

# Kyrgyzstan's "Squatter Communities" and the Potential of Housing Micro Finance to Support Upgrading<sup>1</sup>

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In recent years Kyrgyzstan's economy has shown solid growth after the very difficult years following Russia's 1998 financial crisis. This solid record was broken in 2005 as a result of the March "Tulip Revolution." As shown in Table 1, growth is expected to return in 2006 but this will depend on continued political stability.

Despite the generally good growth during 2000-2004, the country remains poor, with a per capita GDP of only about \$400 in 2004; in 2000, 52 percent of the population lived below the poverty line.<sup>3</sup> The Kyrgyz Republic remains substantially rural in character with 65 percent of its 5.1 million population still living in the countryside. In 2003, agriculture and forestry accounted for 52 percent of employment.<sup>4</sup>

The shuttering of plants and the disappearance of other work opportunities during the transition in smaller cities and in the countryside produced a major wave of migration to Bishkek (the capital) and, to a lesser extent, Osh. These migrants created new "marginal rings" or novostroika, ie, occupancy of completely unserviced sites, around the destination cities. Around Bishkek, some 42 communities have been established, with a total population of about 250,000.

This article focuses on these new areas and the role that market rate housing finance can play in improving living conditions in them. We argue that this is a prime opportunity for housing micro finance to play a significant role. Such lending has begun but could be sharply expanded.

## The Novostroika and Government Policies

Beginning in 1989, even before the collapse of the Soviet Union, these settlements were created by occupancy of completely unserviced land. Locally, such actions are called "invasions." But the term is something of a misnomer. The current reality is that households wanting a land plot in a new area (have to) apply to the government of the municipal raion (district) where the land sought is located. This procedure was created to accommodate those wanting to move to the major cities but without the means to purchase or rent a dwelling. Qualifying for a plot is demanding. Among the requirements in principle is that the household demonstrate that it has had at least one employed member for three

**Table 1. Macro-economic Indicators, 2000-2005**

Indicator	2000	2001	2002	2003	2004	2005	2006a
GDP growth rate (%)	5.4	5.3	0	7.0	7.1	-0.6	5.0
Inflation rate (%)	18.7	6.9	2.1	3.1	2.8	4.9	5.7

a. Projected

Source: IMF.

<sup>1</sup> This article is based on work for the project, Pre-Feasibility Study for Housing Finance in the Kyrgyz Republic, done for KfW under contract in 2006. Positions expressed are those of the authors and not necessarily those of KfW, the Urban Institute or Bankakadamie International

<sup>2</sup> The project is being executed for USAID by Chemonics International. When Mr. Struyk worked on this article, he was a Senior Fellow at the Urban Institute in Washington DC

<sup>3</sup> World Bank web site, Kyrgyz Republic Data Profile, as of January 2006.

<sup>4</sup> Economic Intelligence Unit, *Country Profile 2005: Kyrgyz Republic*, p.40.

years, someone is currently employed, and the household does not own a dwelling in the city. The raions have prepared the layouts of the novostroika areas and allocated the plots to those on the approved waiting list. Land rights come with the allocation, which the household can then register quite inexpensively.

The land allocated by the raions has all been publicly owned. In Bishkek, land, mostly from collective farms, has been transferred to municipality by a series of Government Resolutions. No private land has been taken. When households have claimed private plots, municipal officials have required them to give it up. In 2006 the Government decided that it would not allocate additional land to the municipality and that further novostroika around Bishkek would be in the Chui Oblast.

The plans developed by the raions have generally been enforced. Road rights-of-way are generous and residential lot sizes large—500 to 600 sq.m. is typical. Hence, these are low-density areas in contrast to the extremely high-density jumbled invaded areas of Asia and Latin America. The settlements' locations differ sharply in their quality, with some being in areas subject to frequently flooding or other hazards.

The municipality has responsibility for

providing infrastructure services, including roads, water, electricity, schools, and polyclinics. Since 1996 these investments have been partially financed by the Republic budget. In 2005, the agency responsible (OGUKS) had a budget of Som 162 million of which Som 104 million came from the Republican budget.

In oldest novostroika areas roads have been paved, electricity provided, schools built, and water pipes laid, although water-borne sanitation is not present. But the municipality is constrained by low budget resources and areas already 5-6 years old have only electricity installed. Transportation everywhere is provided by private vans that operate on municipally approved routes. In short, the municipality has the responsibility for providing these services but is able to finance only a small part of the needed investment.

Some squatters brought doors, windows, and other elements from their former units to use in constructing new units that begin really as shacks. Generally, the development of dwellings units has followed the classic model of incremental construction. Initially, a small unit is often constructed of mud bricks and a roof of durable materials. It is then improved and expanded over time. In the oldest novostroika areas most dwellings are now

constructed of durable materials, although a large proportion are not fully completed.

Experience in developing countries has fully demonstrated the complexity of defining and implementing a successful approach to upgrading squatter areas or marginal housing rings. Only a few countries have succeeded in organizing initial land occupancy by the "invaders" so that it is orderly, thereby greatly facilitating the eventual provision of basic infrastructure.<sup>5</sup> In this context, Kyrgyzstan's record is impressive.

### Housing Finance<sup>6</sup>

After independence in 1991, a two-tier banking system was implemented in Kyrgyzstan. Supervision is executed by the National Bank of Kyrgyzstan (NBKR). As shown by the figures in Table 2, the banking systems in the countries in the so-called CIS-7 region are quite underdeveloped overall, even compared with the Baltics and Central Eastern Europe; and Kyrgyzstan fits this pattern.

There are 19 commercial banks and 319 credit unions operating throughout the country. In addition, there are 103 micro credit institutions, with Finca and Bai Tushum being the largest operating in urban areas.<sup>10</sup> They offer a mixture of crop, livestock, agro-processing, trade and

**Table 2. Indicators of Financial Debt in Selected Countries, 2002<sup>7</sup>**

Country Group	M2/GDP	Bank assets/GDP	Deposits/GDP
CIS-7	13.8	18.3	10.7
SEE <sup>8</sup>	35.4	45.5	23.5
CEE+B <sup>9</sup>	49.3	74.4	47.9

<sup>5</sup> For a good discussion of the components of a comprehensive upgrading program, see L. Antolihao and B. van Horen, "Building Institutional Capacity for the Upgrading of Barangay Commonwealth in Metro Manila," *Housing Studies*, vol. 20, no.6, 2005, pp. 873-96. Indonesia is an example of a country where informal land development has been regularized. See Chapter 4 in R. Struyk, M. Hoffman, and H. Katsura, *The Market for Shelter in Indonesia Cities* (Washington, DC: Urban Institute Press, 1990).

<sup>6</sup> In places this section draws upon, IFC, "Kyrgyzstan Housing Finance Gap Analysis," draft February 27, 2006, which will be one part of a larger report on mortgage lending in Central Asia.

<sup>7</sup> Source: World Bank, *World Development Indicators*, 2004, Table 5.5.

<sup>8</sup> Albania, Bosnia and Herzegovina, Bulgaria, Yugoslavia, Macedonia, Romania

<sup>9</sup> Central and Eastern Europe and the Baltic States: Croatia, Czech Republic, Hungary, Poland, Slovakia, Estonia, Latvia, and Lithuania.

<sup>10</sup> See International Business Council, "Priority Recommendations to Improve the Kyrgyz Business Environment," summer 2005.

### 3. Home Purchase Mortgage Product Examples at the End of 2005

	Minimum down payment (%)	Annual interest rate (\$)	Annual interest rate (Som)	Term (years)	Prepayment penalties?
Energobank	30	20	20	5	Yes
Kyrgyz Credit	50	24	24	3	No
Halyk Bank KYG	40	16	16	7	Yes
Demir Kyrgyz Int'l Bank	30	20	N/A	3	Yes
IneximBank	30	20	24	5	No
Bai Tushuma	40	N/A	24	5	Yes

a. Micro finance company

Source: IFC report, op. cit., with authors' additions.

mortgage loan products aimed primarily at the micro and SME markets. Combined lending amounted to \$19 mln. at the end of 2005.<sup>11</sup> The Kyrgyz Agricultural Finance Corporation (KAFC) also belongs to this group, which has been extending micro loans to farmers with World Bank financing.<sup>12</sup>

The banking system has experienced substantial growth in the past two years. Commercial banks' assets almost doubled over 2003-2005. Importantly, deposits from individuals rose by 86 percent over the same period. Despite the banks' growth, competition has not been sufficient to narrow sharply the spread between loan and deposit rates. They stand at 12-14 percentage points, in part because limited lending opportunities means that banks' costs are being amortized over a relatively small base.

In the context of banks' high liquidity, the demand for mortgage loans over the past years has been readily embraced by lenders. Mortgage lending increased sharply since 2002 when it really began, reaching Som 540 million (\$13 million) in outstanding loans at the end of 2005. Year-on-year growth in outstanding loan

balances was: 2002-2003, 372 percent; 2003-2004, 230 percent; and 2004-2005, 90 percent. At the end of 2005, mortgage loans accounted for 2.4 percent of bank assets and 7.0 percent of outstanding loans.<sup>13</sup> These figures give the upper limit to the development of mortgage lending for home purchase and improvements because the National Bank does not collect separate information on residential loans. But even including loans for other purposes secured by property, compared even to the countries of Eastern Europe, mortgage volume is very small. For example, the stock of mortgage loans is the equivalent of 0.4 percent of GDP in Kyrgyzstan, compared with 5 percent for the Czech Republic and Poland.

By March 2006, 17 of 19 commercial banks with full banking licenses were originating mortgages. Some non bank financial institutions are also originating mortgages for significantly lower loan amounts. One example is the Bai Tushum micro finance company, where home purchase mortgages in Bishkek average about \$10,000 and home improvement loans about \$5,000. A few of the country's 300+ credit unions have recently begun making mortgage loans.

**Mortgage products.** As shown in Table 3, interest rates are high and lending terms short. Average loan amounts are about \$15,000 according to the IFC, although there appears to be considerable variation among banks.<sup>14</sup> Many lenders impose prepayment penalties, but these seem mostly to apply only to the first year or two of the loan term. Maximum payment-to-income ratios are hard to define because the presence of substantial income that goes underreported or unreported to avoid taxes. Trying to determine true borrower income is a major challenge to loan underwriting. Banks interviewed reported using very high standards for the maximum share of monthly income for the mortgage payment as a percentage of net income (PTI), ie, 50 percent and even higher. Loans are fixed rate, self-amortizing. Most banks require property insurance but life insurance is viewed as excessively expensive. It is common practice to charge a 1 percent origination fee.

Under these conditions, only a small share of Kyrgyz households is able to take a mortgage loan for home purchase. The affordability problem associated with the short loan term and high interest rates is

<sup>11</sup> See Demir Kyrgyz International Bank, Annual Report 2004, page 5.

<sup>12</sup> It will remain a non-bank institution until its privatisation which is expected to be completed by end-2006. See IMF, "Kyrgyz Republic: First Review under the three year Arrangement under the Poverty Reduction and Growth Facility – Staff Report", November 2004, page 15.

<sup>13</sup> Data provided by the National Bank of the Kyrgyz Republic.

<sup>14</sup> One bank with whom the team met stated an average mortgage loan amount of \$30,000 to \$35,000.

<sup>15</sup> The high charges create strong incentives for collusion between the buyer and seller to understate the sales price.

worsened by the extremely high tax on property sales (5 percent).<sup>15</sup> All banks and the Non Bank Financial Institutions interviewed stated that they made home improvement loans as well and in all cases these are also secured by a mortgage on the property. Lending terms vary. At some banks the loan term (up to 5 years) and interest rate are the same as for home purchase loans. But at others the loan term is as short as one year, and both interest rates and loan origination fees are higher.<sup>16</sup>

**Risks in mortgage lending.** The two major risks associated with mortgage lending are credit and interest rate risk. Liquidity risk is also a problem with long-term loans reducing the ability of banks to generate cash quickly should it be needed. On the other hand, exchange rate risk associated with dollar denominated loans is manageable as 73 percent of deposits in commercial banks were in foreign currency at the end of 2005.<sup>17</sup>

**Credit risk.** There are four significant sources of credit risk.

- At least at some lenders' underwriting practices and elements of loan servicing are not well-developed, with an absence of clearly defined procedures and staff training. There are presently no publicly offered training courses for mortgage loan officers or on housing finance topics in general.<sup>18</sup>
- The process for registering the mortgage is not only cumbersome but also entails risk because there is a several day period between the recordation of the sale, and probably the payment of the seller by the bank, and the recordation of the mortgage lien. Worth noting is that amendments to

the Law on Registration were passed in January 2006 that permit private persons to access full records on individual properties, something that was not previously possible. Actual registration fees are low.

- The foreclosure process contains a good deal of uncertainty in principle. This arises from the ability of the borrower-in-default to exercise the option of having the bank's claim adjudicated in court at any time, even when an out-of-court settlement is near completion. It is also possible for the borrower-in-default to drag out the court process for as long as two years. Finally, proceeds obtained by the bank from in-court settlements are subject to taxation, which can be as high as 16 percent. Clear eviction regulations and procedures are absent.
- Property appraisals are done by bank staff who do not have specialized training in appraisal, putting lenders at risk of inflated value estimates.<sup>19</sup>

Most banks interviewed cited few problems in practice with registration and foreclosure. They are, however, pressing for amendments to the Law on Mortgage that would make the process more certain and efficient.<sup>20</sup> Moreover, the EBRD representative and some bankers indicated that they saw the foreclosure process as quite uncertain with respect to timeliness. A credit bureau (Credit Information Bureau—Trust) was established two years ago as a for-profit entity. It provides reports on juridical and physical persons. Presently about seven banks contribute data and get credit reports. Others complain of the high fees associated with membership and individual credit reports.

**Interest rate risk.** Banks are often making 5-7 year loans funded by short-term deposits. As long as mortgages and other long-term loans accounted for only a few percentage points of a bank's assets, the risk is clearly manageable. But if mortgages begin to account for a greater share of assets, they will represent a significant risk in the event that the cost of liabilities rises significantly. Banks have no way to hedge this risk.

**Expanding Housing Finance in the Novostroika**

The widespread availability of loans for dwelling upgrading would accelerate consolidation of homes in the novostroika. The probable welfare gains from improving living conditions appear to be large. Families' expenses for heating would very likely fall, leaving them with greater disposable income. In addition, positive health effects—a reduction in work days missed among the majority of those employed that have marginal jobs without any sick leave provisions—would also add directly to household incomes.

In early 2006, at least three lenders, two commercial banks and one micro finance agency, were already extending loans for dwelling upgrading or purchase to households living in Bishkek's novostroika. All three built this lending on their experience in extending SME and micro loans. Interest rates are comparable or somewhat higher than for other residential borrowers. Loans are mortgage loans, in part because registration is inexpensive and title search on these new properties very straightforward. The question is how to expand the lending volume.

The answer is to apply an adjusted version of the classic housing micro finance (HMF),

<sup>16</sup> For example, at one lender the terms for a home purchase mortgage are 5 year loan term, with a 20 percent interest rate and a 1 percent origination fee; for a home improvement loan the term is 1 year, the interest rate 27 percent and there is a 3 percent origination fee.

<sup>17</sup> Data from the NBKR web site. 97 percent of new deposits were in foreign currency, reflecting the political uncertainty in the country.

<sup>18</sup> A Bank Training Center has recently been founded that is associated with the National Bank. The team was unable to meet with the director.

<sup>19</sup> This is according to the Association of Kyrgyz Appraisers. It is worth noting that thanks to a donor-financed technical assistance program, the Association offers a range of courses on appraising various types of property using international standard methods. The Association certifies qualified members; certificates are signed as well by four government agencies. There are no licenses. The Association reported that generally bank staff are not interested in this type of training. It appears that prior donor SME finance programs, for example, have not required banks to use certified appraisers.

<sup>20</sup> In late February when the team was in Bishkek amendments to the Law on Mortgage were being considered by the parliament that would strengthen banks' position in the process.

as described by Bruce Ferguson based primarily on Latin American experience.<sup>21</sup> As he notes there are HMF products that are “linked,” ie, they determine the borrower’s creditworthiness on the basis of an already-developed credit history through prior SME loans, and “stand-alone” products. Many Kyrgyz lenders are skilled in underwriting SME loans and some in micro loans, and they are employing these practices in determining creditworthiness for housing improvement loans in the *novostroika*. But this still limits significantly the number of qualifying borrowers.

The second, “stand-alone,” product is a way to improve outreach and to increase the number of borrowers. It combines the loan component with a simple savings scheme that serves as a pre-screening instrument to select future reliable borrowers. According to experiences of contract savings schemes in European countries, customers with a savings contract prior to the loan disbursement have shown lower default rates than customers without a pre-savings contract.<sup>22</sup> Note, however, that this product needs to be offered only to those clients whose creditworthiness cannot otherwise be determined. Typically, such a scheme would be unnecessary for those clients who have already received a loan from the lender.

The main elements for this product are shown in Table 4. The underlying idea that a savings effort would lead to a loan promised for after successful completion of the savings contract. Both the savings and the loan periods would be aligned to the individual participant’s capability to set aside a certain amount of money every month. For example, a customer who would be able to save \$50 per month could save within 2 years \$1,200 plus accrued interest.

Consequently, he would be entitled to loan amount of \$1,200 that would result in an amount of \$2,400 to be available for financing a modernization or upgrading measure. (The monthly payment on a 3-year, 24 percent loan of this amount is about \$47.)

The length of the savings period could be individually negotiated but should be not shorter than one year, as the client might be able to borrow from friends and relatives to top up his own monthly savings for a several month period. Savings should earn market interest rates to maintain a positive savings incentive. Customers who might cancel the savings contract prior to completion would be assessed a penalty.

To enhance the attractiveness of the product, the bank might consider offering a longer repayment term or a rebate from the current market loan interest rate (eg 200 basis points in the Kyrgyz context). Such measure would be justified in view of the lower credit risk associated with them. Since only few financial institutions have been active in the *novostroika* areas, most of the people may have very limited access to financial services. In Kyrgyzstan overall a small share of households have bank accounts.<sup>23</sup> Thus, an extensive marketing campaign may be required to reach potential borrowers and to raise their confidence in dealing with formal financial institutions. One possibility for the latter could be the distribution of leaflets in the mini vans that link the *novostroika* to Bishkek center.

### A Wider Market?

Although the *novostroika* are rare in the transitional economies of Southeastern Europe and the Commonwealth of Independent States (CIS) with Albania (Tirana) being the only other country known to the authors to have a significant problem of this type, there is a major opportunity for housing micro finance in region. In a number of these countries, households in rural areas in particular often occupy very basic housing. For example, in Kyrgyzstan 83 percent of households in rural area lack running water in their units and 96 percent do not have flush toilets; in Albania’s rural areas 74 percent of dwellings have no indoor toilet and 54 percent lack indoor running water; among dwellings in rural Romania, 89 percent lack indoor running water, 95 percent are heated with solid fuel, and 45 percent are officially rated as “slums.”<sup>24</sup> With governments in the region retreating from responsibility for housing generally, issues about stimulation of household upgrading of the basic units they occupy come to the fore.

The foregoing points to a very large market for micro housing finance in the region—one that to date has received very little attention from lenders or from the international donor community. It is only a short-step from micro lending generally to micro housing finance, and there is abundant donor support for SME and micro lending programs present in the region. This combination of the stark need for housing improvements and the ability of private lenders to meet it with very modest mentoring argues for including micro housing finance in these programs.

<sup>21</sup> “Scaling up Housing Micro Finance: A Guide to Practice,” Housing Finance International, September 2004, pp. 3-13.

<sup>22</sup> The combined default ratio of the whole Bausparkassen industry in Germany was 0.04 % of the total loan portfolio (data per September 2004). In Slovakia this ratio amounted to 0.56 % (as per end 2003). Source: Association of Private Bausparkassen. Loan performance on micro finance loans is also reported to be good; see the essays in F. Daphnis and B. Ferguson, *Housing Microfinance: A Guide to Practice* (Bloomfield, CN: Kumarian Press, 2004).

<sup>23</sup> “A 2004 World Bank report stated that only 4 percent of the population held bank accounts.

<sup>24</sup> Sources: for Kyrgyzstan, Institute for Urban Economics, op.cit; for Albania, Economic Commission for Europe, *Country Profiles on the Housing Sector: Albania*, (Geneva: ECE, 2002); for Romania, Economic Commission for Europe, *Country Profiles on the Housing Sector: Romania*, (Geneva: ECE, 2001).

**Table 4. Suggested features of an optional savings scheme within the home loan improvement program for novostroika areas**

<b>Feature</b>	<b>Comment</b>
Contract amount in savings period	Defined amount (eg, \$3,000) linked to individual savings effort per month in relation to duration of savings contract
Contract savings term	eg, 1-3 years
Interest rate on savings	Current market rates for at least one-year deposits
Payment of savings installments	Monthly
Loan promise	Depends on savings contract, ie, loan amount should be same as the value of the savings contract
Allocation of loan	On completion of the contracted savings term
Redemption of loan	In equal monthly installments; annuity mortgage
Loan interest rate	Market rate possibly adjusted for strong credit rating of borrower
Security	Up to \$1,000 the bank may not want to ask for property as collateral