 million was brought in to the banking system.

Furthermore, under the Law “On Guaranteeing Individual Deposits,” participating banks (on a voluntary basis) establish a guarantee fund, and allocate 1% of the amount of total deposits by individuals as insurance premiums. The Law establishes progressive scheme in insuring deposits:

- up to 250 Somoni (approximately US \$78) covered at 100%
- up to 2,500 Somoni (approximately US \$780) covered at 90%
- over 2,500 Somoni (approximately US \$780) covered at 70%

Chart 4



Source: National Bank of Tajikistan

In 2005, the overall volume of bank deposits increased 1.7 times over 2004, to US \$172.8 million.

The table below shows aggregated data on local and foreign currency deposits in the country’s banking system.

Table 7: Deposits in the Tajik Banks (millions)

	2002		2003		2004		2005	
	Somoni	US\$	Somoni	US\$	Somoni	US\$	Somoni	US\$
Total deposits	147.4	53.3	242.5	79.2	291.6	98.2	539.2	172.8
Local currency	73.6	26.6	117.8	38.5	124.8	42.0	183.6	58.8
Foreign currency	73.8	26.7	124.7	40.7	166.8	56.2	355.5	113.9
Deposits by legal entities	129.1	46.7	166.7	54.5	183.0	61.7	254.7	122.3
Local currency	68.5	24.8	105.669	34,517.0	106.073	35,709.0	139,571	49.9
Foreign currency	60.5	21.9	61.020	19,932.0	76.956	25,907.0	115,148	72.4
Deposits by individuals	18.3	6.7	75.8	24.8	108.6	36.6	129.5	50.5
Local currency	5.1	1.8	12.1	3.9	18.7	6.3	23.6	8.9
Foreign currency	13.3	4.8	63.7	20.8	89.9	30.3	106.0	41.6

Source: National Bank of Tajikistan.

As mentioned, bank capital has increased significantly over the last five years, reaching US \$89.6 million in aggregate paid-in capital as of April 1, 2006.⁷⁸ Bank capital will be one of the main sources of funding for residential mortgage lending (along with individual and business deposits). However, this amount of capital will not be sufficient to fund the expected residential mortgage volumes. Furthermore, the deposit base, primarily short-term (up to one year), will not suffice to fund mortgage lending without exposing the banks to significant liquidity risk because mortgage lending requires long-term resources.

The Role of SME /Micro Lending

In 2003, in conjunction with the European Bank for Reconstruction and Development, IFC established a credit facility for entrepreneurs: the Tajikistan Micro and Small Enterprise Finance Facility. Four commercial banks are participating in the facility. By October 2005, over 7,200 loans had been disbursed. The total was in excess of US \$20 million, of which nearly 80% was for loans under US \$5,000.⁷⁹ Under the program, 207 bank lending officers have already received training.⁸⁰ The success of this program indicates that local banks could cooperate effectively with international financial institutions in introducing new products, including residential mortgage loans.

Capital Markets

An institutional capital market infrastructure is in place in Tajikistan (stock exchange, registrars and depositaries of securities), but the stock market remains underdeveloped. Capitalization and the volume of turnover in the stock market are insignificant when compared with other developing countries. Capitalization of the stock market in 2004 was approximately US \$49.12 million.

The majority of securities transactions are carried out in the debt market, consisting mainly of medium and long-term government bonds, including about US \$64.83 million in twenty-year government bonds and US \$8.17 million in promissory notes issued by the Ministry of Finance.

The liquidity of equity issues is limited to several companies, and the majority of share transactions are carried out directly between purchasers and sellers, bypassing the stock exchange. As at 2003, the securities registrar and the Ministry of Finance had registered only 1,500 equity transactions.

The market for corporate debt securities is also underdeveloped. Corporate debt securities issued in 2004 totaled only US \$18.52 million.

The development and strengthening of the stock market is of great importance in providing additional sources of business financing. The creation of an efficiently functioning capital market to attract long term and relatively cheap resources from institutional and private investors will be a key factor in the development of future funding sources for mortgage lending. Further, capital markets are an efficient means to diversify risk, both for investors and for banks.

Mortgage Lending in Tajikistan

The mortgage market in Tajikistan has barely gotten off the ground. As a percentage of GDP, the mortgage portfolio is about 0.03%, and mortgage debt per capita is less than one Euro.

At present, only three domestic lenders have experience in residential mortgage lending. Moreover, mortgage lending by these banks was, in some cases, a one-time experiment to test new product. In other cases, mortgages were financed through the State Program on Provision of Housing for State Employees and Judges. In 2004, the value of mortgage transactions was only US \$118,000. Financing through the State Program on Provision of Housing to State Employees and Judges totaled US \$318,580.

⁷⁸ Source: National Bank of Tajikistan. Website: www.nbt.tj.

⁷⁹ Source: EBRD website.

⁸⁰ Ibid.

Furthermore, banks do not have internal policies or procedures to deal specifically with residential mortgage lending. The internal banking structures for underwriting, closing, and servicing mortgage loans, and the associated internal risk management policies and procedures, are either nonexistent or too rudimentary to allow for mortgage lending on a medium to large scale. However, these procedures were put in place for SME and micro loans in the four banks mentioned earlier, as a prerequisite for receiving SME/micro loan funding from international organizations.

The relatively high risk in residential mortgage lending in the country is exacerbated by the inadequacy of the laws and regulations related to repossession of residential property used as collateral for mortgage loans, and by the lack of internal risk management mechanisms in commercial banks. Risk management for residential mortgage lending in commercial banks is absent or not sufficiently developed to handle residential mortgage lending on a wide scale, and banks do not have staff qualified to analyze the risks associated with longer-term residential mortgage loans.

However, the four Tajik banks associated with the EBRD SME/micro lending program are now developing credit skills related to the repayment capacity of small, retail clients in a non-transparent environment (i.e., high incidence of unofficial salary payments). This is encouraging, in that many of the skills required to analyze the creditworthiness of potential mortgage clients can be transferred from this type of lending.

The table below shows the residential mortgage loans offered by the three local banks in conjunction with the state program mentioned above. These loans are quite expensive and have very short terms. Although the banks claim to offer terms of up to ten years, in practice, clients can expect terms of only two to three years. Even those terms are only available on a very limited scale, since the absence of capital and lack of internal competency severely constrain residential mortgage lending generally.

Table 8: Key Mortgage Loan Conditions in Tajikistan

	Maximum Loan Amount (US\$)	Minimum Down Payment (%)	Interest Rate (%)	Term (Years)	Maximum Debt Service Ratio (%)	Early Repayment Penalty
Vnesheconombank	17,000	40	25	3	50	N/A
Agroinvestbank	70,000	N/A	20	10	N/A	N/A
Amonat Bank	N/A	N/A	N/A	8 to 10	N/A	N/A

Source: IFC Interviews with local banks.

As in other project countries, one of the key issues hindering the further development of the residential mortgage sector in Tajikistan is access to longer-term funding resources. Potential growth in the industry is further hampered by low (albeit increasing) capitalization in the banking system and by poorly functioning capital markets.

Realty Services Sector

The realty services sector is in the initial stages of development, but it is making rapid progress. In the past year alone, ten new realty companies were established. Just one year ago, only two were operating. It is important to note that there are currently no specialized laws to regulate realtor activities, and the sector lacks transparency, standards, methods and linkages to residential mortgage providers. To further enhance an effective and transparent realty services sector and increase the level of professionalism, it is essential to introduce a self-regulating professional body to license realtors.

Credit Bureaus

The country currently lacks legislation to regulate the creation and operation of credit bureaus. In the absence of this legal base, and in the absence of demand, credit bureaus do not exist in the country.

The lack of credit history information makes residential mortgage loans riskier, and thus more expensive. The National Bank of Tajikistan understands the importance of a functioning credit bureau, and it will actively develop supporting legislation to create one.

Insurance Sector

The insurance sector is underdeveloped and weakly capitalized, and a limited range of insurance products is presently offered. Moreover, the insurance products offered are among the most expensive in the former Soviet Union. The insurance sector is poorly integrated into the broader financial sector, which is evident in the lack of standard insurance products necessary to redistribute and lessen risk to lenders. Property insurance is available in principle, but is not commonly purchased except when banks require it for property used as collateral. Life insurance and title insurance are not generally available due to the lack of demand. In addition, insurance for mortgage lending to minimize risk is nonexistent.

Real Estate Appraisal Sector

The country does not have an independent appraiser institute, and, in general, the industry is not regulated. Appraisal standards have just been introduced, but they are not specific to residential appraisals. Without independent appraisal services, banks have serious problems related to the objective assessment of residential property value.

Under these conditions, banks will assess properties themselves. This practice has the potential for conflict of interest. Moreover, banks have not developed the internal capacity to perform this function. This issue will become more important when Tajik banks seek external financing for their residential mortgage portfolios.

Legislation was passed in May 2006 in an attempt to regulate appraisal activities and set minimum industry standards. These acts established guidelines to be followed by all appraisal firms and set out qualification requirements for professional appraisers. Nevertheless, the legal status of independent appraiser institute is not defined in that legislation.

The Tajik parliament is currently reviewing the draft Law “On Appraisal Activity,” aimed at filling remaining regulatory gaps to stimulate the development of appraisal activity, which is necessary for a stable and reliable residential mortgage market.

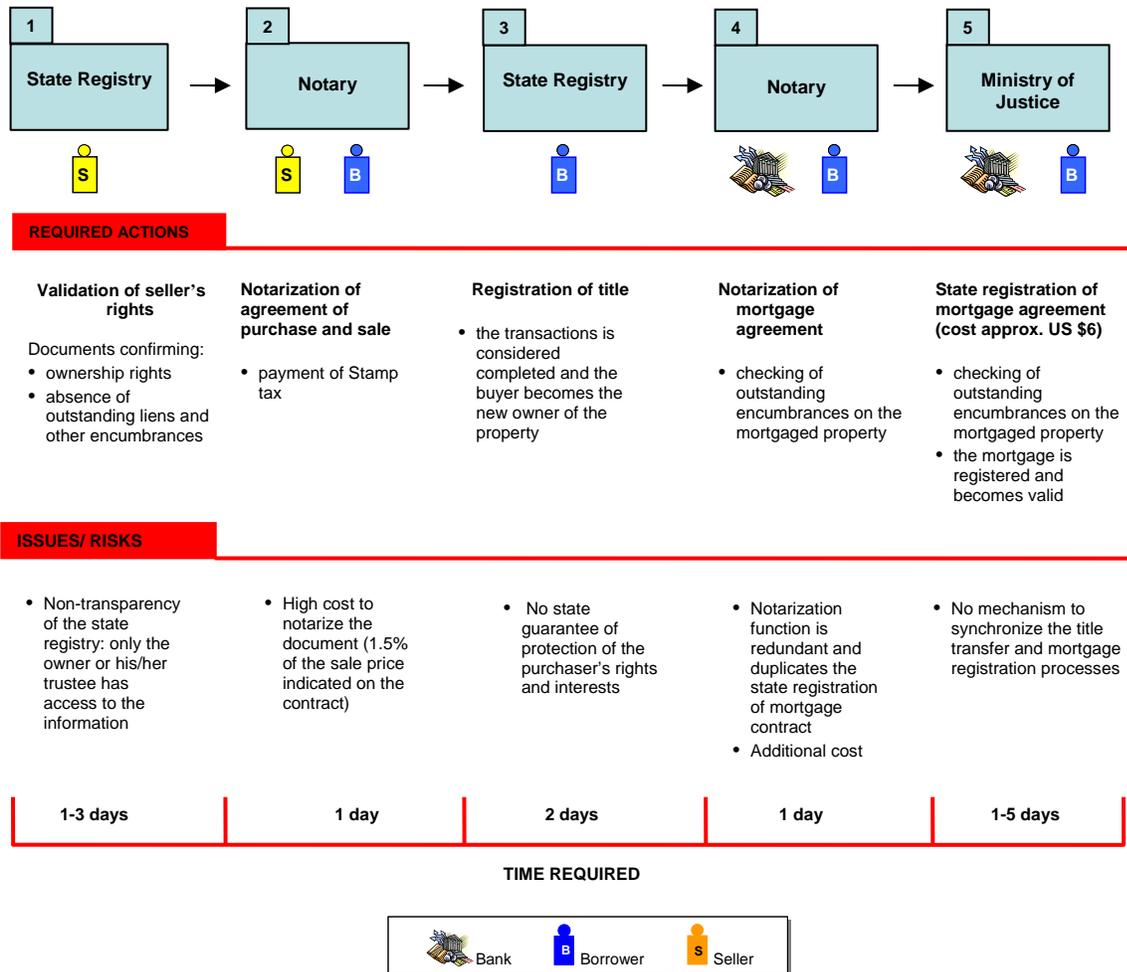
5.4 The Legal & Regulatory Environment

Process for Registering Title on Immovable Property

The existing title registration process for properties financed with mortgages is not efficient and does not fully protect the property rights and legal interests of either the lender or the borrower. There is a significant lack of transparency in the system. For example, access to information in the State Register for residential property title is limited to the property owner. The one exception is the collateral registry, and the public is allowed access to information on pledged residential property.

The flow chart below shows the title transfer process for mortgage-financed residential property and outlines main issues and risks.

Process for Registering Title and Mortgage in Tajikistan



Currently, agreements on purchase and sale of real estate and mortgage agreements are subject to mandatory notarization. Failure to do so renders the transaction invalid. The state duty to notarize an agreement of purchase and sale is 1.5% of the value stated in the agreement. Notarizing a mortgage agreement costs the equivalent of a minimum monthly salary (currently around US \$6).

By law, prior consent from the child welfare agency to sell a property is not necessary if the children residing there are registered as occupants along with their parents. It is required only when guardians undertake real estate transactions for or on behalf of minor children.

The Ministry of Justice may refuse to register a mortgage on a residential property in the following circumstances:

- the documents submitted for registration do not conform to the list of required documents established by the Resolution “On State Registration of Pledge Agreements”;
- the state duty is not paid;
- the individual is not authorized to place a lien on the property (only the parties involved in residential mortgage transaction may do so).

The following documents are needed in order to register a mortgage on a residential property:

- copy of the mortgage agreement;
- copy of the borrower’s passport (or state registration certificate in the case of a business entity);
- document(s) proving ownership of the property (to be mortgaged);
- certificate from the local state notary confirming that there are no existing liens on the property to be mortgaged;
- certificate from the state property management agency attesting to the state-assigned value of the property (only required if there is a dispute between the lender and the borrower as to the appraisal of the mortgaged property); in practice, the lender and the borrower make a joint appraisal report to submit for mortgage registration and the state certificate is not required;
- certificate from the National Bank of Tajikistan regarding the official US dollar exchange rate (in cases where the assets to be mortgaged are in US currency);
- document indicating spousal consent to mortgage the residential property;
- receipt for payment of the state registration fee.

The list of documents required for mortgage registration, for both legal entities and individuals, is considerable. Some of them are redundant because they have been submitted in earlier stages of the process, as is the case with the notarization of agreement of purchase and sale and the mortgage agreement, for example. It would be beneficial to rationalize the documents required in order to save time and expense, without compromising protection for the parties.

Time Lag between Title Transfer on Property and Further Mortgage Placement

The total time required to register transfer of title and register a mortgage on a residential property ranges between six and twelve working days. This is less than in some other project countries, but the time lag nevertheless creates potential risks for mortgage lenders. Experience in other countries shows that lenders will extend mortgages without the corresponding collateral in place, or they will demand additional collateral. This appreciably increases the costs related to the mortgage transaction for both parties to the agreement.

In practice, banks must assume these risks because the registration of the title transfer and the mortgage registration are carried out through different registration authorities. Title transfer is registered with the State Register and the mortgage is registered with the Ministry of Justice, which complicates and delays the process.

Since sellers are not willing to give up title before receiving payment, banks can either turn down the loan application or disburse the loan funds and assume the risk of having no underlying collateral during the time it takes to register a mortgage on the property. Some banks mitigate the risk by requiring the borrower to issue a power of attorney in favor of the bank, whereby a bank representative is entrusted to complete the title transfer and mortgage registration processes. This mitigates the risk somewhat, but does not remove it. However, the process is still very much theoretical, and the volume of title transfers undertaken in combination with mortgage registration in this way has been negligible. In any event, mortgage registration can still be delayed by the necessity of registering title and the mortgage at different state agencies.

System of Title Registration on Property and Related Transactions

There is no uniform system for title registration on property and related transactions (such as title transfer and mortgage registration). Legislation on the process is undeveloped and does not provide for “one window” registration. The registering body varies depending on the type of real estate.

“One Window” Registration

“One window” registration implies that all steps in the process can be undertaken through one agency, rather than several bodies. Minimizing interaction with government agencies in the course of registering property rights and mortgages would reduce the time and expense associated with the process for individuals and lenders.

Three different state bodies currently carry out various aspects of real estate registration:

- Registering title and title changes to apartments, offices, retail establishments or any other building is done through the Bureau of Technical Inventory, as long as there is no land involved in the transaction.
- Registering title to land is done through the Bureau of Land Management. Thus, a single family dwelling will require separate registration of the dwelling itself and the underlying land at two separate state registries.
- The registration of mortgages on any property is done with the Ministry of Justice.

The lack of a uniform registration system, as well as poor coordination between the state registration authorities which perform title registry functions, complicate the registration procedure, creating additional obstacles, difficulties and risks for those dealing with residential properties.

A good example is the purchase of a single family dwelling using funds borrowed under the mortgage loan. The transaction would have to be registered with three separate authorities:

- The title transfer for the dwelling must be registered with the Bureau for Technical Inventory.
- The transfer of the right to use the land must be registered with the Bureau of Land Management (since private ownership of land is not allowed in Tajikistan).
- The mortgage must be registered with the Ministry of Justice.

Access to Real Estate Registries

Legislation regulating the registration of real estate rights does not allow for public access to information on the legal status of properties. Thus, the information in the registers of notaries and the Bureau for Technical Inventory is not readily available. Participants in the real estate market do not have access to crucial information regarding the status of residential properties. Access to this information would be helpful in preventing potential disputes over title.

However, information on liens is available, not only to banks, but also to any individual or legal entity. A state fee of 50% of the minimum monthly salary (currently around US \$3) is charged for extracts from the register of pledged properties.

Protection of Rights and Interests of Good Faith Purchasers of Real Estate

There are currently no legal mechanisms to protect good faith property purchasers during the title registration process. For example, there have been cases where property was sold by people who were, without the purchaser's knowledge, not the rightful owners. The buyers were given forged ownership documents and they could not check their authenticity because they did not have access to real estate registry information.

Protecting Good Faith Property Purchasers

In many countries, the law provides various ways of ensuring the honesty of real estate transactions and the protection of good faith purchasers' rights. For example, in some countries the state accumulates title registration fees in a fund used to compensate victims of real estate fraud.

There is no indemnification either for the previous owner who may not have the right to recover the property or for the good faith purchaser in cases where the property is returned to the previous owner.

This is a significant problem, given that title insurance is not available due to the general underdevelopment of insurance system. Properties owners thus have limited means to minimize their risks and mitigate potential losses.

There are also implications for financial institutions that have found that they have lent money for the purchase of property whose title has subsequently come under question. In these cases, the financial institution's position is weakened, since the borrower no longer owns the property and has no incentive to repay. Also, the financial institution's lien on the property is not valid in these cases.

Notarization of Property Transactions

A significant problem arising during property ownership transfers is the cost of notarization. The state duty for notarization is currently 1.5% of the purchase price. This "title transfer tax," even though in line with fees charged in many other countries, forces parties to transaction to understate the real transaction value and may actually curtail the number of residential real estate transactions, especially those involving mortgages.

In addition, under current legislation, mortgage agreements are also subject to mandatory notarization, which duplicates the function of the mortgage registration authority. It also results in additional time and significant expense for the mortgage borrower and the financial institution. When residential mortgage lending increases, and when refinancing or sale of mortgage portfolios begins, the notarization of mortgage agreements will become untenable. The requirement is a crucial barrier to completing mortgage portfolio transfers quickly and efficiently and it will adversely affect the cost of funding mortgage portfolios.

Land Rights

Under the Constitution of the Republic of Tajikistan, all land is owned by the state. Land cannot be the property of any legal entity or individual, and the sale of the land is not permitted. The right to use land can be mortgaged, but not the land itself.

Thus, the current legislation divides the right to use land and the right to the structures on that land. The owner of a building cannot own the land under it.

Since the law does not provide for simultaneous collateral for land and dwellings, it actually establishes two types of mortgages, depending on what the parties consider the subject of the property transaction (land use rights or rights to buildings).

Legislation establishes cases where the land rights of individuals and legal entities may be terminated or restricted by the state for state and social needs, but only after meeting the following conditions:

- the state provides the owner with a replacement plot of land;
- construction of a replacement dwelling of similar dimensions (if there was a dwelling on the confiscated land property);
- compensation of the owner for all losses, including expected profits, in accordance with Land Code.

These provisions guarantee protection of the owner's rights and interests, as well as the interests of mortgage lenders.

Transfer of Mortgages to the Third Party

By law, a lender can assign mortgage rights, if doing so does not contradict legislation or the initial borrower/lender agreement. Current legislation does not provide for any interdiction or any restriction on assignment of mortgages or other credit, unless an agreement between the borrower and lender stipulates otherwise.

Under civil legislation, the assignment of rights related to any transaction that initially passed through state registration must be registered according to the same procedure. Thus, the assignment of rights in a transaction concluded through a simple written or notarial form must be completed in the same form.

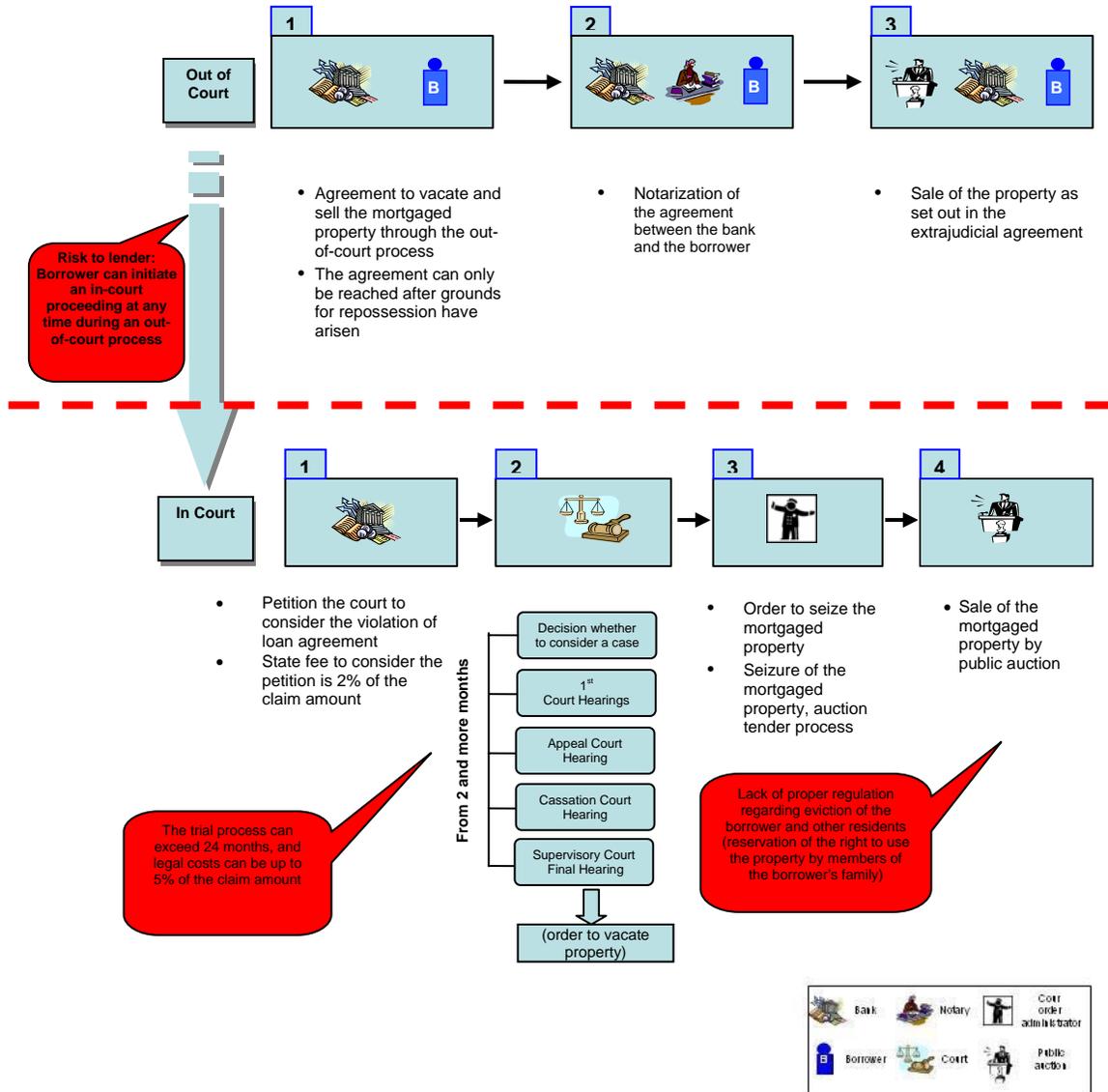
To register assignment under a mortgage agreement, it is necessary to present the application and the documents confirming the transfer of these rights. The application must include the date of the assignment agreement, the consent to the assignment signed by the lender, and the name (the title) and address of the new mortgage-holder. A copy of the amended agreement must be presented along with the application. The state registration is to be completed within five days of receipt of all necessary documents. The state fees for the registration of amendments (including transfer of property rights, assignment, etc.) and termination of the registered mortgage are not set out in legislation.

In practice, the mortgage note is not transferable. This is because the legislation does not envisage a mortgage note to certify the rights of its owner to receive payments under the obligation secured by the mortgage and the mortgage agreement. The Law "On Pledge" does not regulate this issue either.

Foreclosure Procedure on a Mortgaged Property and Eviction

Current legislation provides for both in-court and out-of-court foreclosure on mortgaged properties. The foreclosure process and the problems associated with it are illustrated in the flow chart below.

Foreclosure Procedure on a Mortgaged Property and Eviction in Tajikistan



The general rule regulating foreclosure of a mortgaged property is that the lender is to be made whole through the repossession of the property by court judgment (in-court settlement). In exceptional cases, the lender’s claim can be settled on the basis of a notarized agreement between the lender and the borrower (out-of-court settlement) after grounds for repossession have arisen (for example, default by the borrower).

Under current legislation, both in-court and out-of-court foreclosure carries significant risks for the mortgage lender. Uncertainty remains regarding procedures for the eviction of residents of foreclosed properties. At present, there is no judicial precedent in connection with the residents’ obligation to vacate a property in case of foreclosure.

In-Court Procedure

Judicial foreclosure involves a lengthy trial proceeding and a prolonged property sale process, both of which are significant expenses for the lender. The court may delay, at the request of the mortgagor, the sale of the foreclosed property through public auction for up to one year. Further appeals by the borrower may delay the trial process for an additional year. To a certain extent, this can prevent the lender from satisfying a claim against the borrower for a considerable time period. Moreover, there have been no precedents in the repossession process, and it is difficult to estimate the actual time required for a financial institution to repossess a property. Thus, neither the time nor the costs can be stated with any accuracy. The state duty, calculated at 2% of the claim amount, is an added burden for the borrower, as the lender will eventually compensate its expenses from the proceeds received after the sale of a foreclosed property.

The execution of judgments in foreclosure and the sale of pledged property are functions of the law enforcement officer, on the basis of a court order and according to procedural legislation. The sale of the pledged property is by public auction, likewise in accordance with procedural legislation, unless otherwise stated by law or agreement. The auction can be organized by the bank (possessor of the property or property right) or by an auction company under contract with the bank. Seizure of the property and its transfer for sale are carried out within the time determined by the law enforcement officer, but at least five days after and within one month of the court order.

Out-of-Court Settlement

When under the mortgage loan grounds for foreclosure have arisen (for example, default by the borrower) and the lender wishes to foreclose, an out-of-court settlement is possible based on a notarized agreement with the borrower. This can be an advantage to both parties. The lender can satisfy its claim, and the borrower avoids legal costs and receives the portion of the proceeds of the sale of the property in excess of the amount owed to the bank.

It is important to note that an agreement on out-of-court foreclosure on a mortgaged property may be challenged by the borrower (as well as by previous property owner or mortgage-holder, if his/her rights are being infringed upon by the agreement on out-of-court foreclosure), at any stage of implementation, whereupon the agreement becomes invalid. Thus, the process is based on voluntary cooperation by the borrower to ensure that the sale of the property to recover the loan is performed as efficiently and quickly as possible.

However, since lenders and borrowers commonly have an adversarial relationship once a mortgage is in arrears, out-of-court settlement is expected to be the exception rather than the rule. If the borrower does not wish to proceed with the settlement, the lender has no choice but to initiate court proceedings. Thus, for the lender, out-of-court foreclosure does not eliminate the risk of lengthy and costly legal proceedings.

Reserved Right to the Use of Residential Property

Housing legislation in Tajikistan does not consider the transfer of ownership of residential property to a lender as legal grounds for evicting the people who live there. In other words, even after a lender has successfully repossessed a property, the borrower's family continues to have the right to use the dwelling, and they are not subject to compulsory eviction upon repossession and subsequent change of ownership. This adds time to the repossession process and lowers the collateral value of residential real estate, which ultimately leads to increased barriers to residential mortgage lending as a whole, especially for borrowers living with family members.

OTHER LEGAL ISSUES

Lack of Banking Regulation Requirements with Respect to Mortgage Lending

Banking legislation does not regulate the organization, operations, and supervision of mortgage lending institutions. For example, the legislative acts of the National Bank of Tajikistan do not provide for specialized regulations for residential mortgage lending by financial institutions with respect to reserve, capital or any other normative requirements. There is no legal or regulatory basis governing banks in originating, underwriting and servicing mortgage loans, or in the assessment and management of related risk.

The lack of regulation may increase the risk to the banking sector and to the economy as a whole. In addition, the lack of information on aggregate residential mortgage lending activity means that governments and regulatory bodies will have difficulty making informed decisions when framing government housing policies and other strategies to reform and stimulate this sector.

Absence of an Adequate Taxation Framework

The existing taxation system as it applies to property transactions does not create an environment conducive to the development of mortgage lending, residential construction or increased consumer interest in mortgage financing.

Some of the major taxes that affect the development of residential mortgage markets include a value added tax, personal income tax, property tax and a profit tax on financial institutions. For example, the VAT imposed on construction companies when newly built housing is sold or when construction materials are imported leads to increased construction costs, making home ownership even less affordable.

Currently, there is no favourable tax treatment of income from the sale of a taxpayer's primary residence if it was owned and occupied for less than five years, nor is mortgage interest tax deductible. Favourable tax treatment in these cases could enhance primary mortgage market growth and mortgage affordability. A supportive tax regime would include the tax deductibility of interest on residential mortgages and tax exemption for gains on the sale of a principal residence.

5.5 Government Policy in Housing Finance

A properly formulated residential mortgage market can be useful in solving the problem of access to affordable, quality housing. The government has yet to take any concrete steps to create a comprehensive system of residential financing or a mortgage lending system as the basic mechanism for its implementation. The state has not defined its role in the development of this system, nor has it identified the elements necessary to develop and support the residential mortgage industry. Currently, therefore, there is no conceptual framework for forming a residential mortgage financing system.

The participation of the state is required to create the necessary institutional and legislative conditions to set in motion the development of various forms of residential lending. In particular, the regulatory environment needs to be clear. The strategy for developing the mortgage market must be comprehensive. Resolving individual problems in isolation or developing key elements separately will not be sufficient to facilitate dynamic development in this market.

A more comprehensive approach shall be utilized in formulating the state program on mortgage market development in the country. The program should define major objectives and tasks, means and mechanisms to implement reform, sourcing of funds, and a plan setting out the new legislation necessary to develop a robust residential mortgage market.

5.6 Recommendations

The recommendations for the development of a national system of residential mortgage lending fall into three general categories:

- strengthening the regulatory environment to encourage the development of system of housing finance;
- creating the conditions necessary for strengthening the capacity of key participants in the mortgage market and furthering the development of their institutional potential;
- improving state housing policy.

Key recommendations for each proposed area of reforming are described below.

Enhancement of the Legal Environment

- Develop the legal basis to encourage residential mortgage lending, including a step-by-step plan to draft and adopt the legislation necessary to form a residential mortgage financing system.
- Amend civil and housing legislation to eliminate encumbrances with respect to the foreclosure on pledged property and the eviction process.
- Amend the Law “On State Duty” to decrease state notary fees for real estate transactions.
- Develop and introduce refinements to the Civil Code that will strengthen creditor rights and borrower responsibility to creditors, especially with respect to repossessing property.
- Enhance legislation on the state registration of rights and liens on real estate and introduce a unified registration process so that title transfer and mortgage registration may be accomplished simultaneously.
- Enhance the normative legal acts of the National Bank of Tajikistan to provide a comprehensive regulation of bank activity with respect to residential mortgage lending.
- Amend the current legislation in order to create conditions for the development of residential construction (including land legislation and tax regulations, legal norms, and acts pertaining to land allocation for residential construction).
- Enhance legislation regulating the principal participants in the residential mortgage market. Develop and adopt the Law “On Credit Bureaus,” and amend legislation regulating insurance companies and appraisers to increase their effectiveness in decreasing risks for residential mortgage lenders.
- Amend existing legislation to introduce regulations to govern “escrow accounts”.
- Eliminate contradictions in existing legislation on residential mortgage lending.
- Develop proposals to amend existing legislation to encourage investment by pension funds and insurance companies into the residential mortgage sector.
- Develop and introduce current risk management techniques for residential mortgage lending in the banking sector.

Mortgage Market Infrastructure and Its Further Development

Establish Effective Mortgage Lending Practices in the Banking Sector

- Develop and introducing unified standards and procedures for residential mortgage underwriting, closing, servicing, and risk management.
- Develop and introducing standard residential mortgage documentation, including standard closing documents.
- Develop and introduce a range of residential mortgage products.
- Improve the skills of bank staff engaged in residential mortgage lending.

Strengthen Independent Property Appraisal Services

- Develop an effective monitoring system and certification program for professional residential real estate appraisers.
- Improve the services of appraisal companies by standardizing appraisal techniques disseminating those techniques through specialized training.

Strengthen Cooperation between the Insurance and Residential Mortgage Sectors

- Broaden the variety of insurance products as necessary for residential mortgage market development.
- Develop and introduce new standard insurance products and standard insurance documentation, including uniform insurance contracts and policy documents for the residential mortgage market.

Develop the Secondary Mortgage Market

- Identify the conditions necessary to create a secondary market for residential mortgage lending.
- Develop and introduce structures and mechanisms for secondary market operations, including standardized procedures and effective systems of cooperation with partner banks.

Improve Government Housing Policy

- Develop a comprehensive state housing policy, including the development of a national system of housing finance.
- Implement plans to adopt normative acts on the structure of a national system of housing finance.
- Create a tax framework conducive to the development of residential mortgage lending.
- Develop effective state policies and mechanisms (oriented towards developing and stimulating residential mortgage financing) to support groups with low incomes in improving their housing conditions.
- Reform the residential construction sector to raise construction standards and housing quality.
- Improve public awareness of residential mortgage lending by introducing specialized information programs

6. UZBEKISTAN

6.1 Economic Overview

The Republic of Uzbekistan is located in the center of the region. It has the largest population among Central Asian countries, 26.4 million at January 1, 2006. The economically active population exceeds 10 million.⁸¹

The government's economic policy in the 1990s was mostly based on continuing administrative reallocation of resources. On the one hand, this policy slowed the process of building a market economy, but on the other hand, it helped Uzbekistan to avoid the substantial economic downturn that took place in neighboring countries after the collapse of the Soviet Union and even facilitated moderate economic growth in the second half of the 1990s. According to official sources, GDP grew at 4% per annum from 1996 to 2001, with a shift from the agriculture and extractive/mining sectors to other sectors such as the oil/gas and automotive sectors. The government's tight monetary policy from 2000 on, the standardization of exchange rates in 2002, and a number of structural reforms coupled with favorable international prices for exportable goods (cotton fiber, non-ferrous and precious metals) helped Uzbekistan to improve its economic performance substantially. Official statistics show that the annual inflation, based on the consumer price index, dropped from 28.2% in 2000 to 7.8% in 2005, and the GDP growth rate increased from 3.8% in 2000 to 7.2% in 2005.

Lower inflation, high GDP growth (and thus increasing wages) and a stable exchange rate mean that the fundamental macroeconomic conditions for an effectively operating primary mortgage market are mostly in place.

Table 1: Key Macroeconomic Indicators

	2000	2001	2002	2003	2004	2005
GDP (US\$, billions)	13.5	11.5	9.5	9.9	12	13.2
Real GDP growth (%)	3.8	4.2	4.2	4.4	7.7	7
Industrial growth (%)	5,9	7,6	8,3	6,2	9,4	7.3
Inflation (%)	28.2	26.5	21.6	3.8	3.7	7.2
State deficit (%)	-2.5	-1.3	-1.9	0.1	0.4	0.1
Exports (US\$, millions)	2935	2740	2510	3240	4263	5631
Net current transfers from abroad (US\$, millions)	13	43	120	319	253	na

Source: State Statistical Committee of the Republic of Uzbekistan

Most western companies operating in Uzbekistan view the investment climate as mostly unfavorable. This, coupled with increasing tension with the USA, EU and major international financial institutions, has forced the government to attach more importance to strengthening regional cooperation. In 2006, Uzbekistan joined the Eurasian Economic Community, aimed at building a common Eurasian market. In 2005/2006, Russian companies increased their investment in Uzbekistan's oil/gas and telecom sectors. Kazakh companies have also expressed interest in investing in Uzbekistan, but have not done so to date.

⁸¹ The data used throughout the Report is from different statistical reviews of the State Statistical Committee of Uzbekistan, Center of Efficient Economic Policy and Rating Company "Akhbor-Rating".

Russia and Kazakhstan are important destinations for labor migrants from Uzbekistan. Reliable statistics are not available, but some Uzbek non-governmental organizations estimate that the number of labor migrants may be between 500 thousand to 1 million. The significant remittances by labor migrants have direct implications for the housing market in Uzbekistan. Increasing demand for housing in the major cities, starting from the second half of 2005, is mostly attributable to the growing volume of remittances by Uzbek labor migrants in USA, Russia and Kazakhstan.

The economy still faces a number of serious problems that may slow down the process of building and developing a national housing finance system including residential mortgage lending. One of the key issues affecting the demand for mortgage loans is the high price of housing. Therefore, mortgage payments would considerably exceed the average household income. There is a serious risk that most households (especially outside Tashkent) will not be able to repay, fully and on time, even the residential mortgage loans provided through the Mortgage Lending Support Fund.⁸²

6.2 Overview of the Housing Sector

Housing Stock

In the second half of the 1990s, the government privatized the bulk of the housing stock and discontinued the centralized financing of housing construction. As a result, over the past five years, the housing stock has grown modestly, from 339.4 million square meters in 2001 to about 381.5 million square meters in 2005, or from 14 square meters to about 14.6 square meters per capita.

Currently, about 98% of the housing stock is privately owned by Uzbek citizens. Reliable information on the condition of the housing stock is not available, but it has likely deteriorated since the large-scale housing privatization in the mid-1990s and the drastic increase in the cost of utilities.⁸³

In recent years, the pace of new housing construction has slowed from 7.1 million square meters in 2001 to about 6 million square meters in 2005. Official statistics measure the housing stock only in terms of apartments, and therefore the number of apartments versus single-family homes is difficult to calculate.⁸⁴ However, 97.3% of new housing construction in 2005 took place in rural areas, and this suggests that the new housing stock mostly consists of single-family homes built by individuals at their own expense. In the same year, private construction accounted for approximately 99.2% of the new housing stock, which further demonstrates that the growth in housing stock is mostly driven by the construction of single-family homes.

Professional residential real estate developers are few, and bulk of single-family home construction is handled by individuals on their own. Only two developers currently work in Tashkent and account for bulk of the construction of high-end apartment buildings. Government, at both the national and regional levels, discontinued free or subsidized housing for those in need and no longer finances the social housing construction traditionally aimed at low-income families, public servants and other disadvantaged groups. As a result, the supply of new apartments in the market is very limited.

Current conditions for new developers entering the residential real estate market (both apartments and single-family homes) remain rather unfavorable, which can be attributed partly to the following factors:

- Government measures over the last few years indicate that it tends to support the development of single-family home construction rather than apartment construction to meet the country-wide housing demand. Single-family homes are financed from personal savings or informal loans (from relatives or friends), and

⁸² The activity of Mortgage Lending Support Fund is reviewed in “State housing finance policy” section.

⁸³ The situation is more favorable in bigger cities, especially Tashkent, where most of the housing stock was re-built after the devastating earthquake in 1966.

⁸⁴ For example, officially reported 54,700 new “apartments” built in 2005 include both actual apartments and single family homes

usually built by temporary, unregistered groups of construction workers, typically to save money.⁸⁵ Professional developers are unable to compete on price, and therefore operate only in the relatively limited high-end apartment market.

- The only aspect of the allocation of land for housing construction that is clearly defined in law is which state authorities are accountable. Land plots may be allocated for sale, lifetime rights or rent by the Cabinet of Ministers, or by the khokims (heads of municipal authorities) of oblasts, Tashkent city, other cities, and rayons.⁸⁶ The khokim is required to set up a standing committee under the local state authority.⁸⁷ With exception of basic functions, which are set out in the Land Code, the duties of the committee are at the discretion of the khokim.

The methods for allocation are not set out in legislation. The Land Code provides for auction to individuals of lifetime rights with hereditary succession for land plots for individual housing construction. A presidential decree⁸⁸ extended this provision to allow khokimiyats to auction land plots of 0.04 hectares to individuals for housing construction. However, the legislation does not specify that auction is the only means of allocation, nor does it set out the legal rights to the land of the persons or legal entities acquiring those rights.

This lack of clear regulation with respect to land plot allocation for housing construction can lead to non-transparency and misconduct and hinder developers in identifying opportunities.

- Growth in the residential real estate development market is also constrained by the lack resources among developers for capital-intensive long-term construction projects, and by difficulties obtaining bank financing. Reportedly, the average residential construction project in Tashkent takes about two years to complete, and most potential developers do not have the working capital required for such long-term projects. Banks are reluctant to finance residential housing construction projects due to their duration and high risk. Most banks have limited experience in this area and lack efficient mechanisms for cost and quality control⁸⁹
- Potential developers lack adequate experience, skills and knowledge to pursue large-scale residential construction projects, which is also a serious barrier to the development of competition in this market.

Table 2: Housing Stock, 2001-2005

	2001	2002	2003	2004	2005
Total housing stock (m ² , millions)	339.4	360.9	365.6	373.5	379.5 ⁹⁰
New housing construction (m ² , millions)	7.1	7.58	6.76	6.2	6
New apartment construction (units, thousands)	65.7	68.8	60.9	54.5	54.7
Housing stock per capita (m ²)	14.0	14.3	14.3	14.4	14.6 ⁹¹

Source: Goscomstat, and IFC estimates

Housing Demand

Overall, housing prices in Uzbekistan were stable from 2000 to 2005, ranging from US \$250-500 per square meter in Tashkent to US \$100-200 in other regions. The vast majority of housing sales were registered with

⁸⁵ Especially in rural areas, single-family homes are commonly built by “hashar”, that is, by the owners themselves with help from close relatives and neighbors.

⁸⁶ Article 23, Land Code of the Republic of Uzbekistan.

⁸⁷ Article 34, Land Code of the Republic of Uzbekistan.

⁸⁸ UP-1009, November 24, 1994.

⁸⁹ Until recently, most residential housing construction was financed by one specialized bank.

⁹⁰ Estimate.

⁹¹ Estimate.

underrepresented values to minimize the obligatory state duty (recently abolished) of 10% of the sale price.⁹² According to the Ministry of Finance, approximately 112,000 housing transactions were notarized in 2005, generating fee revenue of about US \$6.3 million. Assuming average understatement of 10-15%, the value of transactions in 2005 was about US \$500-600 million.

In the second half of 2005, housing prices in Tashkent increased to US \$300-600 per square meter. The reasons include increased interest in purchasing real estate in Tashkent by Russian and Kazakh investors, growth of remittances from labor migrants and relaxed procedures for withdrawal of cash from bank accounts by companies and individuals.⁹³ Housing prices also increased in other cities, though to a lesser extent. The overall increase in housing prices indicates growing demand for housing.

The significant pent-up demand for housing will likely continue to grow, for the following reasons:

- New housing construction in recent years has fallen short of population growth. Simply comparing the current number of housing units with the current number of households indicates a possible housing deficit of about 80,000 units.⁹⁴
- This deficit is likely to grow in the medium term. The 15-25 age group represents about 25% of the population, which implies further growth in the number of households in the near future.
- With limited financial resources at its disposal, the government does not plan to launch large-scale housing construction programs for lower-income families, including military staff, teachers, doctors, and other economically vulnerable groups. Since free or subsidized housing is unavailable, the option available to families is to purchase housing commercially.
- Housing prices in Uzbekistan are still low compared to neighboring countries, although the gap is likely to diminish once the EurasEC integration process gathers momentum.
- Given the lack of resources and insufficient skills among residential housing developers, and cumbersome procedures, new housing construction is unlikely to keep pace with growing demand.

Official statistics for 2005 reported gross household income of US \$8.9 billion. Divided by the total population (26.4 million) and multiplied by the average number of persons per household (5.1), the approximate average gross annual household income is just over US \$1,700. Assuming necessary household expenses, taxes and other mandatory payments of at least 70% of gross income, the average family would need almost fourteen years to accumulate the funds to purchase the average apartment.

Currently, the main factor suppressing the demand for housing is the low per capita disposable income. With an average annual household savings of US \$500 and an average price of US \$7,000 for a 70-square meter apartment, the purchase of an apartment remains unaffordable for much of the populace.

Demand for Mortgages

In early 2005, German Development Bank (KfW) retained LFS Consulting Company (Germany) to carry out a survey of 500 entrepreneurs in Tashkent, Samarkand and Andijan to estimate the potential for interest in housing loans (including renovation, construction and mortgage loans). According to this survey, only 28% of respondents were interested in financing the purchase of an apartment or house, 49% were not interested in

⁹² See the Legal Environment section for further discussion of this issue.

⁹³ From late 2002 through mid-2005, Uzbek enterprises faced serious delays in withdrawing cash from bank accounts. Reportedly, this caused widespread arrears in the payment of salaries and pensions of up to several months. From the second half of 2005, the situation improved, and companies and individuals had easier and more timely access to their cash deposits.

⁹⁴ Official statistics on the total number of households and dwelling units is not available. However, dividing the total population (26.4 million) by the average number of persons per household (5.1) approximates the number of households (5,176 thousand). Multiplying the average number of persons per household (5.1) by the average housing area per capita (14.6 square meters) approximates the housing area per household (74.4 square meters). Dividing the total existing housing area (379.5 million square meters) by the average housing area per household yields the number of existing dwelling units (5,100 thousand). Comparing the number of households (about 5,180 thousand) with the number of existing dwelling units (about 5,100 thousand) shows a deficit of about 80 thousand dwelling units

housing loans at all, and 22% were interested in construction or renovation loans. These results can be attributed to low awareness of residential mortgage lending in general, a lack of understanding of the types of mortgage instruments, the high percentage of monthly incomes required for mortgage payments, and the significant cost of the appraisals and mandatory insurance required by banks to provide residential mortgage loans.

Residential housing loans are affordable for a very limited segment of the population. For example, at the longest term of residential mortgage available from Ipoteka bank, 10 years, and highest debt service ratio, 80%, a US \$22,000 mortgage at 20% interest would carry a monthly payment of about US \$500. Only very small fraction of the population, those with above average incomes, would be able to obtain such a mortgage.

Until recently, both bankers and potential borrowers viewed the high level of state duty (10%) payable upon notarization of agreements of purchase and sale for residential real estate as a key impediment to the growth of residential mortgage market. Despite the significant reduction in this state duty recently, its legacy remains and the populace still believes that price of residential property should be under-reported. This perception needs to be corrected, since residential mortgage lending requires full disclosure of the sale price.

The government took the first steps toward developing the system of residential mortgage lending just over a year ago, in February 2005. The concept of mortgages is still relatively new to most people, including policy-makers and banking specialists. Nevertheless, from the outset of Ipoteka Bank's residential mortgage lending program in December 2005, through mid-2006, the bank's mortgage loan portfolio rapidly grew from zero to about US \$1,000,000, with minimal publicity efforts. In the short term, demand for residential mortgage loans will likely originate from the limited number of borrowers who meet the existing requirements of banks that offer residential mortgage loans. This group primarily consists of the employees of large foreign companies and international organizations and entrepreneurs. Therefore, the aggregate mortgage portfolio is expected to grow at moderate pace, reaching a maximum of US \$2-3 million by the end of 2006,⁹⁵ and US \$10-15 million by the end of 2007.⁹⁶ In longer term, as the pent-up demand for housing increases and longer-term funds from institutional and other investors flow in, the demand for mortgage loans may increase substantially.

6.3 Institutional Capacity for Residential Mortgage Lending

An adequate institutional framework for residential mortgage lending has not yet been established in Uzbekistan. The main market participants do not have adequate mortgage lending skills and resources. Moreover, the legal and regulatory framework requires further development, and banks need access to longer-term financial resources.

Banking Sector

There are currently twenty-eight commercial banks operating in Uzbekistan, including three state-owned banks, eleven joint-stock banks (with indirect government control), ten private banks and four banks with foreign participation.

Following a sharp devaluation of the Uzbek Sum in 2000-2001 and the transfer of foreign exchange reserves to the Central Bank of Uzbekistan (CBU), total banking assets declined from US \$7.5 billion in 2001 to \$4.5 billion in 2003. (See Chart 2) At the end of 2005, total banking assets were about US \$5 billion, and down from 65% of GDP in 2001 to 37% of GDP in 2005. (See Chart 4).

⁹⁵ Assuming that Ipoteka Bank's mortgage loan portfolio continues to grow at the same pace, and that the Fund for Mortgage Lending Support disburses UZS 2-3 billion (US \$1.5-2.5 million).

⁹⁶ Assuming that the Fund for Mortgage Lending Support accumulates funds from the State Pension Fund, and that institutional investors and larger banks dedicate resources to mortgage loans also.

In 2005, aggregate bank capital increased to approximately US \$835 million from US \$814.6 in 2003. The sector in general enjoys a favorable capital adequacy ratio, 28% in 2004.⁹⁷

Bank deposits grew to about US\$ 2 billion in 2005, but still did not exceed 15% of GDP. For a number of years, total bank deposits have represented a quite low fraction of total liabilities, on average about 25% from 2000 to 2004 and about 40% in 2005. As a result, the most important source of bank refinancing was short-term interbank credits and foreign borrowings to facilitate on-lending in a number of priority government projects. In 2005, interbank credits and foreign borrowings constituted about 35% of total liabilities in the banking system.

A comprehensive deposit insurance scheme, in place since 2002,⁹⁸ and growth in yields on term deposits has helped to gradually restore public trust in the banking system. This is evident in the growth of personal deposits from 22.9% of total deposits in 2004 to about 25% in 2005. At the end of 2005, personal deposits accounted for about 10% of total liabilities, most of which was concentrated in the group of larger banks traditionally associated with the state (NBU, Promstroibank, Halk Bank, Pakhta Bank, Ipoteka Bank, and others). In 2005, the six largest banks controlled about 85% of total personal deposits.

Most term deposits are for less than one year, and total term deposits account for not more than one third of total deposits. Given this limited size and short-term nature, the existing deposit base is insufficient to facilitate the growth of residential mortgage lending, either in terms of volume or in terms of appropriate terms. Short-term liabilities combined with longer-term loans can expose banks to substantial liquidity risk. This will be cause for concern once bank mortgage portfolios (which are assumed to be long term) exceed equity.

The charts below show that, despite some positive trends, including growth in assets, deposits and capital, the banking sector continues to represent a relatively small fraction of GDP. At the same time, the banking system is exposed to significant risk stemming from the concentration of assets, deposits and loan portfolios in a few large banks. Furthermore, despite the substantial slowing of inflation in recent years, interest rates on bank loans remain high.

Chart 1

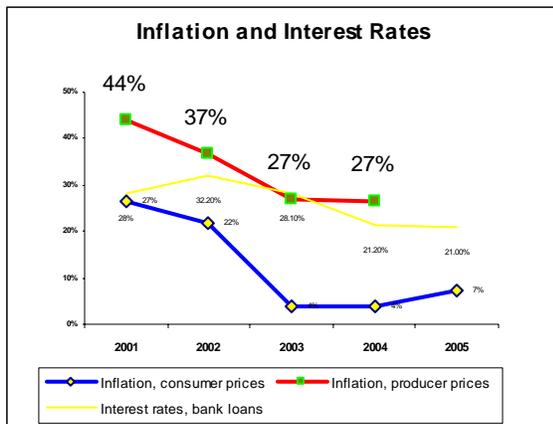
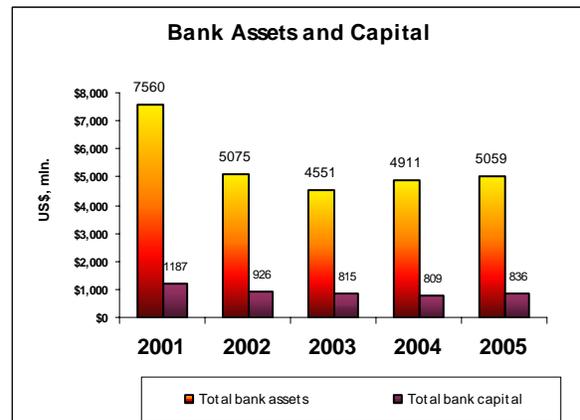


Chart 2



⁹⁷ Favorable CAR is influenced by the value of government guaranteed loans. In 2004, such loans constituted about 70% of the credit portfolio.

⁹⁸ The deposit insurance scheme covers both local and foreign currency deposits. Banks pay 0.5% of eligible deposits per quarter to Deposit Guarantee Fund that compensates 100% of deposits up to 100 times the minimum wage (about US\$ 850) and 90% of deposits up to 250 times the minimum wage (about US\$ 2100) if bank's license is withdrawn.

Chart 3

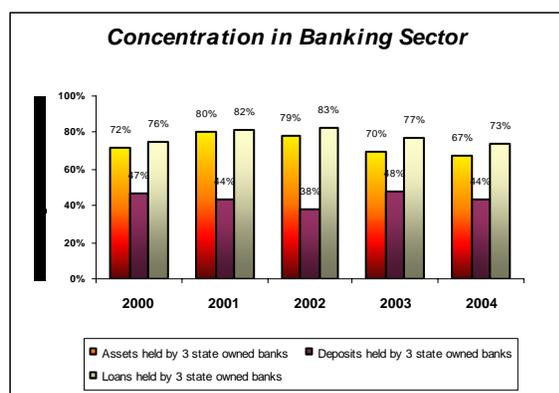
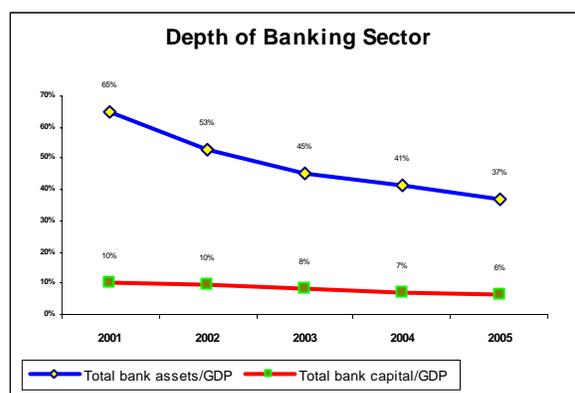


Chart 4



Source: IMF, Akbbor rating, Bankovskie Vedomosti, Center for Monetary Policy, Center for Effective Economic Policy

A sharp reduction in inflation, from 28.2% in 2000 to 7.2% in 2005, has not yet translated into correspondingly lower interest rates on bank loans. (See Chart 1) In 2005, the average interest rate for loans in local currency to businesses and individuals hovered around 20%, down from 25.7% in 2000. Over the same period, the Central Bank of Uzbekistan (CBU) cut its refinancing rate, more than two-fold, to 16% as at year-end 2005.

Despite the positive trends noted above, and the generally sound supervision policy of the CBU, certain structural problems in the banking sector remain, representing potential sources of instability. One is the high concentration of assets and capital in a few large state-owned banks. (See Chart 3) For example, the National Bank for Foreign Economic Activity (NBU) accounted for about 55% of the total assets and about 51% of the total capital in the banking sector in 2005, though this is down from 70% in 2001. In 2005, its loan portfolio exceeded 60% of the total loan portfolio in banking sector. Five large banks (NBU, Asaka Bank, Promstroibank, Ipoteka Bank and Pakhta Bank) controlled about 84% of total assets in the banking system, about 90% of the loan portfolio and more than 70% of deposits. This level of concentration in the banking sector can lead to a systemic crisis if the quality of the loan portfolio deteriorates further, causing liquidity problems for banks. Reliable information on the quality of loan portfolios is not available but according to some estimates non-performing loans may constitute 15-20% of the total assets in banking system, or 25-30% of total loan portfolio. This is almost entirely concentrated in a few larger banks (mostly NBU).

Non-banking financial sector

The non-bank financial sector is just emerging, and at this stage, it is unable to play an active role in developing the residential mortgage lending market. As of the end of 2005, there were nineteen active credit unions, with about 33 thousand members. The minimum initial membership installment ranged from 500 to 20,000 soum. The total assets of credit unions reached about US \$6.7 million and the total loan portfolio was about US \$5.9 million, with consumer loans constituting more than 60%. Most loans were to individual members, with up to one-year terms and at 3-7% monthly interest rate. The maximum loan per borrower was US \$4,000-5,000. Currently, credit unions do not offer residential mortgages, but they plan to look into this opportunity in the future.

Capital Markets

Neither the equity nor the debt market play a significant role in channeling investment into the economy. In their current state of development, they are not able to facilitate the development of mortgage lending, either in attracting institutional investors or in offering the relevant financial instruments. In 2005, Uzbek companies raised about US \$10 million (in local currency) through the corporate bond market, but market capitalization effectively declined 17% to just over US \$30 million. Yields varied from 20% to 26% per

annum, and the maturity for the most issues was two years. The main purchasers of debts issues have been local commercial banks.

The government issues short-term (six, nine, and twelve months) and medium-term (eighteen months) treasury bills in local currency. In 2005, the structure of the market changed, as the volume of short-term bills in circulation fell by 60.7% and the volume of medium-term government securities rose by 62.6%. There are few official statistics on the size of this market, but the approximate capitalization at the end of 2005 was about US \$42 million. As with corporate bonds, the main purchasers of treasury bills have been local commercial banks.

Pension System

The pension system is fully state-controlled and includes both pay-as-you-go and accumulative pillars. The latter was established in 2005 and funded through a mandatory deduction of 1% of salary for all employed individuals, plus individual voluntary contributions. In 2005, the assets of accumulative pension fund stood at about US \$16 million invested in short- and medium-term treasury bills or short-term bank deposits. The law provides for also using the accumulated pension funds for investment and lending purposes.

As in some neighboring countries (e.g. Kazakhstan) with incrementally growing funds, pension funds could be an important long-term financial resource for the mortgage market. The government is considering the possibility of using part of accumulated pension fund to finance loans through the State Mortgage Support Fund.⁹⁹ However, the use of pension funds for subsidized mortgage lending at negative real interest rates exposes the pension system to substantial risk. It will result in lower returns on pension savings, and a possible shortfall in meeting pension commitments.

Residential Mortgage Lending by Banks

Only two banks offer residential mortgages, but have been doing so for just over six months. The key barriers to the development of residential mortgage lending in Uzbekistan are, in many respects, similar to those faced by other countries in Central Asia.

The history of housing finance in Uzbekistan began in 1996, when the specialized Uzbek Housing-Savings Bank (Uzjilzberbank) began offering loans to the public for the purchase of newly built apartments. The construction of these apartments was commissioned by the bank.¹⁰⁰ These loans were not truly mortgages, since title transfer took place only upon full repayment of the loan. (Such schemes are common in other regions, such as Southeast Asia.) By 2003/2004, the bank had gradually stopped providing these loans due to a significant increase in housing construction costs, discontinued state financing and hurdles in obtaining new land plots for development and construction.

In early 2005, the government established Ipoteka Bank, a specialized mortgage bank, by merging Uzjilzberbank with Zamin Bank. As a legal successor to Uzjilzberbank, Ipoteka Bank has taken over a portfolio of “quasi-mortgages” outstanding of about US \$3 million. Towards the end of 2005, Ipoteka Bank started offering true residential mortgages, in local currency. By mid-2006, it had disbursed more than one hundred loans for the equivalent of about US \$1 million. The terms and conditions are shown in Table 3, below.

In January 2006, a private commercial bank, Credit Standard, became the second bank in Uzbekistan to offer residential mortgages. The mortgage product is mostly targeted to employees of its corporate clients. As of early March 2006, Credit Standard had not yet disbursed a residential mortgage loan.

⁹⁹ See the Government Policy section for information of State Mortgage Support Fund.

¹⁰⁰ Uzjilzberbank built two types of housing, social and commercial. The difference between them was better location, planning and finishing in the commercial units. The government paid 50% of the loan for social housing, 20% was the down payment by borrower, and 30% was the actual loan by Uzjilzberbank. Social housing loans were offered for terms of up to ten years. Loans for commercial housing required 50% down payment, and the bank loan was 50% for terms of up to five years. Uzjilzberbank had no cases of defaults in either portfolio.

Ipoteka Bank offers only three mortgage products, or three variations on the same product, which is not sufficient to meet the needs of a wide spectrum of potential borrowers. Interest rates decline with early repayment. The maximum term is ten years, and loan amount cannot exceed 2,500 times the minimum wage. At the end of first quarter 2006, the maximum loan was about US \$22,500.

Table 3: Residential Mortgage Loans Offered by Ipoteka Bank

Down payment (% of house value as agreed between bank and borrower)	Interest rate (10 year term)	Interest rate if repaid in five years	Interest rate if repaid in three years
20 %	20 %	19 %	18 %
30 %	18 %	17 %	16 %
40 %	17 %	16 %	15 %
50 %	16 %	15 %	14 %
60 %	15 %	14 %	13 %
70 %	14 %	13 %	12 %

Source: Ipoteka Bank

Key Risks in Residential Mortgage Lending:

Credit Risk

Currently, Ipoteka Bank grants mortgage loans based on a temporary credit policy. The following are the credit risk mitigation measures set out in Bank's policy and potential problems in applying them in practice:

- The maximum loan amount is about US \$22,500 per borrower.
- Mortgage on purchased housing. However, the reliable information on real estate prices is scarce and the bank may have difficulty establishing the market value of mortgaged property.
- The borrower is required to have life insurance for the period of loan. However, since insurance premiums are paid annually and escrow accounts are not available, the bank may have difficulty ensuring full and timely payment of premiums to keep the policy current. The bank does not have a procedure for monitoring the payment of premiums, but reportedly is in the process of developing one jointly with the only active life insurance provider in Uzbekistan.
- The borrower is required to have property insurance for the period of loan. As with life insurance, the bank is only now in the process of developing the mechanism for monitoring timely payment of premiums. The bank's credit policy does specify that the bank must be a beneficiary under the insurance policy, nor whether the required insurance amount decrease as the loan is repaid. Reportedly, the latter is in the process of development.
- The maximum loan to value ratio is 80%, which appears justifiable at this stage of development in the market.
- The bank's credit officer and lawyer carry out the underwriting, which takes five days. The bank requires a statement of income from the borrower's employer and/or proof of other income. However, the bank has limited ability to verify income where, for example, the borrower is an entrepreneur. In general, people are reluctant to disclose income since a large portion of income is generated in the unofficial economy.
- The bank believes that its debt service ratio of 70% (monthly mortgage payments as a percentage of gross income net of taxes, interest, necessary household expenses, etc.) is conservative. However, it appears high compared to other developing countries, including other former Soviet countries, and may lead to repayment problems in the future.

- The bank plans to obtain credit reports from the National Bureau of Credit Information, but the bureau is not yet operational.
- Although the bank requires an account statement to confirm the availability of the down payment amount, it does not check on the source of the funds to ensure that the down payment is not borrowed.
- The property is assessed by the bank's in-house appraiser. Typically, the valuation is 20-30% lower than that of a third-party appraiser. The lack of accepted appraisal standards and methods creates potential risks. Bank appraisers tend to use the comparative method, but there is little objective market information.

The sources of potential credit risks can be summarized as follows:

- Limited ability to verify income due to unofficial incomes and the short underwriting period
- Inability to verify the source of down payment funds
- Weakness in property appraisals owing to the lack of common standards and objective market information
- Credit bureau reports are not available
- Since escrow accounts do not exist, there is risk of lapsed insurance (and settlement-related risk for both buyer and seller)
- Lack of title insurance

Ipoteka Bank is therefore exposed to a number of credit risks associated with its mortgage portfolio. Unless appropriate policies and procedures are put in place, these risks may become a serious source of instability as the bank's portfolio grows.

Interest Rate Risk

Ipoteka Bank offers mortgages of up to ten-year terms at fixed interest rates. This exposes the bank to significant risks should interest rates increase across the banking sector. The bank could then have difficulty refinancing mortgage loans as a significant portion of its liabilities is funded from short-term deposits.

However, in recent years, loan interest rates across the banking sector were in a downward trend which is likely to remain in medium term. In addition, Ipoteka Bank currently has a safety cushion in the form of significant, regular and relatively inexpensive public budget funds deposited by its clients – government organizations. The risks will increase, however, once the State Treasury is established and starts receiving public budget funds currently held by banks. The similar problem can be faced also by other banks that fund liabilities from short-term deposits. To mitigate the interest rates risk, banks should develop new loan products such as floating rate loans, hybrid products, etc.

Liquidity Risk

In the short term, while its long-term mortgage portfolio is small, Ipoteka Bank is unlikely to be exposed to serious liquidity risk. However, unless the bank increases funding from longer-term sources, its liquidity risk will increase, especially once the State Treasury is established. Mortgage Lending Support Fund does not intend assisting banks in maintaining the liquidity parameters, so banks will have to deal with this problem in their own.

Exchange Rate Risk

Mortgage loans are disbursed and funded in local currency, and therefore, Ipoteka Bank does not have direct risk with respect to foreign exchange. However, since loan interest is not indexed to exchange rates, devaluation of local currency against other currencies may expose the bank to risk. Banks do not hedge their foreign currency risks. Some experts think, however, that Uzbekistan's banking sector is exposed to significant exchange rate risks stemming out of currency structure of assets and liabilities of large banks.

Early Repayment Risk

Currently, Ipoteka Bank encourages early repayment of because its funding base is reportedly predominantly short-term.

Obstacles to the Development of Residential Mortgage Lending

Mortgage lending effectively started less than six months ago, with the participation of only two banks. The main obstacles to its development therefore stem from insufficient legal and institutional infrastructure, and from the lack of institutional capacity. These conditions are similar to those found in other Central Asian countries.

For the most part, Uzbek banks lack efficient internal procedures for the origination, underwriting and servicing of mortgage loans and for managing the related risks. The legal and regulatory framework for mortgage lending is underdeveloped, and Ipoteka Bank offers its limited range of lending products based on a fragmented, temporary lending policy, with many elements still under development.

In addition to insufficient internal policies and procedures, there is lack of access to long-term funding. This severely limits the ability of banks to offer loan products that suit the needs of the potential client base and considerably limits their capacity to offer long-term loans without considerably increasing liquidity and interest rate risks. Ipoteka Bank is forced to limit the maximum loan amount to the equivalent of about US \$22,500 and encourage its clients to repay early in order to reduce the liquidity gap and interest rate risk. With underdeveloped capital markets, lack of longer-terms resources and a limited capital base, banks will need, at least initially, to seek funding through long-term loans from international financial institutions.

In addition, there is a lack of qualified specialists in underwriting and servicing mortgage loans and managing mortgage risk.

Real Estate Agencies

There are no licensing requirements for real estate agents and a large number of companies and individuals provide realtor services. Their functions include collecting and compiling information on real estate supply and demand, providing brokerage services and assisting with preparing agreements of purchase and sale. The average cost of these services is about 3% of the final sales price of the property.¹⁰¹ Most real estate agents operate unofficially and are not licensed or regulated in any manner. The size of the market for their services and the number of transactions in which they are involved is therefore unknown.¹⁰² There is an Association of Real Estate Companies, but its membership is small and it has limited institutional capacity. It is thus unable to serve as a mechanism for establishing a transparent and efficient marketplace for realtor services based on uniform professional and ethical standards.

Currently, no real estate agencies perform market research or regularly publish information on the housing market. Any analysis is typically based on intuitive estimates. This further limits the ability of mortgage market participants, primarily banks, to obtain fair and accurate pricing and other information on the housing market, thus distorting their perception of the risks.

Insurance

At the end of 2005, twenty-five insurance companies were operating in Uzbekistan, including twenty-three companies specializing in general insurance and two companies providing life insurance. In 2005, the total authorized capital of insurance companies reached about US \$64.4 million. Like the banking sector, the insurance sector is very concentrated. In terms of insurance premiums, three companies control more than 50% of the market.¹⁰³

¹⁰¹ Based on information obtained from realtors.

¹⁰² Since escrow accounts and bank safety deposit boxes are not available, most realtors are paid in cash, which exposes them to substantial risk of non-payment.

¹⁰³ BVV newspaper, №.49, December 7, 2005 and № 52, December 29, 2005

Although nearly all insurance companies offer both commercial and residential property insurance, other insurance products required in mortgage lending are unavailable. There has never been a need for title insurance, for example, and therefore insurance companies have not developed this product. The same true of primary mortgage insurance. Because of strict capital requirements, only two insurance companies have licenses to provide life and disability insurance. Effectively, only one provides this service, and it is extremely expensive.¹⁰⁴

The main impact on mortgage lending of this lack of appropriately developed insurance products is increased credit and title risk for banks. Property insurance in Uzbekistan costs about the same as in neighboring countries, but the high cost of life insurance may either limit access to mortgages for potential borrowers or force banks to forgo this requirement and assume higher risk. (However, life insurance is not compulsory at a number of banks in Eastern Europe that offer mortgage loans, nor does Fannie Mae require it in the United States.)

Appraisal

Currently, pre-qualified borrowers, at their own cost, provide Ipoteka Bank with a third-party appraisal (by a licensed appraisal company) of the property they are considering. More than 250 companies are licensed to perform residential appraisals, but only thirty to forty actually operate in this market. The bank's in-house appraiser also values the property, usually, as mentioned, at 20-30% below the third-party appraiser's valuation. The bank will proceed with underwriting only if the borrower accepts this lower valuation (in most cases they do). Though this process may be warranted at the current stage of development in mortgage market, in the longer term, given the inadequate regulation of appraisal activity, it may promote corruption among both appraisal companies and banks.

Appraisal is regulated by the Law "On Appraisal Activities," adopted in 1999. However, the law cannot be fully implemented before unified appraisal standards are established. The law does provide for the development of standards, but for unknown reasons, they are not yet in place. Currently, appraisers use cost-based, income-based and comparative methods in valuing residential real estate. All three methods contain some flaws that cast serious doubt on the quality of the appraisal. For example, the cost method is based on data dating back to 1990s. For the comparative method, the appraiser lacks a credible source of information. Additional problems hindering the development of reliable appraisals include the insufficient qualifications among appraisers and the lack of quality control. The incomplete legislative framework for appraisal activities, and lack of the institutional capacity, also prevents the existing Association of Appraisers from addressing these issues.

¹⁰⁴ See Appendix 4.2 for insurance costs in Uzbekistan compared with other project countries.

6.4 The Legal & Regulatory Environment

Although the current legislation does contain regulations governing mortgage lending, a number of critical legal obstacles remain. The primary mortgage-related legislation is rudimentary and theoretical. Further development is needed, because there is not enough practical detail to provide comfort for large-scale mortgage lending activities.

There is currently no separate law governing mortgages. The key acts applicable to mortgages are the Civil Code and the Law “On Pledge.” These regulate certain related elements, such as mandatory registration of mortgages. However, this legislation does not contain other provisions important to the efficient functioning of residential mortgage lending, such as the foreclosure process or the assignment of mortgages.

At time of writing, the government has begun drafting a Law “On Mortgage.” The draft law contains more detailed provisions regarding collateral. It also introduces new legal definitions. In particular, it defines terms such as “mortgage note” and “mortgage by operation of law.” These legal mechanisms should help reduce risk for lenders, bring efficiency to mortgage market as it develops and reduce borrowing costs, including transaction costs.

In order to encourage progress in the development of the residential mortgage market, certain matters require the attention of the authorities. The most critical issues are discussed in the following sections.

Title Registration Process

The system of title registration is unified throughout the country. State registration of title and other proprietary rights in real property is required by law. The agreement of purchase and sale and the mortgage agreement are also subject to mandatory registration.

The state authorities¹⁰⁵ enter the registration data for title and all property-related documents in a central registry. In Uzbekistan, unlike other jurisdictions, information on a property may be held in several registries maintained by various state bodies. Thus, information on a registered mortgage is contained in the registering body’s registry, as well as in the registry of the 1st State Notarial Office.¹⁰⁶

However, the interaction between the 1st State Notarial Office and the state registering body is unclear, since both entities are involved in processing property pledge transactions (see below). At the same time, the objectives and tasks of both registers are practically identical. Notably, the Law “On Pledge” provides that property registration information is a matter of public record. However, the same law provides that access to the information in both registers is limited to certain persons/organizations with the right to access that information. Upon request from such a persons/organization, the state registering body and the 1st State Notarial Office can provide an abstract of the record of existing encumbrances on any registered property. It is important to note that the legal power of such an abstract is not set out in the legislation. The cost of obtaining an abstract is 50% of the minimum monthly salary.¹⁰⁷ The abstract is issued within one hour of the request and is valid for one calendar day.

The existing process of registering title for a sale involving mortgaged property is burdensome and expensive, for both the borrower and the lender, and contains certain issues and risks. There is no mechanism for simultaneous registration of title transfer and mortgage, and the parties have to register the agreement of purchase and sale and the mortgage agreement through consecutive processes.

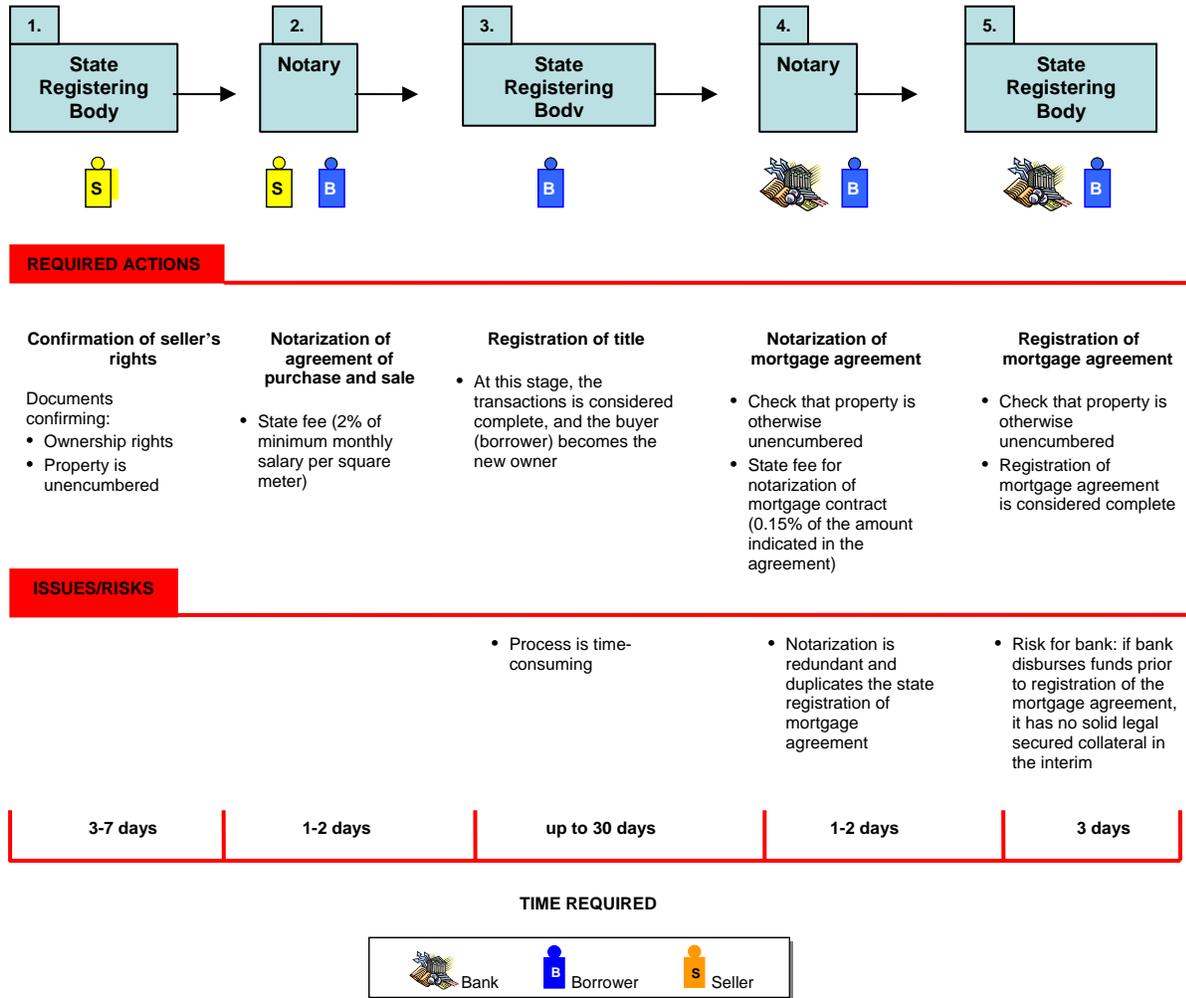
¹⁰⁵ Goskomzemgeodezkadastre and its regional branches, including the Bureau for Technical Inventory, are primarily responsible for registering title to property and any encumbrances on that property.

¹⁰⁶ The state notarial office established by the Ministry of Justice of the Republic of Uzbekistan.

¹⁰⁷ As of July 2006, the minimum monthly salary is 10,800 Uzbek Soum (around US \$8.80).

The diagram below describes the steps in the registration process, as required by current legislation, and outlines the issues and risks.

Process for Title and Mortgage Registration in Uzbekistan



As is clear from the diagram above, the existing legislation requires further development in order to streamline the procedure for the registration of title and mortgages. The following matters should be given priority:

1) Consecutive Registration of Title and Mortgage

One of the most important problems in the registration process is the lack of a mechanism that allows for simultaneous registration of title and mortgage. The time between registering title and registering the mortgage agreement can exceed thirty days. This creates risks both for the lender and for the seller. In practice, in order to reduce risk, banks will not advance money to the seller until the mortgage is registered. At the same time, the seller assumes the risk of surrendering title without any guarantee of payment.

Moreover, current legislation does not provide for efficient method of settlement where the purchase is financed through a mortgage. In western practice, parties use escrow accounts¹⁰⁸ to transfer funds in a safe and reliable manner.

2) Lack of Private Property Land Rights and Separate Consideration of Land and Buildings

The land legislation limits the private ownership of land.¹⁰⁹ Most land is state owned. In general, individuals and legal entities obtain proprietary rights to the use of land, where the ability to pledge their rights is uncertain. Although legislation allows proprietary rights to land to be pledged, there is no mechanism regulating the transfer of proprietary rights to land where a mortgage is involved.

Moreover, the Uzbek legislation does not recognize the concept of real property as comprising land and buildings, even for registration purposes. Only buildings are considered in real estate transactions. For example, there is no foreclosure procedure for pledged land. As a result, lenders will incur higher risk if they accept a residence as collateral. Legally, they accept a pledge only on the building, not on the land on which it is built. Thus, the most serious risk for the lender is that the owner of the land, the state, may seize the land to build a road, for example. Although all of the relevant legislation, such as the Civil Code and land, housing and urban development legislation, provides for compensation in cases of expropriation of land, there is little detail regarding how such compensation is to be paid.

Proprietary Right to land allows the person who possesses it to act without the consent and support of other persons with respect to the property.

Uzbek legislation provides for the following proprietary rights to land:

- lifetime possession, with hereditary succession
- permanent or temporary possession and use

Ownership includes three elements: right to use, right to possess and right of disposal. By contrast, proprietary rights usually do not include the right of disposal. Thus, the holder of proprietary rights, in most cases, has no right to dispose of the property without the consent of the actual owner, generally the state.

3) Mandatory Notarization of Agreement of Purchase and Sale and Mortgage Agreement

The existing process for executing an agreement of purchase and sale and subsequent mortgage agreement includes the requirement for mandatory notarization of the agreements. In the case of the agreement of purchase and sale, the notary certifies the signatures of the seller and the buyer and verifies, if applicable, the consent of the seller’s spouse and children of legal age¹¹⁰ to sell the subject property. The notary also checks for any encumbrances on the property. This is an important and necessary function. However, the notarization of the mortgage agreement is redundant, because its function at this stage (establishing the ownership rights of the seller) is fully duplicated in the subsequent registration of the agreement with the state registering authority. Furthermore, when title insurance becomes available, notarizing mortgage agreements will be even more duplicative.

To register a mortgage agreement, the applicant¹¹¹ must produce a notarized mortgage agreement. The notary bases the notarization on a review of the following documents:

- an abstract from the record in the state registering body confirming that the property is free of any encumbrances or third-party interests (the information in the abstract is identical to the similar abstract from the records maintained by the 1st State Notarial Office)

¹⁰⁸ *Escrow accounts* - documents, real estate, money, or securities deposited with a neutral third party (the escrow agent) to be delivered upon fulfillment of certain conditions, as established in a written agreement.

¹⁰⁹ According to Article 18 of the Land Code of the Republic of Uzbekistan the right of ownership of land may be enjoyed by (a) legal entities and individuals as a result of privatization of constructions (and land plots under them) used for trade and non-manufacturing businesses/ services; (b) foreign diplomatic organizations and their personnel.

¹¹⁰ In cases when property tenants are children without parents (under guardianship), written and notarized consent of the guardian is needed (Housing Code, Article 32). There is also no special provision in the legislation requiring a permission from the state body supervising rights of the elderly or aged people (such body does not exist in Uzbekistan).

¹¹¹ The borrower and lender must be present during the notarization of a mortgage agreement.

- Cadastre Book previously issued to the property owner (by law, only the property owner has the legal right to mortgage the property), containing the certificate of property ownership, a schematic drawing of property layout and any other documents confirming legal possession (e.g. notarized original of the agreement of purchase and sale)
- notarized written statement of family members of legal age confirming consent to mortgage the property
- receipt for payment of the state notarization fee (0.15% of the property value stipulated in the mortgage agreement)¹¹²

Since the legal documents presented for mortgage registration are generally reviewed by notaries, the grounds on which notarization may be refused, in which case the mortgage cannot be registered, are set out in the Law “On Notarization:”

- the transaction or documentation does not comply with the standards set out for notarization (for example, the documents do not comply with requirements or the property cannot be pledged owing to prior encumbrances or a previous court ruling)
- the notary is not authorized to perform the notarization (for example, non-residents must obtain notarization from the 1st State Notarial Office)
- the applicant is legally incapacitated

The notary must notify the applicant in writing, within three day of the application, if notarization is refused.

The legislation contains a number of contradictions with respect to the documents required to notarize an agreement of purchase and sale and a mortgage agreement and to register them. In practice, the parties must gather documents repeatedly, including duplication, in order to complete these processes. Consideration should be given to a comprehensive review of the documentation required for notarization and registration in order to streamline the list. This would eventually contribute to reducing time and expense, without detriment to the interests of the parties.

The notary function has minimal legal value. This is because notarization does not render the notarized agreements legally valid. The agreement of purchase and sale and the mortgage agreement become legally valid only after they are registered with the state registering authority.

4) Registration of a Mortgage

Registration of a mortgage at the state registering body requires the notarized mortgage agreement, a completed application and a receipt for payment of the state registration fee. The fee is 0.1% of the property value indicated in the mortgage agreement (the fee for mortgage extensions is 0.2% of the agreement value).

The legislation does not set out any grounds for refusal to register the mortgage. In practice, the registration authorities never refuse to register title and mortgage on a property if all required legal documents are properly notarized.

5) High State Duty

The fee for registering title is low (one-tenth of the minimum monthly salary), but other expenses related to processing property ownership rights are quite burdensome. Until recently, one of the significant obstacles to the development of mortgage lending was the requirement to pay a state duty of 10% of the transaction amount to notarize the agreement of purchase and sale. This amount payable was calculated based

Inventory cost is the value of the property as appraised by the state property registering authority. It is used to calculate various taxes and other fees with respect to the property. It is similar to the western term “assessed value” for tax purposes.

¹¹² It is important to note that the mortgage registration process does not require submission of the mortgage agreement.

on the “inventory cost” (assessed value) of the property and was payable to the notary by either the seller or the buyer (as mutually agreed). Practically all agreements of purchase and sale in Uzbekistan showed either the inventory cost or slightly more, rather than the actual price.

The high state fees resulted in massive understatement of transaction values.¹¹³ This led to considerable risk for the seller and the buyer and had negative implications for mortgage lending:

- Given the incentive to understate value, the parties would press appraisers for a valuation well below the market price, thus creating incentive for corruption.
- Ultimately, the state fee is factored into the sale price, making property less affordable.
- With the country-wide practice of understating values, it is impossible to identify real price trends in the property market. This impedes the ability of the buyer and the seller to make an educated decision as to fair pricing. Moreover, this environment prevents appraisal companies from compiling the real market data necessary to perform accurate appraisals.

In early July 2006, the Cabinet of Ministers adopted a resolution to lower the fee, which will substantially eliminate much of this risk.¹¹⁴ The new state fee to notarize an agreement of purchase and sale was set at 2% of the minimum monthly salary per square meter of living space.

6) Contradictions in Regulations Governing the Mortgage Agreement Registration Procedure

The legislation contains conflicting regulations with regard to the state registration of mortgage agreements. For example, the Law “On Pledge” requires registration of mortgage contracts with the state body responsible for registration of the rights in real property (Goskomzemgeodezkadastre). At the same time, the decree of the Cabinet of Ministers No. 50, which is still in force, stipulates that all mortgage contracts must be registered with the Ministry of Justice. In practice, commercial banks operate with the provisions of the Law “On Pledge” as the controlling law, but there is the possibility that the courts may invalidate mortgage contracts registered in accordance with the Law “On Pledge” because of the conflicting interpretations of the proper registration procedure.

7) Assignment of Mortgages

Under the Civil Code, the assignment of a principal obligation involves a simultaneous transfer of a pledge, which can also apply to a mortgage. The assignment of the rights of a primary lender does not require the consent of a borrower. Thus, the new lender will bear the risk of any unfavorable consequences flowing from failure to notify the borrower of the transfer. Fulfillment of obligations to a primary lender is still acknowledged as fulfillment of obligations to a new lender.

The Civil Code requires that an assignment of rights in any transaction requiring state registration must be registered in the same manner as the original transaction. In the case of a mortgage, this implies mandatory notarization of the amended mortgage agreement and subsequent registration of the amended agreement with the state registration authority.

¹¹³ Typically, the seller and the buyer would agree to declare only a fraction of the real amount of the transaction officially in order to minimize the fee. The buyer would pay the difference in cash, unofficially.

¹¹⁴ Resolution of the Cabinet of Ministers No. 109, “On revising state duties for notarial services” (July 7, 2006). The state fee for notarization of an agreement of purchase and sale depends on relation degree between the seller and the buyer, but must not exceed 2% of minimum monthly salary per square meter of living space. However, for commercial premises, the fee is based on a total area.

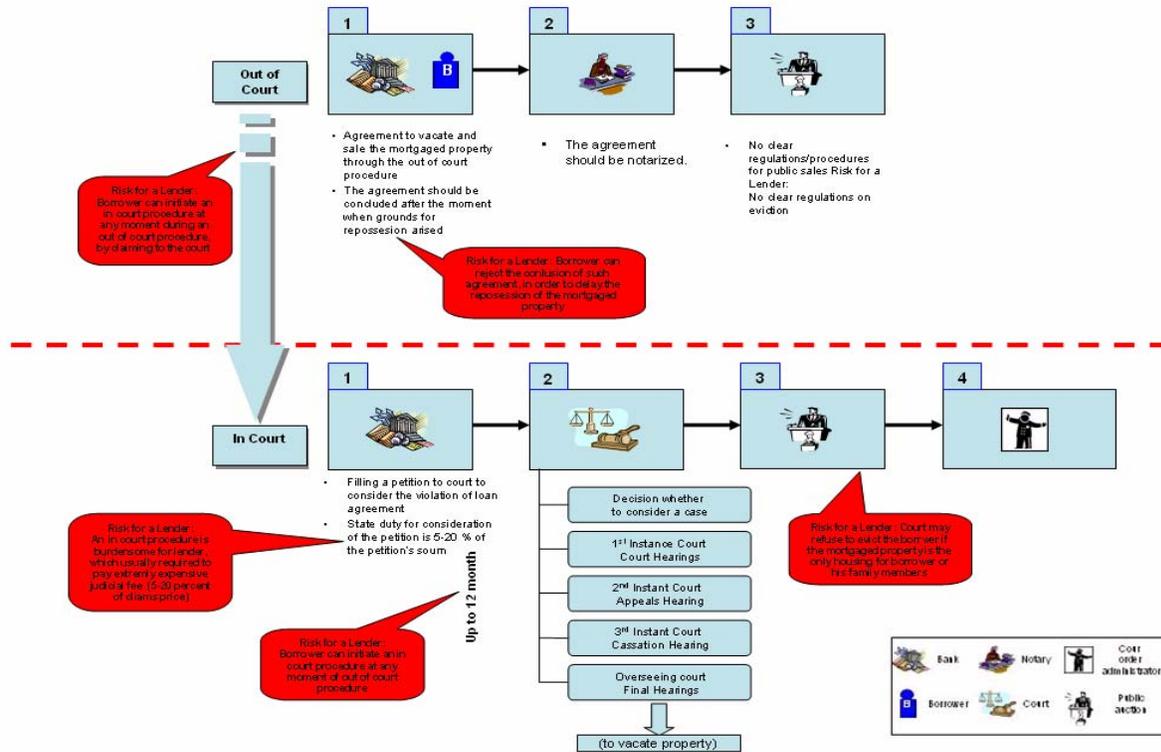
However, the Law “On Pledge” places the responsibility for submitting the documents required for registration of the amended mortgage agreement on the borrower. Thus, the lender cannot apply the provision of the Civil Code that allows assignment of a credit obligation without notifying the borrower. Moreover, the lender is in a difficult position if the borrower refuses to cooperate. These requirements and contradictions make assignment difficult to complete.

Although there has been no assignment of mortgages in practice, the cumbersome procedure set by the existing legislation could prove to be a serious obstacle to increasing the liquidity of the mortgage lending market by developing the secondary mortgage financing market.

Foreclosure and Eviction Procedure for Mortgaged Property

The general foreclosure procedure is outlined in the Law “On Pledge”. The provisions of the law are applicable to both court proceedings and out-of-court foreclosure (based on a notarized agreement between the lender and the defaulting borrower). Disposition of the pledged property is by public auction according to a process set out in the legislation. However, if the property is the only residence of the borrower, a provision of the Law “On Execution of Judicial Orders and Orders of Other Bodies” applies to prevent foreclosure. Because of this provision, and the lack of actual foreclosure practice, the lender’s rights in settling a claim in the event of default are unclear. The following diagram shows court and out-of-court foreclosure procedures and identifies major risks for the parties involved.

Foreclosure and Eviction Procedure in Uzbekistan



Out-of-Court Settlement

The out-of-court foreclosure procedure for a mortgaged property is ineffective and does not provide a balanced approach to protecting the rights of the lender and the borrower. The borrower has the right to suspend the out-of-court procedure at any time petitioning the court for protection. This will draw the lender into an expensive and lengthy court proceeding. There has been no foreclosure on mortgaged property in practice, but local commercial banks express concern that the existing legislation does not fully secure the rights of lenders.

The out-of-court procedure is voluntary. To be successful, the defaulting borrower must acknowledge the default, agree to the sale of the mortgaged property and be willing vacate the property.

The parties are obliged to conclude and notarize an agreement on the out-of court settlement as soon as grounds for foreclosure emerge. In theory, when the property is sold at public auction, the bank receives the proceeds of the sale, applies it to the borrower’s outstanding debt (including expenses related to the foreclosure procedure) and remits the amount remaining, if any, to the borrower. However, as noted, the borrower has the right to suspend the out-of-court procedure at any time by petitioning the court. If the court agrees to hear the case, it will require suspension of any out-of-court procedures (including preparations to sell the foreclosed property). As a result, lenders have more confidence in court proceedings, however lengthy and expensive.

Court Proceedings

The legislation governing court foreclosure proceedings also has a number of problems that may hinder the further development of the primary mortgage market in Uzbekistan. The most serious problem relates to uncertainty with respect to possible exemptions from eviction orders, especially when the property is the borrower's the only residence. By law, the property may not be seized if it is the only residence of the borrower and/or members of the borrower's family. The lender therefore runs the risk that the court may deny a foreclosure application in such instances, and banks are reluctant to take sole residences as collateral. Thus, mortgages are least accessible for the potential borrowers who are most in need of housing because they have a single residence.

During the court process, the lender incurs the risk of a delay in the judgment (up to one year) if the borrower chooses to appeal the initial ruling. In addition, the court may order the lender to stop accumulating interest on the arrears (although, by this stage, the mortgage should be non-accrual in any case).¹¹⁵

Another serious problem in the court procedure is the high court costs. The costs can be as much as 20% of the amount claimed. Although the losing party pays, the high costs materially reduce the amount ultimately received from the sale of the foreclosed property. This is certainly the case for the borrower, because the bank will deduct the costs from any surplus realized on the sale of the property after discharging the debt. However, the bank runs the risk that the sale price may not cover both the debt and the costs.

Lack of Provisions Regulating the Public Auction Procedure

In both court and out-of-court foreclosures, the property is sold by public auction. However, the legislation does not provide any clear regulation to govern the process. This provides opportunities for the defaulting borrower to contest the result of the auction, or even to prevent the auction from taking place, thus adding another risk for a lender.

Rights of the Borrower's Family Members

The housing legislation does not provide for the simultaneous termination of the rights of the family members of the primary owner if a property is repossessed. This greatly increases the lender's risk, since the defaulting borrower's family members may continue to use the property even after foreclosure. In this situation, it is almost impossible to dispose of the property.

Lack of any Priority on Satisfying Claims Secured by a Mortgage

The Law "On Pledge" provides for the priority of claims secured by a registered mortgage over claims by other creditors. However, the legislation on the execution of court orders provides that claims secured by the pledge are to be satisfied only as the fourth priority, after satisfaction of claims by the state authorities and certain other claims.¹¹⁶ The lack of priority for claims secured by a pledge may become a serious obstacle for financial institutions in further advancing their mortgage lending operations.

Limitations on Valuation

The pledge legislation provides that the appraised value of the mortgaged property may not be lower than the value assigned by the state authority for registering property rights. As discussed above, in most cases the

¹¹⁵ Under the Central Bank provisions, short-term loans (up to one year) are to be non-accrual when payment has been outstanding for sixty days. Long-term loans (over one year) are to become non-accrual after payment has been outstanding for ninety days.

¹¹⁶ The following claims have priority over the claim of a mortgage lender:

1. mandatory payments to the state, alimony payments, payments under employment contracts, judgments to pay damages, and fees for legal services
2. pension contributions, and payment for loss or damage to the property of any individual or legal entity through a criminal or administrative act
3. claims by any of the compulsory insurance programs

inventory cost value is lower than the market value, but this limitation contradicts the legislated right of parties to mutually agree on the value of the mortgaged property.

Taxation Issues

The tax system is not structured to encourage the development of the primary mortgage market. There are a number of deficiencies, which need to be further investigated and possibly addressed by the government. For example, commercial banks are enjoying an exemption from tax on income from mortgage lending until January 1, 2010. Non-bank financial institutions planning to begin mortgage lending (mainly credit unions, which are heavily regulated by the Central Bank of Uzbekistan) will not have this exemption and will therefore not have a level playing field.

Furthermore, VAT of 20% is to be imposed on the proceeds of the sale of foreclosed property. This high tax burden may force lenders to lower loan to value ratios, thus decreasing access to mortgage loans.

Another pressing issue potentially hindering the development of the primary mortgage market is that mortgage interest is not tax deductible for the borrower.

6.5 Government Policy in Housing Finance

The government only recently identified housing development as a priority for the country. Initially, this priority was emphasized in the Presidential Resolution of February 2005, where one of the main tasks identified was to establish the Mortgage Lending Support Fund, under the Ministry of Finance, with a focus on developing a subsidized housing finance program for low-income families. The government has allocated around US \$3 million for the fund to start operations. Under the proposed program, the resources allocated will be disbursed to authorized commercial banks for mortgage on-lending. These mortgages will have fifteen-year terms, with maximum loan-to-value ratio of 80%, interest rates of less than 5% per annum and a grace period of up to three years for repayments. At present, the fund's proposed operating policies and procedures are being reviewed by the Central Bank of Uzbekistan.

In addition, the government is also actively discussing various options to improve the business plan of the Mortgage Lending Support Fund, with a view to transforming it into a true mortgage institution.

Outlining strategic priority areas for further reforming and modernizing the country in his March 2005 Resolution, the President directed the relevant ministries and agencies to develop a full-fledged Law "On Mortgage." The intra-ministerial working group set up to complete that assignment was quite efficient and successful in drafting the law and guiding it through the first three readings in the Lower Chamber of Parliament. The last took place in June 2006. The draft law is currently being further reviewed and amended in preparation for reading in the Upper Chamber, the Senate, scheduled for the end of August 2006.

The draft Law "On Mortgage" draws on experience with similar legislation in other CIS countries. It will eventually regulate such key mortgage-related matters as registration, foreclosure (court and out-of-court) and eviction, the rights of subsequent mortgagees, and the status and issuing provisions for mortgage notes and other mortgage-related instruments.

In general, if fully adopted, the new law will significantly improve the legal environment for mortgage lending by consolidating and unifying, under one legal act, the issues most important for the industry. The government will also start amending other legislation to bring it into conformity with the proposed Law "On Mortgage." Some examples are the Civil Code, the Housing Code (to curtail the rights of the family members of a property owner), and the Law "On Execution of Court Orders and Orders by Other Bodies" (to allow foreclosure where the property is the sole residence of the defaulting borrower).

The most notable recent government decision was related to the development of an appropriate mechanism for introducing private ownership of residential and commercial land. However, the government still lacks a clear vision for how this measure should be implemented.

6.6 Recommendations

The recommendations for the development of a national system of residential mortgage lending fall into three general categories:

- Strengthening the legal and regulatory environment to encourage the development of system of housing finance
- Strengthening the institutional capacity of key participants in the mortgage market and furthering the development of their potential
- Improving state housing policy

Key recommendations for each proposed area of reforming are described below.

Strengthen the Legal Environment

- Develop and adopt the Law “On Mortgage,” including a detailed description of the mortgage registration process and foreclosure procedures (court and out-of-court), a mechanism to introduce mortgage note and govern their circulation, and any other provisions necessary for the development of the residential mortgage lending industry.
- Amend the Civil Code, the Law “On Pledge” and other existing legislative acts to bring them into conformity with the proposed Law “On Mortgage.”
- Develop and adopt a specialized legislative act to regulate the state registration of ownership rights in real property and any transactions involving the property
- Amend the Land Code to establish clear procedures with respect to pledging certain types of proprietary rights on land, its seizure and disposal to third parties in case of default
- Amend the Civil Code and any other relevant legislation to establish the concept that real estate consists of both the land and the buildings on it, including for registration purposes.
- Gradually eliminate duplication in the functions of notaries and registration authorities in the process for registering title and mortgages on residential property.
- Amend the legislation to facilitate the enforcement of eviction orders where the property is the sole residence of the borrower and his/her family.
- Amend the legislation to provide mortgage lenders with the priority claim on the proceeds of the sale of a foreclosed property by public auction.
- Develop and adopt all relevant normative acts detailing the foreclosure procedure for mortgaged property upon default by the borrower.
- Amend legislation to reflect the government intention to introduce private ownership of the land component of housing.
- Adopt legislation governing the use of escrow accounts.
- Adopt specialized legislation to govern securitization of mortgages and issuance and circulation of mortgage-backed securities.

Strengthen Institutional Capacity in the Mortgage Market and Develop its Potential

Develop Efficient Mortgage Lending Practices in the Banking Sector

- Develop and introduce unified standards and procedures for residential mortgage underwriting, closing, servicing, and guidelines for risk management
- Develop and introduce standard residential mortgage documentation
- Develop and introduce a broader mortgage product line
- Improve the professional skills of bank staff with respect to residential mortgage lending
- Introduce a separate reporting system under the Central Bank of Uzbekistan for mortgage loans in order to efficiently monitor the performance of the aggregate mortgage portfolio of the banking sector and improve knowledge of market conditions.

Strengthen the Role of Independent Appraisers

- Develop effective monitoring and certification systems for professional appraisers of residential property.
- Develop and introduce standard methods and procedures for residential property appraisal, including standard reporting forms.
- Improve the institutional potential of the Association of Appraisers.

Strengthen Cooperation between the Insurance and Residential Mortgage Lending Sectors

- Broaden the line of insurance products necessary for the further development of residential mortgage lending.
- Develop and introduce standard insurance products and standard insurance documentation for use in residential mortgage lending, including a uniform insurance contract and uniform policy.

Strengthen the Potential of the Mortgage Lending Support Fund

- Improve the business model of the Mortgage Lending Support Fund to transform that organization into a true mortgage institution, and create appropriate and efficient mechanisms for mobilizing long-term funding for further development of residential mortgage lending.

Introduce a Comprehensive State Housing Policy

- Develop a comprehensive state housing policy regarding the creation and development of a national system of housing finance.
- Develop effective policies and mechanisms to guide state support for housing for low-income groups.
- Analyze the opportunities to create a tax framework that will stimulate and foster the growth of residential mortgage lending.
- Reform the residential construction sector to increase the supply of higher-quality, affordable housing.
- Improve public awareness of residential mortgage lending through the introduction of special information programs.

7. APPENDIX

The Status of Land Ownership and Land Lease Rights in the Project Countries

	AZERBAIJAN	KAZAKHSTAN	KYRGYZSTAN	TAJIKISTAN	UZBEKISTAN
Ownership of land (private vs. government)	Private property on land parcels exists along with state and municipal ownership rights.	Private property on land parcels exists along with state and municipal ownership rights.	Private property on land parcels exists along with state and municipal ownership rights.	All land is in state ownership. Land parcels are granted to other entities on the basis of other kind of property rights (usage or possession).	All land is in state ownership (marginal exceptions from this rule exist). Private property arises only on land parcels under the privatized commercial trade objects and land parcels sold to diplomatic missions.
Ownership rights registration system (under title transfer)	Parties are obligated to notarize the sale-purchase contract and then register the ownership rights on real estate object at the state registering body.	There is no obligatory requirement to notarize the contracts of sale-purchase of real estate object.	Parties are obligated to notarize the sale-purchase contract and then register the ownership rights on real estate object at the state registering body.	Parties are obligated to notarize the sale-purchase contract and then register the ownership rights on real estate object at the state registering bodies	Parties are obliged to notarize agreement of purchase and sale and then register the ownership rights on real estate object at the state registering body.
Terms of Land Lease	N/A	N/A	N/A	Land parcels can be given to entities on the basis of <i>lease (up to 20 years), term (3-10 years) and 'term-less' usage</i> and on the basis of <i>life-long inherited possession</i> rights.	Land parcels can be given to entities on the basis of <i>lease (identified only for agricultural land parcels 30-50), term (3-10 years) and 'term-less' usage</i> and on the basis of <i>life-long inherited possession</i> rights.