

**REPORT AND RECOMMENDATION
OF THE
PRESIDENT
TO THE
BOARD OF DIRECTORS
ON A
PROPOSED LOAN
TO THE
KYRGYZ REPUBLIC
FOR THE
SECOND PHASE OF THE CORPORATE GOVERNANCE AND
ENTERPRISE REFORM PROGRAM**

October 2001

CURRENCY EQUIVALENTS

(as of 15 October 2001)

Currency Unit	–	Som
Som1	=	\$0.021
\$1.00	=	Som47.7

The exchange rate of the som is determined by the National Bank of the Kyrgyz Republic under a managed float system.

ABBREVIATIONS

ACS	–	Arbitrazh Court System
ADB	–	Asian Development Bank
AGM	–	annual general meeting
BOD	–	board of directors
BOM	–	board of management
CAR	–	Central Asian Republic
CDC	–	Corporate Development Center
CDF	–	comprehensive development framework
CGERP	–	Corporate Governance and Enterprise Reform Program
CGERP-II	–	Second Phase of CGERP
CJRG	–	Consultative Judicial Reform Group
CSPFI	–	Committee on State Property and Foreign Investment
EBRD	–	European Bank for Reconstruction and Development
FDI	–	foreign direct investment
FIRM	–	Financial Intermediation and Resource Mobilization
FSU	–	former Soviet Union
GDP	–	gross domestic product
HAC	–	Higher Arbitrazh Court
IAS	–	international accounting standards
IMF	–	International Monetary Fund
JAC	–	Judicial Advisory Commission
JRMG	–	Judicial Reform Monitoring Group
JSC	–	joint-stock company
KSE	–	Kyrgyz Stock Exchange
LBBA	–	Law on Banks and Banking Activity
LEPS	–	Law on Economic Partnerships and Societies
MCC	–	Model Company Charter
NBKR	–	National Bank of the Kyrgyz Republic
PIP	–	public investment program
PMO	–	Prime Minister's Office
SCSFRA	–	State Commission on Standards of Financial Reporting and Auditing
SCSM	–	State Commission on Securities Markets
SDR	–	Special Drawing Rights
SOE	–	state-owned enterprise
TA	–	technical assistance
USAID	–	United States Agency for International Development
WB	–	World Bank

NOTE

In this report, "\$" refers to US dollars.

CONTENTS

	Page
LOAN AND PROGRAM SUMMARY	ii
I. THE PROPOSAL	1
II. INTRODUCTION	1
III. THE MACROECONOMIC CONTEXT	2
A. Government's Development Objectives, Strategy, and Plans	2
B. Recent Economic Performance and Prospects	3
IV. THE SECTOR	6
A. Background and Recent Performance	6
B. Constraints and Issues	9
C. External Assistance to the Sector	17
D. ADB's Operations and Strategy in the Sector	17
V. THE PROGRAM	18
A. Rationale	18
B. Objective and Scope	20
C. Policy Framework and Actions	20
D. Social and Environmental Issues	27
VI. THE PROPOSED LOAN	28
A. Amount of Loan and Source of Funds	28
B. Interest, Maturity, and Utilization Period	28
C. Implementation Arrangements	28
D. Procurement and Disbursement	29
E. Counterpart Funds	29
F. Monitoring and Tranching	29
VII. THE TECHNICAL ASSISTANCE	31
VIII. PROGRAM BENEFITS AND RISKS	32
A. Benefits	32
B. Risks	32
IX. ASSURANCES	33
X. RECOMMENDATION	34
APPENDIXES	35

LOAN AND PROGRAM SUMMARY

Borrower	The Kyrgyz Republic
The Proposal	Support to the Government for the Second Phase of the Corporate Governance and Enterprise Reform Program (CGERP-II) through a program loan of Special Drawing Rights (SDR)27,398,000 (\$35 million equivalent), and technical assistance (TA) of \$850,000 for Strengthening Corporate Governance and Judicial Reforms.
The Program Rationale	<p>The first phase of CGERP¹ helped establish a basic legal, regulatory, and institutional framework for corporate governance and bankruptcy procedures in the Kyrgyz Republic. The program focused primarily on nonfinancial enterprises. While there is greater awareness of corporate governance issues now, poor corporate governance practices and weak operational and financial performance of enterprises, however, remain as endemic problems in the country, and affect the viability of large joint-stock companies (JSCs), state-owned enterprises (SOEs), and banks. Common problems include weak internal governance, lack of disclosure and transparency, continuing use of the old Soviet-type accounting and asset valuation standards, and constraints on skills for effectively monitoring and enforcing the existing legal and regulatory provisions. These constraints, in combination with the overall poor macroeconomic environment, have rendered a large number of enterprises insolvent and nonviable. Compounding these problems is a weak judicial system, which suffers from inefficient and time-consuming procedures and lacks finality and transparency in its processes. Judges lack independence and legal training. Furthermore, public and investor perception of significant corruption, as reported in various studies, has eroded confidence in the judiciary.</p> <p>To address these problems and attract domestic and foreign private investments, which are critical given the fiscal constraints, the Government needs to launch deeper reforms building on the lessons learned from CGERP and focusing on (i) strengthening the legal framework for corporate and banking sector governance; (ii) improving enforcement; (iii) going beyond judicial training to address judicial sector weaknesses; and (iv) strengthening the policy framework for resolution of weak enterprises, without relying exclusively on insolvency procedures initiated by creditors.</p>
Objective and Scope	Building on CGERP, CGERP-II aims to enhance investor confidence by strengthening corporate, financial, and judicial governance and taking steps to improve the efficiency and viability of the enterprise sector. To achieve this objective, the Program will (i) promote, strengthen, and implement good corporate governance by developing

¹ Loan 1546-KGZ (SF): *Corporate Governance and Enterprise Reform Program (CGERP)*, for \$40 million equivalent, approved on 25 September 1997.

policy, legal, and monitoring frameworks; (ii) introduce international accounting, auditing, and valuation standards; (iii) strengthen governance of commercial banks and the legal framework to protect creditors' rights; (iv) launch legal and judicial reforms to establish arbitration as a mechanism for resolving commercial disputes, and streamline judicial processes and procedures; and (v) facilitate expedient resolution of weak enterprises.

In promoting and strengthening corporate governance, the Program will enhance the capacity to implement and monitor good governance measures, adopt a sound legal framework for JSCs, and improve the corporate governance and policy framework for SOEs. Concurrently, steps will be taken to harmonize national accounting and auditing standards with corresponding international standards, and formulate asset valuation standards. In addition, the Program will strengthen governance in the banking sector by developing sound criteria for key appointments in banks, improving the regulatory framework to support restitution and retribution for insider abuses, and facilitating swift resolution of banking sector insolvency. Finally, the legal and enforcement framework will be strengthened to protect creditors' and pledge-holders' rights.

In the judicial sector, the Program seeks to provide an institutional framework that will facilitate greater understanding of judicial weaknesses and implementation of initial reform measures. The Program has supported the establishment of a Consultative Judicial Reform Group (CJRG) under the President of the Kyrgyz Republic to address process-related and systemic weaknesses in the legal framework and the judiciary. The President has endorsed CJRG's recommendations to (i) introduce commercial arbitration, (ii) streamline court appellate procedures, and (iii) enhance judicial independence. To promote enterprise governance and restructuring, CGERP-II supports commercial arbitration, streamlining the court appeals process and enhancing transparency, and establishment of a Judicial Advisory Commission (JAC) to undertake an in-depth diagnostic assessment of judicial sector constraints. The JAC will formulate wide-ranging short-and longer-term reform measures to improve the quality, transparency, and efficiency of the judicial system in line with the recommendations of the CJRG and comprehensive development framework (CDF) Reports.

The Program will also facilitate expedient resolution of weak enterprises by formulating an industry sector reform strategy, and supporting liquidation and other resolution measures for a limited number of weak and nonviable enterprises. In addition, policy measures will be implemented to mitigate the adverse impact of enterprise restructuring.

Classification

Economic growth

Environmental Assessment	Category C. Environmental implications were reviewed, and no significant adverse environmental impacts were identified.
The ADB Loan	
Loan Amount and Terms	It is proposed that the Asian Development Bank (ADB) support the Government's policy reforms by providing a loan of SDR27,398,000 (\$35 million equivalent) from ADB's Special Funds resources. The loan will have a 24-year maturity including an 8-year grace period, and will carry an annual interest charge of 1 percent during the grace period and 1.5 percent thereafter.
Program Period and Tranching	The Program period is 3.5 years, from January 2001 to June 2004. The loan will be released in two equal tranches. The first tranche will be made available upon loan effectiveness. The second tranche is expected to be released by September 2003, subject to satisfactory implementation of the program conditions.
Executing Agency	The Ministry of Finance will be the Executing Agency for the Program, and will be responsible for effective administration and disbursement of the loan proceeds and proper maintenance of records. The Corporate Development Center (CDC) in the Prime Minister's Office (PMO) will be the Implementing Agency for the overall Program. The CDC will report to an interministerial Consultative Council, to be chaired by the Prime Minister's Office chief of staff, to steer the implementation of the Program. Key ministries and agencies will also nominate staff to work for 18 months on the implementation of the Program. The judicial component of the Program will be overseen by the Judicial Reform Monitoring Group (JRMG), headed by the chief of staff of the President's Administration and comprising the Minister of Justice and the heads of the legal departments of the PMO and the President's Administration.
Procurement	The loan proceeds will be used to finance the foreign exchange costs of items produced and procured in ADB member countries (other than items specified in the negative list and imports financed by other bilateral and multilateral agencies). The Government will certify that the volume of eligible imports exceeds the amount of ADB's projected disbursements under the loan for the given period. ADB reserves the right to audit the use of the loan proceeds and verify the accuracy of the Government's certification.
Counterpart Funds	The Program includes specific components that bear distinct costs of structural adjustments. The counterpart funds to be generated out of the loan proceeds will be used to finance the cost of such structural adjustments and high-priority development projects.
Technical Assistance	The objective of the advisory TA, amounting to \$850,000, is to strengthen corporate governance and support judicial reforms in the Kyrgyz Republic. It will focus on (i) promotion and effective monitoring of good governance norms in all enterprises, (ii) adoption of modern accounting and asset valuation methods in large enterprises, and

(iii) reforming judicial procedures and processes. The CDC will be the Executing Agency for the TA, which will be implemented over 15 months starting in April 2002. It is estimated that the TA will require 20.5 person-months of international and 75 person-months of domestic consulting support. All consultants will be selected in accordance with ADB's *Guidelines on the Use of Consultants* and other arrangements satisfactory to ADB.

Risks and Safeguards

The Program faces three major risks. First, given the small market size and the continuing dependence of the Kyrgyz economy on Russia, macroeconomic stability is critical to ensure that structural reforms proceed in an uninterrupted manner across the corporate, financial, and other sectors of the economy. Recognizing this, the Government, with the support of the International Monetary Fund, continues to stress adherence to a macroeconomic stabilization program, with emphasis on improving fiscal, monetary, and external debt management. The Government is also pursuing a multifold strategy to reduce debt, including pursuing a tight fiscal policy and reducing the public investment program (PIP).

The second risk facing the Program pertains to the resolution of weak enterprises. While there are significant enterprise-level vested interests that could prevent reorganization or liquidation, the Government fully recognizes the extent of nonviability facing the industry sector. The Program proposes a gradual, phased-in approach to resolution, which involves a sequence of measures, including management change, reorganization and liquidation among others, to enable the Government to explore all plausible avenues and assure the stakeholders in the process.

Third, because legal and judicial reforms are politically sensitive and prone to resistance from vested interests, they may not be effectively implemented. Given the weaknesses in the legal framework, the Program requires amendments to several laws. Some of the critical judicial reform measures require technical amendments to the Constitution of the Kyrgyz Republic. ADB has provided significant TA support to amendments to legislation. In light of its stated goal to achieve foreign direct investment of 15 percent of gross domestic product by 2010, the President of the Kyrgyz Republic and the Government are committed to strengthen the legal framework and attract investors. To initiate judicial reforms, ADB has closely worked with the Government to establish the CJRG under the President. The President has subsequently endorsed the CJRG's report, which recommends wide-ranging reforms in the judiciary, including amendments to existing legislation to achieve those reforms. A sound implementation framework has also been agreed upon with the Government, including the establishment of the JAC to undertake an in-depth diagnostic assessment of the judicial problems, and an institutional mechanism to draft the required legal amendments.

I. THE PROPOSAL

1. I submit for your approval the following Report and Recommendation on a proposed loan to the Kyrgyz Republic for the Second Phase of the Corporate Governance and Enterprise Reform Program (CGERP-II). The report also outlines proposed technical assistance for Strengthening Corporate Governance and Judicial Reforms, and if the proposed loan is approved by the Board, I, acting under the authority delegated to me by the Board, shall approve the technical assistance.

II. INTRODUCTION

2. The Kyrgyz Republic has introduced major reforms in many areas of economic policy formulation: introducing the national currency (som) soon after independence, shifting from monobanking to the current two-tier banking system with the swift establishment of a central bank, privatizing enterprises, liberalizing trade, and formulating a basic legal and regulatory framework to guide the transition to a market economy. Despite these structural reforms, the economy has remained susceptible to exogenous shocks, given its landlocked geography with limited natural resources, and high degree of dependence on countries of the former Soviet Union (FSU) for trade. The external shocks, together with an inefficient and narrow industrial base and a nascent financial sector, have introduced a high degree of economic vulnerabilities. Further, while broad-based reforms have been supported early on, progress in some key areas such as privatization and judicial reforms has only been gradual.

3. Recognizing the weaknesses in the real and financial sectors, the Government has focused its recent reform initiatives on (i) strengthening corporate governance in enterprises, (ii) improving the legal framework for enterprise restructuring, and (iii) strengthening the banking and nonbank financial sectors. Supporting these endeavors, the Asian Development Bank (ADB) approved the Corporate Governance and Enterprise Reform Program (CGERP) in 1997¹ and the Financial Intermediation and Resource Mobilization (FIRM) Program in 1999.² CGERP and the FIRM Program have supplemented and complemented the overall structural reforms that the Government has undertaken with support from the International Monetary Fund (IMF) and the World Bank (WB). CGERP aimed to improve the efficiency and performance of private enterprises and state-owned enterprises (SOEs) to make them viable in a competitive market-based environment. To achieve this objective, the program undertook to (i) develop and implement guidelines for best practices in corporate governance, (ii) eliminate subsidized loans from the budget to all SOEs, (iii) improve the legal framework for insolvency procedures, and (iv) strengthen institutional capacity in these areas. It also helped establish the Corporate Development Center (CDC), the first of its kind in transition economies, with the mandate of assisting enterprises in corporate governance, management, marketing, and finance.

4. The FIRM Program helped contain the impact of the 1998 Russian financial crisis on the banking system. The program focused on improving the efficiency of financial intermediation by promoting a sound, well-functioning, and resilient banking system and enhancing the role of capital markets. It supported the formulation and implementation of an enabling policy, and an operational and regulatory framework, and undertook to (i) resolve problem banks; (ii) improve

¹ Loan 1546-KGZ (SF): *Corporate Governance and Enterprise Reform Program*, for \$40 million equivalent, approved on 25 September 1997, and implemented over 1997-1999. TA Loan 1547-KGZ(SF): *Capacity Building in Corporate Governance*, for \$4 million, was approved concurrently.

² Loan 1723-KGZ (SF): *Financial Intermediation and Resource Mobilization Program*, for \$35 million equivalent, approved on 19 December 1999, and currently being implemented. TA Loan 1724-KGZ (SF): *Commercial Bank Audits*, for \$1 million equivalent, was approved concurrently.

prudential norms and strengthen their implementation, through stringent on-site and off-site monitoring of emerging problems in weak banks, (iii) enhance financial transparency in banks, (iv) rationalize the public debt management and guarantee process, and (v) develop nonbank financial institutions.

5. However, given the transitional environment and the related macroeconomic constraints, several weaknesses in corporate and financial governance remain, particularly in large joint-stock companies (JSCs), SOEs, and banks. The weaknesses include generic internal governance problems at the firm level, lack of protection for minority shareholders' rights in many JSCs and SOEs, continuing use of the old Soviet-type accounting and asset valuation standards, and capacity and skills constraints for effectively monitoring and enforcing the existing legal and regulatory provisions in JSCs. In addition, the weak macroeconomic environment in the first few years of the transition and in the aftermath of the Russian financial crisis rendered a large number of enterprises nonviable, and a weak judicial system complicated their satisfactory resolution and liquidation. Specifically, the judiciary lacks independence, and the judicial processes and procedures are inefficient and time-consuming, and lack clarity and transparency. Judges lack specialized training, but the extent of problems within the judiciary indicates that provision of training alone will not be meaningful without wide-ranging judicial reforms. The prevalence of insider abuses in some commercial banks and reported political interference, combined with a weak and inefficient judiciary, have affected the internal corporate governance of commercial banks.

6. Given these weaknesses and structural constraints, the Government requested ADB's support to (i) further strengthen corporate governance in all enterprises and banks through improvements in the legal framework and enforcement of governance standards, (ii) undertake legal and judicial sector reforms to enhance public and investor confidence, and (iii) facilitate expedient resolution of industry sector problems. To meet this request, ADB approved a project preparatory technical assistance (TA) amounting to \$700,000 in September 2000.³ As part of the preparatory process, a Reconnaissance Mission (November 2000) and a Fact-Finding Mission (March-April 2001) formulated the objectives and scope of CGERP-II (the Program), and understanding reached with the Government was confirmed by an Appraisal Mission (June-July 2001) and a Policy Consultation Mission (August 2001).⁴ The Program also incorporates the lessons learned from the implementation of CGERP, FIRM, and other economic and sector work in support of these programs. The Government's commitment is recorded in the development policy letter in Appendix 1. The policy matrix for the Program is in Appendix 2 and the program framework is in Appendix 3.

III. THE MACROECONOMIC CONTEXT

A. Government's Development Objectives, Strategy and Plans

7. In the 10 years since its independence from the FSU, the Kyrgyz Republic has implemented broad-ranging reforms in agriculture, trade, and industry. Most price controls were removed as early as in 1992. Export and import licensing requirements were lifted in 1994. The Kyrgyz som became fully convertible in 1995, and the Kyrgyz Republic joined the World Trade

³ TA 3505-KGZ: *Preparation of the Second Phase of the Corporate Governance and Enterprise Reform Program*, for \$700,000, approved on 28 September 2000.

⁴ The Appraisal Mission comprised R. Subramaniam, Mission Leader, Financial Economist; J. Boestel, Economist; L. Raquipiso, Associate Economic Analyst; and S. Tamondong, Poverty Reduction Coordinator. S. Akhtar, Manager, IEFI; R. Clendon, Senior Counsel; and R. Subramaniam, participated in the Policy Consultation Mission, and the Resident Representative, Kyrgyz Resident Mission, provided support throughout the processing.

Organization in 1998. Since then, it has established one of the most liberal trade regimes among the Central Asian Republics (CARs). Significant progress was also achieved in privatizing small and medium-size enterprises in the first half of the 1990s. Introduction of modern legislation on banking, bankruptcy, and other commercial areas has been faster than in the neighboring transition countries. To solidify its own reform efforts, the Government has also launched various aid-supported enterprise and financial sector reform programs aimed at strengthening the policy, institutional, and regulatory frameworks governing financial and nonfinancial institutions.

8. However, the Kyrgyz Republic is also one of the countries most adversely affected by the transition. Its forward-looking reforms could not offset the adverse effects of a number of negative factors. For instance, the highly specialized division of labor that existed across the FSU states made a large number of the country's enterprises obsolete and redundant after independence. The Kyrgyz Republic also lost access to heavily subsidized products and markets, as it had traded commodities on very favorable terms with its neighbors prior to 1991. The lack of natural resources relative to its neighbors and its landlocked nature have also been major constraints to sustained growth and diversification of the industrial structure.

9. Real gross domestic product (GDP) contracted by 50 percent in the first half of the 1990s due to the recession induced by the transition. However, the broad-ranging economic liberalization measures adopted started yielding results by 1997, when economic growth increased to 10 percent per annum. The authorities simultaneously pursued a tight monetary policy, which helped in containing inflation from 35 percent in 1996 to 14.7 percent in 1997. On the external front, the current account deficit as a percent of GDP declined from 25 percent in 1996 to 8 percent in 1997, and gross official reserves rose from the equivalent of 1.5 months of imports at the end of 1996 to 3 months of imports by the end of 1997. To sustain this growth performance, the Government sought ADB's support to remove the constraints affecting the efficiency and performance of enterprises. CGERP, besides introducing modern corporate governance norms, helped introduce hard budget constraints and transparent financial practices in SOEs, which helped in better accounting of enterprise-level arrears.

B. Recent Economic Performance and Prospects

10. The gains achieved through structural reforms were, however, reversed by the onset of the Russian financial crisis in August 1998. Real GDP growth slowed down to 2.1 percent in 1998, and the som depreciated by about 48 percent in nominal terms year-on-year by the end of 1998, generating inflationary pressures, that pushed the inflation rate to 18.3 percent in 1998 and further to 40 percent in 1999. The current account deficit as a percent of GDP again increased to 22.3 percent in 1998. The sharp depreciation of the currency led to a crisis of confidence in the Kyrgyz economy and a buildup of excessive interest rate pressures. The banking sector was particularly affected, as loan defaults grew due to unhedged foreign currency liabilities of many borrowers and the hike in interest rates on credit to around 75 percent in early 1999. Weak corporate governance and a significant buildup of nonperforming loans due to connected lending also exacerbated the banking sector problems. Erosion of confidence led to a withdrawal of domestic currency deposits and their substitution with foreign currency deposits in the banking system.

11. Over the last 18 months, however, the economy appears to be recovering from the adverse shock of the Russian crisis.⁵ Real GDP grew at 5 percent in 2000, and the continued

⁵ See the Kyrgyz Republic: *Country Economic Review Update* circulated to the Board on 10 September 2001.

pursuance of a tight monetary policy helped in lowering inflation to 9.6 percent.⁶ The overall cash deficit of the central Government declined to 9.4 percent of GDP in 2000, down 2.6 percentage points from the previous year. During the year the som depreciated only by 6.3 percent against the US dollar. Exports grew by 10.4 percent over 1999, while imports fell by 8.2 percent due to cuts in the public investment program (PIP) as well as foreign direct investment (FDI). As a result, the external current account deficit declined from 14.9 percent of GDP in 1999 to 6.8 percent of GDP in 2000. At the end of 2000, gross international reserves stood at 4.5 months of imports, relative to 2.5 months at the end of 1998. These positive macroeconomic trends have continued in 2001, with real GDP growing at 6.7 percent during the first six months, inflation contained at 5.9 percent, and the som depreciating by a marginal 0.5 percent. Import compression has continued, however, with imports declining by 14.7 percent due to the declining PIP.

12. To sustain the recovery and stabilize the economy, the Government adopted a fourfold macroeconomic strategy to (i) strengthen fiscal management, which has been the weakest component in the overall economic policy framework due to revenue constraints and expenditure pressures; (ii) strengthen external debt management in short and medium terms by rationalizing and downsizing the PIP; (iii) stabilize the banking sector and enhance public confidence in the domestic currency; and (iv) expedite structural reforms, focusing on privatization of large enterprises and downsizing the public sector. Due to the fiscal pressures, the budget deficit remains high, as tax revenue collections and expenditure management have deteriorated. However, reforms are under way to strengthen tax collection and tighten public spending. The Government has adopted monthly financial plans and cash limits, in line with IMF standards on fiscal transparency.

13. Another major challenge facing the Government is the high level of external debt, which stood at \$1.7 billion or 132 percent of GDP at the end of 2000, compared with virtually no external debt at the time of independence in 1991. Of that amount, \$1.24 billion or 95 percent of GDP is Government guaranteed. Dependence on external assistance has grown to meet the large need for public investments for social and economic development, persistent fiscal deficits since 1993, and a shortage of domestic savings. Further, the sharp decline in the value of the Kyrgyz som over 1997-1999 more than doubled the external public debt burden from 44 percent of GDP in 1997 to 91 percent in 1999. Multilateral debt constitutes about 73 percent of the external public debt. While the bilateral debt is relatively small, its shorter repayment periods and higher rates of interest would have made debt servicing fiscally unsustainable between 2001 and 2006, but for the successful debt renegotiation concluded recently with Russia and Turkey, the two largest creditors of the Kyrgyz Republic. As a result, the debt-servicing burden, which stood at 25.6 percent of fiscal revenues in 2000, is likely to be moderate over the next several years.

14. The already high levels of external debt combined with increasing pressures to raise military expenditure because of the greater security needs in the south of the country, leave little leeway for the Government even to maintain spending on infrastructure investment and social transfers. Almost the entire share of the budget that is not spent on military or external debt servicing is now spent on current expenditures, which has led to a deterioration in the quality of publicly owned and maintained infrastructure in health, transport, and education. To curtail a further rise in the debt burden, the PIP, amounting to 9 percent of GDP in 1999 and about 6.8 percent in 2000, will have to be trimmed. The Government has agreed with the IMF for a

⁶ The pre-independence level of output has not yet been achieved, with the real gross domestic product in 2000 amounting to only 78 percent of the 1991 real GDP.

phased reduction in PIP to about 3 percent of GDP by 2005. The social impact of this adjustment is likely to be minimized, however, by avoiding across-the-board cuts and improved prioritization of projects.⁷

15. To strengthen the banking sector, the National Bank of the Kyrgyz Republic (NBKR) has (i) placed several insolvent banks under liquidation in stages over the last five years, (ii) enhanced the quality of its on-site inspection, and (iii) increased minimum capital requirements for existing as well as new banks and placed restrictions in the licenses of those banks that cannot meet the increased requirements. However, public confidence in the banking system is yet to be fully restored. Further, the efficient conduct of monetary policy has been hampered by the growing dollarization in the economy, which can be reduced only over time as confidence in the economy and domestic institutions returns. Privatization of large SOEs has proceeded only gradually, in part as a result of unrealistic price expectations on the part of the Government. The Government announced a civil service reform program in January 2001, and restructured a number of ministries and state agencies, including the State Property Fund and the National Securities Commission. Further initiatives are being formulated with WB support.

16. The collapse of the regional export markets led to the closure of a number of enterprises, but the decline in industrial output since 1997 was halted in 2000, with the sector growing at 6 percent. This result, however, was made possible only by the initial growth performance of the Kumtor gold mining project, supported by a large foreign investment. While agriculture performed well in 1999-2000, low productivity and poor supporting infrastructure, including finance, supplies, and marketing, continue to hinder growth in the sector.

17. GDP growth is expected to remain stable at 5 percent and 5.2 percent in 2001 and 2002, respectively. The ongoing fiscal consolidation will reduce the budget deficit to 5.9 percent of GDP in 2001, further to 5 percent by 2002 and to about 3.7 percent by 2005. The cuts in PIP will help restore some stability in the accumulation and servicing of the external public debt. To stimulate private domestic and foreign investment, the Government's National Poverty Reduction Strategy and the comprehensive development framework (CDF) call for an increase in private domestic investment of around 6 percentage points, from 8.6 percent in 1999 to 14.4 percent of GDP by 2004. Thus far, private investments have failed to take off. Moreover, net FDI fell sharply from \$86.6 million to \$44 million in 1999, and to \$6.9 million in 2000. The Government aims at increasing FDI to 15 percent of GDP by 2010. These targets are ambitious, but they are critical for future economic growth. Recognizing the acute need, the National Poverty Reduction Strategy and the CDF focus on formulating broad-based policy reforms to create an environment conducive to attracting private investments to fill the void caused by the cuts in PIP. Domestic and foreign investors continue to face various constraints, including a complex licensing process,⁸ difficulties in obtaining finance as well as protecting their investments, general unpredictability in bureaucratic and judicial decisions, concerns over asset stripping and renationalization of SOEs, an ineffective legal framework on secured transactions, widespread practices of barter and informal transactions, poor supporting infrastructure, and legal inadequacies and process and procedure-related judicial impediments. The proposed Program will focus on structural reforms in three critical areas to improve the investment climate. It will specifically (i) strengthen corporate and financial governance reforms, (ii) launch legal and judicial sector reforms, and (iii) facilitate enterprise restructuring.

⁷ TA 3382-KGZ: *Strengthening Capacity of the Ministry of Finance in Financial Management and Planning of the Public Investment Program*, for \$463,500, approved on 28 December 1999.

⁸ It is not uncommon for businesses to get 40 different clearances and licenses. The World Bank's ongoing Comprehensive Sector Adjustment Credit (approved in 2000) is addressing these constraints.

IV. THE SECTOR

A. Background and Recent Performance

18. Despite wide-ranging reforms in many areas, sustainable economic growth and recovery have been elusive in the Kyrgyz Republic. While this is partly a result of locational and structural constraints, a major factor has been the size and scope of activities in the corporate and financial sectors. There is significant excess capacity in the industry sector and the financial sector continues to be small and nascent due to limited lending opportunities. The Program components on corporate and financial governance improvements, and legal and judicial reforms will benefit all enterprises (state-owned and private, financial and nonfinancial, as well as limited-liability companies and JSCs) in all sectors of the Kyrgyz economy. However, the enterprise resolution and restructuring component focuses on SOEs⁹ in the industry sector and private enterprises with a significant level of indebtedness to the Government.¹⁰

1. Legal Structure of Joint-Stock Companies in the Kyrgyz Republic

19. The primary statutes in the legal framework for enterprises¹¹ include the Civil Code, the Law on Economic Partnerships and Societies (LEPS), the Law on Banks and Banking Activity (LBBA), and the Model Company Charter (MCC). All JSCs with more than 50 shareholders, and commercial banks regardless of the number of shareholders, are required to establish a two-tier board structure, comprising a board of directors (BOD) and a board of management (BOM). Members of the BOD are elected at the annual general meeting (AGM) of shareholders of JSCs, and upon nomination from the BOD, the members of the BOM are elected by all the shareholders. A BOD for a nonfinancial JSC has a minimum of three members and that for a commercial bank has a minimum of five members. A BOM has a minimum of five members. There may be no overlapping membership between the two boards.¹² The BOD determines the remuneration structure for members of the BOM and performs oversight functions on the latter. Members of both boards may be removed by an AGM or any extraordinary meeting of shareholders. In addition, each JSC is required to have an Audit Commission, with no overlapping membership on the BOD. Under the law, all JSCs are required to register their charters with the Ministry of Justice, developed in line with the provisions of the MCC, which was adopted in 1997 under CGERP.

2. Industry Sector

20. In 2000, industrial enterprises contributed 22.5 percent to GDP; enterprises in agriculture, 26 percent; those in construction and transport sectors, 9.1 percent; and all remaining enterprises (including trade and services), 42.4 percent. The enterprises, which were inherited from the Soviet era, had been set up in line with the interrepublican division of labor that existed then among the FSU states. The typical structure consisted of giant industrial

⁹ Those enterprises in which the State holds at least 25 percent of the shares.

¹⁰ Based on comprehensive background work done under TA 3505-KGZ, which focused on 65 large enterprises (excluding the four largest utilities, namely JSC Kyrgyz Energo, JSC Kyrgyz Telecom, JSC Kyrgyz Airlines, and JSC Kyrgyz Gas). Appendix 4 presents data on key indicators on these enterprises.

¹¹ Enterprises can be organized as general partnerships, limited partnerships, limited-liability companies or JSCs. Supplementary Appendix A presents these concepts. Given the liability and shareholding structure of JSCs, corporate governance issues assume much greater importance in JSCs. Supplementary Appendix A also presents some excerpts from the Model Company Charter.

¹² The legal framework allows an exception in the case of very small JSCs, where the management of the company may be vested in one person. Then that person can be a member of the BOD, thereby creating a unitary board.

complexes and enterprise towns located throughout the FSU to serve the markets of the FSU. The location of such enterprises was based on national considerations and had little to do with local conditions. These enterprises were thus isolated from the local economy, since the centrally planned system determined their input sources and the markets for their products. The structure and location of the industrial complexes placed little significance on economic or financial viability of the enterprises, but focused on generating employment, in many cases for the workers of closed mines. Further, the financial viability of these enterprises was artificially propped up by subsidized energy imports (like gas from Uzbekistan), railway transportation, and raw materials. After independence, when links with the FSU were severed, a vast majority of such enterprises lost their competitiveness virtually overnight.

21. The Government initiated a three-phase privatization program in 1991, which is still ongoing. The Committee on State Property and Foreign Investment (CSPFI)¹³ was established in 1991 to oversee the privatization process and to act as a guardian of state assets. During the first phase (1991-1993), about 4,700 small SOEs in trade and services were fully privatized through cash and privatization-voucher auctions to managers and workers. During the second phase (1994-1996), about 1,300 medium-sized and large SOEs were first corporatized as JSCs and privatized by free distribution of 5 percent of the shares in each JSC to workers and management, voucher auctions of up to 25 percent of the shares to the general public, and divestment of the remaining 70 percent through competitive private bidding or direct sale. In reality, however, these proportions differed according to the strategic importance of the enterprise being privatized as well as the preferences of the buyers (primarily managers and workers). The third round of privatization involving the large and strategic SOEs has been under way since 1997.

22. At present, there are around 248 enterprises in which the state holds shares: 149 are majority state-owned, including 14 enterprises fully owned by the state. In total, there are over 6,500 registered enterprises, of which 2,162 are classified as industrial enterprises. The size distribution of enterprises is skewed, with the top four SOEs (JSC Kyrgyz Energo, JSC Kyrgyz Telecom, JSC Kyrgyz Gas, and JSC Kyrgyz Airlines) dominating the industrial landscape and accounting for about 70 percent of the capital stock in the economy. Around 40 percent of all industrial enterprises have recorded significant losses over the past consecutive five years, and have also accumulated large financial arrears (Appendix 4). By constraining liquidity, rising arrears stifle enterprise growth and transactions. To offset this, payments in kind and barter transactions are most prevalent in the Kyrgyz Republic, among the CARs.

23. Barring the initial rounds of privatization, limited measures have been taken in recent years to reorganize enterprises so as to adapt them to the new prevailing market conditions.¹⁴ The Government relied mainly on creating the basic legal framework, on the assumption that the market can enforce efficiency on company operations. However, a large majority of enterprises generally have continued to operate “as-is,” resulting in ever steeply increasing

¹³ Until January 2001, it was called the State Property Fund.

¹⁴ The Kyrgyz legal framework allows for five separate types of resolution and bankruptcy proceedings: (i) special administration, resulting in liquidation; (ii) restructuring, in which viable assets are transferred to new entities, with the debts and nonviable assets staying behind with the old enterprise; (iii) sanation, which is a court-sanctioned procedure where a third-party guarantees the payments of all liabilities of a bankrupt enterprise, which can then function as a going concern; (iv) rehabilitation, which is a consensual agreement among debtors and creditors to reorganize the business through the preparation of a comprehensive plan; and (v) amicable settlement, involving settlement of some debts to allow the enterprise to function. Though there are different possibilities, most enterprise resolution attempts have resulted in liquidation. For purposes of this Program, the term “restructuring” is used in a broad sense, in some places interchangeably with the term “resolution.”

losses, rising debts, significant excess capacity, and growing insolvency. While the Government has introduced measures to restrict debt guarantees and budget loans to enterprises, the budget constraints on enterprises continue to be soft, which in turn has impeded efforts to strengthen enterprises. Thus far, bankruptcy proceedings have been initiated against 422 nonperforming or loss-incurring enterprises, of which 365 have been liquidated. About 10 percent have been restructured and very few rehabilitated. The financial health of the restructured enterprises is, however, poor, as they are burdened with large outstanding debts to creditors. Proceeds from the liquidation sales have financed less than half the total claims, since there is no major market for the assets. On the other hand, there are expectations that all assets will fetch their book values less depreciation, which considerably delays the disposal of the assets. The average time to complete liquidation is high (4-5 years), compared with that in developed and emerging economies.

3. Banking Sector

24. The financial sector in the Kyrgyz Republic is small and at a nascent stage of development. There are at present 19 licensed commercial banks including a branch of the National Bank of Pakistan, in addition to the Central Asian Regional Development Bank. Banking sector assets account for about 9 percent of GDP, the stock market capitalization is around 10 percent of GDP, and the ratio of financial deepening (broad money or M2 to GDP) stands at 8.5 percent. The ratio of bank deposits to GDP stood at 5 percent and the ratio of bank credits to GDP was 2.3 percent at the end of 2000. Lending margins and intermediation costs have been relatively high. All these reflect the evolving state of the financial sector. Reforms since the early 1990s have strengthened the structure as well as the regulatory framework, facilitating prompt and corrective actions against insolvent banks. In 1996, with support from WB under the Financial Sector Adjustment Credit, three large state-owned banks were liquidated and Debt Restructuring Agency was established to facilitate recovery of bad assets in problem banks. With support from ADB through the FIRM Program,¹⁵ NBKR closed seven insolvent banks, and increased minimum capital requirements from Som25 million (\$0.52 million) in 1999 to Som100 million (\$2.1 million) for existing banks and Som300 million (\$6.3 million) for new banks. However, the banking system needs further strengthening, given the overall weak real sector environment.

4. Judicial System

25. The Constitution of the Kyrgyz Republic provides for three types of courts in the Kyrgyz judicial system (Appendix 5). The Constitutional Court, comprising nine judges, deals with all issues and disputes relating to the constitutionality of laws and practices. The Arbitrazh Court System (ACS) deals with all commercial disputes involving legal entities. It consists of the Higher Arbitrazh Court (HAC), which hears appeals from the arbitrazh courts of the capital city of Bishkek and the seven oblasts or administrative districts¹⁶. The ACS has 60 judges at present, including 18 at the HAC. Within the arbitrazh courts, cases are heard by one judge at the first instance, and by three judges at the appeals stage within the same court. The HAC offers an appellate procedure called "supervision," although any of the parties concerned can move to the supervision stage at the HAC directly, by-passing the appeals stage. The HAC meets only in Bishkek.

¹⁵ Loan 1723-KGZ (SF), footnote 2. See the Board Information Paper (No.R166-01), circulated on 5 October 2001, for further information.

¹⁶ These are Chui, Osh, Jalal-Abad, Yssyk-kul, Naryn, Talas, and Batken.

26. Disputes of a civil, criminal, or administrative nature relating to physical persons (i.e., individuals) are dealt with in courts of general jurisdiction, headed by the Supreme Court. Jurisdiction on disputes between legal entities and physical persons is subject to case-by-case determination by the court of first instance. Given the larger demand for the adjudication of local-level civil and criminal disputes, there are more courts and judges of general jurisdiction than there are arbitrazh courts. The Supreme Court has 17 judges and the lower courts have 244 judges. The Supreme Court and the courts of general jurisdiction are governed by the same procedures of appeal and supervision as within the ACS. Besides these three courts, there is no other process (such as third-party arbitration) for resolving disputes in the Kyrgyz Republic. The Constitution also recognizes military courts.

27. Judges in high courts (Constitutional Court, HAC, and Supreme Court) must be between 35 and 70 years of age, qualified as practicing lawyers for not less than 10 years. The judges of the Constitutional Court are nominated by the President of the Kyrgyz Republic, and elected for 15 years by both houses of Parliament. Judges of the Supreme Court and HAC are nominated by the President, and elected for 10 years by the lower (legislative) house of Parliament. Judges of local courts should be under 65, and have at least 5 years of legal practice. They are appointed directly by the President initially for a term of three years. Upon recommendation by an Attestation Commission, their terms are extended for another seven years.¹⁷ Under the Kyrgyz Constitution, judges enjoy full immunity for acts performed in their judicial capacity.

B. Constraints and Issues

1. Weak Operational, Monitoring, and Legal Environment for Corporate Governance

28. With implementation of CGERP, there is greater awareness of corporate governance standards and procedures, as outlined in the Handbook on Corporate Governance and the MCC.¹⁸ As of mid-2000, 95 percent of the 1,400 JSCs had registered their company charters with the Ministry of Justice. The CDC had provided training and advisory services in corporate management and governance to around 1,500 managers and employees of various enterprises.¹⁹ However, while basic institutional capacity for corporate governance has been established, the environment for good corporate governance continues to be weak, particularly in large SOEs and JSCs in the private sector. While the formulation and adoption of a company charter has been mandatory, there are operational, regulatory, and monitoring, as well legal weaknesses. In many cases, the key shareholders of JSCs are not aware of, or neglect, their responsibilities and accountability, and abuse their rights. The concept of limited personal liability is often interpreted in a liberal manner and used by key shareholders to the detriment of enterprises. Corporate governance is particularly weak in SOEs. Members of the BOD of SOEs are generally appointed by their supervising ministries and include mainly Government officials and local administration officials. In most SOEs, independent directors have no representation on the BOD, as there is no specific legal requirement for the same. In such cases, directors intervene in day-to-day managerial decisions, compromising the autonomy of management. In many SOEs, the contracts between the BOD and the BOM are poorly defined, thereby

¹⁷ Appendix 5 presents the scheme relating to jurisdictions and appeals in the Kyrgyz court system. Tables 1 to 7 in Supplementary Appendix B present data on the number of cases that pass through the ACS, number of judges, and their salaries.

¹⁸ Both adopted under CGERP in 1997, through Government Resolution No. 433. The handbook outlines the general corporate governance principles and practices around the world. It is a promotional document, while the MCC is a legal statute.

¹⁹ Supported under TA Loan 1547-KGZ (footnote 1).

preventing the emergence of a good performance-based incentive system. In general, failure to follow sound criteria for appointment to the BOD and the BOM, and the practice of overlapping appointments between the two boards in some enterprises lead to operational problems and internal conflicts of interest.

29. Overall, the monitoring process and regulation of legal provisions on corporate governance of SOEs have been weak. The State Committee on Securities Market (SCSM), which is entrusted with monitoring JSCs for compliance with legal provisions on governance, comes into frequent conflicts on regulatory issues with the CSPFI, which acts as a guardian of state shares. Further, SCSM also lacks regulatory capacity. It compiles a large amount of information on JSCs, but does not engage in effective compliance monitoring. In addition to weak internal governance, as evident in the case of JSC Kyrgyz Gas Munaizat for example, which became bankrupt due to lack of adequate internal controls, SOEs also suffer from the absence of a clear and coherent corporate policy framework. Even strategically important enterprises do not have clear objectives or forward-looking development plans that could guide their production or prudent financial planning. A weak operational and financial environment, which is worsened by the overall weak economic conditions, in combination with lack of adherence to good governance principles in appointment to the BOD and BOM, leads to misreporting and improper transactions, including asset stripping.

30. There are various inadequacies in the legal framework, both within the LEPS as well as in terms of inconsistencies between the Civil Code and the LEPS. These include (i) the provision that shareholders can redeem their shares if they disagree with the decisions of an AGM; (ii) provision that shareholders have to approve all transactions, including minor ones, that the BOD and BOM can engage in on behalf of a JSC; (iii) undue powers given to majority shareholders to suspend the decisions of the BOD and the BOM, without convening a general meeting of all shareholders; (iv) excessive liability placed on the BOM for any negative outcomes from business judgments, which results in a misalignment of incentives given to the BOD and the BOM; (v) inadequate representation of independent directors in the BOD; (vi) inadequate provisions on the valuation of shares; (vii) unclear provisions on conversion of preferred (i.e., nonvoting) to ordinary shares; (viii) lack of clear definition of affiliated parties; (ix) unsatisfactory treatment of capital, including lack of flexibility to increase share capital to cover losses; (x) nonpermissibility of debt-to-equity swaps; (xi) stipulation that 25 percent of profits be paid as dividends rather than giving flexibility to the AGM to determine dividends and retained earnings, which may constrain a JSC's ability to meet its critical investment needs; and (xii) lack of protection given to third parties that enter into transactions with JSCs.

2. Lack of Reliable and Transparent Information on Enterprises

31. The reporting requirements imposed by the CSFPI and by the SCSM on SOEs and JSCs, respectively, appear to be cumbersome and outdated. These agencies collect a lot of information, but most of it is eventually not utilized. Financial information on critical indicators (e.g., periodic valuation of capital stock, utilization and/or reinvestment of profits, etc.) and data on compliance with labor and environmental standards by SOEs and JSCs are not available. Lack of financial information is due partly to lack of national standards on financial valuation of physical assets, which affects commercial and financial transactions. Enterprise liquidation proceedings are delayed due to lack of reliable estimates on the value of assets.

32. The implementation of accounting reforms in the Kyrgyz Republic started in 1998 when the Government established an Interagency Commission on Accounting, with authority to regulate accounting and determine the uniform state policy in accounting issues. The Kyrgyz

Accounting Standards, formulated in 1997, consisted of 18 standards generally based on international accounting standards (IAS). However, in some major respects, the standards adopted materially differed from the IAS, leaving the Kyrgyz Accounting Standards non-compliant with the IAS. Also, a majority of the strategic JSCs and many state organizations, including the State Tax Inspectorate, are still using the Soviet accounting standards. Through an Accounting Reform Project financed by the United States Agency for International Development (USAID) over three years in 1998-2000, Kyrgyz Accounting Standards were introduced in 1,060 small and medium-size enterprises, and 4,500 private sector commercial accountants were trained. The Government recently established the State Commission for Standards of Financial Reporting and Auditing (SCSFRA) to enhance the quality of accounting and financial reporting. SCSFRA has the authority to develop and prescribe accounting and auditing standards and norms for all registered enterprises and businesses, which fully correspond to the international standards of financial accounting being developed by the IAS Committee (London). SCSFRA is in need of significant support in policy, regulatory, and capacity-building areas to carry out these tasks. While the Government has stipulated that financial accounting of all legal entities must conform to IAS beginning from 2001 through resolutions and decrees, progress thus far has been slow due to lack of institutional capacity in accounting in the Kyrgyz Republic.

3. Poor Corporate Governance in the Banking Sector

33. The regulatory framework for banks has been strengthened over the last five years. However, interference by shareholders in the day-to-day functioning of commercial banks' management and in lending decisions, and insider abuses result in imprudent lending practices. There have been instances of deliberate frauds committed by shareholders with the connivance of managers (e.g., Maksat Bank), and cases of shareholders advising managers to defy NBKR regulations. The financial positions of Kramds Bank and Insan Bank deteriorated significantly as a result of shareholder interference and interconnected lending. While these problem banks have been placed under liquidation, the imprudent practices have emerged because current legislation (particularly the LBBA) impedes NBKR's ability to effectively exercise its oversight functions. The weaknesses relate to (i) weak licensing provisions that do not properly define a bank and its capital and contain inadequate remedies for unauthorized banking, (ii) inadequate criteria for enforcement actions, (iii) unclear provisions for dealing with anticompetitive activities in the banking sector, (iv) lack of sound provisions on corporate governance, and (v) problems in the insolvency framework for commercial banks.

34. Further, the LBBA gives no specific criteria on fitness and propriety for shareholders and directors. While NBKR can establish requirements in its regulation, the law does not require members of the BOD to have any professional qualifications. For instance, a court conviction does not disqualify a person from continuing on the BOD. The major defect in the LBBA, however, is in respect of principal shareholders (those holding at least 5 percent of the shares) who are required to present evidence only of their financial status, but their fitness or propriety in other respects is generally not examined or challenged. For instance, a shareholder may be unfit (e.g., with criminal convictions for fraud or involvement in failed banks or other banks whose licenses have been revoked for serious breaches of legislation) and yet may be permitted to be a shareholder if his financial stability can be proved. Members of the BOM and other senior executives must be professionally qualified, but the requirements are not applied on a continuous and ongoing basis. These problems are further compounded, as many shareholders of commercial banks are influential through position or power, which impedes corrective regulatory actions by NBKR. Further, whatever minimal sanctions and powers NBKR has are too often ignored because of practices within the judiciary. While the inadequacies in the LBBA may be ameliorated through appropriate NBKR regulations, courts often resort to

legislation rather than allow themselves to be governed by the regulations. In summary, the legal framework lacks requirements for (i) the presence of independent members on the BOD; (ii) qualifications of principal shareholders and members of the BOD, or on the disclosure of the financial interests of members of the BOD and the BOM, on an ongoing basis; (iii) establishment of obligatory committees of the BOD for risk management and director nominations; (iv) explicit fiduciary responsibilities for members of the BOD or the BOM, thus jeopardizing the depositors' interests; (v) rules on avoiding conflicts of interest by the BOD and the BOM; and (vi) the apparent preferential treatment given to transactions with related parties vis-à-vis unrelated parties.

35. The general Law on Bankruptcy deals with bankruptcies of banks as well. Recent experience has shown that judges are generally inexperienced in bank regulatory matters. More importantly, courts are reluctant to declare technically insolvent banks as bankrupt, as they use the balance sheet-over-liabilities²⁰ test, which poses major problems in the absence of good valuation practices. While NBKR presents its valuation of a bank's assets, in addition to the bank's own book values and doubtful assertions of other assets, the Law on Bankruptcy does not set out adequate grounds for treatment of insolvency of financial institutions; as a result, liquidation of insolvent banks is delayed. This significantly undermines the credibility of banking supervision, and aggravates the problem if insolvency has been due to the principal shareholders' violation of governance norms. At the same time, a viable bank cannot be rehabilitated, since the Law on Bankruptcy does not provide for special administrators to eliminate insolvency by lowering the claims of creditors. Moreover, the powers of special administrators are limited, as the rights of the shareholders are not fully extinguished under the law on bankruptcy even after insolvency is established. The problems are compounded by the prevalent court practice of replacing qualified liquidators appointed by NBKR.

4. Deficiencies in the Legal Framework on Protection of Creditors' Rights

36. Significant problems exist in the legal and implementation framework on pledges, which impose unnecessary transaction costs and risks and act as deterrents to potential investments.²¹ First, conflicts between the Civil Code and the Law on Pledges have prevented creditors from effectively enforcing pledges, or from doing so without court and notary participation, which is time-consuming, uncertain, and costly. Second, while the Law on Mortgage seems to focus on land transactions, its provisions are not clearly defined and the relationship between this law and the Law on Pledges is unclear, particularly with regard to (i) the rights of ownership (and pledge rights) of companies where foreigners have more than 20 percent of the equity, or (ii) whether the Law on Mortgage applies to a pledge of a whole enterprise under the Law on Pledges. Creditors face difficulties in creating and registering different types of pledges. Moreover, the court system is perceived to be inefficient and corrupt, lending credence to the argument that courts should be excluded from involvement in enforcing pledges on immovable property. This, however, is not possible at present. The process of pledge enforcement on immovable properties under the Law of Mortgage is time-consuming. Taking control of collateral that is in the possession of a third party is difficult, and it is not clear which court supervises the execution of a judgment—the court where the jurisdiction of the property lies or the court that issues the execution writ. These problems are compounded further by significant court costs, fees to notaries and court executors, rigidities in execution and

²⁰ In general, this focuses on the balance of physical and financial assets, rather than a proper assessment of the actual debts and liabilities, on a net basis. For banks, this refers to reliance on book values of assets (loans), rather than assessment of recovery potential.

²¹ The existence of a major commercial bank recently was threatened by significant losses on pledges.

court procedures, problems with valuations of pledged property on sale, delays caused by absent pledgers, and claims by taxation authorities that the funds obtained by banks from the sale of a pledged property amount to a taxable profit.

5. Weaknesses in the Judiciary and Law Enforcement

37. A recent survey on corporate governance sponsored by the European Bank for Reconstruction and Development (EBRD) reported that investors perceive the legal framework and the law enforcement system to provide only limited protection of their interests in the Kyrgyz Republic, as opposed to Russia (moderate protection) and Kazakhstan (reasonably comprehensive protection). Despite the introduction of recent legislation on JSCs and limited-liability companies, bankruptcy, and pledge procedures, the resolution of commercial disputes is based on inefficient procedures and often involves unpredictable outcomes for creditors. More importantly, significant problems exist within the judiciary itself. Many recent studies and surveys, including those carried out by Transparency International, United Nations Development Programme, and ADB, have pointed out that the general public, and both local and foreign investors perceive as poor the way the judiciary functions in the Kyrgyz Republic, particularly for commercial dispute resolution. The main issues are (i) weaknesses and inefficiencies in the judicial decision-making process, and (ii) possible corruption and lack of independence of the judiciary.

38. The Kyrgyz judicial system is somewhat unique in that there are separate stages for "appeals" and "supervision of appeals."²² In many instances, the appeals and supervision stages decide issues of fact by considering new evidence, which should in the first instance be considered by the lower courts. Recently, the Constitutional Court ruled that the HAC or the Supreme Court cannot deliver a judgment that is different from that of the original court and must therefore refer the case back to the lower court for a rehearing. This process of a case moving back and forth between the appeals and supervision stages leads to significant delays in the settlement of disputes and lack of finality. For example, the Debt Restructuring Agency went through 37 appeals in one of its cases, resulting in significant time and monetary costs. Until recently, the supervision stage consisted of only 3 HAC or Supreme Court judges. However, as a result of a recent ruling by the Constitutional Court, all cases that come for supervision now have to be heard by nine or more judges. This has led to significant delays in resolving commercial and other disputes.

39. In addition to civil and criminal cases, the Supreme Court may also handle many disputes that are of a commercial nature, involving physical persons or individuals. This role played by the Supreme Court and its lower level courts, however, leads to frequent conflicts of jurisdiction. For example, if NBKR challenges a bank in the ACS and seeks to revoke its license, a shareholder who is a physical person may challenge this decision in the Supreme Court, causing a deadlock. Such conflicts cause problems in enforcing legal rights in many situations, and not only in relation to NBKR and banks.

40. The Kyrgyz Constitution states that justice cannot be determined outside the court system. The Constitutional Court has interpreted the Constitution to exclude specialized courts or bodies, including an arbitration tribunal that was functioning earlier under the Kyrgyz

²² In general, an appeal is made on the decision reached at the first instance, and the appeals stage will consider whether the first instance court wrongly applied the law to the facts or followed wrong procedures. In the Kyrgyz Republic, the second level of appeal is referred to as supervision, and the court at this stage is bound to consider the whole case again in its fullest detail.

Chamber of Commerce. Hence, extrajudicial or third-party resolution of disputes is not permissible at present in the Kyrgyz legal system. As a result all commercial disputes have to go through the ACS, which has been significantly overburdened in light of the rulings on appellate procedures and court bench composition. This lack of recognition of arbitration outside the national court system extends to foreign arbitral awards as well. While the Kyrgyz Republic is a signatory to the New York Convention on Recognition and Enforcement of Foreign Arbitral Awards, Kyrgyz courts have not adhered to its provisions in several cases, and awards made elsewhere are not enforceable in the Kyrgyz Republic. There have also been instances where legislation was deliberately misinterpreted to discriminate against foreign creditors and investors.

41. While the preceding constraints pertain to the resolution of commercial and investment-related disputes, various other shortcomings of a systemic nature apply to the judicial system as a whole, including the ACS. The nominations of judges are made by the President and approved by one or both houses of the Parliament for the higher levels (Constitutional Court, HAC, and Supreme Court positions), and the appointments at the lower levels (ACS and lower courts of general jurisdiction) are made by the President, upon initial selection by the President's Administration. This, in addition to the limited tenure of the judges and the attestation process that certifies judges based on opaque procedures, makes the judges beholden to the executive branch of the Government. It is also common practice for lawyers who have previously worked in Government offices in positions of influence to get appointed as judges. Such practice casts doubt on the independence of the judiciary, as not all judges are appointed purely on the basis of merit. While there are broad requirements on age, educational background and experience, there is no consistent system of training for judgeships, as practiced in many developed countries. All these factors have given rise to concerns that judges may not be sufficiently qualified to be judges, and that they may be biased in their judgments, besides being officially and materially influenced. Judges, particularly at the lower levels, can also be dismissed or demoted fairly easily. While the population at large needs to be protected from incompetent or corrupt judges in order to ensure that the judiciary is held in the highest esteem, judges need to be protected in their positions as well.

42. While judicial salaries have been increased to around Som15,000 (\$314) per month for judges at the highest level, the salaries, status, and working conditions in the judiciary are considered to be inadequate. At present, salaries in the judiciary are on average only 20 percent of what private sector lawyers earn.²³ Low salaries and lack of job security may provide avenues for corruption, which in turn may make any salary or administrative reforms meaningless. Hence, it is critical that the pecuniary and nonpecuniary rewards be reviewed to encourage well-qualified and experienced candidates to become judges and to reduce the scope for material or other influence in the judicial processes and procedures. A related issue is also how the existing system of determining court fees and allocating budgetary resources for the court system can be strengthened to provide proper incentives to the judiciary.

43. Not all judicial decisions are published. Judges do not separate factual from legal issues in their judgments and generally they do not present any reasons or explain how they reached their decisions, which make the decision-making process appear opaque. Given the lack of published judgments and the gaps in the decisions, other judges cannot easily verify

²³ Uzbekistan is the leader among the CARs, with the ratio of public versus private sector salaries at 50 percent, followed by Kyrgyz Republic, Tajikistan, Kazakhstan, and Azerbaijan, in that order. The ratio in Russia is around 15 percent. See EBRD, 2000. *Transition Report*, p.26-27.

precedence or fully understand prior verdicts. In several instances, similar cases have not been treated alike. Moreover, public access to hearings is restricted, even in simple cases.

44. Since the rights, powers, and functions of executors of judicial awards are not clearly defined in existing legislation, enforcement of judgments often encounters difficulties. Judgments are ignored in some cases, and owners or managers may prevent executors, including liquidators in bankruptcy cases, from taking possession of property. As a consequence, legal norms continue to be violated even after executors or liquidators are appointed. An added problem for the plaintiffs is that the executors' fees are high, as they are fixed percentages of the assets recovered. Moreover, Kyrgyz legislation does not have any specific rules to deal with contempt or disobedience of court orders and rulings, and the fines imposed are generally miniscule in relation to the claims involved.

6. Weak Operational and Financial Performance of Industry Sector Enterprises

45. The operational and financial performance of enterprises²⁴ in the industry sector has been poor and a growing number of firms are on the verge of technical insolvency. As of 1999, out of the 2,162 industrial enterprises for which information is available, and around 40 percent of the enterprises have been incurring losses over the last five years. Total losses amounted to 8 percent of GDP in 1999 (Som3.8 billion), relative to around 14 percent of GDP in 1998 (Som4.7 billion).²⁵ The losses are a result of a combination of factors, including high production cost due to low capacity utilization. In 1999, average capacity utilization in the sector was about 36 percent. Only a few enterprises operate throughout the year.²⁶ This problem has been aggravated in many enterprises where the Government extended credits to purchase new equipment without regard to the marketability of the manufactured products or adequacy of finance for raw materials. As a result, existing equipments are underutilized in most enterprises. Enterprise management has generally been reluctant to downsize operations by selling idle assets. In many situations, downsizing of production facilities will require decommissioning of obsolete plant and equipment and restructuring production. Inventories of finished goods and materials have also stockpiled. At the end of 1999, the inventory of finished goods stood at Som7.5 billion (\$158 million) or about 15 percent of GDP.

46. Many enterprises are highly leveraged. The Government through loans from the budget and guarantees had extended a total assistance of Som17.2 billion (\$364 million) at the end of 2000. Over 91 percent of budget loans and 21 percent of direct foreign credits, amounting to about \$84 million, guaranteed by the government remain overdue. Bankrupt enterprises owe about a third of the outstanding debt. These figures do not capture the actual default position, as the Government has resorted to rescheduling loans at highly soft terms and without seeking any major reorganization of enterprise operations in numerous cases. In many instances, loans were extended to enterprises already insolvent and had little opportunity to repay. A large number of enterprises have also accumulated significant social security and tax arrears.

²⁴ Enterprises here refer to SOEs as well as privately owned enterprises. As noted earlier, all SOEs are organized as JSCs following their corporatization.

²⁵ These figures measure against the following indicators for the industry sector: realized output valued at Som28.9 billion (\$605 million), total assets valued at Som30 billion (\$29 million); and capital at Som19 billion (\$398 million).

²⁶ A survey of 151 large and medium-size enterprises, carried out by the Polish Socio-Economic Research Center, indicates that only 13 percent of the companies operated throughout the year and only 12 percent are utilizing more than 50 percent of capacity.

47. In 1999, the total accounts payable in the industry sector stood at Som6.4 billion (\$134 million or about 13 percent of GDP), against overdue receivables of Som5.2 billion (\$109 million or 10.7 percent of GDP).²⁷ Over 40 percent of the payables are overdue, i.e., over one year, and about 30 percent of the receivables, of which a major part is outside of the Kyrgyz Republic, is not collectible. The high level of receivables with delays in obtaining cash has put pressure on the working capital requirements of enterprises. The largest creditor and debtor arrears are in energy-related enterprises, despite the fact that energy inputs continue to be heavily subsidized. One significant result of accumulated debts to creditors is the transfer of financial distress to local suppliers of materials, energy, transport services, and the financial sector.

48. Private enterprises have little access to bank finance for a variety of reasons. Trade finance is provided only on a very limited basis, as few exporting firms have access to letters of credit, money orders, bills of exchange, and other modern payment instruments for commercial transactions. In addition, settlement accounts in commercial banks are taxed. Since the first quarter of 1999, the stock of total loans to the private sector has shrunk by almost 25 percent, and has then stabilized at Som1.5 billion. Less than 10 percent of all industrial enterprises resort to loans from banks, and the share of bank loans in total loans is in the order of 5 percent.

49. Three broad sets of constraints have led to the dismal performance of the industry sector, including (i) lack of internal controls and management weaknesses that stem from the privatization process, in which large segments of enterprises were sold at steep discounts to existing management and workers; (ii) lack of environment conducive to private sector development, and the distorted industrial structure inherited from the FSU; and (iii) lack of access to foreign markets and protectionist trade practices adopted by neighboring countries and trading partners.

50. While the enterprise-level problems and constraints are significant, a coordinated approach to reorganization²⁸ of facilities, coupled with an asset disposal plan and phaseout of nonviable enterprises, is yet to be developed. Persistent losses, inability to reorganize production facilities and products, lack of knowledge of markets and marketing, poor management, and lack of appropriate cost and financial records are common factors hindering the establishment of modern business practices. Management and government officials still focus on maintaining or increasing production levels, without reviewing the financial implications and commercial viability of operations. Imprudent operational and financial management practices have resulted in significant deterioration of the quality of assets and loss of attractiveness to investors. These sector-level weaknesses in policy, operational, and financial areas have also been confirmed in an in-depth sample survey and analysis of 65 large enterprises undertaken by ADB.²⁹

²⁷ Overall enterprise sector (covering industrial and nonindustrial enterprises) creditor and debtor arrears were also high at 39 percent and 28.7 percent of GDP, respectively, in 1999.

²⁸ In the Kyrgyz legal context, reorganization is understood to include operational and financial restructuring as well as partial liquidation.

²⁹ Supported by ADB TA 3505-KGZ: *Preparation of the Second Phase of the Corporate Governance and Enterprise Reform Program* (footnote 3). The enterprises are in building materials, wood, chemicals and glass, machine building, electronic, light industry, and food processing subsectors, and account for about 20 percent of industry sector employment. Their average capacity utilization is around 32 percent, and 32 percent of their transactions are on barter terms. Their accumulated accounts payable stand at Som2.7 billion (\$56.6 million), which is about 50 percent of the sector-wide arrears; receivables amount to Som588 million (\$12.3 million). Appendix 4 presents the operational and financial data on these enterprises.

C. External Assistance to the Sector

51. Reforms in the enterprise and financial sectors have been supported by ADB, IMF, WB, and USAID. Under the Private Enterprise Sector Adjustment Credit of \$60 million, approved in 1994, WB focused on privatization of SOEs, and supported restructuring and liquidation of 25 large loss-incurring SOEs, through a special care and maintenance program executed by a special resolution agency. Under the program, 21 enterprises were restructured in varying degrees and 4 enterprises were liquidated. WB subsequently approved the Agriculture Privatization and Enterprise Adjustment Credit of \$45 million in 1995, which supported de-monopolization and privatization of SOEs in agriculture and eliminated commodity price and trade controls. No major multilateral support for enterprise restructuring has been provided after these two programs. EBRD has acted as a catalyst for introducing good governance in enterprises that receive EBRD credit or equity investments. USAID has supported capital market development, training of accountants to implement IAS, and training and capacity building of lawyers under its commercial law project. The Government has requested ADB to play a central role in the area of corporate governance. Support from other aid agencies in the abovementioned areas will complement ADB's efforts in corporate governance.

52. WB's Financial Sector Adjustment Credit, approved in 1996, focused on strengthening prudential regulation of banks, privatization and commercialization of former state-owned banks, and liquidation of nonviable banks. In October 2000, WB approved the Comprehensive Structural Adjustment Credit of \$45 million, to streamline licensing processes for new start-ups and to strengthen reforms in key public utilities (specifically in JSC Kyrgyz Energo). As a follow-up to this, preparatory work by WB is under way to formulate a Governance Reform Adjustment Credit to focus on public expenditure management reforms and, to a limited extent, civil service reforms.

D. ADB's Operations and Strategy in the Sector

1. Country Strategy

53. ADB's operational strategy for the Kyrgyz Republic envisages support for a smooth transition to a market-oriented economy while maintaining macroeconomic stability. The strategy focuses on several key areas (i) improvements in the provision of public services; (ii) agriculture, including rural finance; (iii) human resources development; and (iv) infrastructure, particularly investments to preserve the economic utility of past investments in the energy and road sectors. To address the financial sector weaknesses aggravated by the Russian financial crisis of 1998, ADB in 1999 expanded the scope of the strategy to support selected financial sector reforms within the overall framework of facilitating the economic transition.

54. While the strategy continues to support the transition to market-orientation, poverty reduction has taken the central role in ADB's country strategy. The Government is at present formulating the National Poverty Reduction Strategy, with significant support from ADB. The National Poverty Reduction Strategy and the CDF set the broad strategic directions for adoption by the Kyrgyz Republic over the next decade. While reforms have focused on macroeconomic growth to be broad-based, their impact on poverty and inequality has not been satisfactory. The Kyrgyz Republic remains one of the poorest countries among the FSU countries, with a GDP per capita of \$255 as of 1999. Poverty incidence rose sharply from 51.9 percent of the population in 1996 to 64.1 percent in 1999. Against this background, poverty reduction will remain on top of any reform agenda that the Government pursues.

2. Sector Strategy

55. The Kyrgyz Republic has made significant strides in liberalizing external trade. The benefits from trade liberalization will increase if its trading partners also undertake commensurate reforms. The immediate challenges lie, however, in effectively managing the real and financial sectors, as domestic policy reforms in these sectors have lagged behind trade and external sector reforms. Specifically, the tasks relate to (i) speedy resolution of enterprise problems and providing a conducive policy and institutional environment in which enterprises can function well; (ii) enhancing public confidence in the banking system through effective resolution of problem banks, particularly those with internal governance weaknesses; and (iii) restoring public and investor confidence in the judiciary.

56. Under CGERP,³⁰ the Government, with ADB's support, adopted a comprehensive approach to facilitate the transition of Kyrgyz enterprises to a market-oriented economy. CGERP also supported significant capacity-building activities through a TA loan³¹ that provided support for (i) enhancing the awareness and capacity of government officials in the area of corporate governance; (ii) training enterprise managers and officials; (iii) a comprehensive public information dissemination program on the benefits of a sound corporate governance structure; and (iv) training judges, court personnel, government officials, and liquidators dealing with bankruptcy cases. The TA loan also included a component to finance the renovation of selected buildings for use by the ACS. While the program loan component of CGERP has been concluded, the TA loan is currently under implementation.

57. The FIRM Program³² aimed at strengthening financial intermediation through (i) measures for prompt and corrective action on weak banks, (ii) enhancing prudential norms and tightening on-site supervision procedures, (iii) improving the reliability of vulnerability assessments through financial and operational audits of commercial banks, and (iv) enhancing transparency and disclosure of all financial information pertaining to the banking sector as well as public debt management. The second tranche of the FIRM Program, (\$16.1 million) originally scheduled for release in March 2001 was released in October 2001 after one of the core second tranche release conditions relating to the resolution of Kairat Bank was complied with in September 2001. While the FIRM Program has supported increased efficiency of commercial banks, a full-fledged reform program is needed to enhance the viability of the enterprise sector, since there are significant credit quality concerns on the part of commercial banks. Past ADB programs, however, have not provided any direct operational support for restructuring in the real sector. With regard to the judiciary, while some training was provided to implement bankruptcy procedures under CGERP, no significant support was provided for comprehensive judicial reforms.

V. THE PROGRAM

A. Rationale

58. The macroeconomic recovery achieved in 1996-1997 was primarily a product of accelerated growth in agriculture, as productivity in industry had been on the decline since the early 1990s. The initial phase of enterprise privatization was implemented during 1991-1996, through the issuance of privatization vouchers and sale of shares in smaller and medium-sized

³⁰ Loan 1546-KGZ (SF): *Corporate Governance and Enterprise Reform Program*, (footnote 1).

³¹ Loan 1547-KGZ (SF): *Capacity Building for Corporate Governance*, (footnote 1).

³² Loan 1723-KGZ (SF): *Financial Intermediation and Resource Mobilization Program*, (footnote 2).

enterprises (para. 21). This led to widely dispersed and small shareholdings, making it difficult for shareholders to monitor the performance of enterprises. In addition, the privatization program awarded minority, but large blocks of shares (in the range of 30-35 percent) to the existing management and workers, which led to insider control by management and workers, who lacked the modern management skills necessary to operate these enterprises in a market environment. Recognizing the need to enhance enterprise efficiency so as to sustain macroeconomic recovery, the Government sought support through CGERP to address problems resulting from the enterprise privatization process, which hindered good corporate governance. CGERP (i) introduced guidelines on corporate governance standards—stipulated through the MCC and a Government resolution—and established institutional capacity in the form of the CDC; (ii) aimed to eliminate budgetary support to enterprises; and (iii) strengthened the legal framework and institutional capacity for bankruptcy procedures.

59. While CGERP and FIRM (paras. 3 and 4) supported the first round of corporate and financial sector reforms, the process of transforming enterprises and financial institutions is far from complete. The transition to full market orientation has been impeded by continuing structural constraints as well as weak governance at various levels, particularly in large JSCs, SOEs, and banks, as outlined in Chapter IV. Though basic awareness of corporate governance has increased, implementing CGERP has demonstrated a number of lessons that need to be considered for any governance reforms to be meaningful. A sound legal framework needs to be formulated to facilitate the adoption of modern corporate and financial governance standards. While CGERP has provided the basic foundation through the MCC, the guiding legislation for JSCs and commercial banks needs to be significantly strengthened. Given that judges rely heavily on legal provisions and procedures without due regard for commercial expediency, the inconsistencies across different laws must be removed. Adoption of modern accounting and auditing standards has to be backed by a proper legal framework, to ensure that enterprises will convert from old to internationally accepted standards.

60. The most important lessons from CGERP pertain to the need to strengthen the enforcement of good governance standards, promote a sound and well-functioning judiciary, provide alternative means for resolving commercial disputes, and formulate measures to address the weak financial and operational performance of enterprises. CGERP has shown that inadequate legal provisions and weak enforcement can lead to erosion in public and investor confidence. Hence, it is critical to strengthen the enforcement and regulatory framework with respect to corporate and financial sectors. These steps are critical to ensure a steady and sustainable flow of private and strategic direct investments through domestic as well foreign sources, and attract nonbank sources of financing corporate growth in view of the decline in public investments and banking sector limitations. The extent of judicial problems demonstrates that training or capacity building alone will not be meaningful, in the absence of measures to address other deep-rooted constraints. The enterprise sector problems stem partly from lack of a coordinated Government strategy. The viability of a core of the enterprise sector needs to be guaranteed to facilitate the adoption of good internal governance practices. In line with these lessons, the proposed Program will help the Government in promoting (i) a conducive and transparent environment in which enterprises and financial institutions can function efficiently and remain viable, and (ii) a sound legal framework and a well-functioning judicial and law enforcement system to enhance public confidence and assure domestic and foreign investors that their assets will be protected. The urgent need for attracting domestic as well as foreign private investments was recently underscored in the background work undertaken for the CDF

process. ADB, along with other funding agencies, took an active part in the CDF deliberations, including those on sustainable measures to promote good governance.³³

B. Objective and Scope

61. The Program aims to enhance investor confidence and promote the efficiency of enterprises by strengthening corporate, financial, and judicial governance. To achieve this objective, the Program will (i) promote, strengthen, and implement good corporate governance through development of a policy, institutional, legal, and regulatory framework; (ii) introduce international accounting, auditing, and valuation standards; (iii) strengthen governance of commercial banks and the legal framework to protect creditors' rights; (iv) launch legal and judicial reforms to introduce arbitration as a mechanism for resolving commercial disputes, and streamline judicial processes and procedures; and (v) facilitate expedient resolution of weak enterprises.

C. Policy Framework and Actions³⁴

62. While CGERP laid the foundation for corporate governance, good governance is viewed as a public good in the current transition environment in the Kyrgyz Republic. Given the slow progress on privatization, enterprises are still not fully developed, viable, or market-oriented. The financial markets are not mature yet, and investors generally are not sophisticated enough to fully appreciate the need for sound governance structures and internal control processes in enterprises. Regulatory capacity needs significant strengthening, and self-regulation by market players is a new concept. In view of these factors, the Government has a major role to play in ensuring that enterprises and financial markets embrace good corporate and financial governance standards. Its efforts in promoting good governance need to be supplemented by concurrent judicial reforms and initiatives to ensure and sustain the enterprise sector's viability. Institutional capacity building for development as well as regulating corporate governance norms, developing consensus for reforms in legal and judicial areas, and formulating feasible options for restructuring enterprises have been at the center of ADB's policy dialogue with the Government. ADB has closely coordinated with senior-most officials in the President's and Prime Minister's administrations, and provided TA support in formulating the Program. The reform areas and the policy measures are presented in detail in the policy matrix (Appendix 2) and the program framework (Appendix 3). A description of the policy actions under the first and second tranches of the Program follows.

1. Promote, Strengthen, and Implement Good Corporate Governance Standards

63. **Develop the Policy and Institutional Framework, and Enhance Capacity to Implement Good Governance Standards.** Under the Program, the CDC has been elevated to the status of a full department the Prime Minister's Office (PMO)³⁵ and will perform two important roles: (i) coordinate and implement the Program, for which its location in the PMO will

³³ ADB made presentations on corporate and financial governance at the CDF Workshop on Good Governance, held in Bishkek in July 2000.

³⁴ TA 3505-KGZ (footnote 3) provided consulting and advisory support in formulating the framework, as well as assisted the Government in complying with the first tranche conditions and drafting of new legislation and amendments to current laws, as required under the Program.

³⁵ The CDC was established under CGERP as a unit within the Department of Economic and Sector Development in the PMO. Subsequently, in July 2000, the Government moved the CDC to CSPFI for budgetary considerations as well as to support enterprise restructuring initiatives.

be critical; and (ii) undertake training, capacity building, and information dissemination in all areas of corporate sector development. The CDC's skills mix has been strengthened and a two year work program has been prepared, focusing on (i) management development and training;³⁶ (ii) public education and information campaign on corporate governance; (iii) implementation of the new asset valuation standards; (iv) development of a corporate governance rating system; and (v) monitoring legal and regulatory developments with regard to corporate and financial governance.³⁷ In line with the plan, the CDC will strengthen its initiatives in management development, training, and advisory support for enterprises, based on partial cost recovery to ensure its financial sustainability in the long run, so that it could eventually be privatized. *Corporate Herald*, a Russian language monthly newspaper, will disseminate information on corporate governance, management, finance, accounting, and valuation standards. The CDC will also provide advisory support to minority shareholders. In addition, the CDC will develop a corporate governance rating system for large enterprises, satisfactory to ADB, and publish by December 2002 the first round of ratings on all enterprises listed on the Kyrgyz Stock Exchange (KSE) and all commercial banks. Further, the CDC in coordination with SCSM, will formulate a medium-term plan for continued promotional activities in the sphere of corporate governance, in close conformity with regulation. The plan will include sustainable venues where corporate governance activities can be anchored, including modalities for encouraging private sector involvement in this area.

64. Strengthen the Policy Framework for SOE Governance. The Program will support measures to improve corporate governance and management of SOEs. The corporatized SOEs have adopted the practices outlined in the handbook and MCC (para. 28).³⁸ However, SOEs have not effectively implemented the principles of good corporate governance, as evident from many recent cases (e.g., ad hoc approach adopted to the reorganization of JSC Kyrgyz Gas Munaizat; renationalization of JSC Kyrgyz Bakai). The poor performance of a large number of SOEs is partly due to the lack of guidance and expertise of the members of the BOD, who are not always appointed on the basis of merit or qualifications. The Program aims to (i) strengthen the requirement on qualifications for members of SOEs' BOD, including state representatives; (ii) introduce a system of nomination committees for selecting candidates for the BOD and the BOM of SOEs; (iii) strengthen the requirements on disclosure of financial interests of members of the BOD and the BOM; (iv) establish contractual arrangements between SOEs and members of BOM, to ensure that a proper incentive structure is adopted; and (v) introduce clear indemnity rules, to ensure that directors or managers are not liable for decisions taken in the best interest of an SOE, after due inquiry as to relevant considerations and in good faith and based on good business judgment. Under the Program, the Government (through CSPFI) will have at least 10 major SOEs (those with at least 51 percent of state ownership) adopt and continuously comply with the above practices by December 2002.

65. Strengthen the Legal and Regulatory Framework for Good Governance in JSCs. The Parliament recently initiated amendments to the LEPS. The Government has drafted a new

³⁶ This component will train enterprise officials in efficient enterprise management skills in a transition environment; operational and organizational strategies; principles of good corporate governance, including ethics, responsibility to shareholders, employees, and society at large; principles of corporate finance and modern marketing. In view of the significant need for enterprise renewal, this component will include a component on motivating and educating workers and managers for concerted action and renewal of enterprises (entitled Educare).

³⁷ The project implementation unit (PIU) will have a staff of three from PMO, who will be supported by advisory and technical inputs from a number of other ministers and agencies for coordinating and implementing the Program. The promotional unit will be staffed by around 15 domestic consultants. The PMO will provide for the salary of Government staff and counterpart administrative expenses for CDC.

³⁸ See Supplementary Appendix A.

law on JSCs, that will focus exclusively on JSCs while the LEPS could effectively regulate the activities of limited-liability companies. While this follows the practice adopted in other CARs and countries of the FSU, the draft law on JSCs also offers considerable improvements in the legal framework with respect to good governance. Under the Program,³⁹ the Government will adopt a sound legal framework for JSCs, whether an improved version of the LEPS or the draft law on JSCs, embodying certain sound principles of corporate governance (i) members of the BOD may be replaced only by shareholders at the general meeting or special meetings of shareholders; (ii) the BOD will have primary responsibility for establishing policies for the operations of the JSCs and overseeing their implementation; (iii) indemnity rules for members of the BOD and the BOM, to ensure that they are not penalized for sub-optimal outcomes if their decisions are in the best interest of a JSC; and (iv) a JSC may repurchase its own shares only on its volition or by contract. In addition, in view of the poor regulatory and monitoring processes (para. 29), the Program requires that the SCSM take steps to (i) develop its human resource capacity in promotional as well as regulatory activities pertaining to corporate governance; (ii) ensure timely submission of financial information and reports by JSCs, as stipulated in legislation; (iii) strengthen its regulatory activities to ensure that JSCs comply with all relevant legislation and regulation; and (iv) periodically monitor the conduct of AGMs to ensure compliance with the legal provisions on AGMs.

2. Introduce International Accounting, Auditing and Valuation Standards

66. Harmonize National Accounting and Auditing Standards with Corresponding International Standards. Under the Program, SCSFRA has (i) fully adopted IAS 2001 with proper licensing from the IAS Committee; (ii) initiated the process for adopting fully International Auditing Standards 2001; (iii) initiated a review of all relevant legislation, codes, and Government resolutions and decrees, pertaining to the financial sector and taxation, to ensure consistency with IAS 2001 and International Auditing Standards 2001; and (iv) prepared, and adopted through a Government resolution, a realistic timetable for conversion of all JSCs and other enterprises to the new standards. Further, over the Program period, SCSFRA will (i) enhance its capacity to implement IAS 2001 and International Auditing Standards 2001 and demonstrate satisfactory progress in the adoption of these standards; and (ii) ensure, with Government support, conversion to IAS 2001 of all enterprises listed on the KSE and all commercial banks.

67. The Government, through SCSFRA, has submitted to Parliament a new Law on Accounting, which provides a sound legal framework for introducing modern accounting methods and practices, and amendments to the Law on Auditing (1998) to ensure conformity with the Law on Accounting. Under the Program, the Law on Accounting and amendments to the Law on Auditing will be adopted by July 2002. Further, the Government, through the State Tax Inspectorate, will (i) train a core group of its tax inspectors on IAS 2001; and (ii) accept financial statements based only on IAS 2001 for all enterprises listed on KSE and all commercial banks for the financial year 2002.

68. Formulate National Standards on Valuation of Assets. Under the Program, a valuation standards committee and the CDC have drafted documents for introducing national standards on valuation of movable, immovable, and nonmaterial assets. The documents include basic provisions on asset valuation, requirements for valuers, standards for asset appraisal,

³⁹ Advisory support has been provided under TA 3505-KGZ (footnote 3). While it is envisaged that the new law on JSCs, if adopted, will automatically replace the provisions on JSCs in the LEPS, follow-up advisory support will be provided to ensure that there is no legal and regulatory arbitrage between the two laws.

valuation standards for functional enterprises, and valuation of intellectual property. A draft law on asset valuation and the associated regulations have been prepared, along with amendments to the Law on Licensing to strengthen the provisions on licensing of asset valuation activities. By the third quarter of 2002, the Government will submit these laws to the Parliament, following which the national standards on valuation will be adopted. By December 2002, the CSPFI will have completed reevaluation of the physical and financial assets of three large SOEs, based on the new standards.

3. Strengthen Governance of Commercial Banks and the Legal Framework to Enhance Creditors' Rights

69. **Improve Banking Sector Governance.** Strengthening the internal corporate governance standards of commercial banks is critical to improve their operational and financial management. Adherence of a bank's BOD and BOM to good corporate governance essentially requires the preparation and adoption of an appropriate strategic plan, identification and effective management of credit, market, and operational risks; and measuring performance against the objectives of the strategic plan. For such practices to be effectively implemented, significant shareholders and members of the BOD and the BOM must have the requisite knowledge and experience in bank governance and the determination to pursue proper governance standards. The LEPS and the draft law on JSCs contain general provisions on qualifications of members and composition of the BOD and the BOM. However, courts in the Kyrgyz Republic generally tend to focus on specific legislation, and particularly on exemptions in such legislation.

70. To address these issues, the Program supports amendments to LBBA to require (i) principal shareholders and members of the BOD and the BOM to comply with the stipulated qualification requirements on an ongoing basis; (ii) allocation of at least one BOD position to an independent director;⁴⁰ (iii) obligatory committees of the BOD for risk management, managerial compensation, and director nominations; (iv) the establishment of an explicit fiduciary duty for banks and members of the two boards; (v) disclosure of the financial interests of members of the two boards; (vi) rules to avoid exploitation of conflict of interest by directors and managers; and (vii) nonpreferential treatment of banks' transactions with related parties. The NBKR under the Program will amend its regulations (consistent with the amendments in the LBBA) by December 2002 to strengthen the governance of commercial banks and submit a report to ADB on banks compliance with the enhanced provisions in these regulations and the LBBA.

71. Under the Program, the Government will strengthen the role of the Debt Restructuring Agency and assign all bank liquidation functions to it. Besides facilitating the liquidation process, it will also relieve NBKR's burden regarding appointment of its legal and supervision staff as special administrators in banks placed on liquidation. Further, a separate law on bankruptcy of banks will be drafted and submitted to the Parliament by December 2002. This law will address the constraints on resolution of insolvent banks (para. 35) and facilitate liquidation as well as recovery of assets.

⁴⁰ As per LEPS and LBBA, BODs should have a minimum of five members; under the Program, at least one of these positions will be reserved for independent members, who will be from the private sector and independent of the management of the bank and shareholders who own more than five percent of any class of voting shares of the bank. Independent in this context means not related to company management or principal shareholders by family ties (through marriage or consanguinity to the second degree), or through common investment or business interest.

72. **Protect the Rights of Creditors and Pledge-Holders.** The Kyrgyz Law on Pledges compares favorably with that found in other CARs and countries of the FSU. However, the law appears to be ineffective, due partly to the inconsistencies between it and other legislation, and also because of deficiencies in the court processes and the pledge execution system (para. 36). Under the Program, the Government will (i) remove inconsistencies between the Law on Pledges and the Civil Code, and the Civil Code and other legislation (including the Law on Mortgage), by amending the Civil Code to facilitate the application and enforcement of the Law on Pledges; (ii) allow the pledger to execute collateral without court intervention, and limit the grounds on which appeals to courts by a defaulting party may be made; (iii) ensure that the priority of pledges is not affected by rules relating to execution of court actions by non-secured creditors; (iv) clarify and simplify the process of notarization and registration of rights to pledges; (v) simplify the procedures for the sale of pledged assets, including the bidding and auction requirements; and (vi) rationalize the structure of fees for execution of pledge rights.⁴¹

4. Launch Legal and Judicial Reforms to Enhance Governance

73. The problems of the judicial and court system are multifaceted, ranging from excessive reliance on procedures to poor protection for parties involved in a commercial transaction to judicial complexities. To address these issues and to formulate measures to enhance public and investor confidence by reforming the judiciary and improving existing legislation as well as its enforcement, the President of the Kyrgyz Republic, under the Program, established a Consultative Judicial Reform Group (CJRG). The CJRG, comprising public and private sector participants, has produced a Report on Judicial Reforms, based on a set of terms of reference (TORs) agreed to by the Government and ADB (Appendix 6).⁴² The CJRG deliberated on a number of sensitive issues and its report (Supplementary Appendix C) presents indicative directions to strengthen the judiciary. The CJRG advocates reforms to (i) allow extrajudicial resolution of commercial disputes (i.e., arbitration); (ii) enhance transparency of judicial proceedings; (iii) develop a framework to deal with judicial corruption; (iv) build up a professional corps of judges; (v) separate the executive from judicial appointments and dismissals, by designing a system of parliamentary appointment of judges at all levels; (vi) streamline court appellate and other procedures; and (vii) rationalize the court fees, funding, and salary structures. These and other broad judicial reform directions were also addressed in the CDF document endorsed by the President in May 2001.⁴³ The President in July 2001 endorsed and approved the findings and recommendations of the CJRG.⁴⁴

74. Under the Program, the Government has formulated a suitable implementation framework to oversee judicial reforms. A Judicial Reform Monitoring Group (JRMG) has been

⁴¹ Advisory support has been provided under TA 3505 (footnote 3) to prepare draft amendments to the Civil Code, Law on Mortgage, Law on Pledges and other relevant legislation, and a new draft law on secured obligations for the Government's consideration. The NBKR will coordinate work in this area, in consultation with a working group established for the purpose.

⁴² Appendix 6 presents the Presidential Disposition No.128, dated 13 April 2001, and the terms of reference for the CJRG. An ADB adviser (under TA 3505) and the project director of the ongoing Commercial Law Project of the USAID participated as observers at the CJRG's meetings. While neither ADB nor the advisers took part in formulating the recommendations, background papers were prepared to guide the group's discussions.

⁴³ The President also highlighted the need for pursuing judicial reforms in his May 2001 speech to an annual convention of judges, and underscored the need for adopting the CJRG's recommendations at an investor roundtable organized by the Embassy of the United States of America and the European Union in July 2001.

⁴⁴ Through President's Disposition No. 220, dated 12 July 2001.

established and an action plan adopted to implement the recommendations of the CJRG, through President's Dispositions.⁴⁵ The JRMG will coordinate and monitor the implementation of the judicial reform measures under the Program, and submit bi-annual reports to ADB.

75. To undertake more in-depth diagnostic work to operationalize the CJRG's recommendations, the President, under the Program, has also established a Judicial Advisory Commission (JAC) with broad-based participation, comprising judges, lawyers from the private sector, legal scholars, parliamentary deputies, and members of civil society.⁴⁶ The JAC will (i) widely disseminate the CJRG report and hold workshops on its recommendations in Bishkek and at least three other regional centers; (ii) undertake a comprehensive diagnostic study of the legal and judicial sector (with ADB TA support) to improve the quality, transparency, and efficiency of the judicial system, in line with the judicial reform measures outlined in the CDF and CJRG reports; and (iii) organize a major participatory workshop to discuss the findings and recommendations of the diagnostic study, with representatives from the judiciary, civil society, private sector, and the aid community.

76. **Allow Out-of-Court Resolution of Commercial Disputes.** In the Kyrgyz Republic, the Constitution precludes arbitration by third parties. Commercial disputes can be settled only by a court (in the ACS, or a court of general jurisdiction). Given the widespread problems in the judicial system and with the execution of court judgments, the Program will support out-of-court arbitration for resolution of commercial disputes to provide an efficient alternative to the ACS, if the parties to a transaction so wish. Recognizing this, the President recently issued a decree on arbitration of land disputes. The need for arbitration is also articulated in the CDF documents. Under the Program, amendments have been drafted to appropriate legislation, including the Constitution of the Kyrgyz Republic, to recognize and allow extrajudicial resolution of commercial disputes. Further, a new law on extrajudicial resolution of disputes, to establish the procedural and legal formalities and also deal with the enforcement of foreign as well as local arbitral awards, has also been drafted. The Government has undertaken to enact the new and amended legislation by December 2002. Once the legal framework for arbitration is strengthened, it is envisaged that the private sector will provide arbitration services.

77. **Streamline Court Appellate Procedures and Processes to Increase Efficiency.** The process of judicial decision making in the ACS and the courts of general jurisdiction needs to be streamlined. There is lack of clarity over "matters of principle or law" versus "matters of fact," when cases are presented for appeal or supervision. Further, it is unclear why appeals should be supervised. These problems have been further compounded by the recent Constitutional Court rulings on appellate procedures. Under the Program, the Government will, by December 2002, amend relevant legislation, including the Constitution of the Kyrgyz Republic, to allow higher courts the power to render judgments with finality and efficiency.

78. The Government will also undertake initial measures to increase the transparency of judicial proceedings. Under the Program, it will develop mechanisms, including coordination with the private sector (e.g., the Toktom Database⁴⁷) to disseminate the decisions reached within the

⁴⁵ The JRMG, established through President's Disposition No. 239, dated 7 August 2001, will be chaired by the President's Chief of Staff. In addition, it comprises the heads of the legal departments of the President's and Prime Minister's offices, and the Minister of Justice. The action plan, adopted through President's Disposition No.282, dated 5 October 2001, nominates various ministries and agencies to prepare draft legislation and undertake the other tasks as outlined in the CJRG's report.

⁴⁶ Through President's Disposition No.281, dated 5 October 2001.

⁴⁷ Toktom is a private sector provider of legal and judicial sector information through the print and computer media. It is a locally incorporated company.

ACS and other courts of general jurisdiction. The JAC will focus on other issues relating to transparency and formulate a comprehensive strategy to deal with publications, establishing judicial precedence, and public participation during court trials.

5. Facilitate Expedient Resolution of Weak Enterprises in the Industry Sector

79. Formulate a Sound Legal and Policy Framework for Resolution of Weak Enterprises. The extent of nonviability in the industry sector demonstrates the need for strengthening the policy and legal framework to facilitate speedier resolution of operational and financial problems in enterprises. The Program will support measures in three different areas (i) adoption of a Government resolution to require overindebted SOEs and private sector enterprises with significant outstanding arrears on past loans, social security contributions, or tax payments to the Government, to initiate automatic restructuring on their own and facilitate opportunities for reorganization as an alternative to liquidation in appropriate cases; (ii) formulation and adoption of an industry sector restructuring strategy, based on the operational and financial assessment of 65 large enterprises; and (iii) expedient resolution of at least six enterprises that have significant operational and financial problems, with both reorganization and liquidation as options.

80. Most of the enterprise resolution attempts over the last four years have resulted in liquidation. While this may be due to the extent of insolvency in the sector, the Law on Bankruptcy appears to encourage liquidation over other forms of enterprise reorganization, though bankruptcy cases take longer to move through the court system, as not all judges understand clearly the financial nuances. In view of the complexities and delays, under the Program the most nonviable SOEs are expected to take their own initiatives for restructuring. To support this, the CSPFI will (i) introduce amendments to the Law on Bankruptcy to facilitate speedier resolution of weak enterprises, and (ii) issue a Government resolution mandating overindebted SOEs in which the Government owns more than 51 percent, and other enterprises with large overdue State debts to develop a comprehensive restructuring plan. If the plan is not satisfactory to the creditors, or if no such plan is developed by an overindebted SOE, the Government will appoint a receiver for the sale of the enterprise or piecemeal liquidation of assets. Under the Program, the CSPFI will also increase its monitoring capacity in all aspects of enterprise restructuring, including liquidation as well as operational or financial renewal, and take steps to strengthen its existing database on enterprises being reorganized or liquidated and the court actions taken.

81. The Government, under the Program, will formulate an industry sector restructuring strategy focusing on (i) capacity utilization; and (ii) medium-term commercial, financial, and operational viability. To implement the sector strategy, the CDC and CSPFI will initiate a public information campaign on provisions available for efficient enterprise restructuring, aimed at dispelling the current negative notions on restructuring. Further, to promote transparency, the CSPFI will publish under the Program biannual reports starting in December 2002 on (i) all enterprise restructuring proceedings in the mass media; and (ii) the JSC Kyrgyz Gas Munaizat bankruptcy process, giving clear and transparent information, until the process is completed.

82. The Government has carried out an operational and financial viability assessment of 65 enterprises with support under ADB TA (para. 50 and footnote 29). Ten enterprises, with significant operational and financial problems, were studied in depth and comprehensive

recommendations submitted to the Government for their resolution.⁴⁸ The Government, before ADB's Board consideration of the Program, will initiate steps towards (i) sale of JSC Osh Textiles to a strategic investor; (ii) cross-ownership arrangement with key suppliers of JSC Kyrgyz Chemical and Metallurgy Plant; (iii) sale of 100 percent state shares in JSC Crystal to a strategic investor; (iv) sale of all state shares in JSC Kainda Cable to a strategic investor; (v) preparation of a comprehensive restructuring plan, focusing on financial restructuring options for JSC Oreimi. These measures will address the immediate problems facing some of the weakest enterprises. Following these initial steps, the Government, by December 2002, will have taken further measures to achieve satisfactory resolution through restructuring or liquidation of at least six operationally and financially weak enterprises.

83. The resolution measures proposed for the weak enterprises in the Program are based on an in-depth analysis of the operational, financial, and human resource issues. As indicated in para. 85, the measures proposed in the Program will not have any adverse impact on the workers of the concerned JSCs. However, since the adoption of the industry sector strategy by the Government (para. 81) could have a short-term impact on employment, the Ministry of Labor will formulate and implement adequate safety-net measures. Accordingly, adequate provisions will be made in the 2002 budget for active labor market measures, including employment counseling and retraining. The Ministry of Finance will also make sufficient provisions in the 2003-2004 budgets for these measures.

D. Social and Environmental Issues

84. The thematic classification of the Program is economic growth. It aims to strengthen governance, one of the three pillars of the poverty reduction strategy. Sound corporate governance in enterprises and banking institutions will help reduce losses in the public sector, which in turn compress public expenditures that are critically needed to support poverty reduction and social development. Enhanced corporate governance has the added advantage of protecting small investors, depositors, and pensioners who, through mutual funds, invest in enterprises. While the judicial reform measures under the Program will focus on commercial dispute resolution, the strengthening of judicial processes and procedures will have an impact on protecting the interests of all.

85. With regard to resolution of weak enterprises, the Program proposes a phased approach, consisting of (i) operational or management restructuring; (ii) financial restructuring; or (iii) liquidation, if both (i) and (ii) fail. While some retrenchments will be unavoidable, it is imperative that the operational and financial problems in some of the most nonviable and loss-incurring enterprises be resolved or the enterprises liquidated. Further, a fairly large number of workers in the targeted enterprises have already gone on unpaid leave and the rest receive their wages primarily in kind. The Program will support the provision of training and employment counseling, to assist the affected workers. Overall, restructuring of the selected enterprises in particular, and other loss-incurring and nonviable enterprises in general will contribute in the medium to long term to improvements in efficiency in resource use, and help rationalize investments and priorities, increase economic growth, and generate employment opportunities. Reduced government expenditures on SOEs will free up revenues for social services and expenditures, including allocations for supportive labor market measures.

⁴⁸ Tables 1 to 10 in Supplementary Appendix D provide in-depth information on JSC Osh Textiles, JSC Zanar, JSC Kyrgyz Chemical and Metallurgy Plant, JSC Kainda Cable, JSC Oreimi, JSC Kyrgyz Worsted Wool Plant, JSC Crystal, JSC Kyrgyzfarfor, JSC Linoleum, and JSC Jyldyz.

86. A full poverty impact assessment was undertaken for the Program (Appendix 7). Overall, the Program will have a positive net effect on the poor. The poverty classification of the Program is "Other." The environmental implications were reviewed, and no significant adverse environmental impacts were identified. Hence, the Program is classified under category C for environmental assessment.

VI. THE PROPOSED LOAN

A. Amount of Loan and Source of Funds

87. It is proposed that ADB support the Government's policy reforms by providing a loan of Special Drawing Rights (SDR)27,398,000 (\$35 million equivalent) from ADB's Special Funds resources. The Borrower will be the Kyrgyz Republic. The loan size was determined on the basis of the importance and need for sound corporate governance standards, a well-functioning judiciary and a viable industry sector, and the costs of the proposed structural reforms. The latter are estimated at about \$35.8 million during 2001-2004, and will consist of the following components:

- (i) institutional capacity building for corporate governance, through additional investments in the CDC, SCSM, and CSPFI (\$2 million);
- (ii) costs of institutional, capacity building, and administrative reforms linked to the judiciary, from CJRG and JAC deliberations (e.g., changing the system of judicial training; salary reforms over a medium term of five years, etc.) (\$8 million);
- (iii) write-offs for tax and social security payments, defaults on principal and interest repayments on loans owed by nonviable SOEs and overindebted private sector enterprises to the budget, and loss of potential dividends (\$22.8 million);⁴⁹
- (iv) retraining costs for workers laid off in restructured and liquidated enterprises (\$0.25 million); and
- (v) capacity building for implementing and monitoring IAS, and regulating JSCs (\$3 million).

B. Interest, Maturity, and Utilization Period

88. The loan will have a 24-year maturity, including an 8-year grace period. The loan will carry an annual interest charge of 1 percent during the grace period and 1.5 percent thereafter.

89. The loan is expected to be used over a period of 36 months from the date of effectiveness. Its proceeds may be used to finance eligible imports incurred within 180 days before the date of loan effectiveness.

C. Implementation Arrangements

90. The Ministry of Finance will be the Executing Agency for the Program, and will be responsible for administering and disbursing the loan proceeds and maintaining records.

⁴⁹ These are calculated on the following basis: JSC Osh Textiles - Som457 million (\$9.6 million); JSC Zanar - Som42 million (\$0.9 million); JSC Kyrgyz Chemical and Metallurgy Plant - Som41 million (\$0.9 million); JSC Kainda Cable - Som5 million (\$0.1 million); JSC Oreми - Som383 million (\$8 million); and past irrecoverable investments in JSC Crystal - Som160 million (\$3.3 million).

91. The CDC in the PMO will be the Implementing Agency and will provide quarterly reports on the progress of the Program. It will be supported by a consultative council, chaired by the chief of staff of the PMO and comprising all the key ministries and State agencies, including CSPFI, Ministry of External Trade and Industry, Ministry of Justice, Ministry of Finance, NBKR, SCSM, and SCSFRA. Each ministry or agency will deal with the policy, legal, and regulatory component relevant to them, under the overall coordination of the CDC and the PMO. Further, each ministry and agency will nominate staff to work closely with the CDC for 18 months on implementing the Program. The judicial reform component will be overseen and implemented by the JRMG, with appropriate inputs provided by the consultative council, to ensure coordination with the overall objective and scope of the Program. The JRMG will coordinate closely with the CDC and the Ministry of Justice, and submit bi-annual reports to ADB, focusing on, among other things, progress made, problems encountered, remedial actions taken during the previous six-months, and proposed program activity and expected progress during the next six-months.

D. Procurement and Disbursement

92. In line with the simplified disbursement procedures and related requirements for program loans,⁵⁰ and considering economy and efficiency, goods and services produced and originating in ADB's member countries will be procured in accordance with standard public sector procedures of the Kyrgyz Republic and normal private sector commercial practices acceptable to ADB. Goods commonly traded on the international commodity markets will be procured in accordance with procedures appropriate to the trade and acceptable to ADB.

93. The proceeds of the loan will be disbursed for a broad range of imports, subject to a negative list of items.⁵¹ Loan proceeds will be disbursed on the basis of a certification provided by the Government, confirming that in each year in which the proceeds of the program loan are expected to be disbursed, the value of total imports minus (i) imports from nonmember countries of ADB (ii) ineligible imports, and (iii) imports financed under other official development assistance, is equal to or greater than the amounts expected to be disbursed during such year.

94. If appropriate procedures are not followed, ADB reserves the right to withhold the disbursement of funds or seek reimbursement. The loan proceeds will be withdrawn in accordance with ADB's standard disbursement procedures. ADB reserves the right to audit the use of the loan proceeds and verify the validity of the certification issued by the Government.

E. Counterpart Funds

95. The policy matrix for the Program includes specific components that bear distinct costs of structural adjustments. The counterpart funds to be generated out of the loan proceeds will be used to finance the cost of such structural adjustments and high-priority development projects.

F. Monitoring and Tranching

96. The program period will be 3.5 years, from January 2001 to June 2004. The loan will be released in two equal tranches with the first tranche available upon loan effectiveness. The second tranche will be released by September 2003, subject to satisfactory implementation of the agreed-upon conditions. In cooperation with the PMO, ADB will carry out semiannual

⁵⁰ R50-98: *Simplification of Disbursement Procedures and Related Requirements for Program Loans*, 16 April 1998.

⁵¹ See Attachment 1 to Schedule 3 of the Loan Agreement on the Program between the Government and ADB.

reviews of progress in implementing the Program, and will assess its impact on the sectors relevant to the Program, including the industry and banking sectors and the judiciary. The Government will keep ADB informed of the outcomes of its policy discussions with other multilateral and bilateral funding agencies that have implications for program implementation, and will give ADB the opportunity to comment on any resulting policy proposals.

97. In addition to quarterly progress reports, the CDC and the PMO will submit a program completion report to ADB within six months of the release of the second tranche. This report will evaluate the implementation of the policy reform measures under the Program; their impact on the economy, industry and banking sectors, and the judiciary; lessons learned during the period; and further reforms and assistance needed for the development of the relevant sectors.

98. The policy matrix lists 18 actions that will be completed before ADB's Board consideration. The key actions include strengthening the CDC, adopting a Government resolution to strengthen SOE governance, fully adopting IAS 2001, drafting satisfactory laws on accounting and auditing, preparing asset valuation standards, drafting satisfactory amendments to the LBBA to improve corporate governance of commercial banks; initial preparation of amendments to various laws to improve the legal and enforcement framework on pledges; establishing a sound institutional framework to formulate and adopt judicial reforms; drafting satisfactory amendments to existing legislation and preparing new draft legislation to allow arbitration and streamline appellate court procedures; and formulating and adopting policy, legal, and regulatory measures to achieve expedient resolution of operationally and financially weak enterprises.

99. For the release of the second tranche, eight actions are required:

- (i) The CDC will develop for large enterprises a corporate governance rating system satisfactory to ADB, and publish the first set of ratings on all enterprises listed on the KSE and all commercial banks.
- (ii) At least 10 major SOEs (those with at least 51 percent of State ownership) will adopt and continuously comply with the good governance practices adopted under the Program.
- (iii) Legislation for JSCs, drafted in a manner satisfactory to ADB, will be enacted.
- (iv) A Law on Accounting and an amended Law on Auditing, drafted in a manner satisfactory to ADB, will be enacted.
- (v) NBKR will amend its regulations to strengthen governance of commercial banks and submit to ADB a report on banks' compliance with the enhanced provisions on corporate governance in the NBKR regulations and the Law on Banks and Banking Activity.
- (vi) The JAC will (a) widely disseminate the CJRG report and conduct workshops on its recommendations in Bishkek and at least three regional centers; (b) undertake a diagnostic study of the legal and judicial sector (with ADB TA support) to improve the quality, transparency, and efficiency of the judicial system in line with the judicial reform measures outlined in the CDF and the CJRG report; and (c) organize a major participatory workshop to discuss the findings and recommendations of the diagnostic study, with representatives from the judiciary, civil society, the private sector, and the aid community.
- (vii) Legislation will be amended and enacted to allow (a) third-party arbitration in line with the recommendations in the CJRG report; such legislation among others, will deal with the enforcement of foreign as well as local arbitral awards; and (b) higher courts to render judgments with finality and efficiency.

- (viii) The Government will take steps to achieve satisfactory resolution, including restructuring or liquidation, of at least six operationally and financially weak enterprises, based on the assessment supported under the Program.

100. The additional 14 monitorable conditions (Appendix 2) to be implemented during the Program will represent important steps towards complying with the conditions for the release of the second tranche.

VII. THE TECHNICAL ASSISTANCE

101. The TA will strengthen overall corporate and financial governance and judicial reforms in the Kyrgyz Republic by supporting (i) the adoption as well as monitoring of good governance norms in all enterprises, (ii) adoption of modern accounting standards in all enterprises, and (iii) a comprehensive diagnostic assessment of the problems and constraints facing the judiciary.

102. The TA (Appendix 8) will focus on institutional capacity building support for

- (i) corporate governance reforms focusing on support for enterprises in management development, finance, and internal controls;
- (ii) developing a corporate governance rating system;
- (iii) developing a sound institutional and regulatory framework for formulating and adopting corporate governance norms in all JSCs;
- (iv) undertaking a comprehensive legal and judicial sector assessment, with focus on reducing the problems and constraints facing the judiciary; and
- (v) monitoring implementation of the Program.

103. The TA is estimated to cost \$1,000,000 equivalent, of which \$740,000 will be the foreign exchange cost and \$260,000 equivalent will be the local currency component. ADB will finance the equivalent of \$850,000, comprising the entire foreign exchange component and \$110,000 equivalent of the local currency component. Financing will come from the ADB-funded TA Program. The Government will provide \$150,000 equivalent to finance counterpart staff, office facilities, and workshops.

104. The CDC under the PMO will be the Executing Agency for the TA to be implemented over 15 months, starting by April 2002. The JRMG, in consultation with the JAC, will provide overall supervisory support for the judicial reform component. It is estimated that the TA will require 20.5 person-months international and 75 person-months domestic consulting support. In addition, the Government has committed to utilizing about \$340,000 from the ongoing TA Loan 1547, to procure advisory support services from an international consultant for 4 person-months for the enterprise resolution component of the Program, and about 340 person-months domestic consulting support for promoting corporate governance.⁵² All consultants will be selected in accordance with ADB's *Guidelines on the Use of Consultants* and other arrangements satisfactory to ADB. The Government will select the consultants to be funded out of TA Loan 1547 in accordance with the appropriate loan agreement. The CDC will supervise the consultants recruited under TA Loan 1547.

⁵² The terms of reference for the consulting inputs to be procured under TA Loan 1547-KGZ (footnote 1) are in CDC's action plan.

VIII. PROGRAM BENEFITS AND RISKS

A. Benefits

105. The Government has requested ADB to take leadership in assisting with the development of a framework for corporate governance in the Kyrgyz Republic. CGERP has contributed to a significant increase in awareness of basic corporate governance issues among enterprise and Government officials and, to some extent, among shareholders. The Program will further strengthen the adoption of good governance practices in all JSCs, with focus on SOEs and commercial banks. The Program's broadened scope to reform the judiciary and restructure nonviable enterprises is expected to have wide-ranging and sustained benefits.

106. While the Kyrgyz Republic has developed a legal base over the last five years to support private sector development, specific problems with legislation pertaining to enterprises, inconsistencies between legislation, and weaknesses in the regulatory and judicial framework have effectively discouraged investors from taking risks. In addition, due to the poor macroeconomic environment as well as the structural problems inherited from the pre-independence period, a large number of enterprises are nonviable. The Program will formulate measures to address all these constraints.

107. The Program will support institutional capacity building in the SCSM and enhancement of its regulatory authority to effectively monitor compliance with good governance norms in all JSCs. The Program will facilitate privatization of large SOEs by supporting the preparation of a separate corporate governance framework for all SOEs. It will enhance transparency and financial integrity in the banking sector by clarifying and strengthening corporate governance provisions in banking legislation, with specific focus on sound criteria for appointments to the BOD. The Program will also support the Government's measures to take prompt corrective actions on problem banks suffering from shareholder abuse and governance failures.

108. With regard to the legal, regulatory, and judicial framework, the reform measures under the Program aim to promote the credibility and professional standards of the judiciary so that the judicial decision-making and law enforcement process is unquestioned. A key expectation is that public and investor confidence in the judiciary will be enhanced. By introducing alternative methods of dispute resolution, the Program will encourage foreign investments in the Kyrgyz Republic.

109. The Program will help improve enterprise sector viability by supporting the Government's efforts in resolving long-standing problems of tax and social security payment arrears, and defaults on loan repayments owed by a large number of enterprises. It will require greater compliance by state organs with the provisions of the Law on Bankruptcy. Continuing the policy measures adopted under the FIRM Program, the Program seeks to enhance transparency in the resolution of JSC Kyrgyz Gas Munaizat.

B. Risks

110. The Program faces three major risks. First, given the small market size and the continuing dependence of the Kyrgyz economy on Russia, macroeconomic stability is critical to ensure that structural reforms proceed in an uninterrupted manner across the corporate, financial, and other sectors of the economy. Recognizing this, the Government, with support from IMF, continues to stress adherence to a macroeconomic stabilization program, which emphasizes improving fiscal, monetary, and external debt management. The fiscal deficit is to

be reduced from 9.4 percent of GDP in 2000 to 5.9 percent of GDP in 2001. A tight monetary policy will continue to be pursued. The Government is pursuing a multifold strategy to reduce debt, including a tight fiscal policy and reducing the PIP.

111. The second risk pertains to the resolution of weak enterprises. While there are significant enterprise-level vested interests that could prevent reorganization or liquidation, the Government fully recognizes the extent of nonviability in the industry sector. The Program proposes a gradual, phased-in approach to resolution, which involves a sequence of measures, including, among others, management change, reorganization and liquidation. This will enable the Government to explore all plausible avenues and assure the stakeholders in the process.

112. Third, being politically sensitive and prone to resistance from vested interests, legal and judicial reforms may not be effectively implemented. Given the weaknesses in the legal framework, the Program requires amendments to several laws. The judicial system suffers from significant procedural as well as systemic weaknesses and problems related to appointments, dismissals, and independence of judges. Some of the critical judicial reform measures require amendments of a technical nature to the Kyrgyz Constitution. ADB has provided significant TA support to prepare new laws as well as amendments to legislation. To initiate judicial reforms, ADB has closely worked with the Government to establish the CJRG under the President. The President subsequently endorsed the CJRG's report, which recommends wide-ranging reforms in the judiciary, including amending existing legislation to achieve those reforms. A sound implementation framework has also been agreed upon with the Government, including establishing the JAC to undertake an in-depth diagnostic assessment of the judicial problems.

113. It is imperative that the problems and constraints facing Kyrgyz enterprises be addressed effectively and in a comprehensive manner. Governance reforms will not be meaningful without strengthening the supporting legal and judicial framework. Reforming the judiciary is a complex task, but it is one to which the Kyrgyz President is now attaching significance, as outlined in his remarks at various judges' conventions and in the CDF report. The Government fully recognizes the negative perceptions of investors, domestic as well as foreign, and is willing to initiate reforms in key areas to enhance confidence in domestic institutions. In particular, with the stated goal of achieving FDI of 15 percent of GDP by 2010, the President of the Kyrgyz Republic and the Government are committed to strengthen the legal framework and attract investors. The Government has also, thus far, demonstrated strong commitment by formulating the reform measures proposed under the Program. Taking these considerations into account, the Program will launch the first round of judicial reform initiatives in the Kyrgyz Republic.

IX. ASSURANCES

114. The Government has given the following assurances, in addition to the standard assurances, which have been incorporated in the loan agreement:

- (i) The policies adopted and reform measures taken prior to the date of the loan agreement, as described in the development policy letter (Appendix 1) and the policy matrix (Appendix 2), will continue in effect for the duration of the Program period.
- (ii) The measures to (a) promote, strengthen, and implement good corporate governance standards; (b) introduce international accounting, auditing, and valuation standards; (c) strengthen governance of commercial banks and the

- legal framework to protect creditors' rights; (d) launch legal and judicial reforms to enhance governance; and (e) restructure the enterprise sector, will be adopted in accordance with the policies and actions specified in the policy matrix, and the Government will ensure that such policies and actions continue in effect for the duration of the program period.
- (iii) Sufficient counterpart funds will be made available under the Program components where such funds are required.

X. RECOMMENDATION

115. I am satisfied that the proposed loan would comply with the Articles of Agreement of ADB and recommend that the Board approve the loan in various currencies equivalent to Special Drawing Rights 27,398,000 to the Kyrgyz Republic for the Second Phase of the Corporate Governance and Enterprise Reform Program, with a term of 24 years, including a grace period of 8 years, and with an interest charge at the rate of 1 percent per annum during the grace period and 1.5 percent per annum thereafter, and such other terms and conditions as are substantially in accordance with those set forth in the draft Loan Agreement presented to the Board.

TADAO CHINO
President

25 October 2001

APPENDIXES

Number	Title	Page	Cited on (page, para.)
1	Development Policy Letter	36	2,6
2	Policy Matrix for the Second Phase of the Corporate Governance and Enterprise Reform Program (CGERP-II)	40	2,6
3	Program Framework	47	2,6
4	Background Information on the Enterprise Sector	54	7,22
5	Scheme of the Kyrgyz Court System	58	8,25
6	Decree of the President of the Kyrgyz Republic, and Terms of Reference for the Consultative Judicial Reform Group	59	24,73
7	Poverty Impact Assessment	63	28,86
8	Technical Assistance to Strengthen Corporate Governance and Judicial Reforms	70	31,102

SUPPLEMENTARY APPENDIXES

(available on request)

- A Legal Framework for Enterprises in Kyrgyz Republic
- B Data on Kyrgyz Court System
- C Report of the Consultative Judicial Reform Group
- D Enterprise-Level Data from ADB Study
(TA 3505: Corporate Governance and Enterprise Reform Program Phase II)

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РЕСПУБЛИКАСЫНЫН
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ПРАВИТЕЛЬСТВО
КЫРГЫЗСКОЙ
РЕСПУБЛИКИ

БИШКЕК ш., ӨКМӨТ ҮЙҮ

№ 18, 10 2001 ж.г.

г. БИШКЕК, ДОМ ПРАВИТЕЛЬСТВА

№ 16-1519

DEVELOPMENT POLICY LETTER

Mr. Tadao Chino
President
Asian Development Bank

Dear Mr. President,

1. The Government of Kyrgyz Republic (the Government) requested the Asian Development Bank in 2000 for support through a Program Loan to further strengthen corporate governance standards and facilitate the introduction of reform measures aimed at enhancing investor confidence in Kyrgyz Republic. The first Phase of the Corporate Governance and Enterprise Reform Program (CGERP-I) is considered by the Government of the Kyrgyz Republic as successful and pioneering, given that Kyrgyz Republic was among the first set of countries to adopt corporate governance reforms and since all the objectives and conditions of the program have been completely fulfilled. In this regard, the Government of the Kyrgyz Republic would like to express its gratitude to the Asian Development Bank (ADB) for supporting us in improving the legal, regulatory and institutional environment to introduce good governance, as well as for implementing reforms to enhance the efficiency and viability of enterprises.

2. The Government highly appreciates the efforts of the ADB in formulating the second phase of CGERP (CGERP-II), in response to our request. In our view, enhancing investor confidence through corporate and judicial governance reforms and facilitating prompt corrective measures for problem enterprises are vital at present. In view of our planned reduction in the public investment program, it is vital that the Government's efforts are now aimed at attracting private domestic and foreign investments. The measures being proposed under CGERP-II will result in improving living standard of the population of the Republic, and help us in addressing the challenges posed by poverty in the medium-term. In our opinion, the measures, taken in this field by the ADB, including in our country, clearly reflect the core of your Organization's activity as an international institution working towards improving living standards and development of the member-countries.

3. CGERP-II is aimed at deepening reforms started within the framework of the first program. Most of the measures envisaged under the new Program are of a systemic character as the Program includes the following five key components: (i) promoting, strengthening and implementing good corporate governance through development of policy, legal and monitoring framework; (ii) implementation of international accounting, auditing and valuation standards; (iii) enhancing governance of commercial banks and strengthening the legal framework to

protect creditors' rights; (iv) launching legal and judicial reforms to enable arbitration as a mechanism for resolution of commercial disputes, and streamlining judicial processes and procedures; and (v) facilitating expedient resolution of weak and inefficient enterprises.

4. The Government has closely coordinated with the Mission of the ADB, and we have jointly formulated the Program framework and policy measures. The understandings reached at each stage of the Program have been reflected in Memoranda of Understanding between the Government (represented by a Consultative Council for CGERP-II, established through a Government Resolution) and the ADB (represented by the Mission).

5. In our view, CGERP-II will make important contributions in two respects: (i) introducing actual, pro-active, measures to attract investments; as well as (ii) addressing issues of concern to, and the negative perception held by, the potential investors. Unfortunately, to the present day, several surveys and analyses of various international organizations have appraised the efficiency and transparency of the legal and judicial sector, and the law enforcement system to be very low, particularly concerning the system of economic dispute resolution. In particular, the matter concerns procedures of (the inefficient system) judicial decision-making and the necessity to strengthen independence of the judicial system from external factors. Addressing these issues will form a core pillar of CGERP-II.

6. Through this Development Policy Letter (DPL), the Government hereby commits to take all the measures needed to meet the objectives and fulfill the scope of CGERP-II. A Policy Matrix, outlining these measures in detail, is attached to this DPL. The following sections outline the measures that have already been implemented, as well as those that the Government will implement during the course of CGERP-II. The DPL outlines some of the key measures, as an indication of the Government's strong commitment to the reforms being adopted under CGERP-II.

7. **Adoption of good corporate and financial governance measures:** Under the Program, the Government will further enhance our institutional capacity in corporate governance policy formulation and regulation. The Corporate Development Center (CDC), established under the first phase, has been transferred as a full-fledged department under the Prime Minister's Office, reporting directly to me. This will ensure that there is effective coordination under the Program, as well as the diverse elements of good governance are all promoted well. The Government will also adopt a sound legal framework on joint stock companies (JSCs), in line with international best practices. We will also improve the corporate governance practices in state-owned enterprises (SOEs) under the Program. In particular, good governance practices will be adopted, on a demonstration basis, in at least 10 major SOEs (those with at least 51 percent of state ownership).

8. Good accounting and auditing standards are a cornerstone of transparency and good governance. Under the Program, the Government will fully adopt International Accounting Standards (IAS) 2001 and International Auditing Standards (IAuS). There will also be a phased program of adoption of these international standards in all enterprises over the Program period. In particular, all enterprises listed on the Kyrgyz Stock Exchange and all commercial banks will adopt IAS for the 2002 financial year. Asset valuation is at a nascent stage of development in Kyrgyz Republic. We will adopt internationally accepted asset valuation standards under the Program, and revalue assets of at least three large SOEs.

9. The importance of sound financial intermediation cannot be understated, for availability of credit is critical for revival and growth of enterprises. While we have adopted financial sector

strengthening measures with ADB support in the past, in this Program, we will amend the Law on Banks and Banking Activity to incorporate sound provisions on corporate governance in banks. The Government will also undertake measures to facilitate swift resolution of problems in the banking sector, including the adoption of a separate law on bankruptcy of commercial banks.

10. It is our assessment that the Kyrgyz Law on Pledge compares favorably with that found in other Central Asian Republics. However, we recognize that the law may be ineffective, due partly to the inconsistencies between this Law and other legislation, and also because of deficiencies in the court processes and the pledge execution system. Under the Program, the Government has drafted amendments to: (i) remove inconsistencies between the Law on Pledge and the Civil Code, and the Civil Code and other legislation (including the Law on Mortgage), by amending the Civil Code, to facilitate an easier application and enforcement of the Law on Pledge; (ii) allow the pledgor to execute collateral without court intervention; (iii) simplify the procedures for the sale of pledge assets, including the bidding and auction requirements; and (iv) rationalize the structure of fees for execution of pledge rights. These amendments will be enacted under the Program by December 2002.

11. **Launch legal and judicial sector reform measures:** The Government recognizes the negative investor perception with regard to the Kyrgyz judicial system. CGERP-II will support our own initiatives in alleviating such a negative perception. The importance of this issue was clearly expressed by President in his speech at the 4th congress of judges of the Kyrgyz Republic and was set out in the resolution of the congress in May 2001. In consultation with the ADB, the President established the Consultative Judicial Reform Group (CJRG) in April 2001. The President endorsed the recommendations contained in the CJRG Report on 12 July 2001. This is an important milestone in CGERP-II. The CJRG Report stipulates wide-ranging reforms in the judicial system, including (i) the necessity of introduction of arbitration for economic dispute resolution, as an alternative to dispute resolution in arbitrazh courts; (ii) granting of finality to judicial judgements taken by higher courts; (iii) formulating a sound framework for judicial corruption; (iv) adoption of measures to promote a professional corps of judges in the future; and (v) enhancing judicial independence through election of judges at all levels by the Parliament. That the President has approved all these recommendations, including arbitration, granting of finality to higher courts and election of judges, all of which require amendments to the Kyrgyz Constitution, underscores our commitment to introducing wide-ranging reforms in this area. These measures are also reflected in the Comprehensive Development Framework (CDF) Report, which sets out our long-term development vision.

12. Based on the recommendations of the CJRG, the Government under the Program has undertaken several important steps. These include: (i) initiating the drafting of new legislation and legislative amendments to introduce extra-judicial dispute resolution mechanisms; (ii) streamlining court appellate procedures; (iii) establishment of a Judicial Advisory Commission (JAC) to undertake a comprehensive diagnostic assessment of the legal and judicial sector problems; and (iv) measures to enhance transparency in the process of judicial decision-making. Under the Program, a suitable implementation framework to oversee judicial reforms has been adopted. A Judicial Reform Monitoring Group (JRMG) and an institutional mechanism for drafting legislative amendments have been formed through Presidential Dispositions. The JRMG will coordinate and monitor the implementation of the judicial reform measures under the Program, and submit semi-annual reports to the ADB. The JAC with broad-based participation will widely disseminate the findings of the CJRG and undertake a comprehensive analysis of the problems and constraints facing the judiciary. This process will enable us to introduce broader and deeper reforms in the near future to strengthen our judiciary.

13. Recognizing the extent of unviability in the industrial sector, the Government through the Program will undertake measures in three different areas: (i) formulation and adoption of a legal framework to require SOEs to initiate automatic restructuring on their own and facilitate opportunities for reorganizations as an alternative to liquidations in appropriate cases; (ii) formulation and adoption of an industrial sector strategy, based on an operational and financial assessment of 65 large enterprises (undertaken with ADB TA support); and (iii) resolution of at least six enterprises, with both reorganization and liquidation as options.

14. The Government will undertake measures towards: (i) sale of 100 percent of state shares in JSC Osh Textiles to a strategic investor; (ii) cross-ownership arrangement with key suppliers of JSC Kyrgyz Chemical and Metallurgy Plant; (iii) sale of state shares in JSC Crystal to a strategic investor; (iv) sale of all state shares in JSC Kainda Cable to a strategic investor; (v) preparation of a comprehensive restructuring plan, focusing on realistic financial restructuring options of JSC Oremi. In addition to these enterprises, the Government, in line with Resolution No. 627 of 11 October 2001, will ensure that 8 other financially weak SOEs and 9 heavily indebted private sector enterprises will initiate automatic restructuring on their own. Following these measures, the Government, by December 2002, will take steps to achieve full and satisfactory resolution of at least six enterprises, including reorganization, restructuring or liquidation, based on the above comprehensive assessment.

15. I would like to assure you that the Government's full adoption of the Program is based on our in-depth analysis and recognition of the problems facing the Kyrgyz economy. The understandings that we have reached with the ADB are the results of much efforts and hard work, and strong will and commitment on our part to the reforms. However, reforms in any area are complicated, particularly if the internal structures and organization of the state and the economy are formed in a different manner to that found in more mature and market-oriented economies. But I believe that our sincere efforts to strive for solving the current problems will allow the Kyrgyz Republic to achieve stable economic growth and improvements in the living standard of the Republic's population in the nearest future. CGERP-II is poised to play a vital role in this process and support us in our endeavors.

16. Taking this opportunity, I would like to express my sincere respect and gratitude, on behalf of Kyrgyz Republic, for the assistance being rendered by the Asian Development Bank and we, as a country, wish the ADB every success and achievement in all your planned tasks.

Yours sincerely,



Prime Minister,
Kyrgyz Republic
Kurmanbek Bakiev

18 October 2001

**POLICY MATRIX FOR THE
SECOND PHASE OF THE CORPORATE GOVERNANCE AND
ENTERPRISE REFORM PROGRAM (CGERP-II)**

Objective: The key objective will be to enhance investor confidence and promote efficiency of enterprises by strengthening corporate, financial, and judicial governance. To achieve this objective, the Program will

- (i) promote, strengthen, and implement good corporate governance through development of policy, institutional, legal, and regulatory framework;
- (ii) introduce international accounting, auditing, and valuation standards;
- (iii) strengthen governance of commercial banks and the legal framework to protect creditors' rights;
- (iv) launch legal and judicial reforms to improve commercial disputes resolution, and streamline judicial processes and procedures; and
- (v) facilitate restructuring of inefficient but viable enterprises and resolution or liquidation of nonviable enterprises.

Policy Objective	FIRST TRANCHE CONDITIONS (January 2001 to Board Approval)	SECOND TRANCHE CONDITIONS (Board Approval to September 2003) ¹
I. PROMOTE, STRENGTHEN, AND IMPLEMENT GOOD CORPORATE GOVERNANCE STANDARDS		
Develop the policy and institutional framework, and enhance capacity for corporate governance	<p>F1. The Government has</p> <ul style="list-style-type: none"> (i) moved the Corporate Development Center (CDC) from the Committee on State Property and Foreign Investments (CSPFI), and established it as a Department within the Prime Minister's Office (PMO); (ii) developed an organizational structure for CDC, comprising a corporate sector development division to undertake promotional activity relative to corporate governance, and a project implementation division to coordinate and implement CGERP-II; and (iii) provided for salary and administrative expenses, as a part of the PMO's budget, involved in maintaining CDC as a fully functional department. 	<p>S1. The CDC to submit periodic quarterly and final reports, as appropriate, to the Asian Development Bank (ADB) on the various components of CGERP-II as identified in sections (I)-(III) and (V) below [Continuous].</p>
	<p>F2. The CDC has</p> <ul style="list-style-type: none"> (i) prepared an action plan and a work program to guide its future development for a period of at least 2 years, based on an evaluation of its terms of reference and resource availability; and 	<p>S2. The CDC will develop a corporate governance rating system for large enterprises, satisfactory to ADB, and publish the first set of ratings on all enterprises listed on the Kyrgyz Stock Exchange (KSE) and all commercial banks [December 2002].</p>

¹ The second tranche release conditions appear in **bold**.

Policy Objective	FIRST TRANCHE CONDITIONS (January 2001 to Board Approval)	SECOND TRANCHE CONDITIONS (Board Approval to September 2003) ¹
	(ii) strengthened its skills mix to effectively promote corporate governance and coordinate implementation of policy reforms under CGERP-II.	
	<p>F3. The CDC has finalized plans and undertaken measures to</p> <ul style="list-style-type: none"> (i) strengthen efforts in management development, training, and advisory support for enterprises based on partial cost recovery to ensure financial sustainability; (ii) continue its public information campaign on corporate governance, accounting and valuation standards, insolvency procedures, restructuring of enterprises, and judicial reforms; (iii) continue to provide advisory support for minority shareholders; and (iv) publish <i>Corporate Herald</i> (the newspaper on corporate governance) and a revised Handbook on Corporate Governance. 	<p>S3. The CDC, in coordination with the State Commission on Securities Markets (SCSM) and the Government, will prepare and submit to ADB a plan for continuation of promotional activities in the sphere of corporate governance, including shifting those to an appropriate body in the future and encouraging private sector involvement in this area [April 2003].</p>
<p>Improve the corporate governance and enterprise restructuring policy framework for state-owned enterprises (SOEs)</p>	<p>F4. CSPFI passed a Resolution on SOE governance to</p> <ul style="list-style-type: none"> (i) strengthen qualifications criteria for supervisors and members of senior management; (ii) strengthen the procedures for selecting candidates for boards of directors and management of SOEs; (iii) establish contractual arrangements between SOEs and general managers; and (iv) improve the system of state share management and state representation in SOE bodies. 	<p>S4. At least 10 major SOEs (those with at least 51 percent of state ownership) will adopt and continuously comply with the practices adopted under the Program [December 2002].</p>
<p>Strengthen the legal and regulatory framework for corporate governance of joint stock companies (JSCs)</p>	<p>F5. The SCSM has initiated the formulation of a sound legal framework for corporate governance in JSCs in line with the international best practices in corporate governance. [done]</p>	<p>S5. Legislation for JSCs, drafted in a manner satisfactory to ADB, will be enacted [July 2002].</p> <p>S6. The SCSM will take steps to (a) develop its human resource capacity in promotional as well as regulatory activities pertaining to corporate governance; (b) ensure timely submission of financial information and reports by <i>open</i> JSCs, as stipulated in legislation; (c) strengthen its regulatory</p>

Policy Objective	FIRST TRANCHE CONDITIONS (January 2001 to Board Approval)	SECOND TRANCHE CONDITIONS (Board Approval to September 2003) ¹
		activities to monitor JSCs compliance with all relevant legislation and regulations; and (d) periodically monitor conduct of annual general meetings (AGMs) to ensure compliance with legal provisions on AGMs [December 2002].
II. INTRODUCE INTERNATIONAL ACCOUNTING, AUDITING AND VALUATION STANDARDS		
Provide a sound legal and regulatory basis for accounting, and adopt International Accounting Standards (IAS) 2001 and International Auditing Standards 2001 in the Kyrgyz Republic	<p>F6. The State Commission for Standards of Financial Reporting and Auditing (SCSFRA) has</p> <ul style="list-style-type: none"> (i) Adopted IAS 2001 fully and initiated the process to adopt International Auditing Standards 2001 fully in the Kyrgyz Republic and prepared a timetable for its phased introduction; (ii) Initiated a review of all relevant legislation, codes, and Government resolutions/decrees (pertaining particularly to taxation and the financial sector), to ensure consistency with IAS 2001; and (iii) Prepared and adopted through a Government resolution a realistic timetable for conversion of SOEs and JSCs to the new standards. <p>F7. The Government, through the SCSFRA will finalize</p> <ul style="list-style-type: none"> (i) the draft law on accounting; and (ii) the draft amendment to the Law on Auditing, ensuring conformity with the law on accounting and the adoption of IAS 2001 as the governing norms on accounting. 	<p>S7. The SCSFRA to</p> <ul style="list-style-type: none"> (i) Adopt International Auditing Standards 2001 [December 2001]; (ii) Enhance its capacity in implementing IAS 2001 and International Auditing Standards 2001 and demonstrate satisfactory progress in adoption of the international standards; (iii) Ensure that all commercial banks [April 2003] and all Enterprises [on an ongoing basis throughout the Program Period] listed on the KSE have converted to IAS 2001. <p>S8. The Law on Accounting and the revised Law on Auditing, with draft satisfactory to ADB, will be enacted [July 2002].</p> <p>S9. The State Tax Inspectorate will</p> <ul style="list-style-type: none"> (i) train a core of its tax inspectors on IAS 2001; and (ii) accept financial statements based only on IAS 2001 for the entities included in S7 for the financial year 2002 [April 2003].
Introduce modern standards on asset valuation to promote transparency	<p>F8. The CDC has prepared</p> <ul style="list-style-type: none"> (i) national standards on valuation of movable, immovable and nonmaterial assets (e.g., trademarks, copyrights, etc.); 	<p>S10. The Government to submit the draft law on asset valuation and the revised Law on Licensing to Parliament in the third quarter of 2002. The CSPFI will complete reevaluation of the physical and financial assets of 3 large SOEs, in accordance with the new standards [December 2002].</p>

Policy Objective	FIRST TRANCHE CONDITIONS (January 2001 to Board Approval)	SECOND TRANCHE CONDITIONS (Board Approval to September 2003) ¹
	(ii) a draft law on asset valuation and associated regulations; (iii) a draft amendment to the Law on Licensing relating to licensing of valuation activity.	
III. STRENGTHEN GOVERNANCE OF COMMERCIAL BANKS AND THE LEGAL FRAMEWORK TO ENHANCE CREDITORS' RIGHTS		
Improve corporate governance standards and practices for commercial banks	F9. The Government through the National Bank of Kyrgyz Republic (NBKR) has drafted amendments to the Law on Banks and Banking Activity (LBBA) to require/introduce <ul style="list-style-type: none"> (i) continuous requirements on the qualifications of the principal shareholders (holding more than 5 percent of the shares) and directors of banks; (ii) the board of directors in each bank to have at least one independent director;² (iii) banks to establish separate obligatory committees of their boards of directors for risk management, credit, and asset and liability management, managerial compensation and directors' nominations; (iv) strengthening the role of the Audit Committee; (v) establishment of an explicit fiduciary responsibility on the part of directors and managers of banks; (vi) full disclosure of the financial interests of managers and directors; (vii) clear rules to avoid conflicts of interest involving principal shareholders, directors, and managers; and (viii) nonpreferential treatment in the banks' transactions with related parties. 	S11. NBKR will amend its regulations (normative acts) to strengthen governance of commercial banks, and submit a report to the ADB on compliance by banks with the enhanced provisions on corporate governance in the aforesaid regulations of NBKR and the LBBA [December 2002].
	F10. The Government through Ministry of Finance and NBKR has introduced appropriate measures to allow the Debt Restructuring and Bank Reorganization Agency as the sole liquidator of problem banks, was to ensure that liquidation of problem banks can proceed in an efficient manner.	S12. NBKR to draft and submit to Parliament a separate law on bankruptcy of commercial banks [December 2002].

² Independent here means not related to the management or principal shareholders by marriage, consanguinity to the second degree, employment or business interest.

Policy Objective	FIRST TRANCHE CONDITIONS (January 2001 to Board Approval)	SECOND TRANCHE CONDITIONS (Board Approval to September 2003) ¹
Protect the rights of creditors	<p>F11. The Government has drafted amendments to</p> <ul style="list-style-type: none"> (i) remove inconsistencies between the Law on Pledge and the Civil Code, and the Civil Code and other legislation (including the Land Code and Law on Mortgage), by amending the Civil Code and other legislation, as appropriate, to facilitate easier application and enforcement of the Law on Pledge; (ii) allow the pledger to execute collateral without court intervention; (iii) simplify the procedures for the sale of pledged assets, including the bidding and auction process; and (iv) rationalize the structure of fees for execution of pledge rights. 	<p>S13. Enact amendments to all relevant legislation that define commercial transactions between debtors and creditors, in the manner contemplated, to protect the rights of creditors [December 2002].</p>
IV. LAUNCH LEGAL AND JUDICIAL REFORMS TO ENHANCE GOVERNANCE		
Undertake a comprehensive review of procedure and process related constraints and systemic weaknesses in the Kyrgyz judicial system	<p>F12. Presidential disposition will be issued to</p> <ul style="list-style-type: none"> (i) establish a Consultative Judicial Reform Group (CJRG) to deliberate on and discuss measures to address weaknesses in the judicial system; (ii) approve the recommendations contained in the CJRG's report; (iii) establish a Judicial Reform Monitoring Group (JRMG)³ to oversee the implementation of the recommendations of the CJRG report; (iv) establish an institutional mechanism to draft the legislative amendments required to implement the recommendations of CJRG; and 	<p>S14. The JRMG will coordinate and monitor the implementation of the judicial reform measures, and submit bi-annual reports to ADB on the same [continuous].</p> <p>S15. The JAC will</p> <ul style="list-style-type: none"> (i) widely disseminate the CJRG report and conduct workshops on its recommendations in Bishkek and at least 3 regional centers; (ii) undertake a diagnostic study of the legal and judicial sector (with support of ADB technical assistance) to improve the quality, transparency, and efficiency of the judicial system in line with the judicial reform measures outlined in the Comprehensive Development Framework and the CJRG reports; and

³ The Judicial Reform Monitoring Group will be headed by the Chief of Staff of the President's Administration; its other members will be the Heads of the Legal Departments in the President's Administration and the PMO, and the Minister of Justice.

Policy Objective	FIRST TRANCHE CONDITIONS (January 2001 to Board Approval)	SECOND TRANCHE CONDITIONS (Board Approval to September 2003) ¹
	(v) establish a Judicial Advisory Commission (JAC), with broad-based representation, ⁴ to (a) operationalize the recommendations of the CJRG Report; and (b) formulate future judicial reform directions.	(iii) organize a major participatory workshop to discuss the findings and recommendations of the diagnostic study, with representatives from the judiciary, civil society, private sector, and aid community [April 2003].
Allow out-of-court commercial dispute resolution, and streamline court appellate procedures and processes to increase efficiency	F13. The bodies established under F12(iv) will draft (i) amendments to appropriate legislation and draft new legislation to allow extrajudicial resolution of economic disputes, so as to provide competing and out-of-court alternatives to contracting parties if they so wish; and (ii) amendments to appropriate legislation to allow higher courts the power to render final judgment.	S16. Amend and enact relevant legislation to allow (i) third-party arbitration in line with the recommendations in the CJRG report. Such legislation will, among others, deal with the enforcement of foreign as well as local arbitral awards [December 2002]; (ii) higher courts to render judgments with finality and efficiency [December 2002].
Adopt measures to increase transparency of judicial proceedings	F14. The Government, in consultation with the courts, will further develop mechanisms, possibly with the assistance of the private sector (e.g., Toktom), to deal with the dissemination of court decisions.	
V. FACILITATE EXPEDIENT RESOLUTION OF ENTERPRISE SECTOR PROBLEMS		
Facilitate the liquidation, restructuring, and renewal of enterprises	F15. The Government will (i) initiate a review of the bankruptcy workouts and drafting of amendments to the Law on Bankruptcy to strengthen bankruptcy procedures and facilitate resolution and liquidation of enterprises; and (ii) issue a resolution requiring overindebted SOEs (with more than 50 percent owned by the Government) and enterprises with large overdue State debts (including budgetary loans, Government-guaranteed foreign credits, and tax and social fund arrears) to initiate automatic restructuring on their own, without the need for liquidation pressures from other creditors.	S17. Enact the amendments to the Law on Bankruptcy. [December 2002] S18. The CSPFI will have increased its monitoring capacity with regard to all aspects of enterprise restructuring, including liquidation as well as operational or financial renewal. It will undertake measures to strengthen its existing base of data on all options chosen by enterprises being restructured and the court actions [December 2002].

⁴ The JAC will have broad based representation, comprising judges, lawyers in the private sector, legal scholars, Parliamentary deputies and distinguished representatives of the civil society.

Policy Objective	FIRST TRANCHE CONDITIONS (January 2001 to Board Approval)	SECOND TRANCHE CONDITIONS (Board Approval to September 2003) ¹
Assess the operational and financial state in a representative sample of enterprises, and formulate a strategy to support the renewal and restructuring of enterprises	<p>F16. With support from ADB TA, Ministry of External Trade and Industry and CSPFI will jointly launch a financial and operational review of at least 65 enterprises to assess, among others</p> <ul style="list-style-type: none"> (i) capacity utilization, with regard to physical as well as human resources, and (ii) medium-term commercial, financial, and operational viability, including a review of the obsolescence and depreciation of equipment and facilities. <p>Based on this and a sector review, the Government will initiate the formulation of an industrial sector restructuring strategy.</p>	<p>S19. The Government will adopt the industrial sector restructuring strategy. As part of the restructuring strategy, CDC and CSPFI will initiate a public awareness program on provisions available for efficient enterprise restructuring [July 2002].</p> <p>S20. CSPFI will publish</p> <ul style="list-style-type: none"> (i) a bi-annual report on all enterprise restructuring and bankruptcy proceedings of all enterprises in the mass media. In addition, (ii) a separate report, providing clear and transparent information on the JSC Kyrgyz Gas Munaizat bankruptcy process will be published or released in the mass media twice a year until the process is completed [December 2002].
Restructure selected SOEs to reduce the extent of nonviability in the enterprise sector	<p>F17. Ministry of External Trade and Industry and CSPFI will undertake measures toward</p> <ul style="list-style-type: none"> (i) sale of 100 percent of State shares in JSC Osh Textiles to a strategic investor; (ii) cross-ownership arrangement with key suppliers of JSC Kyrgyz Chemical and Metallurgy Plant; (iii) sale of 100 percent state shares in JSC Crystal to a strategic investor; (iv) sale of all state shares in JSC Kainda Cable to a strategic investor; and (v) preparation of a comprehensive plan, focusing on financial restructuring options for JSC Oreimi. 	<p>S21. The Government will take steps to achieve satisfactory resolution, including restructuring or liquidation, of at least six operationally and financially weak enterprises, based on the assessment supported under the Program [December 2002].</p>
	<p>F18. The Ministry of Labor will formulate adequate active labor market measures to ameliorate any adverse impact of enterprise restructuring. As part of this, adequate provisions will be made in the 2002 budget for employment counseling, retraining, and other active labor market measures.</p>	<p>S22. Ministry of Finance will provide sufficient provisions in the 2003 budget for employment counseling, retraining, and other active labor market measures, and Ministry of Labor will implement these remedial measures for workers in the affected enterprises [Ongoing].</p>

PROGRAM FRAMEWORK

Design Summary	Performance Targets	Monitoring Mechanisms	Risks and Assumptions
<p>Goal To support sustainable economic growth by laying the foundations for strong and robust corporate and financial sectors of the economy, and accompanying institutions</p>	<ul style="list-style-type: none"> • Growth and development of industry sector, and sustained contribution of that sector to gross domestic product (GDP) • Phased reduction in enterprise arrears • Fewer central bank regulatory actions for insider abuse or weak governance in commercial banks • Sustained medium- to long-run economic growth 	<ul style="list-style-type: none"> • Published industrial and enterprise sector indicators • Economic reports • Asian Development Bank (ADB) review missions 	<ul style="list-style-type: none"> • Macroeconomic stability • Political stability • Stable and sound support provided by other institutions, the most important being the judiciary • Sustained growth in neighboring countries.
<p>Purpose To enhance investor confidence and promote efficiency of enterprises by</p> <p>(i) promoting, strengthening, and implementing effectively good corporate governance through development of policy, institutional, legal, and regulatory framework</p> <p>(ii) Introducing international accounting, auditing, and valuation standards</p>	<ul style="list-style-type: none"> • Increase in private domestic and foreign direct investments (FDI) • Increase in collateralized lending (based on Law on Pledges) • Adoption of arbitration to resolve commercial disputes • Increase in banking system deposit base and lending • Enhanced transparency in regulatory reporting to state agencies, including State Commission on Securities Markets (SCSM) and Committee on State Property and Foreign Investments (CSPFI) • Adoption of a sound legal framework on joint-stock companies (JSCs) • Adoption of international accounting standards (IAS), auditing and new asset-valuation standards in listed enterprises, banks and large SOEs • Adoption of the law on accounting and law on auditing 	<ul style="list-style-type: none"> • Published macroeconomic, banking sector, court system, and enterprise level operational and financial information • Publication of judgments in commercial dispute resolution and arbitration process • ADB review missions • Review of regulatory reports on compliance from SCSM and NBKR, and data from CSPFI • CDC reports on training and public information campaigns • Enacted legislation on JSCs • Submission of financial statements to State Tax Inspectorate for tax purposes by large enterprises • Adopted legislation on accounting and auditing • Reports from State Tax Inspectorate • Valuation reports submitted by CSPFI on the three largest SOEs 	<ul style="list-style-type: none"> • Sustained commitment from the Government to undertake prompt and corrective actions on enterprises and financial institutions • Lack of political will and resistance to reform in affected institutions (primarily the judiciary) can be overcome. • Adoption of a sound legal framework on JSCs • All majority state-owned enterprises (SOEs) will adopt the new governance norms, as nonviability in the enterprise sector may lead to allocation of fewer resources.

Design Summary	Performance Targets	Monitoring Mechanisms	Risks and Assumptions
<p>(iii) strengthening governance of commercial banks and the legal framework to protect creditors' rights</p> <p>(iv) launching legal and judicial sector reforms to improve commercial dispute resolution and streamline judicial processes and procedures</p> <p>(v) facilitating the restructuring of enterprises</p>	<ul style="list-style-type: none"> • Fewer regulatory actions by National Bank of Kyrgyz Republic (NBKR) for violations of prudential norms • Faster pledge registration and execution processes • Completion of diagnostic assessments by the Judicial Advisory Commission (JAC) • Adoption of some of the recommendations of the Consultative Judicial Reform Group (CJRG) • Adoption of legislation on commercial arbitration • Commercial expedience with consistency in judicial decision-making process • Private sector adoption of arbitration • Automatic restructuring initiated by majority SOEs • Initiation of bankruptcy proceedings 	<ul style="list-style-type: none"> • Regulatory reports from NBKR • Reports from commercial banks/bankers' association on pledge execution • Reports from Judicial Reform Monitoring Group (JRMG) and JAC • Assessment of lag between arrival and clearance of cases in the court system (reports by Government and review by ADB) • Actual process of sale or tenders occurring during the program period 	<ul style="list-style-type: none"> • All legal amendments suggested are adopted in the Law on Banks and Banking Activity, Civil Code, Law on Pledge and other legislation. • Introduction of arbitration and granting of finality to higher courts need amendments to the Kyrgyz Constitution • All legal amendments are adopted promptly. • Continuation of political commitment to the process of privatization and enterprise restructuring.
<p>Outputs</p> <p>1. Promote, strengthen and implement good corporate governance through development of policy, legal, and regulatory framework:</p> <p>(i) Institutional capacity building in CDC;</p> <p>(ii) Development of a corporate governance rating system</p> <p>(iii) SCSM taking steps to enhance its monitoring capacity, and strengthening its regulatory activities to ensure that all JSCs comply with relevant legislation</p>	<ul style="list-style-type: none"> • Increased awareness of corporate governance and management issues (through surveys to be launched by CDC) • SCSM's annual regulatory review to include more comprehensive investigation of violations of any corporate governance regulations in JSCs 	<ul style="list-style-type: none"> • Reports from CDC • Publication of corporate governance ratings on all listed companies and commercial banks • Regulatory reports from SCSM • ADB review 	<ul style="list-style-type: none"> • Provision of adequate resources and cooperation from all enterprises and commercial banks. • Lack of adequate regulatory capacity within SCSM • Interagency conflicts within the Government if SCSM's oversight involves any SOE.

Design Summary	Performance Targets	Monitoring Mechanisms	Risks and Assumptions
<p>(iv) The Government adopting a resolution to enhance governance in SOEs</p> <p>(v) Strengthening the legal and regulatory framework for JSCs</p>	<ul style="list-style-type: none"> • Adoption of the new corporate governance framework by strategic SOEs • Finalization and enactment of appropriate legislation on JSCs 	<ul style="list-style-type: none"> • CSPFI reports • ADB review • Reports from SCSM 	<ul style="list-style-type: none"> • Actual adoption and implementation should not fall short of the objectives of promoting transparency within SOEs due to state dominance. • Enactment of appropriate legislation.
<p>2. Provide a conducive supporting environment for good corporate governance by:</p> <p>(i) Harmonizing national accounting and auditing standards with corresponding international standards; removing inconsistencies between legislation; and preparing a realistic timetable for converting SOEs and all JSCs to the new national accounting standards; and</p> <p>(ii) Drafting and implementing new national standards on valuation of movable and immovable assets, and prepare a law on asset valuation; Government to complete reevaluation of physical assets of at least 3 major and strategically important SOEs</p>	<ul style="list-style-type: none"> • Completion of the harmonization activity for all the clauses in the IAS • Adoption of a timetable for conversions by the State Commission on Standards for Financial Reporting (SCSFRA) • Preparation of regulatory documents on implementation of IAS • Preparation and dissemination of the timetable for adoption • Completion of drafting of all standards • Draft law on asset valuation prepared and submitted to Parliament in the third quarter of 2002 • Completion of the asset reevaluation exercise in major SOEs 	<ul style="list-style-type: none"> • Preparation and dissemination of the standards • Reports on compliance with the new norms • Publication of standards and their wide dissemination • Regulatory documents for the law on asset valuation • Statements on SOE asset reevaluation 	<ul style="list-style-type: none"> • Resistance by SOEs to convert in view of the resource and capacity implications, as the costs for changing documentation and training might be seen by the profession as prohibitive • State Tax Inspectorate and other state agencies will comply and require statements based on new national standards from all reporting enterprises. • Industry commitment to implementation of modern valuation standards • Adequacy of institutional capacity.

Design Summary	Performance Targets	Monitoring Mechanisms	Risks and Assumptions
<p>3. Strengthen corporate governance in the banking sector and enhance investor protection through protecting legal rights of pledge-holders by</p> <p>(i) formulating minimum acceptable standards of governance for commercial banks, which clearly define "fit and proper" criteria for appointment to board of directors, and preclude holding of important public positions by key shareholders of banks</p> <p>(ii) NBKR and Government formulating efficient bankruptcy procedures to achieve swift resolution of insolvent banks</p> <p>(iii) drafting and submitting to Parliament a law on bankruptcy of banks</p> <p>(iv) formulating a sound legal framework for collateralized lending by removing inconsistencies between Law on Pledge, Civil Code, Law on Mortgage, and other relevant legislation</p>	<ul style="list-style-type: none"> • Regulatory declaration in this regard by the National Bank of Kyrgyz Republic (NBKR) • All banks following the newly defined criteria on governance, to be confirmed through on-site and off-site supervision • Transfer of Debt Restructuring Agency to Ministry of Finance (MOF) • Circulation of draft inter-Government comments and review by banking sector participants • Finalization and submission of draft amendments to Parliament • Improvements in pledge registration and execution system, and the fee structure 	<ul style="list-style-type: none"> • Reports by NBKR on compliance with the newly defined norms • Reports by NBKR • Drafts of appropriate legislative amendments • NBKR and bankers' association reports 	<ul style="list-style-type: none"> • Resistance by politically connected bank shareholders • Risk that the true intent of the condition may not be met if politically connected individuals act through proxy shareholders. • Judicial problems are expected, and dispute resolution in cases involving banks is likely to be considerably slow, unless measures recommended in the Program are adopted fully. • Adoption of the law on bankruptcy of banks. • Actual adoption of the various legal amendments in totality • Resistance by vested interests.

Design Summary	Performance Targets	Monitoring Mechanisms	Risks and Assumptions
<p>4. Launch legal and judicial sector reforms to undertake a comprehensive diagnostic assessment of judicial problems and introduce arbitration and streamline court appellate procedures:</p> <p>(i) Issuance of a Presidential Decree and establishment of a Consultative Judicial Reform Group (CJRG) to discuss the issues, weaknesses and constraints facing the judiciary and to counter the negative investor and public perceptions of the judiciary, which is viewed to have significant corruption of a systemic and endemic nature</p> <p>(ii) Formation of JRMG and JAC, with broad-based participation</p> <p>(iii) JAC to undertake dissemination activities relative to CJRG's recommendations; undertake a comprehensive diagnostic assessment; and engage in broad and in-depth consultations with stakeholders within the judiciary as well as the civil society</p>	<ul style="list-style-type: none"> • Presidential Decree issued and the CJRG established • Regular meetings of the CJRG in an open and transparent format to discuss the issues and deliberate on reform measures • Submission of a Report on Judicial Reforms to ADB by 15 July 2001 on the weaknesses related to process and procedures as well as problems of a systemic nature, and appropriate measures to deal with them • Preparation of clear recommendations on legislative and administrative amendments • Issuance of Presidential disposition and finalization of terms of reference for JAC • Periodic deliberations of JAC • Completion of the diagnostic assessment (with ADB TA support) • Dissemination of CJRG findings 	<ul style="list-style-type: none"> • Reports of CJRG • Drafts of revisions to judicial processes and procedures • Requisite steps taken for establishing alternative methods of commercial dispute resolution • Review on implementation of new norms and procedures by ADB review missions • Dissemination of JAC's activities and deliberations • Reports from JRMG and JAC • Dissemination of JAC's activities and deliberations • Reports from JRMG and JAC 	<ul style="list-style-type: none"> • Support and significant political will from the Executive and Legislative branches of the Government • Resistance from the existing judicial institutions, particularly at the Constitutional Court and Higher Arbitrazh Court • Adequacy of resources and capacity to undertake reforms to current processes and system. • JAC will be independent and free from any political or other influence • Adequate resources will be provided for JAC to undertake a thorough review of judicial weaknesses and strengths. • Full cooperation from participants for JAC's review and assessments.

Design Summary	Performance Targets	Monitoring Mechanisms	Risks and Assumptions
<p>(iv) Allow out-of-court commercial dispute resolution and streamline court appellate procedures and processes to increase efficiency</p> <p>(v) Undertake initial measures to increase transparency relative to judicial decision making through publication of proceedings</p>	<ul style="list-style-type: none"> • Drafting of appropriate legislative amendments (to the Constitution) and preparation of a new law on extrajudicial resolution of economic disputes • Drafting of amendments to appropriate legislation (the Constitution and other relevant procedural codes) to grant finality to higher courts in judicial decision making • Publication of initial rounds of earlier (pre-1998) judgments of the commercial courts 	<ul style="list-style-type: none"> • Finalization of drafts and actual enactment of the legislative amendments • Published judgments • Reports from the Ministry of Justice 	<ul style="list-style-type: none"> • Political resistance to the proposed changes, although they are only of a technical nature and introduced with a view to promoting investor confidence. • Allocation of adequate resources.
<p>5. Facilitate the revival of industry and enterprise sectors</p> <p>(i) Government to formulate a viable medium to long term enterprise restructuring strategy with specific focus on measures to enhance capacity utilization and medium-term operational and financial viability, and eliminating the system of ad hoc debt restructuring support to enterprises</p> <p>(ii) Government to design and conduct a public awareness program on provisions available for efficient restructuring of Enterprises, including awareness-building in state agencies on the need for liquidations</p>	<ul style="list-style-type: none"> • Development of the strategy • Preparation of a time-bound plan to restructure nonviable and loss-incurring enterprises • Completion of restructuring in selected enterprises • Preparation of public information program • Increased acceptance in key state agencies on the need for prompt corrective actions on nonviable enterprises • Publication of a biannual report from CSPFI on all enterprise restructuring and bankruptcy proceedings, including a separate report on Kyrgyz Gas Munaizat bankruptcy proceedings 	<ul style="list-style-type: none"> • Implementation of parts of the strategy • Implementation of the time-bound plan • Sale of assets hived off from restructured and liquidated enterprises • Formation of new enterprises • Completion of public information campaign prior to the end of Program 	<ul style="list-style-type: none"> • Macroeconomic stability to facilitate implementation of the strategy. • Resistance to change at the level of key Government agencies and institutions.

Design Summary	Performance Targets	Monitoring Mechanisms	Risks and Assumptions
<p>(iii) With support from ADB TA, Government to undertake a major financial and operational review of 65 enterprises, and formulate restructuring options and programs for adoption in key and strategic enterprises</p> <p>(iv) Government to undertake measures to resolve problems pertaining to JSC Osh Textiles; JSC Kyrgyz Chemical and Metallurgy Plant; JSC Crystal; JSC Kainda Cable; JSC Oremi and JSC Zanar</p> <p>(v) Government to make adequate provisions in 2002-2004 budgets for active labor market measures</p>	<ul style="list-style-type: none"> • Completion of financial and operational reviews • Classification of enterprises into those needing operational and financial restructuring • Preparation of time-bound plans for restructuring selected enterprises • Identification of appropriate modalities for restructuring and liquidation of enterprises • By December 2002, the Government to initiate appropriate measures to resolve problems in at least six SOEs • Preparation of training, employment counseling, and other active labor market measures • Identification of any social obligations stemming from enterprise closures 	<ul style="list-style-type: none"> • Preparation, adoption, and implementation of restructuring plans • Adherence to the time-bound plan • ADB review • Reports from Ministry of Finance and Ministry of Labor on the actual provisions and design and implementation of active labor market measures 	<ul style="list-style-type: none"> • Resistance from enterprise managers and other creditors in carrying out liquidation or restructuring. • Risks of the process being very slow and facing resistance from enterprise directors and managers, given the past difficulties. • Active labor market measures provide effective support.
<p>Inputs</p>	<ul style="list-style-type: none"> • Program loan of \$35 million equivalent to the Government of the Kyrgyz Republic to support the Second Phase of the Corporate Governance and Enterprise Reform Program • TA of \$850,000 to assist with implementation of reform measures under the Program 	<ul style="list-style-type: none"> • ADB review missions (April 2002, November 2002, and April 2003) • TA reports and review 	<ul style="list-style-type: none"> • Continuous monitoring and concerted policy dialogue with the Government and the judiciary • Close coordination with JAC and JRMG

BACKGROUND INFORMATION ON THE ENTERPRISE SECTOR

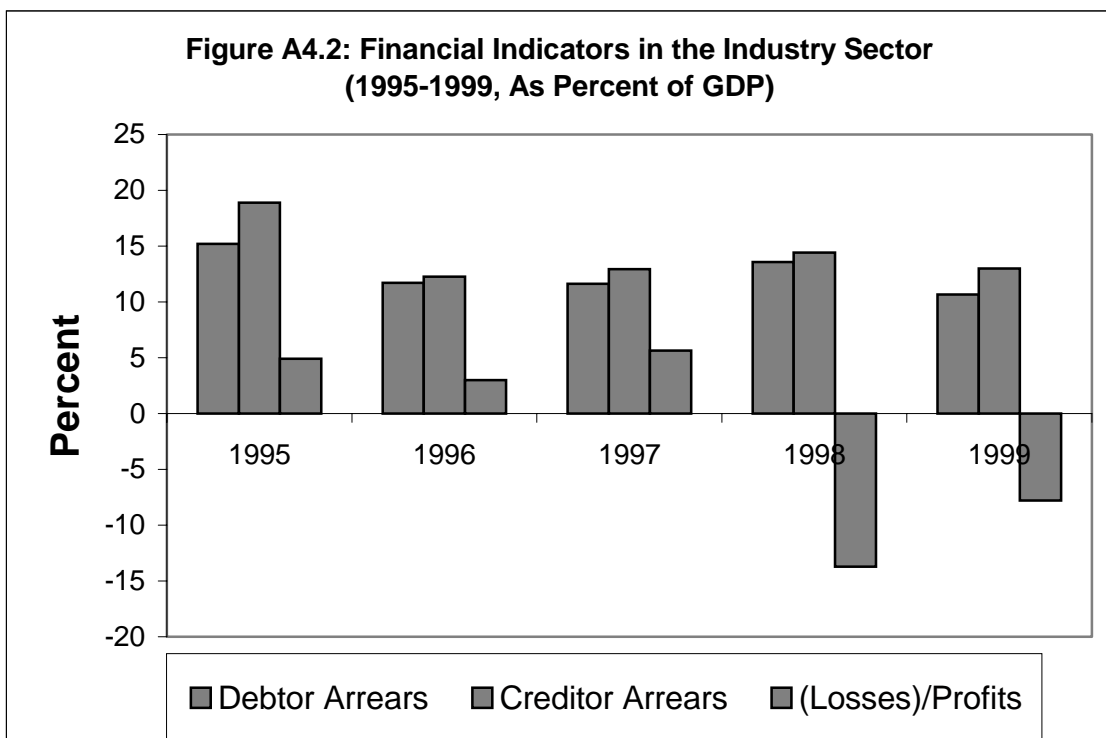
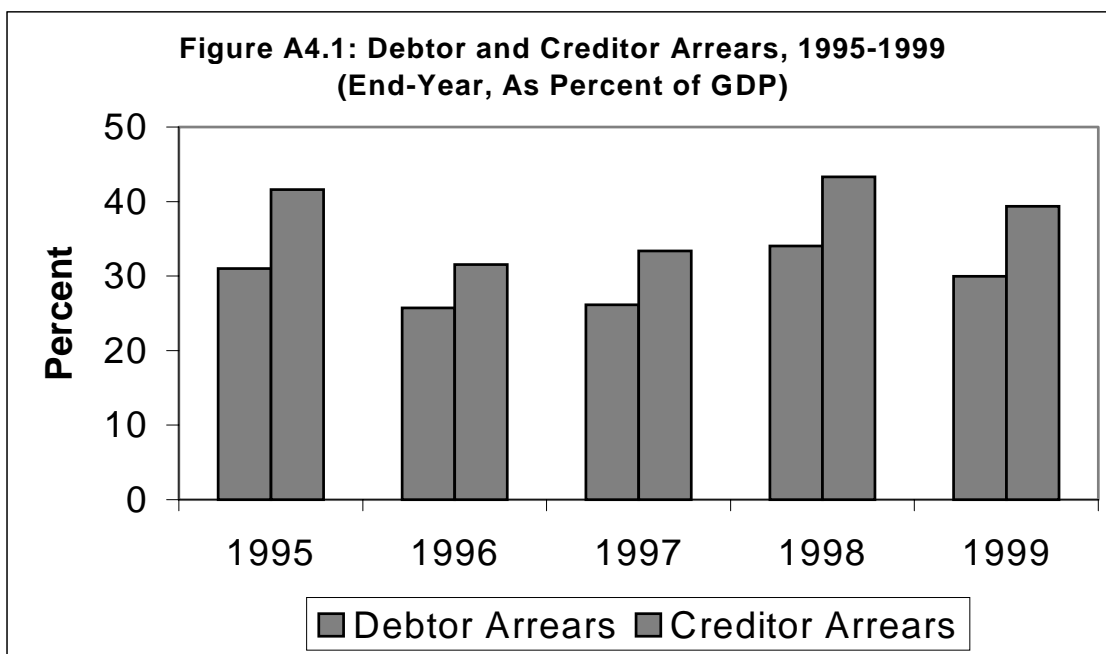


Table A4.1: Financial Indicators from ADB Study (TA 5305)

Industry	Name of Enterprise	Total Amount of Sales (thou. Som)	Barter (%)	Capacity Utilization (%)	Profit (thou. Som)	Government Loans (thou. Som)	Foreign Loans with Govt. Guarantee (thou. Som)	Bank Loans (thou. Som)	Tax Debt and Social Fund Arrears	Amount Owed to Other Creditors (thou. Som)	Total Creditors	Total Debtors	Full-Time Staff	Adm. Leave	Avg. Salary (net)	Payment in kind (%)
Building Materials	Tokmok KSM		51	13	-1,725	0	0		1,780		1,780	1,870	155	5	1,232	5
	Bishkekstroimaterialy	21,113			0	0	0		857		857	454	400	0		
	Kyrgyz Too-Tash					0	0				0		347	77	929	
	Kyrgyzfarfor	294	0	0	-263	232.34	0	0	327	361	920	73	112	99	1,098	87
	Kyrgyzlinoleum	2,210	50	10	-3,806	0	3,294.2		228	1,413	4,935	1,520	41	10	718	0
	Kyrgyz-Tash	7,064	40	33	-6	0	0	0	105	925	1,030	450	42	1	1,200	0
	Osh Ak-Tash	19,131	66	36	-86	0	0		1,852	10,638	12,490	5,083	323	63	1,045	0
Building Materials Total	49,812	41	18	-5,886	232.34	3,294.2	0	5,149	13,337	22,012	9,450	1420	255	1,037	18	
Wood	Chynar	1,864	80	45	34	0	0		163	568	731	413	210	180	818	36
	Karton	1,940	40	20	85	0	0	0	88.1	64	152	373	38	1	500	20
	Kyrgyzmebel	51,829	7	35	2,592	0	0	5,885	2,059.3	12,333	20,277	17,099	417	51	1,552	
Wood Total	55,633	42	33	2,712	0	0	0	5,885	2,310.4	12,964	21,159	17,885	665	232	957	28
Chemical	Crystal					23,909.03	54,000		40,000		117,909		450			
	Ak-Tilek	1,129			-3,834	1500	0				1,500	114	118	47		
	KCMP	69,890		50	2,235	11,780.30	0	33,832	6702	36,647	88,961	10,500				
	Kadamjai					0	0				0					
	Antymony plant Khaidarkan mercury plant					0	0				0					
Chemical Total	71,019		50	-1,599	37,189.33	54,000	33,832	46,702	36,647	208,370	10,614	568	47			
Glass	Chui-Glass Ltd	29,301	25	46	4,043	0	0	0	435	3,369	3,804	8,522	127	0	2,032	
	Interglass Ltd.				-14,146	0	0		347	347	9,505	455	2	1,591		
Glass Total	29,301	25	23	-10,103	0	0	0	782	3,369	4,151	18,027	582	2	1,812		
Machine Building	Avtosborochnyi	19,193	26	13	3,016	0	0		662.7	1,722	2,385	1,980	308	5	1,979	0
	BARZ	5,330	95	17	0	0	0		26		26	583	76		716	61
	Kyrgyzavtomash	69,271	10	78	9,888	0	0	0	0	41,890	41,890	22,169	884	51	1,466	0
	Kyrgyzzorgmash	13,596	0	54	319	0	0	0	303.2	626	929	7,631	172	12	1,881	0
	Kyzyl-Kiya Machine Building Plant	3,603	20	40	3,603	0	0		0	397	397	339	261	123	622	0
	Usta	7,696	90	1	-981	0	0		702	1,743	2,445	1,750	208	3	446	
	Zavod Sverl	3,418	26	11	-601	0	0		2,672.6		2,673	71	220	69		

Table A4.1: Financial Indicators from ADB Study (TA 5305)

Industry	Name of Enterprise	Total Amount of Sales (thou. Som)	Barter (%)	Capacity Utilization (%)	Profit (thou. Som)	Government Loans (thou. Som)	Foreign Loans with Govt. Guarantee (thou. Som)	Bank Loans (thou. Som)	Tax Debt and Social Fund Arrears	Amount Owed to Other Creditors (thou. Som)	Total Creditors	Total Debtors	Full-Time Staff	Adm. Leave	Avg. Salary (net)	Payment in kind (%)
Machine Building	Total	122,107	38	31	15,245	0	0	0	4,366.5	46,377	50,744	34,522	2129	263	1,352	12
Electro technik	Ainur	7,701	10	61		0	0		310.7	2,434	2,745	495	500		2,700	0
	Ak-Maral	7,891			1,291	309,305.3	0				309,305	5,041	130	0	923	0
	Dostuk	4,204	0	42	34	0	9,524.1		2,708.5	1,513	13,746	97	519	328	925	40
	Electrotechnik	23,909	0	70	3,350	0	0	2,860	4,288.7	19,779	26,927	3,984	471		1,874	0
	Enar	1,482	2	63	24	0	0	0	26.4	505	531	28	23	3	1,677	0
	Janar	8,655	50	20	-1,833	14,171.3	0	0	16,000	12,000	42,171	17,376	393	154	0	
	Kyrgyzzorteknik a	4,963	10	40	279	0	0		16	480	496	96	140	0		
	OREMI	9,408	70	65	-25,391	0	362,000		20000	4,258	386,258	7,725	389		800	
	Kaindacable	20,256	30	4	196	635	0	0	4,869.2	7,564	13,068	8,184	270	20	1,300	
Electrotechnik	Total	88,468	22	46	-22,051	324,111.6	371,524.1	2,860	48,219.5	48,533	795,248	43,027	2835	505	1,275	8
Light Industry	Aigul	2,741		30	-490	0	0		2,027.9		2,028	1,983	557	100	1,000	0
	Ak-Bula	10,971	0	13	25	5207	0	33,928	1,768.1	12,721	53,624	9,256	340	34	800	60
	Baipack	14,491	90	15	-2,935	3,713.2	29,550.9	0	3,554.5	4,367	41,186	3,453	163	6	1,437	
	Bishkek Kenaf Factory	41,688	8	50	5,215	0	0	4,900	1,338.26	5,040	11,278	7,452	179	6	2,068	3
	Bi-Style	19,376	0	20	1,262	0	0		1019		1,019	2,270	104	6	2,235	0
	Boolgary			78		0	0		1,864.8	2,223	4,088	3,358				
	Edelwais	27,672	23	32	14	0	11,542.87	2,400	6,279.2	3,542	23,764	2,784	432	114	1,271	40
	Ilbirs	4,780	70		27	0	53,544.57	10,511	900	6,440	71,395	7,137	830	2	889	26
	Jyldyz	4,839			-10,281	0	201,988.1	0	10,330.5	3,792	216,110	1,539	136			100
	Kasiet	28,224	50	3	-11,286	7,531.11	21,884.04	50	2974	3,352	35,791	1,930	950	640	1,100	35
	KKSK	95,424	40	30	866	0	278,800.1	6,550	9,290.1		294,640	224,328	1247	438		
	Tariz	1,500	0	50	-39	0	0		105.4	146	251	8	55	1	750	0
	Tekstilchik	176,367	78	8	-15,831	468,000	1,498.57	0	31,000	18,302	518,801	14,300	4319	2522	818	78
	VLKSM	1,883			260	14,332.1	58,323.33		822.2	1,944	75,422	380	500			
	Osh-Jibek					0	0				0					
Light Industry	Total	429,956	36	30	-33,195	498,783.4	657,132.5	58,339	73,273.96	61,868	1,349,397	280,177	9812	3869	1,237	34
Food	Abdysh-Ata Ltd.	4,410	10	65	0	1433	0		78.2	1,589	3,100	703	241	22	1,273	0
	Confectionery Factory	12,897	30	6	-334	0	0	0	1338	2,203	3,541	1,599	365	260	600	100
	Gul-Azyk	734	20	10	11	0	0	3,485	19.4	24	3,529	19	52		770	0
	Kaindy-Kant	425,669	14	33	-30,620	3,699.64	0	8,388	61,402	81,904	155,394	133,577	949	207	6,752	59
	Koshoy					0	0			0	0					
	Tattuu	29,086	20	37	251	0	0	4,680	364.5	3,092	8,137	807	244	47		

Table A4.1: Financial Indicators from ADB Study (TA 5305)

Industry	Name of Enterprise	Total Amount of Sales (thou. Som)	Barter (%)	Capacity Utilization (%)	Profit (thou. Som)	Government Loans (thou. Som)	Foreign Loans with Govt. Guarantee (thou. Som)	Bank Loans (thou. Som)	Tax Debt and Social Fund Arrears	Amount Owed to Other Creditors (thou. Som)	Total Creditors	Total Debtors	Full-Time Staff	Adm. Leave	Avg. Salary (net)	Payment in kind (%)
Food Total		472,797	19	30	-30,692	5,132.64	0	16,553	63,202.1	88,812	173,700	136,705	1851	536	2,349	40
Trade	Jibek					0	0				0					
	Kyrgyzserviscontract					0	0				0					
	Kyrgyztemir	88,366			2,297	0	0		714		714	6,512	287	24		0
	NPK	3,461			70	0	0				0	11,117				
	SU-93				1,907	0	0				0	11,793	158	0	1,893	0
	Kyrgyzzayilkomok	1,955	40		-1,260	0	78,732.5	12,427	29.55	29,538	120,727	8,645	102	6	600	100
Trade Total		93,782	40		3,013	0	78,732.5	12,427	743.55	29,538	121,441	38,066	547	30	1,247	33
Grand Total		1,412,873	32	32	-82,556	865,449	1,164,683	129,895	244,749	341,445	2,746,222	588,473	20409	5739	1,348	25

SCHEME OF THE KYRGYZ COURT SYSTEM

Table A5.1: Scheme of the Kyrgyz Court System

Type of Case	Type of Entities Involved	Court with Jurisdiction	First Instance of Hearing (1 Judge)	Appeal in Same Court (3 judges)	Supervision in SC or HAC (HAC- 9 judges; SC - 12 judges)
Criminal	Physical	CGJ	Local	Local	SC
Civil/ Commercial	Physical <u>or</u> Physical + Legal	CGJ	Local	Local	SC
	Legal only	AC	Local	Local	HAC

AC = arbitrazh courts, CGJ = court of general jurisdiction, HAC = higher arbitrazh court in Bishkek (hears appeals for ACs), SC = Supreme court (hears appeals for CGJ).

NB

1. Conflicts of jurisdiction may arise if a case involves two legal persons, but a physical person claims a separate right against one of them.
2. The supervision stage must return case back for consideration rather than substituting own decision (so ruled for HAC and probably is so for SC). Then after a new decision, the case may be further appealed.
3. Because jurisdiction is based primarily on the type of person, both CGJ and AC hear commercial cases, although bankruptcy cases are reserved for AC (even in such cases, a physical person can turn to the CGJ to dispute such questions as the existence of a debt).
4. The intermediate appeals stage can be ignored and the case can be taken directly to supervision.

Table A5.2: Number of Judges, by Court and Region

Region	CC	CGJ	ACS	Total
High Courts (CC; SC or HAC) – Bishkek	9	17	18	35
Bishkek		55	9	64
Chui		52	7	59
Osh		32	6	38
Jalal-Abad		33	4	37
Yssyk Kul		25	4	29
Naryn		16	4	20
Talas		16	4	20
Batken		15	4	19
Total	9	261	60	330

ACS = arbitrazh court system, CC= constitutional court, CGJ= court of general jurisdiction

Note: In addition, there are 20 judges in military courts in various regions.

DECREE OF THE PRESIDENT OF THE KYRGYZ REPUBLIC**Establishing the
Consultative Judicial Reform Group
Under Asian Development Bank's
Corporate Governance and Enterprise Reform Program - Phase 2**

1. For purposes of (i) providing further development of corporate governance within the framework of the CGERP-II, which is being implemented together with ADB; (ii) improving legislation of the Kyrgyz Republic, which regulates the structure and activities of the Kyrgyz courts; (iii) reforming the judicial system for providing efficient protection of the legitimate rights and interests of investors; and (iv) creating a transparent system to resolve disputes that arise in the commercial sphere.
2. To establish under the President of the Kyrgyz Republic within the framework of CGERP-II the Consultative Judicial Reform Group ([CJRG] comprising the persons in Table A6.1) on disclosure and analysis of the judicial system weaknesses and development of proposals for improving the legislation that regulates the structure and activities of the judicial system in considering commercial disputes.
3. The CJRG, supported by the ADB TA, to produce a report based on the objectives of CGERP-2 by 30 May 2001, and submit it to the President of Kyrgyz Republic for consideration.
4. The Corporate Development Center under the Prime Minister's Office of the Kyrgyz Republic to be in charge of providing arrangements and methodical activity of the CJRG.

**The President
of the Kyrgyz Republic**

A. Akaev

**Government House
Bishkek
13 April 2001
RP #128**

Appendix
to Decree of the President of the Kyrgyz Republic
Dated 13th April 2001

Table A6.1: Members of the Consultative Judicial Reform Group

Aidar Mokenov	-Deputy Head, Economic Policy Department of the President's Administration, Head of the Group
Marat Attokurov	-Deputy Head, Legal Department of the President's Administration, Deputy Head of the Group
Members of the Group:	
Gulnara Abdyjaparova	-Expert, Economic Policy Department of the President's Administration
Asim Ayyylchiev	-Deputy Director, Judicial Department under the Ministry of Justice
Bolotbek Akmatov	-Referent, Legal Department of the President's Administration, Sector of Judicial Bodies
Usenaly Bekishev	-Head, Department on Bankruptcy of the State Property Commission and Foreign Investment of the Kyrgyz Republic
Elena Belkovskaya	-Head, Legal Department of the President's Administration
Mahamadjan Iminov	-Expert, Legal Department of the President's Administration, Sector of Legal Reforms
Marat Kaiypov	-President, "Lawyers of Kyrgyzstan" Association
Bakyt Karasartov	-Judge, Arbitrazh Court of Bishkek
Bakyt Kartanbaev	-Director, Corporate Governance Center, Prime Minister's Office of the Kyrgyz Republic
Temirbek Kenenbaev	-Director, Ltd. "Partner" Law Company
Leonid Komarover	-Head, Department of economic analysis and prognosis, Prime Minister's Office of the Kyrgyz Republic
Hadjimurat Korkmazov	-Deputy, Legislative Assembly, Jogorku Kenesh of the Kyrgyz Republic
Erkinbek Mamyrov	-Deputy Minister of Justice of the Kyrgyz Republic
Chinara Medetbekova	-Aid to Chairman, Higher Arbitrazh Court of the Kyrgyz Republic
Kurmanbek Osmonov	-Deputy, Legislative Assembly, Jogorku Kenesh of the Kyrgyz Republic
Antonina Rybalkina	-Judge, Higher Arbitrazh Court of the Kyrgyz Republic
Rahimberdi Saliev	-Chairman, Court of Bishkek
Olga Stepanova	-Head, Legal Department of the National Bank of the Kyrgyz Republic
Marat Sultanov	-Chairman, Court of Pervomayskiy Region of Bishkek
Galina Fedorova	-Prosecutor, General Prosecutor's Office of the Kyrgyz Republic

**Outline Terms of Reference
for the
Consultative Judicial Reform Group under the President of the Kyrgyz Republic
Established under the Corporate Governance and Enterprise Reform Program – Phase II
(CGERP-II) - Supported by the Asian Development Bank (ADB)**

1. Many recent studies and surveys have pointed out that the general public, and both local and foreign investors have a very poor perception of the way the judiciary functions in the Kyrgyz Republic. This seems to be the case particularly for dispute resolution in commercial cases. According to this perception, which seems to be near-universal and is reported in many studies, the main issues are (i) weaknesses and inefficiencies relative to the judicial decision-making process; and (ii) lack of independence of the judiciary, in the sense that there is said to be possible judicial bias or exposure to various external influences including monetary and official influence.

2. Although it is impossible to verify these perceptions, if the Kyrgyz Republic desires to promote vibrant industry and enterprise sectors, and to attract domestic and foreign investments, it is critical that the judicial decision-making and law enforcement process be held in the highest esteem. Regardless of the actual extent of the problems perceived by many diverse sources, it is highly important that public and investor confidence in the judiciary be restored and enhanced by introducing a range of effective measures to combat the perceptions referred to above. ADB also gives such measures highest importance and regards satisfactory progress in their adoption as an important precondition for CGERP-II. The proposed initiative will be coordinated jointly by ADB and the United States Agency for International Development (USAID).

3. With these objectives in the background, the tasks of the CJRG are in the following areas:

- (i) **Process-Related Weaknesses in the Judiciary (for resolution in 5-15 months).** The CJRG will conduct an in-depth review and analysis of the existing weaknesses and inefficiencies in the commercial dispute resolution process. A sample of the problems that must be addressed includes (a) the cyclical nature of appeals in the arbitrazh process, between the appeals and supervision stages, which leads to lack of finality and significant delays in the settlement of disputes; (b) other problems in the appeals and supervision process, where the judiciary seems to rely heavily on what may seem to be unnecessary procedures in lieu of commercial expediency; (c) the court fee and financial structure in the Arbitrazh Court System (ACS); (d) the skills and knowledge actually possessed by judges, compared with what they should possess and how any deficiencies can be remedied; (e) the overburdening of the ACS; (f) lack of efficient dispute resolution alternatives other than the ACS; and (g) any other relevant matters identified by CJRG. CJRG will examine all relevant legislation with regard to the above issues.
- (ii) **Systemic Weaknesses in the Judiciary (for initial implementation of a reform plan within 15 months).** The underlying premise here is that the judiciary has to function in a fully transparent and independent manner to eliminate the perceptions already referred to. CJRG will undertake a comprehensive examination of the judicial and law enforcement system, focusing on (a) how the procedures for nominating and appointing judges can help ensure

that the members of the judiciary are seen to function in an independent manner; (b) the knowledge and skills mix that should be possessed by judges, and what types of capacity building will be needed; (c) what lasting changes can be made in the current system of judicial education, initial employment training, and rotation at junior levels in private or public spheres; (d) judicial compensation structure; (e) introduction of legislation intended to promote the disclosure and prevention of improper actions; (f) other methods of preventing external influences from affecting the independence of judges, including scrutiny of the financial affairs of judges and means to reduce political interference, publication of all judgments, opening courts to public viewing, and so on; (g) the methods by which judges allegedly guilty of misconduct may be subjected to judicial action; (h) problems with enforcement of judicial decisions in the court-executor system; and (i) whether the ongoing initiatives to establish an Institute of Ombudsman could also promote transparency and disclosure in the judiciary and assist with the tasks outlined herein.

4. CJRG should produce a report, in form and substance satisfactory to the ADB, to be adopted as the view of the group. The report should be submitted to and approved by the President as an action plan for implementation by the Government. The report will (i) contain specific measures and not only general discussions of principles, (ii) be action-oriented, and (iii) include a package of measures intended to deal with the issues above and any others that CJRG thinks are relevant, with a time-based action plan for implementing the package within the given period. Where legislation is proposed, the report will include the main principles to be adopted in the legislation. In the case of systemic weaknesses, the action plan should be ready for implementation in 15 months and should have a clear timetable for completion— not more than 5 years—if such period is necessary for full implementation, together with provisions for regular review and verification of progress made. The report should be produced and submitted to the President no later than 30 May 2001 and simultaneously delivered to ADB. The President's office will notify ADB of the date of President's approval of the report, which should be prior to ADB's proceeding with further appraisal of CGERP-II.

5. CJRG will be participatory, broad-based, and multidisciplinary. It will include representatives of the Government, the judiciary, private sector, as well as nongovernment organizations. Since it is important that all members of CJRG, once nominated, attend regularly, efforts will be devoted to ensuring this objective. Because of urgency of the task, meetings should be held not less than 3 times a week, from 9 to 12 noon. Accordingly, the nominating bodies must ensure that their representatives are given the opportunity to attend. Discussions at CJRG must be frank yet confidential, given the sensitivity of the subject. All participants and those working with CJRG must be guaranteed freedom to express their views without fear of punishment.

6. ADB and USAID will organize support in the form of foreign lawyers and some local lawyers who will produce working papers for CJRG. The working papers will set out a series of issues and possible objectives, with discussions of principles and comparisons with practices and approaches adopted elsewhere. However, CJRG and not the foreign lawyers, will decide on what to include in the report in order to produce a report satisfactory to ADB. Once CJRG has reached its conclusions, the foreign lawyers will assist in writing the conclusions and will present them to the Group for confirmation, before the report is submitted to the President.

7. ADB reiterates the significance it places upon this report and its implementation, as the basis not merely for CGERP-II, but also for similar future ADB programs or projects.

POVERTY IMPACT ASSESSMENT

1. This poverty impact assessment comprises three sections. The first section describes and assesses the current social and economic situation in the Kyrgyz Republic, with a specific focus on the poor and other vulnerable groups. The second section describes the characteristics of and trends in the enterprise sector. The third section discusses the impact on the poor of the policy actions under the Corporate Governance and Enterprise Reform Program – Phase 2.

A. Assessment of the Current Social and Economic Situation

1. Population and Human Development Indicators

2. The 1999 census estimated the population in the Kyrgyz Republic at a total of 4.9 million. Children and teenagers comprise 38 percent while the retired (above the age of 60) comprise 9.2 percent. Sixty-five percent of the population live in rural areas and the rest live in urban areas. Average life expectancy had not changed since 1993, remaining at 67 years. Average life expectancy was 62.3 years for men and 71 years for women. The maternal mortality rate per 100,000 live births decreased slightly from 45 in 1993 to 42 in 1999. Average literacy rates for men and women were 98.6 percent and 96.2 percent, respectively. Overall, the human development indicators for the Kyrgyz Republic augur well for the future, and the country has been able to maintain much of its social capital despite years of painful economic transformation.

2. Incidence of Poverty

3. Levels of poverty are high in the Kyrgyz Republic and the trend in the past decade has been one of increasing poverty. Since independence, per capita gross domestic product has fallen, standing currently at approximately \$255. The transition started with a prolonged recession during 1992-1995. Some reassuring signs of recovery were seen in 1996 and 1997 as strong, positive growth was recorded. Most recently, the Russian financial crisis of 1998 led to a sharp increase in poverty. No data on poverty exists for 2000 or 2001, so it is not clear to what extent the Russian financial crisis has been surmounted.

4. For 1999, the value of food, or the extreme poverty line, was Som3,849 (\$80.7) per person per year. This is the amount of resources required to meet the minimum caloric intake. The value of the overall poverty line is Som7,340 (\$153.9) per annum. Close to two thirds of the population consume less than below this level and, hence, are categorized as poor. Extreme, or food poverty, affected almost a quarter of the population, and the shortfall in consumption was significant. The gap between the consumption of the poor and the poverty line averaged 25 percent. Poverty is principally a rural phenomenon with 80 percent of all the poor living in rural areas.

3. Labor Force Participation and Unemployment

5. The contraction in the economy in the past decade, particularly in the industry sector, is reflected in the significant reduction in the overall labor force participation rates between intercensal years (1989–1999). The rate dropped more significantly in urban areas—from 66.5 to 42.2 percent—than in rural areas—from 67.3 to 64 percent. This can be due to growth of individual peasant farming as well as increase in self-employment.

6. Approximately 37 percent of the total population, or 1.8 million persons, is in the labor force. Of these, 1.7 million are employed, while the total number of unemployed, including

estimates for the unregistered unemployed, is 111,000. Unemployment peaked in 1996 to almost 8 percent, then dropped to around 6 percent in 1997–1999, but increased to 7.5 percent in 2000.

7. In early 2001, more than 78,000 persons in search of work were registered with the local employment offices of the State Employment Department. Of that number, 58,300 were officially unemployed (up from 54,700 on 1 January 2000). Women comprised 53.6 percent; those with secondary education or higher, 89.9 percent; blue-collar workers, 49.1 percent; and those between the ages of 16 and 29 years, 39.8 percent.

4. Gender

8. Women in the Kyrgyz Republic are extensively involved in the economic, social, and cultural life of the country. Employed women are a little less than 50 percent. The main sectors for female employment are health, education, culture, communications, and banking and finance, where they comprise more than half of all employees. On the whole, women's salaries are lower than those of men, but this is largely explained by the fact that women work predominantly in sectors with lower pay. Women represent about 53.6 percent of the officially unemployed in the country.

9. The transition to a market economy and the resulting enterprise restructuring have painfully affected the well-being of women. The network of social support, health care, and child care (kindergarten), often organized through the enterprise, has been significantly reduced, while the functioning of communal and utilities systems has worsened. Many types of services that were essentially free of charge have become very expensive and therefore unaffordable to the majority of women.

B. Employment in the Enterprise Sector

10. At present of the 228,000 people employed in formal sector occupations, approximately 112,000, or 50 percent, are working in industrial enterprises. Ninety-five percent of industrial enterprises are under private ownership. At the end of 2000, state-owned enterprises (SOEs) employ approximately 10,000 persons, or 8.9 percent of all employment in the industry sector. Average monthly salaries in the industry sector amount to Som2,300 (\$48) in 2000.

11. Enterprise restructuring has been an ongoing phenomenon in the Kyrgyz Republic over the past decade. Nonetheless, the number of officially retrenched persons has remained rather small, with employers resorting to alternative means to reduce the workforce. While some of the enterprises that undergo downsizing due to financial difficulties do adhere to the provisions on severance terms in the Labor Code, employers tend to urge employees to take unpaid leave or resign voluntarily and find alternate employment, in order to avoid paying severance payments. In 1999, 5,381 persons were dismissed from industrial enterprises, while 22,057 were on administrative leave, and 7,854 were working part-time. In 2000, only 4,387 persons were officially dismissed, 28,600 resigned voluntarily, and 22,120 remained on administrative leave.

12. The difficulties in the enterprise sector in the past decade have led to an expansion of the black (unofficial) economy. Many transactions are undertaken through barter. Small businesses and individual entrepreneurs have a significant incentive not to register, while much trade in agricultural products is unreported. No accurate data are available on the size of the black economy, but the estimate is that up to 50 percent of GDP may be unrecorded.

13. Most of the future growth in employment will be from the small and medium-size enterprise sector. Out of the total reported vacancies of 2,087 in 2000, only 299 are from the industry enterprise sector. At the end of 1999, almost 8,000 small and 1,000 medium-size enterprises were registered with the Ministry of Justice, in addition to 95,000 individual entrepreneurs and 60,000 enterprises in agriculture. Total employment in the small and medium-size sector came to 940,000.

C. Policy Actions with Potential for Significant Action on the Poor

14. The specific policy actions to be taken under the Program are either pro-poor or poverty-neutral. Taken as a whole, the Program can have a positive impact on the economy and society. The Program objectives follow:

- (i) Provide a sound policy, institutional, and legal environment for good corporate governance
 - (a) Promote, strengthen, and implement good corporate governance standards through development of a policy, institutional, and legal framework;
 - (b) Introduce international accounting, auditing, and valuation standards; and
 - (c) Strengthen governance of commercial banks and the legal framework to protect creditors' rights.
- (ii) Launch legal and judicial reforms to improve commercial disputes resolution and streamline judicial processes and procedures.
- (iii) Facilitate restructuring of inefficient but viable enterprises and liquidation of nonviable enterprises.

15. The actions under objective (i) will promote good corporate governance, allow adoption of a sound legal framework for joint-stock companies (JSCs), develop asset valuation standards, harmonize national accounting and auditing standards with international standards, and strengthen corporate governance of commercial banks. The overall net effect of this policy action on the poor will be positive.

16. Good corporate governance will improve investor confidence, which in turn will lead to a greater and sustained flow of investments, promoting economic activities and job opportunities. Adoption of a well-rounded legal framework for JSCs (including SOEs) will ensure that the shareholders' rights, in particular those of minority investors, are protected. Adherence to international accounting and auditing standards will promote transparency of financial information, limit the opportunities for rent-seeking, and also attract investments in enterprises. Adoption of sound banking sector governance practices and sound financial standards will assure depositors and borrowers that savings are secure and efficiently intermediated to ensure lower spreads in interest rates. All these direct and indirect effects will benefit the poor as well as the non-poor (Table A7.1).

Table A7.1: Poverty Impact of Objective 1: Formulate a Sound Policy, Institutional, and Legal Environment for Good Corporate Governance

Type of Effect				
Channel	Direct Effect (Short-Run)	Indirect Effect (Short-Run)	Indirect Effect (Medium-Run)	Mitigation Measures
Labor	Good corporate governance will improve investor confidence, which in turn will promote economic activities.	Enhanced transparency will lead to greater investments, which in turn will increase employment.	Increased economic activity creates demands for goods and services.	
Prices	Adoption of international accounting and auditing standards will facilitate full and clear costing.	Sound banking sector governance will assure depositors, including pensioners a large majority of whom are poor, that their savings will be protected, and ensure that the cost of banking will be low.	A more transparent and accountable enterprise sector will limit the opportunities for rent-seeking.	
Access for Poor		Increased transparency in enterprises (particularly in large ones providing utilities and services to all and the poor) will support continuation of affordable services.	Greater investments, leading to better growth prospects, will enhance the access of the poor to markets, products, and services.	
Transfers			Reduction of budget subsidies to state-owned enterprises will free public resources for investments in education and health and other antipoverty measures.	
Crucial Assumptions	Laws that will provide a conducive environment for sound corporate governance will be adopted and fully enforced.			
Total Net Effect	Overall positive			
Narrative	The actions covered under this component will permit the promotion of good corporate governance, development of asset valuation standards, harmonization of national accounting and auditing standards, and improve the disclosure of financial and operational information for the benefit of all.			

17. The actions covered under objective 2 enhance public, domestic, and foreign investor confidence. An improved investment climate will promote economic activities, which in turn will create more job opportunities. A strengthened judicial framework will lead to better use of the existing legislation, reduce delays in hearings, and penalize corruption, which will all reduce the cost of doing business. The overall net effect of this policy action on the poor is positive (Table A7.2).

Table A7.2: Poverty Impact of Objective 2: Strengthen the Judicial Framework to Support Good Governance

Channel	Type of Effect			Mitigation Measures
	Direct Effect (Short-Run)	Indirect Effect (Short-Run)	Indirect Effect (Medium-Run)	
Labor	Improved judicial framework and introduction of arbitration will increase investor confidence, which in turn will promote economic activities.	Increased economic activity creates demand for goods and services.	Increased economic activity creates jobs.	
Prices		Improved judicial framework will make corruption less worthwhile.	Reduced corruption will bring down the cost of doing business.	
Access for Poor	While the Program supports speedier resolution of commercial disputes, the reform measures to be developed under the Program will have beneficial effects for other noncommercial courts as well. For instance, land and other disputes of a civil nature will be resolved faster.			
Transfers				
Crucial Assumptions	Laws and legal decrees required to strengthen the judicial processes and procedures will need to be adopted and effectively enforced.			
Total Net Effect	Overall positive			
Narrative	The actions covered under objective 2 will strengthen the judicial processes and procedures and in turn enhance public, domestic, and foreign investor confidence and will therefore benefit the poor and non-poor alike.			

18. The actions covered under objective 3 will help achieve higher and sustainable economic growth in the long run. In general, however, enterprise restructuring measures may lead to involuntary dismissals that will indirectly reduce the purchasing power of the retrenched, and in turn reduce the demand for services and products in the short run. However, in the context of the Kyrgyz Republic, the following facts apply to a large number of weak enterprises, including the ones being targeted under this Program (i) significant losses, and tax and debtor arrears; (ii) sizable buildup of excess capacity; (iii) lack of any future growth prospects without operational or financial restructuring; (iv) large numbers of workers being forced to take administrative leave, so that enterprises can avoid paying severance pay; and (v) significant delays in wage payments, or in most cases nonpayment or payment-in-kind.

19. The policy actions proposed in this Program (items F15-F17 or S21 in the policy matrix [Appendix 2 to the RRP]) are not likely to have any undue negative impact on employment. The characteristics outlined in items (i) to (v) in para. 18 apply to all the five enterprises shortlisted in F17 of the policy matrix, namely JSC Osh Textiles, JSC Kyrgyz Chemical and Metallurgical Plant, JSC Kainda Cable, JSC Oremi, and JSC Crystal. For instance, (i) more than half the labor force in JSC Osh Textiles and JSC Kainda Cable (candidates for eventual liquidation) have been on

administrative leave; (ii) both companies owe large arrears to the social fund and tax authorities; (iii) their capacity utilization levels are, respectively, zero percent (idle) and four percent; and (iv) delayed and in-kind payment of wages have been the norm. Similar characteristics hold for the three other shortlisted enterprises. Hence, the restructuring, resolution, or liquidation measures will help in rationalizing the sunk investments in these firms, and hence, the policy actions will not cause any hardships over and above those being faced by the workers in the enterprises at present due to nonpayment or delays. Moreover, in terms of any adverse impact, the resolution options will be introduced only in a phased manner, in the sense that liquidation will be pursued only as the last option and only for JSC Osh Textiles and JSC Kainda Cable, if the sale or financial restructuring options fail.

20. The Government under the Program will have sufficient provisions in the federal budget to be allocated to the Ministry of Labor, for supporting active labor market measures, including employment counseling, retraining, and public works programs (F19 and S22 of the policy matrix). The State Employment Department within the Ministry of Labor, which is entrusted with promoting employment, has estimated that, in the worst case scenario of about 4,200 workers being retrenched (through liquidation of JSC Osh Textiles and JSC Kainda Cable), such active labor market measures will cost around \$250,000. This will meet the need for (i) public works programs for about 1,750 workers at a unit cost of \$50; (ii) training for around 500 at a unit cost of \$40; and (iii) microcredit support through existing rural credit programs, for about 3,600 workers at a unit cost of \$40.

21. Overall, restructuring of the selected enterprises in particular and other loss-incurring and nonviable enterprises in general will contribute in the medium to long run to improvements in efficiency in resource use, rationalize investments and priorities, increase economic growth, and generate employment opportunities. A direct effect of reduced government expenditures on SOEs will free up revenues for social services and expenditures, including allocations for active labor market measures. The overall net effect on the poor in the long run is positive (Table A7.3).

Table A7.3: Poverty Impact of Objective 3: Provide a Conducive Operational and Legal Environment to Promote Investor Confidence and Support Enterprise Restructuring

Channel	Type of Effect			Mitigation Measures
	Direct Effect (Short-Run)	Indirect Effect (Short-Run)	Indirect Effect (Medium-Run)	
Labor	In the short term, increased retrenchment of enterprise workers. This, however, is not likely to adversely affect the workers in the six problem enterprises as a large majority of them have been on unpaid leave for long periods of time. The measures under the Program will address nonviability in the enterprise sector.	Initial reduction in purchasing power among the retrenched reduces demand for services and products. However, as new smaller and medium-size enterprises are likely to emerge, this negative effect will be ameliorated.	In the medium term, new job opportunities will be created due to the creation of new ventures.	Adherence to the Labor Code will ensure support through active labor market measures.
Prices		Measures to address enterprise sector viability will have a beneficial impact on prices, by lowering the excess capacity and improving		

		the costing of products.		
Access for Poor		Government resources currently used to support insolvent enterprises will be free for investment in education and health and other anti-poverty measures.		
Transfers	Reduced government expenditures on SOEs will free up revenues for social services and expenditures, including severance payments to retrenched workers.		Restructuring of SOEs will contribute in the medium to long run to improvements in allocative efficiency, increase economic growth, and generate employment opportunities.	
Crucial Assumptions	1. Enterprise restructuring continues as agreed upon with the Government. 2. Budget provisions will be adequate to mitigate the negative impact of job losses through a combination of passive and active labor market measures.			
Total Net Effect	Overall positive			
Narrative	The actions covered under objective 3 facilitate restructuring of inefficient but viable enterprises and liquidation of nonviable enterprises to achieve higher and sustainable economic growth in the long run to benefit the poor and non-poor.			

22. While there are risks in fully implementing all the complex reform measures, all the specific policy actions are generally pro-poor. These actions can have a positive impact on the overall economy, by enhancing investor confidence and creating a conducive business environment in the Kyrgyz Republic. A strengthened Kyrgyz enterprise sector, supported by a well-functioning judiciary, sound banking sector, international accounting and auditing standards, improved asset valuation standards, and reduced government expenditures on nonviable SOEs, will become more resilient in the face of any future shocks that are similar in magnitude to the recent contagion stemming from the Russian crisis. This will benefit the whole population at large, poor and non-poor alike.

TECHNICAL ASSISTANCE TO STRENGTHEN CORPORATE GOVERNANCE AND JUDICIAL REFORMS

1. The technical assistance (TA) is in two parts to facilitate easier and effective implementation of the respective components of the Second Phase of the Corporate Governance and Enterprise Reform Program (CGERP-II). Part 1 deals with corporate and financial governance reforms and part 2 deals with legal and judicial sector reforms. TA support for the enterprise-restructuring component of CGERP-II will be provided through Asian Development Bank (ADB) TA Loan 1547.¹ A team of international and domestic consultants will be recruited to perform the tasks specified in the outline terms of reference (TORs).

A. Terms of Reference

1. Corporate and Financial Governance Reforms (Part 1)

2. This part has three components: (i) promotion of corporate sector development and corporate governance; (ii) legal and regulatory framework for corporate governance and (iii) introduction of International Accounting Standards 2001. In addition to advisory and capacity building support, the consultants will also work closely with the Government in ensuring compliance with the program conditions.

a. Corporate Sector Advisory and Management Support Expert - Team Leader (international, 6.5 person-months)

3. The consultant should have an advanced degree in management; extensive experience in a range of corporate sector issues, including international standards and best practices on corporate governance, and corporate sector development; and background in conducting training and providing advisory support services for senior enterprise managers, preferably in transition economies, on management, general finance, and marketing issues. The responsibilities of the consultant will include the following:

- (i) undertake a quick needs assessment, in consultation with the Corporate Development Center (CDC), and formulate a viable training program under which the domestic consultants can be trained to act as trainers/advisers in providing advisory and management support services to Kyrgyz enterprises;
- (ii) act as an adviser to the CDC in all matters relating to corporate sector and corporate governance development;
- (iii) formulate a training and advisory support services program for enterprise managers (to be provided in sessions or individually as needed) with focus on efficient enterprise management skills in a transition environment; operational and organizational strategies; principles of good corporate governance, including ethics, responsibility to shareholders, employees, and society at large; preparation of sound business plans to guide corporate development, including the preparation of a corporate policy statement that may facilitate investments into a company; basic principles of modern accounting and financial management; corporate budgeting and planning; modern marketing approaches;

¹ In addition to this TA grant, the Government will be utilizing a portion of proceeds from TA Loan 1547-KGZ: *Capacity Building for Corporate Governance and Insolvency Procedures*, for \$4 million, approved on 25 September 1997. This will support (i) domestic consulting, operational, and administrative needs of the Corporate Development Center; and (ii) the enterprise restructuring component included in the Program.

formulation of strategies for enterprise renewal and reorganization; and identifying the need for legal and contractual support on the part of the enterprises and advising the domestic consultants of CDC in providing such support;

- (iv) undertake a quick review of the general enterprise and financial sector environment, focusing on availability of data;
- (v) advise and facilitate CDC's coordination with a reputable international credit rating agency, and formulate a methodology appropriate for a transition economy for rating enterprises and commercial banks on compliance with good governance practices;
- (vi) train domestic consultants within the CDC in assessing and rating enterprises, and guide them in preparing rating assessments of all enterprises listed on the Kyrgyz Stock Exchange and all commercial banks;
- (vii) coordinate the tasks of the corporate governance legal and regulatory expert; accounting standards expert; and the legal and judicial adviser to the Judicial Advisory Commission (JAC);²
- (viii) monitor broad and overall progress of the program conditions relative to part 1 and part 2 (the latter subject to contractual arrangements) of the TA; and
- (ix) prepare periodic reports for ADB on (a) corporate sector development, advisory and management services; (b) corporate governance environment; and (c) the rating and assessments methodology, and coordinate the submission of inputs from the other experts on all other components under the TA, as applicable.

b. Corporate Governance Legal and Regulatory Expert (international, 2.5 person-months)

4. The expert will have advanced qualifications, preferably in law, and experience in assessing the monitoring capacity of regulatory agencies (including central banks and securities market agencies) in comparable economies, with regard to joint-stock companies (JSCs). He/she will also have practical experience in evaluating legal developments in corporate and financial sectors. The consultant will:

- (i) assess the capacity of the State Commission on Securities Market (SCSM) in monitoring compliance with the current provisions in the Law on Economic Partnerships and Societies and with provisions in the law on JSCs (if the latter gets adopted during the program period);
- (ii) compile available evidence on major cases of shareholder violations that the SCSM has analyzed in the recent past, and review the measures that the SCSM has taken against those violations;
- (iii) conduct a quick review of the regulatory provisions and powers vested in the SCSM with regard to monitoring of corporate governance norms; and
- (iv) draft recommendations to strengthen the SCSM's capacity in the above areas, with a time-bound action plan for adoption;
- (v) in a manner similar to the above for securities markets, assess the status of compliance with corporate governance norms in commercial banks; in this process, also assess the adequacy and quality of the legislative provisions in the adopted legislation on good governance in corporate and financial sectors; and

² The Team Leader will coordinate the services of the legal and judicial adviser only if the latter is recruited through the same firm providing services under part 1 of this TA. Otherwise, the Team Leader will coordinate only the part 1 components.

- (vi) provide inputs for preparing periodic reports on the TA by the team leader; and provide any advisory and support services needed by the team leader or the expert on accounting standards.

c. International Accounting Standards Expert (international, 2.5 person-months)

5. The consultant will be an experienced accountant, with background in training domestic consultants, preferably in transition economies. The responsibilities follow:

- (i) assess the capacity of the State Commission for Financial Standards Reporting and Auditing (SCSFRA) in enforcing compliance with international accounting standards (IAS);
- (ii) draft the terms of reference for the domestic accounting experts and guide their work in the conversion;
- (iii) coordinate closely with the ongoing externally supported accounting reform programs, to enhance support given to the Government;
- (iv) building on work done earlier through United States Agency for International Development (USAID) and ADB TAs, formulate a training-the-trainers program for domestic accountants;
- (v) conduct short training courses for domestic consultants/accountants on IAS 2001; and
- (vi) prepare a report on the above, including an assessment of the level of preparedness in large enterprises (in particular, all the firms listed on the Kyrgyz Stock Exchange) and commercial banks to adopt IAS 2001.

2. Support for the Judicial Advisory Commission (JAC) in Legal and Judicial Sector Reforms (Part 2)

6. Part 2 deals with TA and capacity-building support to the Judicial Advisory Commission (JAC), established pursuant to Presidential Disposition No.281 dated 5 October 2001, in conducting a comprehensive diagnostic assessment of legal and judicial sector weaknesses. While the Program focuses on enhancing investor confidence in the Kyrgyz Republic by promoting good corporate and financial governance, the JAC's scope of activities may be broader and include reforms to the judicial sector as a whole. A legal and judicial adviser will be recruited for nine months, and about six domestic legal experts will provide consulting services for a total of 45 person-months.

d. Legal and Judicial Adviser to JAC (international, 9 person-months)

7. The legal and judicial adviser will be a qualified lawyer with experience in comparative analysis of legal systems around the world, with focus on legal and judicial systems in transitional economies. Preferably, he/she will have had experience in conducting comprehensive legal and judicial sector assessments, and will work closely with members of the JAC. As the reform issues included under the JAC's purview are of a sensitive nature, the expert should have had a similar type of experience in advising senior judges, judicial system officials, or judicial reform commissions. The adviser's responsibilities follow:

- (i) formulate and guide the tasks of the domestic consultants, who will be taking an active part in the diagnostic assessments and in the JAC's overall work;

- (ii) perform an overall advisory role to the JAC, and provide it with technical inputs, guidance, and support in preparing reports and organizing workshops;
- (iii) prepare detailed TORs for the JAC, in line with the aims and objectives of the JAC as outlined in Presidential Disposition No.281 dated 5 October 2001;
- (iv) prepare an issues paper at the outset, based on the various recommendations on judicial and legal reforms of the Consultative Judicial Reform Group (CJRG), as outlined in its Report endorsed by the President of Kyrgyz Republic on 12 July 2001 (through Presidential Disposition No.220), to provide initial directions to the JAC;
- (v) review and modify as needed, the work program of the JAC, with a view to fulfilling the objectives of CGERP-II effectively;
- (vi) in close consultation with the JAC, prepare an outline for the diagnostic assessment, clearly setting out the goals, parameters, issues to be focused on, and methodology;
- (vii) focus the diagnostic assessment on (a) an overall initial overview of the court systems; (b) their organization, functions, and legal framework; (c) staffing and personnel issues; (d) case loads in different jurisdictions; (e) procedures followed in different courts; (f) a critical analysis of the first instance, appellate, and supervision processes; (g) appointment procedures and cycles; (h) qualifications, experience, and other criteria adopted for recruiting judges at different levels; (i) current process of assessing judicial qualifications; (j) profile of judges at higher and lower levels at present; (k) dismissal procedures and recent practices; (l) methods for enhancing independence of the judiciary; (m) separation of powers between the executive and judicial branches, and efficient means for enhancing such separation; (n) means for developing a professional corps of judges; (o) ways of enhancing transparency in the judicial decision making process; (p) disciplinary procedures in the judiciary, including the feasibility of designing an effective anticorruption framework; (q) financial issues, including salary, fee, and funding structures; and (r) interface with the civil society;
- (viii) advise the JAC in conducting 4 dissemination workshops (as outlined in CGERP-II Policy Matrix), including recommendations on sequencing the workshops appropriately in relation to the diagnostic assessment, to discuss the findings of the CJRG, and formulating a methodology on effectively utilizing the feedback from these workshops;
- (ix) advise the JAC in organizing the final major participatory workshop to disseminate the findings of the diagnostic assessment, with representatives from the judiciary, civil society, and the private sector, and the donor community;
- (x) participate as a resource person in the above dissemination and participatory workshops;
- (xi) provide support to the JAC in the publication (in Russian and English) of the final diagnostic study, a discussion of which will be the subject of the major participatory workshop, at the conclusion of the TA;
- (xii) review progress on commercial arbitration, and assess the need for public or private sector support; and
- (xiii) prepare a comprehensive report on all of the above for ADB and the Government, as outlined in para.15 below.

e. Domestic Consultants

8. One of the main objectives of Part 1 is to enhance institutional capacity to promote and implement good governance norms. The first phase of CGERP established the CDC and the

institutional structure for it. TA Loan 1547-KGZ: Capacity Building for Corporate Governance and Insolvency Procedures (footnote 1) supported the CDC's activities. Over 1997-1999, around 14 domestic consultants were trained in various areas of corporate governance, management, finance, and marketing by a number of international experts. While a part of this group have since left, recently the Government took initiatives to strengthen the skills and expertise in the CDC. With this in the background, the Government has committed to utilizing a portion of the proceeds under the ongoing TA Loan 1547 to procure advisory support services of about 340 person-months domestic consulting needs for corporate governance promotion.³ The consultants to be recruited under the TA loan will work closely with the international and domestic consultants to be selected under the proposed TA grant.

9. In addition, 30 person-months of domestic accountants' inputs are included in part 1 of this TA grant. Significant expertise in this area, stemming from earlier USAID support, can be utilized. It is envisaged that about six experts will be recruited to provide the needed services. The TORs for the domestic consultants will mirror those of the international expert, under whose supervision the domestic consultants will work. The TORs for the domestic accounting experts will mirror those of the international expert, who will draft and guide the tasks of the domestic experts.

10. To support the judicial reform component, six domestic legal experts will be recruited to provide total consulting services of 45 person-months. The domestic legal consultants, together with the international legal and judicial advisor, will be housed at the offices of the JAC. The TORs of the domestic legal consultants will mirror those of the legal and judicial adviser, who will draft and guide their tasks.

11. Overall, 75 person-months of domestic consulting services will be procured under the TA grant.

B. Cost Estimates and Financing Plan

12. The TA is estimated to cost \$1,000,000 equivalent, of which \$740,000 will be in foreign exchange and \$260,000 equivalent will be in local currency. ADB will finance the equivalent of \$850,000, comprising the entire foreign exchange component and \$110,000 equivalent of the local currency component. The Government will provide \$150,000 equivalent to finance counterpart staff, office facilities, and workshops. Table A9 presents the cost estimates and financing plan. In addition to the total cost of the TA, the Government has undertaken to finance (i) domestic consulting support for the CDC; (ii) operational and administrative expenses for the CDC; and (iii) the advisory and consulting services for the enterprise restructuring component in the Program, through savings under TA Loan 1547.

C. Implementation Arrangements

13. The CDC under the Prime Minister's Office will be the Executing Agency for the TA. As per the President's Disposition No.281, dated 5 October 2001, on the Judicial Advisory Commission (JAC), the CDC and the Ministry of Justice shall be providing the counterpart and logistical support for the JAC. The Judicial Reform Monitoring Group (JRMG), in coordination with the JAC, will provide overall supervisory support for the judicial reform component. The TA will be implemented over a period of 15 months from the start date (envisaged in April 2002). It

³ The terms of reference for the consulting inputs to be procured under TA Loan 1547-KGZ are in CDC's action plan.

is estimated that the TA will require 20.5 person-months of international and 75 person-months of domestic consulting support. All consultants will be selected in accordance with ADB's *Guidelines on the Use of Consultants* and other arrangements satisfactory to ADB. The simplified technical proposal approach will be used for selecting the consulting firm.

14. All the international consultants will be selected as a team from a single firm. However, if the services of a well-qualified and experienced legal and judicial adviser under part 2 cannot be procured along with those of the other experts under part 1, the legal and judicial adviser will be recruited separately through another firm.

D. Reports

15. The team will submit an inception report within four weeks of the start of the TA, and monthly progress reports, to be prepared by the team leader (or legal and judicial adviser, if this expert is recruited separately) with inputs from the other experts, and a final report at the completion of the tasks outlined under the TA. The final report will be followed by a draft final report. The draft final report will be finalized about 3 weeks after it is submitted to ADB and the Government for comments.

Table A9: Cost Estimates and Financing Plan
(\$)

Item	Foreign Exchange	Local Currency	Total Cost
A. Asian Development Bank Financing^a			
1. International Consultants			
a. Remuneration (20.5 person-months) and per diem	569,250	0	569,250
b. International Travel	33,000	0	33,000
2. Domestic Consultants – Remuneration (75 person-months)	0	60,000	60,000
3. Translation, Communication and Office Equipment ^b	15,000	20,000	35,000
4. Seminars and Workshops; Training Materials and Publication Needs	20,000	20,000	40,000
5. Representatives for Contract Negotiations	8,000	0	8,000
6. Contingencies	94,750	10,000	104,750
Subtotal (A)	740,000	110,000	850,000
B. Government Financing			
1. Office/Logistical Support	0	75,000	75,000
2. Counterpart Staff, and Administrative and Translation Support	0	75,000	75,000
Subtotal (B)	0	150,000	150,000
Total	740,000	260,000	1,000,000

^a Financing will come from the ADB-funded TA Program.

^b The office equipment will cover five computers and printers, a fax machine, and a photocopier.

Source: ADB estimates.