# ASIAN DEVELOPMENT BANK

PCR:KGZ 29149

## PROGRAM COMPLETION REPORT

ON THE

CORPORATE GOVERNANCE
AND ENTERPRISE REFORM PROGRAM
(LOAN 1546-KGZ[SF])

TO THE

KYRGYZ REPUBLIC

December 2000

## CURRENCY EQUIVALENTS

Currency Unit – Som

| | | At Appraisal | At Program Completion |
|---|---|---|---|
| | | 30 April 1997 | 3 March 2000 |
| Som1.00 | = | $0.057 | $0.021 |
| $1.00 | = | Som17.66 | Som47.3 |

## ABBREVIATIONS

| | | |
|---|---|---|
| ADB | – | Asian Development Bank |
| AGM | – | annual general meeting |
| CDC | – | Corporate Development Center |
| CGERP | – | Corporate Governance and Enterprise Reform Program |
| IAS | – | International Accounting Standards |
| JSC | – | joint stock company |
| MOF | – | Ministry of Finance |
| MOJ | – | Ministry of Justice |
| NBKR | – | National Bank of Kyrgyz Republic |
| NSC | – | National Securities Commission |
| SOE | – | state-owned enterprise |
| SPF | – | State Property Fund |
| TA | – | technical assistance |
| USAID | – | United States Agency for International Development |

## NOTES

(i) The fiscal year of the Government ends on 31 December.
(ii) In this report, "$" refers to US dollars.

## BASIC DATA

### A. Loan Identification

| | | |
|---|---|---|
| 1. | Country | Kyrgyz Republic |
| 2. | Loan Number | 1546-KGZ |
| 3. | Project Title | Corporate Governance and Enterprise Reform Program |
| 4. | Borrower | Kyrgyz Republic |
| 5. | Executing Agency | Department of Economic Sector Development, Prime Minister's Office |
| 6. | Amount of Loan | $40 million equivalent from the Asian Development Fund |
| 7. | PCR Number | PCR:KGZ 600 |

### B. Loan Data

1. Appraisal
   - Date Started: 14 April 1997
   - Date Completed: 30 April 1997

2. Loan Negotiations
   - Date Started: 29 July 1997
   - Date Completed: 31 July 1997

3. Date of Board Approval: 25 September 1997

4. Date of Loan Agreement: 8 December 1997

5. Date of Loan Effectiveness
   - in Loan Agreement: 9 December 1997
   - Actual: 9 December 1997
   - Number of Extensions: None

6. Closing Date
   - in Loan Agreement: 31 December 1999
   - Actual: 26 November 1999
   - Number of Extensions: None

   Terms of Loan
   - Service Charge: 1 percent per annum
   - Maturity: 40 years
   - Grace Period: 10 years

7. Disbursements

   a) Dates

| Initial Disbursement | Final Disbursement | Time Interval |
|---|---|---|
| 17 December 1997 | 1 July 1999 | 16.5 months |

| Effective Date | Original Closing Date | Time Interval |
|---|---|---|
| 9 December 1997 | 31 December 1999 | 24.6 months |

### C. Data on Missions

| Name of Mission | Date | No. of Persons | No. of Person-Days | Specialization of Members |
|---|---|---|---|---|
| Reconnaissance [1] | 2-10 Oct 96 | 4 | 21 | Economist (2) |
| Fact-Finding [2] | 6-20 Nov 96 | 6 | 63 | Deputy Director, IED<br>Sr. Programs Officer<br>Economist<br>Project Engineer |
| Appraisal [3] | 14-30 Apr 97 | 8 | 89 | Director<br>Sr. Economist<br>Sr. Counsel<br>Economist (3) |
| Review 1 | 16-19 Feb 98 | 1 | 9 | Economist |
| Review 2 [4] | 27 Jul 98-<br>10 Aug 98 | 2 | 22 | Sr. Economist<br>Financial Economist |
| Review 3 | 12-23 Apr 99 | 1 | 9 | Financial Economist |
| Program Completion[5] | 29 Feb-<br>03 Mar 2000 | 1 | 4 | Financial Economist |

[1] The Mission was supported in the field by the Programs Review Mission led by P.V. Brevern, Sr. Programs Officer, PE3.
[2] Two consultants under TA 2712-KGZ: *Preparation and Implementation of Guidelines on Best Practice in Corporate Governance*, for $100,000, approved on 13 December 1996, assisted the Mission.
[3] Five consultants under TA 2712-KGZ assisted the Mission.
[4] A staff consultant on corporate governance assisted the Mission.
[5] The Mission consisted of R. Subramaniam, Financial Economist, IEFI.

## CONTENTS

## I. PROGRAM DESCRIPTION

1. On 25 September 1997, the Asian Development Bank (ADB) approved the Corporate Governance and Enterprise Reform Program (CGERP) loan to the Government of the Kyrgyz Republic (the Government).[1] CGERP aimed to improve the efficiency and performance of private and state-owned enterprises (SOEs) to make them viable in a competitive market-based environment. CGERP sought to alleviate internal as well as external constraints to efficient enterprise performance. With respect to internal constraints, CGERP focused on the weaknesses in management and governance structures of enterprises in the Kyrgyz Republic. With regard to external constraints, it called for (i) phasing out of government subsidies and soft loans that impeded innovation, competitiveness, and efficiency; (ii) development of a sound legal framework for closing insolvent enterprises; and (iii) increasing the transparency of financial information at the enterprise level.

2. To achieve these objectives, CGERP undertook to (i) develop and implement guidelines for best practice in corporate governance and mechanisms for their enforcement, (ii) cut off subsidized loans from the budget to all SOEs, (iii) expedite enterprise liquidation and restructuring to eliminate nonviable enterprises and promote the rapid redeployment of viable assets, and (iv) strengthen the legal framework and implementation capacity for insolvency procedures. ADB simultaneously approved a technical assistance (TA) loan[2] to support capacity building in corporate governance and restructuring of SOEs and private enterprises.

3. CGERP has provided timely support to the Government by developing an appropriate policy and regulatory environment for corporate governance reforms and enterprise restructuring. The TA loan provided support to 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. This report provides an overview and evaluation of the implementation of CGERP.[3]

## II. EVALUATION OF PROGRAM IMPLEMENTATION

### A. Program Components

5. Following its independence from the former Soviet Union, the Kyrgyz Republic initiated a three-phase privatization program in 1991. 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. In the second phase, from 1994 to 1995, about 1,300 medium and large SOEs were first corporatized as joint-stock companies (JSCs). The standard modality for privatizing the medium and large SOEs involved 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 to targeted strategic investors. In reality, however, these proportions differed greatly according to the strategic importance of the enterprise being privatized as well as the pressures exerted by the buyers (e.g., managers and workers). The third phase of privatization, which started in 1996, is still ongoing, given the complexities

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[1] Loan 1546-KGZ(SF): *Corporate Governance and Enterprise Reform Program*, for $40,000,000 (SDR28,964,000).

[2] TA Loan 1547-KGZ(SF)*: Capacity Building in Corporate Governance*, for $4,000,000 (SDR2,896,000), approved on 25 September 1997.

[3] A separate project completion report will be submitted on the TA Loan upon its closure on 30 June 2001.

involved in privatizing some of the large state monopolies in the most strategic sectors of the economy. By mid-1998, about 970 enterprises had gone through voucher auctions and the Government had fully divested its shares in these enterprises. The Parliament approved a new privatization strategy in December 1998 to divest shares in the remaining 330 medium and large JSCs, although progress has been slow in this regard.

6. While Government shares were divested expediently in the first two phases, enterprise efficiency did not improve because corporate governance was affected by:

(i) the voucher or mass distribution system, which led to widely dispersed small shareholdings, making it difficult for shareholders to monitor the performance of, or to influence governance in, enterprises;

(ii) the practice of awarding minority but significant 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 for a market environment;

(iii) the continued flow of Government subsidies to SOEs, which deterred enterprise efficiency; and

(iv) weaknesses in operational (e.g., accounting standards) and legal (e.g., bankruptcy) frameworks, which were not conducive to promoting effective enterprise management.

7. To address these internal and external constraints to enterprise efficiency and good governance, CGERP focused on six components (Appendixes 1 and 2).

(i) promoting enterprise efficiency through improved corporate governance by

(a) extending enterprise reforms to sectors that are dominated by Government ownership (e.g., utilities);
(b) institutionalizing best practices in corporate governance; and
(c) strengthening institutional capacity in corporate governance and enterprise restructuring.

(ii) imposing financial discipline on enterprises;

(iii) promoting domestic and international competition to strengthen the environment for foreign direct investment;

(iv) strengthening the legal framework and enforcing insolvency proceedings on bankrupt enterprises;

(v) introducing International Accounting Standards (IAS) in enterprises; and

(vi) mitigating the transition and social adjustment costs of enterprise restructuring.

A chronology of the main events in CGERP implementation is in Appendix 3.

### 1. Promotion of Enterprise Efficiency through Improved Corporate Governance

#### a. Policy and Regulatory Reform

8. JSCs with more than 50 shareholders, referred to as *open* JSCs,[4] were required to adopt a two-tier system of corporate control[5] prior to the implementation of CGERP. Nevertheless, corporate governance within enterprises was fraught with a number of problems (para. 6). In order to strengthen the structure of incentives within firms, the Government, as part of the CGERP, passed Resolution No. 433 in July 1997, *Measures Concerning the Implementation of Corporate Governance Procedures.* The Resolution approved the Model Charter and the *Handbook on Best Practices in Corporate Governance in the Kyrgyz Republic* (the Handbook).[6] This provided guidelines for (i) shareholders' rights and responsibilities; (ii) convening and conducting general and extraordinary shareholders' meetings; (iii) the membership, duties, and responsibilities of the board of directors and the board of executives; and (iv) the establishment and functions of an independent registrar of shares.

9. To strengthen good corporate governance practices, the Government amended the Civil Code and the Law on Economic Partnership and Societies (LEPS). The changes in the Civil Code were introduced to ensure greater protection of shareholders' interests by empowering annual general meetings (AGMs) to (i) amend the company charter, including changing the charter capital; (ii) elect the company's board of directors and audit committee, as well as form and dissolve the company's executive bodies; (iii) approve the annual reports including company accounts; and (iv) decide on reorganization and liquidation of the company. Amendments to the LEPS clarified that management and members of the audit committee could not simultaneously be on a company's board of directors.[7] These measures have helped promote transparency and accountability, and empower shareholders.

#### b. Introduction of Good Governance Practices in SOEs

10. In order to provide a strong demonstration effect, CGERP introduced governance reforms in strategic SOEs that handled electricity generation and distribution, gas distribution, telecommunications, and air-transportation. These enterprises were fully owned by the Government. As part of CGERP, three Government departments in these sectors were corporatized into majority Government-owned JSCs: Kyrgyz Airlines, Kyrgyz Telecoms, and Kyrgyz Gasmunaizat. These JSCs, and the previously corporatized Kyrgyz Energo, were required to clarify ownership rights, incorporate and exercise these rights through their board of directors, appoint the management with appropriate delegation of authority from the board of directors, and realign risk and control through partial divestment of Government ownership to strategic investors and stakeholders.

11. Resolution No. 433, issued in July 1997, required these JSCs to adopt transparent reporting practices and observe sound corporate governance principles. In compliance with CGERP, each JSC adopted a company charter that was in accord with the Model Charter.

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4 Enterprises with fewer than 50 shareholders are referred to as *closed* or *closely-held* JSCs.

5 The two tiers of control refer to the board of directors (representing the shareholders) and the board of executives (or managers).

6 The Model Charter and the Handbook were developed under TA 2712-KGZ: *Preparation and Implementation of Guidelines on Best Practice in Corporate Governance,* for $100,000, approved on 13 December 1996.

7 The audit committee is formed at the AGM, and it consists of shareholders who are not on the board of directors. Its mandate is set and enforced by the AGM.

Further, in accordance with sound corporate governance principles, the AGMs of the JSCs now elect both the board of directors and the board of executives.

#### c. Institutional Capacity Building

12. In October 1997, the Government established CDC as a key agency for disseminating corporate governance and enterprise restructuring principles and for implementing the related guidelines and standards, with support from the TA loan (para. 2). CDC was entrusted with designing a public information and education program, and the Management Development Training Program. In a relatively short period, it implemented an innovative and effective promotional campaign to inculcate awareness and understanding of corporate governance issues in the country. Its staff included international and domestic experts in corporate governance, finance, law, accounting, and public information and media. CDC also facilitated effective coordination among the various ministries and other relevant entities, in particular, the Ministry of Finance (MOF), Ministry of Justice (MOJ), State Property Fund (SPF), National Bank of Kyrgyz Republic (NBKR), and National Securities Commission (NSC). The staff of CDC and MOJ have acquired considerable expertise in evaluating company charters.

### 2. Encouraging Financial Discipline in Enterprises

13. While directed lending through the banking system was eliminated in 1993, enterprises (both public and private) were provided with a cumulative Som1 billion in soft loans directly from the budget, between 1993 and 1996, below market interest rates. At the time of processing of CGERP in 1997, the enterprises owed the Government Som500 million in loan repayments. To encourage financial discipline in enterprises, CGERP stipulated that budgetary subsidies to SOEs be phased out. As a first step toward this goal, the Government issued directives that no new budgetary loans would be extended to those SOEs that were already in default on previous loans. Subsequently, budgetary loans to other enterprises were reduced, by half every year from their initial level of Som320 million ($6.8 million) in 1997.

### 3. Promotion of Competition and Creating an Enabling Environment for Foreign Investment

14. To improve the external environment facing the JSCs, CGERP also aimed at promoting a competitive domestic and international trade regime. The Government undertook to liberalize factor and output prices and remove barriers to entry and exit in the enterprise sector. CGERP also stipulated that no new quantitative restrictions or tariffs on imports be placed except in accordance with World Trade Organization antidumping provisions. This restriction was fully adhered to during the program period. CGERP also supported the passage of an amended Law on Foreign Direct Investment, which provided tax holidays and better profit-repatriation incentives.

### 4. Strengthening the Legal Framework for Insolvency and its Enforcement

15. This component aimed to strengthen the legal framework for bankruptcy and insolvency procedures as well as the capacity of judges in the commercial courts[8] through a judicial training program and improving court and operational facilities (e.g., office and court renovations). The Law on Bankruptcy was enacted in September 1997 and subsequently amended in December

[8] These are referred to as arbitrazh courts, but they are different from the arbitration courts found in many countries in the West.

1998 (Appendix 4). These amendments (i) allow bankruptcy to be initiated if a debtor has failed to abide by the debt repayment obligations, regardless of the health of the debtor's balance sheet; (ii) impose personal liability on members of management of an enterprise if they fail to make appropriate recommendations to the shareholders on debt repayment; (iii) provide greater independence to special administrators; and (iv) provide extraordinary powers to courts to eliminate political interference. This bankruptcy legislation is considered comparable to that found in a number of more advanced countries.

16. To effectively enforce bankruptcy procedures, the Government filled judicial vacancies in the arbitrazh courts as part of compliance with CGERP. Under the judicial training program, all judges in the arbitrazh courts were trained in bankruptcy implementation procedures. The judges attended classroom training on corporate, financial, and insolvency legislation; valuation of assets; basic accounting techniques; interpreting corporate balance sheets; and international bankruptcy and insolvency practices. The judges also visited enterprises under liquidation and courts dealing with bankruptcy cases for practical training. The TA loan supported the renovation of office buildings of the arbitrazh courts and acquisition of training materials for the judges. The Government, with support under the TA loan, prepared a handbook on bankruptcy law and procedures for use by judges in the arbitrazh courts.

### 5. Promotion of Transparency in Financial Accounting and Reporting

17. At the time of processing, accounting standards and reporting requirements of enterprises did not meet IAS. This was primarily due to resistance from various quarters—including enterprises, accountants, and some parts of the Government—which stemmed from lack of understanding of IAS. Recognizing the importance of promoting transparency through the adoption of IAS, CGERP supported the development and promotion of accounting standards that conform to IAS. In this initiative, ADB coordinated closely with the United States Agency for International Development (USAID) through its Accounting Reform Project. As part of CGERP, MOF established a department to support the development of financial accounting methodology and standards, promulgate instructions, provide training, and license professional accounting and auditing activities. In collaboration with the USAID Project, CGERP supported adoption of accounting standards that conform to IAS in 80 enterprises.

### 6. Mitigation of Transition Costs

18. The transition process to a market economy through enterprise reforms is usually accompanied by major effects on employment. In order to mitigate any adverse effects of SOE restructuring, CGERP supported allocation of sufficient budgetary resources for the Employment Fund[9] to finance the unemployment benefits and retraining costs of retrenched workers. The Employment Fund's budgetary requirements for 1998 were estimated at Som70 million ($1.5 million), based on the assumption that unemployment and retrenchments would increase as enterprises were restructured. MOF had initially allocated this amount in the 1998 budget to meet the transition costs. However, as a result of a stronger performance of the economy in 1997 and the slower-than-anticipated implementation of enterprise restructuring in 1998 unemployment declined from 77,200 in 1996 to 55,900 in 1998, and retrenchments from 35,600 to 15,900 in the same period. Increased absorption of labor in agriculture due to the country-wide agrarian reforms implemented during that period, and the later-than-expected

[9] The Employment Fund is responsible for benefit payments and retraining programs for unemployed workers. Meanwhile, the Social Fund is responsible for collecting all social security-related payments from enterprises and workers, including unemployment benefit premiums, which are then transferred to the Employment Fund. The Social Fund also acts as a conduit for all social security-related transfers from MOF.

enactment of the amendments to the Bankruptcy Law in December 1998 (which delayed SOE restructuring to some extent) contributed to these outcomes. Moreover, the Employment Fund's budget has been in balance since 1995, with its collections of unemployment benefit and retraining premiums matching its expenditures.[10] Consequently, the budgetary allocation in 1998 budget was not utilized. Nevertheless, in 1999, the Government transferred Som73.7 million ($1.6 million) to the Employment Fund. Anticipating even greater needs, the 2000 budget has a provision for Som145.7 million ($3.1 million), of which Som19.5 million ($0.4 million) was transferred to Employment Fund in the first half of 2000.

## B. Implementation Arrangements

19. The Department of Economic Sector Development of the Prime Minister's Office acted as the Executing Agency for CGERP. MOF administered the program loan proceeds, while CDC administered the TA loan proceeds. CDC, operating within the Department of Economic Sector Development, coordinated CGERP, in close cooperation with MOF, MOJ, SPF, NSC, NBKR, and the Supreme Arbitrazh Court. A steering committee chaired by the Prime Minister, with representatives from these ministries and agencies, was established to monitor progress on a quarterly basis.

20. In June 2000, the Government passed a resolution to move CDC from the Prime Minister's Office to SPF, in part to ensure that the financial needs of CDC are met once the proceeds of the TA loan are utilized by its closure in June 2001.

## C. Program Schedule

21. CGERP and the related TA loan were approved by the Board on 25 September 1997. The program loan became effective on 9 December 1997, upon fulfillment of all loan effectiveness conditions. The implementation period for CGERP was three years from the date of effectiveness, and the TA loan is to close by 30 June 2001. Overall, a number of far-reaching measures were taken prior to and during the implementation of CGERP and the TA loan to facilitate good corporate governance at the enterprise level. The program loan was officially closed in November 1999. The Government cooperated fully and ensured that CGERP remained on track. The Government also met all requirements on the submission of reports, including its own Program Completion Report.[11]

## D. Engagement of Consultants and Procurement of Goods and Services

22. The program loan did not involve any engagement of consultants or procurement of goods and services. However, the TA loan involved the engagement of a large team of international and domestic consultants, which was undertaken in accordance with ADB’s *Guidelines on the Use of Consultants*.[12] In addition, two international consultants provided 23 person-months of advisory services to the Prime Minister's Office, as part of an accompanying TA.[13] Office equipment (computers, software, printers, and fax machines) in the amount of

[10] Unemployment benefit premiums and contributions toward retraining amount to about 3 percent of gross wages. In absolute terms, the collections rose from Som33.7 million in 1995 to Som48.3 million in 1998, and expenditures increased from Som33.2 million to Som48.3 million over the same period.
[11] An audited report of the TA loan was submitted for the 1998 accounts; however, the 1999 audit report in English has not yet been received by ADB.
[12] An evaluation of the procedures and the performance of the consultants will be undertaken in a separate report on the TA loan.
[13] TA 2876-KGZ: *Strengthening the Economic Policy Making and Monitoring Capabilities of the Prime Minister’s Office*, for $800,000, approved on 25 September 1997.

$80,000 were procured, in accordance with ADB's *Guidelines on Procurement*, to support the policy-making functions of the Prime Minister's Office.

## E. Performance of Consultants, Contractors, and Suppliers

23. The performance of the consultants and suppliers was generally satisfactory.

## F. Conditions and Covenants

24. ADB supported CGERP with a loan of SDR28,964,000 ($40 million equivalent) from its Special Funds, and the TA loan of SDR2,896,000 ($4 million equivalent) from the same source. The program loan has a repayment period of 40 years, including a grace period of 10 years, and it carries a service charge of 1 percent per annum. Its first tranche in the amount of SDR14,482,000 ($19.65 million equivalent) was released in December 1997, and an imprest account for the TA loan was subsequently established. The second and final tranche of the remaining SDR14,482,000 ($19.35 million equivalent) was originally envisaged for release in May 1999, but was actually released in July 1999 upon fulfillment of all the tranche-release conditions.

25. The Government was allowed to withdraw funds from the loan account within three years of loan effectiveness. Nineteen actions in the Policy Matrix were satisfactorily undertaken prior to Board consideration. The passage of the Law on Bankruptcy was a condition for loan effectiveness. In addition, seven tranche-release actions and 16 monitorable actions were required during the program period. At the time of the second tranche release, all the seven tranche release conditions had been fully complied with.

## G. Environmental Impact

26. CGERP was classified as Environment Category C as it had no direct environmental impact.

## H. Performance of the Borrower and the Executing Agency

27. The Prime Minister's Office and CDC have implemented CGERP and the TA loan effectively. Given the multi-disciplinary nature of the tasks involved, the Government entrusted the task of program coordination to the Prime Minister's Office, because it could function in a neutral capacity vis-à-vis all the relevant ministries and agencies responsible for policy formulation and enforcement of corporate governance and enterprise restructuring. CDC was entrusted primarily with information dissemination and training to improve awareness of corporate governance issues, and its role has been commendable. The other ministries and agencies—MOF, MOJ, NBKR, NSC, SPF, and the Ministry of External Trade and Industry—undertook the role of policy formulation and enforcement.

28. Considering that CGERP was the first concerted initiative to introduce corporate governance and enterprise reforms in the Central Asian region, the Government exhibited strong ownership in its implementation. Major decisions included (i) corporatization of strategic JSCs in the State sector; (ii) implementation of corporate governance standards in three of the four largest SOEs, which bore the burden of the old Soviet-style, control-based system of management; (iii) gradual elimination of loans from the budget to SOEs; and (iv) demonstration of willingness to implement bankruptcy procedures despite the perceived labor market risks.

### I. Performance of the Asian Development Bank

29. ADB's performance in support of implementation was satisfactory. CGERP and the TA loan were monitored closely both at Headquarters and during review missions, and their implementation was closely coordinated with the work of the other aid agencies, in particular USAID and the World Bank. ADB fielded review missions in February 1998, August 1998, and April 1999. In addition, processing missions for ADB's Financial Intermediation and Resource Mobilization Program[14] also reviewed progress on corporate governance issues of relevance to the financial sector. ADB senior staff participated in corporate governance workshops held in Bishkek, and held policy discussions on corporate governance and enterprise reform issues.[15]

## III. EVALUATION OF PROGRAM IMPACT

### A. Economic Performance

30. In terms of linkages with the overall economy, the thrust of CGERP was twofold: (i) ease the burden of transition to a market economy by imposing financial discipline on enterprises, and (ii) provide incentives to attract strategic investors to enterprises. The Kyrgyz Republic took a number of major steps toward converting to a market economy since its independence in 1991. The Government launched reforms in agriculture, trade, and industry sectors; initiated a privatization program; and adopted full convertibility of its currency. While these reform measures arrested and reversed the transition-induced recession of 1992-1995,[16] the Government recognized that for sustaining growth the constraints that affected enterprise efficiency should be removed, and sought ADB support to improve corporate governance.

31. CGERP's immediate contribution on the fiscal side was to lower the budgetary loans to enterprises from around Som320 million ($6.8 million) in 1997 to zero at present. While the proceeds from the loan were also utilized to support the budget during 1997-1999,[17] CGERP will yield substantial economic benefits in the medium to long-term in the form of improved enterprise profits and investments. CGERP is also expected to contribute to greater capital market activity, since improved governance structures within enterprises will encourage their increased recourse to nonbank sources for financing.

### B. Program Benefits and Impact of Policy Reforms

#### 1. Program Benefits

32. The key achievements of CGERP are as follows:

(i) About 95 percent of 1,400 JSCs registered with NSC adopted the Model Charter and the related corporate governance requirements.

[14] Loan 1723-KGZ, for $35 million equivalent, approved in December 1999.
[15] The *International Workshop on Corporate Governance in Transition Economies*, held in November 1999; and the *Comprehensive Development Framework Workshop on Good Governance*, held in July 2000.
[16] Compared to GDP contraction of 5 percent per annum during 1992-1995, growth rebounded to 7-10 percent per annum during 1996-1997. Inflation stabilized from about 35 percent in 1996 to around 15 percent in 1997. The balance of payments also strengthened in 1997.
[17] Partially to recover from the adverse impact of the Russian financial crisis of 1998.

(ii) Three of the four large and strategic Government-owned JSCs—namely, Kyrgyzenergo, Kyrgyz Airlines, and Kyrgyz Telecoms—adopted good corporate governance practices including transparent election procedures for members of the board of directors and board of executives, and extended adequate protection to coupon or minority shareholders by conducting AGMs in a fair and transparent manner.

(iii) The number of AGMs, based on advertisements by JSCs in major newspapers, increased from 47 in 1996 to 313 in 1999 (out of the around 500 JSCs of the open type), of which CDC staff attended 175 to monitor the proceedings; in total, CDC staff attended more than 550 AGMs to monitor the proceedings over the last three years.

(iv) Over 50 seminars in corporate management and governance were held, with 1,600 employees trained—including 450 enterprise managers, 250 Government officials, and 900 students—in the areas of law, governance, management, marketing, and finance.

(v) The public education units of CDC prepared 58 television programs, including a popular program entitled *ABC of Corporate Governance*, and 17 radio broadcasts on the basics of corporate governance over the duration of CGERP. CDC also launched an extensive outreach campaign to contact and assist a number of JSCs, and 211 publications of various types, including promotional materials, booklets, and regular newspapers, were widely disseminated to enterprises as well as the investor community.

(vi) About 1,100 JSCs adopted the new Kyrgyz Accounting Standards based on IAS, and around 3,000 individual accountants were trained to use them. The Kyrgyz Republic is the first country among the Commonwealth of Independent States to have an examination system for membership in its national accounting association; in order to receive the highest level of accounting certification, members must pass four examinations, each of five hours duration.

(vii) Subsidized budgetary loans to enterprises were reduced from Som320 million ($6.8 million) in 1997 to Som73.7 million in 1998 ($1.6 million) to Som25 million ($0.5 million) in 1999. The 2000 budget does not have any allocation for such loans.

(viii) The Government pursued an active debt recovery strategy for about Som500 million ($10.6 million) in arrears on budgetary loans to SOEs accumulated since 1993; however, due to the worsening macroeconomic situation stemming from the Russian crisis, the Debt Recovery Agency under MOF collected only about 25 percent of the outstanding loans.

(ix) All judicial vacancies in the arbitrazh court system were filled, to bring the number of judges to 31.

(x) The number of out-of-court liquidations rose to 120 cases and arbitrazh court settlements to 168 cases in 1999, relative to less than a quarter of such cases in 1997 and 1998.

### 2. Impact of Institutional, Policy, and Regulatory Reforms

33. CGERP's primary goal was to lay the foundation for good corporate governance and develop a conducive framework for enterprise restructuring. Its major contributions include: (i) development of a sound policy, legal, and regulatory framework for corporate governance and insolvency procedures; and (ii) capacity building to support good governance in enterprises and to train the judiciary to effectively enforce insolvency procedures.

34. The outcomes, with regard to the actual implementation of corporate governance standards and insolvency procedures, have been impaired by exogenous factors. Corporate governance problems have surfaced in banks[18] and one major enterprise, Kyrgyz Gasmunaizat (Appendix 5). The nature of these problems implies that strong checks and balances should be designed to control corruption and fraudulent behavior by managers, directors, as well as key shareholders in financial and nonfinancial enterprises. Enforcement of the Law on Bankruptcy has been weak due to slow processes within the judiciary (para. 41), as well as external interference with the judicial decision-making process.

#### a. Corporate Governance

35. CGERP has been successful in preparing guidelines and a sound framework for their implementation. It helped clarify the rights and responsibilities of supervisors and managers, which in turn facilitated a speedier and relatively more transparent decision-making process within enterprises. For example, decisions with regard to reinvestment of retained earnings are now made in a transparent manner at AGMs. The mechanisms for shareholder monitoring facilitated periodic evaluations and revaluations of enterprise performance. The adoption of internationally accepted governance standards in strategic enterprises will help attract foreign direct investment. These policy reforms have been implemented along with significant efforts aimed at increasing the capacity of Government officials, enterprise managers, and the judiciary in corporate management and governance-related areas.

36. Under the Management Development Training Program, training and advisory services were provided in four major areas: (i) law and corporate governance, (ii) general management, (iii) marketing, and (iv) corporate finance. Several training programs in modern management systems and methods were successfully implemented throughout the country, in line with CGERP's objective of strengthening the capacity of managers to exercise their duties and functions more effectively. The training programs of CDC were carried out in three phases. In the first phase, international consultants trained the Government officials on secondment as domestic experts in CDC, in corporate governance and enterprise reform. During the second phase, training programs were organized for professors and students from universities. The third phase focused on training programs for Government officials and SOE managers.

#### b. Financial Governance

37. CGERP has been successful in (i) imposing hard budget constraints on enterprises by reducing subsidized budgetary loans to commercially oriented JSCs, and (ii) strengthening transparency and disclosure through adoption of IAS in a large number of enterprises. The requirement that budget loans be halved every year for the duration of CGERP has led not only

[18] The banking sector was not directly targeted under CGERP; however, as part of CGERP, NBKR required all commercial banks to screen credit applications from enterprises for good corporate governance practices.

to a reduction in budget loans to the enterprise sector, but it has also encouraged debt recovery from Government-owned JSCs.

38. There is greater awareness of sound, transparent, and internationally recognized accounting standards at the Government and the enterprise level. While some of the larger enterprises have been reluctant to convert to the new Kyrgyz Accounting Standards due to concerns over tax and depreciation implications, majority of the JSCs have adopted them. Although the need for full conversion to the new standards has been recognized, there has been no coherent framework guiding the implementation of Kyrgyz Accounting Standards. MOF, which was entrusted with the task of enforcement, issued a number of resolutions stipulating steps to be taken and deadlines for compliance with the standards. A National Accounting Standards Board has now been set up to formulate guidelines on the implementation of the new standards.

39. The banking sector has particularly been affected by the lack of sound principles of corporate and financial governance. Shareholders in a number of commercial banks seem to interfere in the day-to-day functioning of management in lending decisions, resulting in loans to bank insiders and connected parties. Weaknesses in enforcement of existing legislation have impeded NBKR's efforts to effectively exercise its oversight functions. The poor state of financial governance in banks is confirmed by the problems of Maksat Bank, whose major shareholders instructed managers to withdraw capital with immediate effect, and Kramds Bank and Insan Bank, which were affected by shareholder interference and connected lending to powerful borrowers. Reforms needed to strengthen supervision are addressed under the ongoing Financial Intermediation and Resource Mobilization Program (para. 29). However, legal and enforcement reforms to improve financial and corporate governance of the banking sector have not been undertaken yet, due in part to resistance from a number of powerful banks.

### c. Enterprise Reform Initiatives

40. CGERP supported the enactment of the Law on Bankruptcy and the preparation of implementation procedures. The Law on Bankruptcy and the Law on Pledge are generally comparable to similar legislation found in more developed countries. The judicial training component of CGERP provided wide-ranging training in basic corporate finance, accountancy, valuation, as well as insolvency procedures and practices to arbitration judges and SPF liquidators. The TA loan supported renovation of selected Arbitrazh Court buildings in Bishkek and other regions.

41. While the legal framework adopted has adequate provisions for creditors to apply liquidation pressures on failing enterprises and for the Government authorities and the judiciary to liquidate enterprises, the resolution of bankruptcy cases has faced many impediments. Enforcement of the legal and regulatory framework is affected by the lack of clear understanding of liquidation and bankruptcy procedures on the part of the creditors and debtors. It is further compounded by (i) inefficient and time-consuming "appeals" and "supervision of appeals" processes, with fresh court fees payable by the creditors at each stage;[19] (ii) lack of understanding by judges of provisions in the relevant laws, and failure to fully enforce provisions of the Law on Bankruptcy and the Law on Pledge; (iii) discriminatory treatment meted out to

[19] Currently, a case goes from the Arbitrazh Court to an Appeals Court, which sends it to a Supervisory Court, which in turn may refer back the case to a lower court for rehearing. In a recent case involving the Debt Restructuring Agency, the banking sector debt-collection agency, 37 such hearings and rehearings were held.

foreign investors and creditors in many cases; and (iv) political interference in some cases, and, as a result, the failure of the judicial process to protect creditors' interests.[20]

## IV. CONCLUSIONS AND RECOMMENDATIONS

### A. Conclusions

42. CGERP has been successful in supporting the Government's initiatives to introduce internationally accepted corporate governance standards and practices in the legal and regulatory framework of the Kyrgyz Republic. The Model Charter adopted for enterprises is in general consistent with, and complementary to, the existing legal framework. The Model Charter and the Handbook have acted as timely and adequate substitutes for more complex legal reforms. The Kyrgyz Republic is the first country in the former Soviet Union to have adopted a structured approach requiring enterprises to comply with internationally accepted practices in corporate governance. The Government has strengthened the environment for enterprise restructuring through bankruptcy and liquidation legislation, implemented a wide-ranging judicial training program for Arbitrazh Court judges and liquidators, and improved the judicial infrastructure.

43. A successful public information and education campaign has become a cornerstone of the reform process in the last three years. CGERP has increased awareness of corporate governance issues among Government officials, entrepreneurs, and common shareholders. While their understanding of the concept and issues is evolving, greater attention is being paid to the need for good internal governance structures and sound shareholder protection. A large number of JSCs have initiated reforms in their internal management systems and adopted modern corporate governance practices. CGERP also supported capacity building of staff from a number of Government agencies and ministries. CGERP successfully reduced the dependence of SOEs on soft budget loans, which were drastically cut as part of the reforms. Financial governance standards have improved through the adoption of IAS in a large number of enterprises.

### B. Lessons Learned

44. The Government implemented a bold reform program, aimed at introducing internationally accepted corporate governance standards in a predominantly control-based economy. Measured against the policy actions specified in Policy Matrix (see Appendixes 1 and 2), CGERP has been successful in meeting its stated objective of improving the performance and efficiency of the enterprise sector. However, while progress has been made in the policy and legal frameworks, the impact of CGERP has been constrained due to (i) weak enforcement of governance standards and enterprise restructuring procedures, as evident from the ad hoc restructuring of Kyrgyz Gasmunaizat following the securities scandal, and the ensuing re-monopolization of the gas sector; (ii) the slow response of a judiciary that has been subject to frequent interference in bankruptcy and enterprise restructuring cases; and (iii) lack of efforts to improve governance in banks.

45. While awareness of corporate governance has improved, the sources of financing corporate growth need to be diversified from a predominantly bank-based or budget-supported system of financing. However, the capital market is at a nascent stage of development. Further,

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[20] In a recent case involving a large Government-owned JSC, one of the suppliers-creditors won a judgement against the JSC. However, the court did not enforce the judgement after receiving a letter from a senior politician.

a large number of enterprises are operating at excess capacity and are in need of restructuring. Unless a vibrant real sector evolves, with financing provided through efficient and diverse sources, the intended benefits of CGERP cannot be fully realized. This calls for a concerted privatization and enterprise restructuring program aimed at divesting Government shares in a large number of JSCs in a structured and expedient manner, and for separating unviable assets from enterprises that need to be liquidated. Such measures will help create an environment of reduced Government dominance, in which private shareholders will take a keen interest in ensuring that enterprises are managed efficiently. Capital market sources of financing would enable periodic reevaluations of the financial health of enterprises, thereby helping improve accountability of managers and key shareholders.

46. Good financial sector governance is fundamental to sound corporate governance. It is imperative that the Government embark on major reforms in the banking sector, initially by giving complete autonomy to NBKR in enforcing existing regulations effectively, then by enacting supplemental legal reforms.

47. It is becoming increasingly evident that the judiciary is not a strong institution. A recent survey on corporate governance sponsored by the European Bank for Reconstruction and Development has reported that investors perceive the legal and enforcement system in the Kyrgyz Republic to provide only a limited degree of protection to their interests, as opposed to Russia (moderate protection) and Kazakhstan (reasonably comprehensive protection). The current LEPS is considered to be weak, necessitating a new JSC law, which is currently being drafted. While a relatively sound legal and regulatory framework exists on bankruptcy, the current state of enforcement leaves much to be desired. The Government needs to undertake an in-depth analysis of the functioning of the arbitration process and formulate more efficient and effective alternatives to strengthen the enforcement of the bankruptcy process.

48. Corporate governance reforms cannot hold ground if public sector governance is not sound. While the process of licensing and registration of enterprises has been simplified, the regulations are not always adhered to, and there are frequent unnecessary inspections fielded by officials from various ministries and Government agencies. The Government recognizes that such unproductive rent-seeking activities should be curbed in order to attract capital and investments to enterprises. It has taken steps to address some of these problems with World Bank support.

## C. Recommendations

### 1. Program-Related

49. **Strengthening of Enforcement of Corporate Governance Standards**: CGERP focused on building the basic legal, regulatory and institutional capacity for corporate governance and enterprise reform. However, the weaknesses in the enforcement of governance standards and insolvency procedures persist and have affected the enterprise performance. The Government, private sector and various stakeholders recognized this shortcoming during the special session held on corporate governance during the Comprehensive Development Framework meeting in Bishkek in July 2000 and an action plan is being developed to address this concern. ADB should monitor the implementation of the action plan.

50. **Enterprise Reforms.** While CGERP addressed the policy and legal issues relative to corporate governance and bankruptcy, it did not directly support enterprise restructuring. Recent evidence shows that there are only few enterprises that can be categorized as profit making,

with others are either incurring losses or technically insolvent. A large majority of these enterprises operate below capacity and lack financial discipline, which has placed considerable strains on domestic banks that extend working capital credit to them. In light of this, it is recommended that future ADB interventions should also assist in restructuring and privatization of enterprises to improve their operational and financial efficiency.

51. **Need for Strengthening Governance of Financial Sector.** The governance in corporate sector is closely tied to governance in the financial sector. In absence of proper governance standards, banks do not induce financial discipline in corporate lending. ADB should address weaknesses in governance of the banking sector through the ongoing Financial Intermediation and Resource Mobilization Program.

52. **Further Follow-Up Action and Additional Assistance:** To ensure sustainability of the policy reforms introduced under CGERP and the TA loan, the Government and ADB plan to continue their efforts to strengthen the corporate and financial sector governance. The Government has requested follow-on support from ADB for strengthening the enforcement of corporate governance standards and bankruptcy processes. Any future support from ADB in this area should have a good balance of policy reforms and enforcement measures.

### 2. General

53. **Consultation with Stakeholder in Program Design:** The difficulties faced with regard to enforcement of insolvency procedures underscore the need for extensive consultations and coordination with the judiciary, to ensure that legal and regulatory measures can be enforced efficiently. Consultations on the process are also essential with other stakeholders, particularly with representatives of minority shareholders and labor unions.

54. **Supportive Public Sector and Civil Service Reforms:** It is important to recognize that corporate governance reforms will be sustainable and effective only if there is a supportive public sector management and civil service environment. In general, it is preferable to launch reforms in a number of areas in a sequential manner, as follows: (i) public sector management and civil service reforms,[21] including a review of salary structures and administrative processes; (ii) legal and regulatory reforms, focusing on strengthening the judicial environment; (iii) measures to strengthen financial sector governance; (iv) development of alternatives to traditional, bank-based sources of financing; (v) real sector reforms to ensure that enterprises function in a vibrant and profitable environment; and (vi) institutional capacity building for enterprise governance. The complex process of transition from a command economy to market orientation has led to the adoption of a mixture of reforms in all of these areas, but not in a holistic manner. At the same time, while the inclusion of reforms in these areas may broaden and deepen the scope of policy interventions supported by ADB and other aid agencies, realistic expectations of outcomes on what is achievable, particularly in the short term, must be formed when designing projects in governance and enterprise restructuring.

[21] The World Bank is preparing a structural adjustment loan focusing on civil service reforms. ADB's future operations in the area of corporate governance and enterprise restructuring will incorporate lessons learned from this and other interventions of multilateral and bilateral aid agencies.

**APPENDIXES**

## COMPLIANCE WITH THE SECOND TRANCHE RELEASE CONDITIONS

| Program Condition | Status of Compliance |
| --- | --- |
| **I. Promote Enterprise Efficiency Through Improved Corporate Governance** | |
| The Borrower shall have caused Kyrgyz Energo, Kyrgyz Telecoms, Kyrgyz Airlines, and Kyrgyz Gasmunaizat to complete implementation of corporate governance structures, including (i) company charters, (ii) appropriate supervisory and management structures, and (iii) monitoring and reporting requirements in compliance with the *Handbook on Best Practice in Corporate Governance*. | **Complied with**. All four enterprises have taken significant steps to strengthen corporate governance structures in accordance with the Handbook. Each has nonoverlapping memberships on the management and supervisory boards, which are elected at the annual general meeting of shareholders. All company charters are in line with the Model Charter, and have been approved by the shareholders at annual general meeting and registered with the Ministry of Justice. |
| The Borrower, through its Corporate Development Center (CDC), shall have completed a public information and education campaign to disseminate the Handbook and explain to stakeholders the basic principles, content, structure, and practice of corporate governance. | **Complied with**. CDC has launched an effective public information and education campaign, published numerous articles and question-and-answer columns, televized programs on governance throughout the Kyrgyz Republic, and widely disseminated the Handbook. Several training workshops, seminars, and conferences have been designed by CDC for shareholders and enterprise and Government officials on basic principles, content, structure, and practice of corporate governance as well as on management, marketing, and corporate finance. |
| The Borrower, through its CDC, shall have completed a training program for senior and middle-level executives of enterprises on (i) best practice in corporate governance, (ii) general management principles, and (iii) marketing and product development. | **Complied with**. Several executive training sessions have been designed and presented throughout the Kyrgyz Republic. About 47 seminars on management, finance, marketing, and corporate governance have been organized, attracting more than 1,400 senior and middle level executives and other trainees from different regions. Around 60 small, medium, and large enterprises have received advisory support on various aspects of management and corporate finance. |
| **II. Impose Financial Discipline on Enterprises** | |
| The Borrower in fiscal year 1998 shall have reduced budget loans to commercial enterprises to not more than Som160 million. | **Complied with**. The 1998 budget had originally allocated Som90 million in loans to commercial enterprises, but only Som73.7 million was disbursed. |
| **III. Strengthen the Legal Framework for Insolvency and Ensure its Enforcement** | |
| The Borrower shall, in accordance with training plans agreed with the Bank and consistent with the Borrower's General Instructions on Insolvency, have completed training for (i) judges of the arbitrazh courts; (ii) other relevant court and Government personnel; and (iii) valuers, receivers, liquidators, and other insolvency professionals in bankruptcy law, procedures, practices, and methods. | **Complied with**. All 50 arbitrazh court judges in the country have received classroom training on corporate, financial, and insolvency concepts; valuation of assets; basic accounting techniques; and interpreting corporate balance sheets. They were also taken on field visits to enterprises and to courts dealing with bankruptcy cases for practical training. Several State property fund valuers and liquidators, and a number of court and Government personnel have also been trained under the Program. The training program was in accordance with the plans agreed with the Bank and with the General Instructions on Insolvency, |
| **IV. Promote Transparency in Financial Accounting and Reporting to Ensure More Effective Monitoring and Control of Enterprises** | |
| The Borrower shall have assisted at least 80 of the enterprises to adopt new national accounting standards in accordance with international accounting standards. | **Complied with**. International Accounting Standards have been introduced in many small and medium enterprises under the Accounting Reform Project supported by the United States Agency for International Development. About 850 joint stock companies have converted to the new Kyrgyz Accounting Standards, which are based on International Accounting Standards, and over 3,000 individual accountants have been trained. |
| **V. Mitigation of Transition Costs** | |
| The Borrower shall have made provision in the 1998 Government budget for at least Som70 million to be allocated to the Social Fund, of which at least Som30 million shall have been allocated for unemployment benefits and at least Som40 million for retraining employees affected by the transition to a market economy. | **Complied with**. The Ministry of Finance had initially allocated Som70 million in the 1998 budget as stipulated. However, a fall in unemployment levels, limited retrenchments, and a better collection of unemployment premiums in 1998 also made the budgetary transfer unnecessary as the Employment Fund was self-sufficient. |

## COMPLIANCE WITH THE MONITORABLE CONDITIONS

| Program Conditions | Status of Compliance |
|---|---|
| **I. Promote Enterprise Efficiency Through Improved Corporate Governance** | |
| Kyrgyz Energo and the corporatized Kyrgyz Telecoms, Kyrgyz Airlines, and Kyrgyz Gasmunaizat to provide corporate statements to the Asian Development Bank (ADB) indicating areas of compliance with the company charter and identifying the remaining areas of noncompliance (October 1997). | **Complied with.** The joint stock companies (JSCs) have provided corporate statements that comply with the Model Charter. Initially, the JSCs had overlapping memberships between their supervisory, executive, and management boards (through Presidential instructions) without ratification at the annual general meetings of shareholders. These problems have been fully rectified in the four JSCs. |
| Kyrgyz Energo and the corporatized Kyrgyz Telecoms, Kyrgyz Airlines, and Kyrgyz Gasmunaizat to submit time-bound plans for instituting changes in their corporate structures and governance mechanisms so as to bring them into compliance with the Handbook (December 1997) | **Complied with**. JSCs submitted time-bound plans to ADB for formulating and implementing effective remedial actions to bring their corporate governance practices in line with internationally accepted standards. They have strengthened their internal audit systems and nominated separate supervisory and management boards for ratification by shareholders. The plans have been effectively implemented in the four JSCs. |
| In accordance with agreements with ADB regarding staffing and functions, establish the CDC, an interdepartmental unit reporting to the Prime Minister's Office, to promote the implementation of the best practice in corporate governance (December 1997). | **Complied with**. CDC was established in October 1997. Expedient Government action was a key factor in CDC's success in achieving the objectives of the Program. In addition to international and domestic consultants, a large number of staff have been seconded from other ministries (Ministry of Finance and Ministry of Justice) and agencies (National Bank, National Securities Commission, and the State Property Fund) to CDC. This significantly strengthened the capacity of CDC to handle multidisciplinary tasks cutting across corporate governance, management, finance, bankruptcy, and legal reforms. |
| Under CDC, and in consultation with ADB, initiate a public information and education campaign to disseminate the *Handbook on Best Practice in Corporate Governance* and explain the basic principles, content, structure, and practice of corporate governance. Train domestic consultants to carry out public information and education functions (January 1998). | **Complied with**. CDC has launched an effective and successful public information campaign under the technical assistance loan. Following the initial "train-the-trainers" program for secondees and domestic experts, several teams were formed within CDC to focus on various areas of corporate governance and management to train enterprise and Government officials. An effective program was developed to disseminate internationally accepted corporate governance standards and practices to enterprises through lectures, conferences, and training programs. |
| Under CDC, and in consultation with ADB, initiate a training program in management and corporate governance principles for senior and middle-level executives of enterprises. Train trainers and develop training materials and manuals (July 1998). | **Complied with**. Three phases were designed. The first focused on training the trainers (i.e., domestic experts and secondees), and comprehensive training materials were prepared during this phase. The other two phases focused on training different levels of enterprise officials and other target groups. |
| **II. Impose Financial Discipline on Enterprises** | |
| Government to provide ADB with reports detailing budgetary allocations, loans, and subsidies made to enterprises (throughout the Program). | **Complied with**. The Government has provided ADB with data and relevant information on transfers and loans made to the enterprise sector. |
| Reduce new budget loans to commercial enterprises to not more than Som80 million, i.e., by 50 percent of the previous year's value, Som160 million (December 1998). | **Complied with**. In the 1999 budget, the Government plans to provide only Som25 million in credits to commercial enterprises. |
| Reduce budget loans to commercial enterprises by 50 percent of the previous years (throughout the Program). | **Complied with**. Recent trends indicate that the limits stipulated will be met by the Government. ADB will continue to monitor progress in this area. |

| Program Conditions | Status of Compliance |
|---|---|
| **III. Promote Domestic and International Competition and Strengthen the Environment for Foreign Direct Investment** | |
| Ensure no new quantitative restrictions are imposed on international trade (throughout the Program). | **Complied with**. Considerable progress has been made on the trade policy front, as reflected by the admission to the World Trade Organization in October 1998, the first country to do so among the Commonwealth of Independent States. There have been no quantitative import restrictions imposed, with the exception of goods that do not comply with safety and health provisions (e.g., military arms, explosives, nuclear materials, etc). |
| No tariffs on imports to be raised except in accordance with World Trade Organization antidumping provisions (throughout the Program). | **Complied with**. A simplified tariff structure is followed, with a flat tariff rate of 10 percent on all imported goods, which is further reduced to 5 percent for goods originating from developing countries, while no tariff is imposed on goods imported from least developed countries. No other exemptions are allowed on tariff duties with effect from September 1998. Overall, the simplified tariff structure has led to a very transparent system with regard to external trade. |
| **IV. Strengthen the Legal Framework for Insolvency and Ensure Its Enforcement** | |
| Fill at least 20 of the 31 judicial vacancies in arbitrazh courts (April 1998). | **Complied with**. As part of its overall efforts to strengthen the judiciary, the Government has filled all the vacancies that were identified at the time of the Program. |
| In consultation with ADB, finalize General Instructions for Implementing Insolvency Procedures to conform with the revised Law on Bankruptcy (February 1998) | **Complied with**. The Government has closely coordinated with ADB in this regard. In 1992, the Government set up a working committee to prepare the Instructions, which were incorporated in the Law on Bankruptcy and approved in December 1998. While the complex nature of the general instructions led to some delays in the necessary amendments, this condition is now fully complied with. |
| In accordance with training plans to be agreed with ADB, and consistent with the finalized general instructions for implementing insolvency procedures, commence a training program for (i) judges in the arbitrazh courts; (ii) other relevant court and Government personnel; and (iii) valuers, receivers, liquidators, and other insolvency professionals (May 1998). | **Complied with**. The training program commenced in January 1999, immediately following the enactment of the new Law on Bankruptcy in December 1998, and has been smoothly implemented. The scope of the program has been expanded to provide training to all judges of the arbitrazh courts. |
| **V. Promote Transparency in Financial Accounting and Reporting to Ensure More Effective Monitoring and Control of Enterprises** | |
| Implement a program to assist 300 enterprises in adopting these standards (December 1997) | **Complied with**. The Ministry of Finance has established a department to develop and approve accounting methodology and standards, promulgate instructions, provide training, and license professional accounting and auditing activities, under a program supported by the United States Agency for International Development on accounting reforms. |
| **VI. Mitigate Transition Costs** | |
| The Social Fund to introduce accounting and reporting systems in accordance with internationally accepted accounting standards (November 1997). | **Compliance under way**. The World Bank is providing technical assistance to the Social Fund in this area under its Social Sector Adjustment Credit, approved in December 1998. |
| Provide budgetary allocation to the Social Fund for transfer to the Employment Fund of Som20 million for training and Som30 million for unemployment benefits (December 1998/1999) | **Complied with**. In the 1999 budget, Som20 million was allocated to cover unemployment benefits of Som150 per month for six months for each retrenched worker, and the associated retraining costs. The Government has assured ADB that any deficits faced by the Employment Fund due to acceleration in the enterprise-restructuring program will be compensated by additional transfers from the budget. |

## CHRONOLOGY OF MAIN EVENTS IN PROGRAM IMPLEMENTATION

| No. | Date | Step Taken |
|---|---|---|
| 1. | 30 Apr 97 | Resolution No. 258 – On Setting up a Steering Committee on Corporate Governance Reforms |
| 2. | 26 Jul 97 | Resolution No. 433 – On Measures Concerning the Implementation of Corporate Governance Procedures [(i) *Handbook on Best Practices in Corporate Governance in the Kyrgyz Republic*, and (ii) Model Charter of a Joint-Stock Company of Open Type)] |
| 3. | 14 Oct 97 | Resolution No. 589 – Measures for Improvement of Industrial Policy and Deepening of Industrial Reforms |
| 4. | 27 Oct 97 | Resolution No. 625 – Establishment of the Corporate Development Center (CDC) |
| 5. | 20 Apr 98 | Resolution No. 205 – Industrial Protection and Trade (setting out the tasks for CDC) |
| 6. | 15 May 98 | Resolution No. 277 – On Making Amendments to Law on Economic Partnerships and Companies, and the Civil Code (stipulating that there be no dual membership on the supervisory and management boards) |
| 7. | 5 Aug 98 | Resolution No. 521 – Follow-up Measures on Resolution No. 589 (expanding the implementation of corporate governance reforms to training for senior management in effectively utilizing capital market opportunities) |
| 8. | 12 Aug 98 | Resolution No. 537 – On the Program of the Government and the National Bank of the Kyrgyz Republic on Structural Transformation in the Economy |
| 9. | 22 Oct 98 | Presidential Decree No. 323 – On Establishment of a Sustainable System of Corporate Governance in the Kyrgyz Republic |
| 10. | 2 Dec 98 | President approves Resolution No. 277, introducing Law No. 148 on Making Changes and Amendments to Some Legislative Acts of the Kyrgyz Republic |
| 11. | 30 Dec 98 | Resolution No. 865 – On Approval of the Implementation of General Bankruptcy Procedures |
| 12. | 30 Dec 98 | Adoption of Law No. 160 on Bankruptcy |
| 13. | 18 Jan–<br>9 Apr 99 | Training Program on Bankruptcy and Liquidation Procedures for 51 Liquidators (Special Administrators) of the State Property Fund |
| 14. | 8 Feb–23<br>Apr 99 | Training Program on Bankruptcy Law, General Procedures and Liquidation for all (55) Arbitrazh Court Judges |

## MAJOR FEATURES OF THE AMENDMENTS TO THE LAW ON BANKRUPTCY AND THE GENERAL RULES ON IMPLEMENTATION

1. The following key features have been incorporated in the recent amendments to the Law on Bankruptcy and the associated rules (the amendments to the Law became effective on 31 December 1998, and the rules became effective on 1 February 1999):

(i) The balance-sheet test for insolvency is eliminated. If a debtor has failed to pay a debt of the requisite size, the debtor is "insolvent" within the meaning of the Law, and a bankruptcy case may be commenced, and this occurs regardless of the contents of any balance sheet.

(ii) Management must cause the debtor to voluntarily begin bankruptcy proceedings if the debtor is generally unable to pay its debts as they fall due. Members of management risk personal liability if they fail to make appropriate recommendations or if they fail to recognize insolvency.

(iii) Valuation of assets as a criterion to judge the special administrator's performance is eliminated. The special administrator must sell to the highest bidder regardless of any prior valuation of assets. Sale of assets is mandated in most circumstances. The special administrator's/court's ability to postpone sale is restricted. It is almost totally restricted if the postponement is done to wait for better sale circumstances.

(iv) The special administrator is independent of the court and of the State Property Fund.

(v) Restructuring is possible and the law and the rules provide detailed guidance. A restructuring is simply a liquidation in which the special administrator chooses certain of the debtor's assets and transfers them to a new company, which the special administrator has created. The special administrator sells the assets to a buyer (or owner of the new company), who receives them free of any encumbrances. The debtor's creditors are paid with the proceeds of the asset sale, and may not seek recourse against the buyer or against the new company.

(vi) The law and the rules provide the courts the power to eliminate interference by political entities with the special administrator's process.

(vii) The special administrator may abandon any property of the debtor if the property is not saleable, or if continued attempts at selling it do not benefit the creditors. The special administrator must follow the abandonment procedure set forth in the rules.

(viii) Rehabilitation is possible, but requires the consent of the creditors. A rehabilitation plan must be rejected by the court if it does not contain independently justified evidence that it will resolve insolvency. The debtor's failure to comply therewith or the court's rejection of the plan results in transfer of the case to the special administrator.

## KYRGYZ GASMUNAIZAT

1. Kyrgyz Gasmunaizat was created through a presidential decree on 4 June 1997, amalgamating two Government-owned enterprises, Kyrgyz Gas and Kyrgyzmunaizat. Following this merger, 10 percent of the shares of the amalgamated enterprises was offered for sale to the general public through coupon auctions, thus converting them into a single joint stock company (JSC). However, given a series of difficulties in the management of Kyrgyz Gasmunaizat, stemming mainly from its financial problems leading to frequent interruptions in gas supplies from Uzbekistan in 1997 and 1998, a presidential decree was issued on 23 September 1998, again splitting Kyrgyz Gasmunaizat back into two enterprises, namely, Kyrgyz Gas and Kyrgyz Gasmunaizat. The decree was issued without any shareholder meeting, citing the extraordinary situation relative to inadequate gas supplies, which had the potential of leading to social unrest.

2. One of the new entities, Kyrgyz Gas, was entrusted with transportation, distribution, and supply of natural and liquefied gas. While it is not very clear what the procedure or rationale was for the division of assets, the Government decided to transfer Som206 million equivalent in fixed assets (out of the total Som308 million equivalent assets of the amalgamated Kyrgyz Gasmunaizat) to Kyrgyz Gas. Further, the Government entrusted Kyrgyz Energo with the management of Kyrgyz Gas, another unclear and unexplained decision, given the financial and administrative difficulties a large entity such as Kyrgyz Energo is likely to face in managing assets outside of its expertise and control. Kyrgyz Gasmunaizat was made responsible for accounts payable and receivable and for loan indebtedness that accumulated on natural and liquefied gas purchases up to 23 September 1998.

3. For a significant time from 23 September 1998, the ownership status of Kyrgyz Gas and Kyrgyz Gasmunaizat remained unclear, since the separation of the single JSC's assets took place without any shareholder ratification. The Government issued a decree on 11 January 1999 entrusting the State Property Fund to hold an extraordinary shareholders' meeting of Kyrgyz Gasmunaizat to consider the creation of Kyrgyz Gas, identify its property status, and to ratify the transfer of Kyrgyz Gas to Kyrgyz Energo's management. A presidential decree issued on 6 February 1999, however, clarified that Kyrgyz Gas would be a JSC (and that the State would *not* expropriate the shares) and that Kyrgyz Energo would no longer be managing Kyrgyz Gas. However, it was not until 4 March 1999, that such a meeting was held in which the transfer of assets received the approval of all shareholders. Based on voting, it was decided that all shareholders, including the minority coupon-auction shareholders, would retain 32.96 percent of their total holdings in JSC Kyrgyz Gasmunaizat, with 67.04 percent of each share being transferred to Kyrgyz Gas.[1] Separate management and supervisory boards were voted upon for each of the two JSCs.

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[1] In the meantime, the general director of Kyrgyz Gasmunaizat borrowed on behalf of the JSC approximately $12 million from several Kyrgyz banks, by placing as collateral the special purpose t-bonds issued by the Government in November 1997 to provide any needed guarantees to the Government of Uzbekistan in the gas trade between the two countries. As a result, the banking sector has come under considerable stress, with a substantial risk that is yet to unfold for the rest of the banking sector. The whereabouts of the $12 million or of the general director are unknown at this point, and a criminal investigation has been initiated. This has placed extreme constraints on the financial health of Kyrgyz Gasmunaizat, which has filed for bankruptcy. Following these events, the Government appointed a new general director to the JSC through a presidential decree. While the Mission has not been provided with any financial statements of Kyrgyz Gasmunaizat, there is anecdotal evidence that the remaining assets of Kyrgyz Gasmunaizat will hardly be adequate to meet a significant portion of the creditors' obligations.

4. While these events introduced a sense of uncertainty, particularly in the first few months of 1999, the Government provided considerable assurances to the Asian Development Bank that these difficult decisions had to be taken in view of the precarious gas supplies during winter. The minutes of the extraordinary shareholders' meeting were made available to the Asian Development Bank, confirming that all the decisions of the Government were placed before, and ratified by, the shareholders.

5. Further, it should be pointed out that the restructuring of Kyrgyz Gasmunaizat, through the transfer of its viable assets to Kyrgyz Gas, was in line with the provisions of the amended Bankruptcy Law (enacted in December 1998). Under the Bankruptcy Law, the assets transferred should be free of any encumbrances. The debtor’s (i.e., Kyrgyz Gasmunaizat) creditors are paid with the proceeds of the sale of assets that remain with Kyrgyz Gasmunaizat, and they cannot seek recourse against the new Kyrgyz Gas.