ADB

Concept Paper

Project Number: 53161-001
July 2019

Proposed Programmatic Approach and Policy-Based Loan for Subprogram 1
Republic of Uzbekistan: Financial Markets Development Program

Asian Development Bank

CURRENCY EQUIVALENTS
(as of 11 June 2019)

Currency unit	–	sum (SUM)
SUM1.00	=	$0.000117
$1.00	=	SUM8518.68

ABBREVIATIONS

ADB	–	Asian Development Bank
CBU	–	Central Bank of Uzbekistan
CMDA	–	Capital Market Development Agency
GDP	–	gross domestic product
SOE	–	state-owned enterprise
TA	–	technical assistance

NOTE

In this report, "$" refers to United States dollars.

Vice-President	Shixin Chen, Operations 1
Director General	Werner E. Liepach, Central and West Asia Department (CWRD)
Director	Tariq H. Niazi, Public Management, Financial Sector and Trade Division, CWRD
Team leader	Syed Ali-Mumtaz H. Shah, Principle Financial Sector Specialist, CWRD
Team members	Marian Therese Bartolome, Senior Operations Assistant, CWRD Begzod M. Djalilov, Senior Economics Officer, Uzbekistan Resident Mission (URM), CWRD Bobir Gafurov, Senior Private Sector Development Officer, URM, CWRD Stephanie Kamal, Public Management Specialist, CWRD Lyle Raquipiso, Senior Economics Officer, CWRD
Peer reviewer	Arup Kumar Chatterjee, Principal Financial Sector Specialist, Sustainable Development and Climate Change Department

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PROGRAM AT A GLANCE

1. Basic Data — **Project Number:** 53161-001

Project Name	Financial Markets Development Program (Subprogram 1)	**Department/Division**	CWRD/CWPF
Country	Uzbekistan	**Executing Agency**	Ministry of Finance
Borrower	Republic of Uzbekistan		

2. Sector

Sector	Subsector(s)	ADB Financing ($ million)
✓ **Finance**	Finance sector development	100.00
	Total	**100.00**

3. Strategic Agenda / **Subcomponents**

Strategic Agenda	Subcomponents
Inclusive economic growth (IEG)	Pillar 1: Economic opportunities, including jobs, created and expanded

Climate Change Information

Climate Change impact on the Project	Low

4. Drivers of Change / **Components**

Drivers of Change	Components
Governance and capacity development (GCD)	Institutional systems and political economy Public financial governance
Private sector development (PSD)	Conducive policy and institutional environment Promotion of private sector investment

Gender Equity and Mainstreaming

No gender elements (NGE)	✓

5. Poverty and SDG Targeting

Geographic Targeting	No
Household Targeting	No
General Intervention on Poverty	No
SDG Targeting	Yes
SDG Goals	SDG17

Location Impact

Nation-wide	High

6. Risk Categorization: Complex

7. Safeguard Categorization **Environment:** C **Involuntary Resettlement:** C **Indigenous Peoples:** C

8. Financing

Modality and Sources	Amount ($ million)
ADB	**100.00**
Sovereign Programmatic Approach Policy-Based Lending (Regular Loan): Ordinary capital resources	100.00
Cofinancing	**0.00**
None	0.00
Counterpart	**0.00**
None	0.00
Total	**100.00**

Currency of ADB Financing: USD

I. THE PROPOSAL

1. The proposed Financial Markets Development Program will support demand and supply measures to broaden and deepen the financial system in Uzbekistan and ground it in a strong legal and regulatory framework. The program is scheduled to be submitted for consideration of the Asian Development Bank (ADB) Board of Directors in the second quarter of 2020.

2. The program was requested by the Government of Uzbekistan as a policy-based lending modality to be disbursed in two subprograms.[1] The policy-based lending will facilitate the design and implementation of reforms necessary to create an enabling environment for the emergence of a competitive securities market. The programmatic approach serves to chronologically sequence the reforms in a multiyear framework and brings the flexibility to incorporate changes where warranted by the country's economic situation and any exogenous shocks.

II. PROGRAM AND RATIONALE

A. Background and Development Constraints

3. The government has accelerated its transition toward a market economy with the adoption of the Strategy on Actions for Further Development of Uzbekistan (2017–2021) and its follow-on Roadmap of Reforms (2019–2021).[2] Each of these recognizes the central role played by banking and capital markets in fostering this transition. The road map, in particular, tasks the government with modernizing and developing financial market infrastructure and services to better meet the needs of the real economy.[3] The introduction of market-based financial instruments (with well-established regulatory frameworks) will mobilize private sector financing to reduce the infrastructure deficit, lower the costs of funding business development needs, and enhance access to finance. Commercially oriented lending and investment practices will enhance capital allocation in the wake of the government's continued prioritization efforts (also prioritized by the road map) and help maintain high rates of economic growth as the state's economic contribution is gradually reduced.

4. ADB's Strategy 2030 accords priority to the development of the finance sector and capital markets to support the growth of the private sector and enhance financial stability.[4] Private sector investment is identified as a key driver of economic growth and a source of employment generation in the course of Uzbekistan's economic transition, and is a strategic area for ADB support, as outlined in ADB's country partnership strategy for Uzbekistan, 2019–2023.[5]

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[1] The program is included in ADB's draft country operations business plan for Uzbekistan, 2020–2022, anticipated for approval in the third quarter of 2019.

[2] Presidential Decree No. UP-4947, dated 7 February 2017; and Presidential Decree No. UP-5614, dated 8 January 2019.

[3] The Government of Uzbekistan's issuance of $1 billion of Eurobonds on 13 February 2019 on the London Stock Exchange shows investors' growing confidence in the country's economic fundamentals and its political will to carry out the reform program. The issuance set a benchmark for corporate issuers and was preceded by the country's first sovereign credit ratings from Standard and Poor's (*BB*-), Fitch (*BB*-), and Moody's (*B1*)—as further indication of the country's efforts to appeal to a broader audience of (international) investors.

[4] ADB. 2018. *Strategy 2030: Achieving a Prosperous, Inclusive, Resilient, and Sustainable Asia and the Pacific*. Manila. Specifically, the program will be aligned with Strategy 2030's operational priority to strengthen governance and institutional capacity (i.e., supporting public management reforms and financial stability).

[5] ADB. 2019. *Country Partnership Strategy: Uzbekistan, 2019–2023—Supporting Economic Transformation.* Manila.

5. **Bank-dominated financial system**. The economy is overly reliant on bank financing—total bank assets account for 52.6% of gross domestic product (GDP) as of the end of 2018.[6] The banking system is highly concentrated, i.e., 77.5% of its assets are owned by the seven largest state-owned banks, the largest of which accounts for 26.3% of total assets.[7] The banks rely on funding sources that expose them to interest rate and liquidity risks (maturity transformation risks, largely from deposits of maturities up to 5 years) and government-directed lending programs at below-market rates—crowding out market funding (and pricing) and narrowing access to credit largely to state-owned enterprises (SOEs).[8] Moreover, the funding structure of Uzbek banks has led them to adopt conservative lending practices, i.e., limiting the tenor of loans, and imposing high collateral requirements and interest rates, which further restricts access to credit.[9]

6. **Marginal and underdeveloped capital markets.** Domestic capital markets currently do not play a significant role in financial intermediation and resource mobilization in the Uzbek economy. The free float market capitalization of the Tashkent Stock Exchange accounted for about 0.5% of the country's GDP as of 31 March 2019,[10] with daily trading liquidity of about $200,000[11]—reflecting both the small scale and low trading liquidity of the exchange. Bond market development is equally constrained. Issuances in the primary market are dominated by government bonds, whereas corporate bond issuances are limited and costly. The government bond market is characterized by short-dated and infrequent issuances, and does not fulfill its role as a benchmark pricing reference; this renders the pricing of securities difficult and corporate bonds less attractive to both issuers and investors.[12] Only 0.33% of the total amount of corporate securities (i.e., shares and bonds) were issued as corporate bonds (totaling SUM198 billion or about $23.5 million) as of 1 March 2019.[13] On the demand side, major institutional investors are state-owned or state-controlled domestic banks. The participation of investors across the maturity spectrum is critical to support market development.[14]

7. Several underlying constraints are preventing the development of the bond market. First, sovereign bond issuances are ad hoc, e.g., no auction calendar is published. Second, the government's debt issuance strategy lacks a clear market development component, and there is no dedicated trading platform, i.e., government securities are transferred to the currency exchange. Third, limited data on outstanding issues or trading in the corporate bond market make investors reluctant to commit funds. Finally, regulatory barriers—e.g., an issuer must be a profitable joint stock company, and a company cannot issue bonds in excess of its capital—limit the issuance of corporate bonds. Both the corporate bond and equity markets suffer from a lack of investor confidence because of weak corporate governance, financial reporting, and auditing

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[6] *CBU Statistical Bulletin*, 2018.

[7] (http://cbu.uz/en/statistics/bankstats/2019/01/158649/), last accessed 13 May 2019.

[8] The International Monetary Fund (IMF) indicates that about 60% of credit is allocated at preferential terms. IMF. 20 November 2018. *Uzbekistan: Staff Concluding Statement of an IMF Staff Visit*. Washington, DC. A 2013 Business Environment Enterprise Performance Survey found that only about one-quarter of small and medium-sized enterprises had a bank loan, while 92% of working capital financing and 82% of fixed asset purchase financing came from internal funds and retained earnings. ADB. Forthcoming. Uzbekistan: Private Sector Assessment. Manila.

[9] The ratio of retail loans to GDP stood at 5% by the end of 2017, indicating the weak penetration of credit, as per Fitch Ratings data.

[10] Capital Market Development Agency data. As of 29 March 2019, 132 companies were listed.

[11] Tashkent Stock Exchange and Silk Capital estimates.

[12] In December 2018, SUM600 billion in government securities were issued after a gap of 6 years (i.e., no government bonds had been issued since 2012). The issuances were in equal amounts of SUM200 billion across three tenors, i.e., 6 months, 1 year, and 3 years.

[13] Central Securities Depository data.

[14] A rough estimate of the current size of institutional investors' assets is SUM7 trillion–SUM8 trillion, or about 1.5% of GDP; it shows that there are substantial assets to be invested in long-term instruments.

practices (and the resulting inability to accurately measure the value of companies issuing securities); and are further hampered by the narrow base of institutional investors.[15] The secondary markets are illiquid because of the absence of market pricing mechanisms and the limited availability of securities, which investors tend to hold until maturity.

B. Policy Reform and ADB's Value Addition

8. The program proposes to introduce reform measures to diversify a predominantly bank-based system of financial intermediation, which will expand the sources of credit and limit the systemic impacts of economic shocks; reduce financing costs by stimulating healthy competition with the banks; and enhance the capital markets' contribution to meeting the increasing financing requirements of a growing economy.[16] The reform program will be guided by a Capital Market Development Strategy and Roadmap (2020–2025), which will be developed under the attached transaction technical assistance (TRTA)—under the purview of the Coordination Council.[17] The road map will advise the sequencing of the reforms in a phased program spanning 2020–2022. Consultations with the government identified the following focus areas:

9. **Improving the legal and regulatory structures for securities market development.** This entails measures to (i) amend securities market laws and regulations with a view to consolidating and removing complexity in the existing framework, broadening market access, and strengthening the legal rights of creditors and shareholders; (ii) enhance the regulatory capacity, oversight procedures, and enforcement powers of the Capital Market Development Agency (CMDA), and step up cooperation with other market regulators (particularly the Central Bank of Uzbekistan [CBU] in regulating commercial banks' activities in the securities market); (iii) align financial reporting, auditing, and disclosure requirements for listed companies with international standards (including strengthening the existing Code of Corporate Governance and with clear directives on accuracy and a periodic disclosure regime); and establish a reliable surveillance and enforcement system.

10. **Increasing the supply and demand of securities.** This involves measures to (i) develop a credible government yield curve and liquid government bond market, including the formulation and pursuance of a strategy to create benchmark issues by increasing the average size of issues and issuing longer tenors as the market matures; (ii) facilitate and expand the issuance of corporate bonds (including the introduction of new instruments such as covered and municipal bonds) and equity securities (concomitantly with the anticipated divestment of SOEs), and improve secondary market trading; (iii) address weaknesses in market information dissemination; and (iv) stimulate institutional investor demand and promote their participation in the capital market. As a crosscutting measure, existing trading platforms and systems will be enhanced.

11. These reforms will complement other ongoing market facilitation initiatives, such as the assistance of the Korea Securities Depository for the development of the Central Securities Depository of Uzbekistan; European Bank for Reconstruction and Development support for the development of the money market, which will boost the liquidity of capital market instruments; and

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[15] The development of the equity market is further constrained by restrictive securities legislation and weak shareholder rights protection practices.

[16] Long-term financial markets present the most viable solution to meeting infrastructure financing needs and the associated prolonged gestation periods of these projects.

[17] The Coordination Council comprises all key stakeholders, including the President's Administration, Parliament, the Ministry of Finance, the Ministry of Economy and Industry, the State Assets Management Agency, the Central Bank of Uzbekistan (CBU), and the Capital Markets Development Agency (CMDA).

ADB support to (i) address the low mortgage finance intermediation by the banks and build capacity for the use of more advanced funding (securitization) mechanisms;[18] and (ii) reduce government-directed lending, support the divestment and stricter governance of SOEs, and introduce risk-based banking supervision (in close collaboration with the World Bank) to improve access to bank lending by the private sector.[19] Furthermore, ADB will combine resources with the United Nations Development Programme and the European Bank for Reconstruction and Development to support the development of the Capital Market Development Strategy and Roadmap (2020–2025).

C. Impacts of the Reform

12. The program's impact will be a well-functioning financial system that supports basic capital and investment needs and the country's longer-term economic objectives, aligned with the road map. The effect of the reforms will be greater capacity and size of the financial markets. The reform areas will be that (i) the legal and regulatory structures for the development of the securities market have improved and (ii) the supply and demand of securities have increased. The reforms will conform to international financial standards and best practices and help implement commitments under the International Organization of Securities Commissions (specifically, the Multilateral Memorandum of Understanding signed by the government in 2018). The design and monitoring framework (initial draft) is in Appendix 1.

D. Development Financing Needs and Budget Support

13. The government has requested policy-based loans totaling $200 million from ADB's ordinary capital resources. The loans will be disbursed as single-tranche policy-based loans of $100 million each for subprograms 1 and 2, in accordance with ADB's *Loan Disbursement Handbook* (2017, as amended from time to time). Subprogram 1 will establish the legal foundations to facilitate market development, while subprogram 2 will deepen these legal reforms and support measures to introduce new financial instruments and promote investor participation. The loan amounts will be confirmed during the fact-finding mission based on budget deficit projections and development financing needs. The policy actions will be complied with prior to approval of the program loan by the Board and the funds will be disbursed upon loan effectiveness.

E. Implementation Arrangements

14. The executing agency will be the Ministry of Finance. The implementing agencies will be the CMDA, Ministry of Finance and CBU. The Coordination Council will oversee and coordinate program implementation, while ADB will maintain close coordination with the multidonor Financial Markets Reform Working Group. The indicative implementation periods are August 2019–July 2020 for subprogram 1 and August 2020–July 2022 for subprogram 2.

III. DUE DILIGENCE REQUIRED

15. Due diligence will be carried out as summarized below:

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[18] ADB. 2019. *Concept Paper: Proposed Policy-Based Loan, Project Loan, and Technical Assistance Grant to the Republic of Uzbekistan for the Mortgage Market Sector Development Program*. Manila. https://www.adb.org/projects/51348-001/main#project-pds.

[19] ADB. 2018. *Report and Recommendation of the President to the Board of Directors: Proposed Programmatic Approach and Policy-Based Loan for Subprogram 1 to the Republic of Uzbekistan for the Economic Management Improvement Program.* Manila.

(i) **Economic and financial**. The economic and financial viability, and the budget support required to prepare, implement, and monitor the proposed reforms, will be assessed to ensure their sustainability and success.
(ii) **Governance**. Uzbekistan's anticorruption policy and legal capacity, public financial management, and other institutional issues and mechanisms will be assessed and supported.
(iii) **Poverty and social**. No adverse poverty, social, or gender issues are anticipated.

16. The program is expected to be classified *category C* for all safeguard aspects.[20]

IV. PROCESSING PLAN

A. Risk Categorization

17. The program is categorized as *complex* since the loan amount exceeds $50 million.

B. Resource Requirements

18. The program will be processed by ADB staff with expertise in the finance and public finance sectors. The staff will dedicate an estimated total of 8 person-months to process the program. Attached TRTA of $500,000 will finance an additional 6 international (15 person-months) and 2 national (3 person-months) experts to undertake diagnostic work, support policy dialogue and the preparation of the Capital Market Development Strategy and Roadmap, and assist in the preparation of the subprograms. The TA will help strengthen market participants' awareness of international standards and build regulators' capacity for supervision and oversight functions. It will be financed by ADB's Technical Assistance Special Fund (TASF 6).

C. Processing Schedule

Proposed Processing Schedule

Milestones	Expected Completion Date
Loan reconnaissance and technical assistance inception mission	August 2019
Loan fact-finding mission	October 2019
Management review meeting	March 2020
Loan negotiations	May 2020
Board consideration	June 2020
Loan signing	July 2020
Loan effectiveness	July 2020

Source: Asian Development Bank estimates.

V. KEY ISSUES

19. The key issues center on (i) providing the extensive capacity development support required to implement the program effectively (through the attached TRTA); and (ii) ensuring strong political commitment and government ownership for initiating key policy changes under the program. A national program coordinator will be mobilized under the TRTA to maintain close coordination with government counterparts on program preparatory activities.[21]

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[20] Initial Poverty and Social Analysis (accessible from the list of linked documents in Appendix 3).

[21] To date, strong government commitment is evidenced by the issuance in January 2019 of a presidential decree to develop the capital markets. Decree of the President of Uzbekistan No. PP-4127 dated 24 January 2019 "On the Organization of the Activity of the Capital Market Development Agency of the Republic of Uzbekistan."

DESIGN AND MONITORING FRAMEWORK
(Initial Draft)

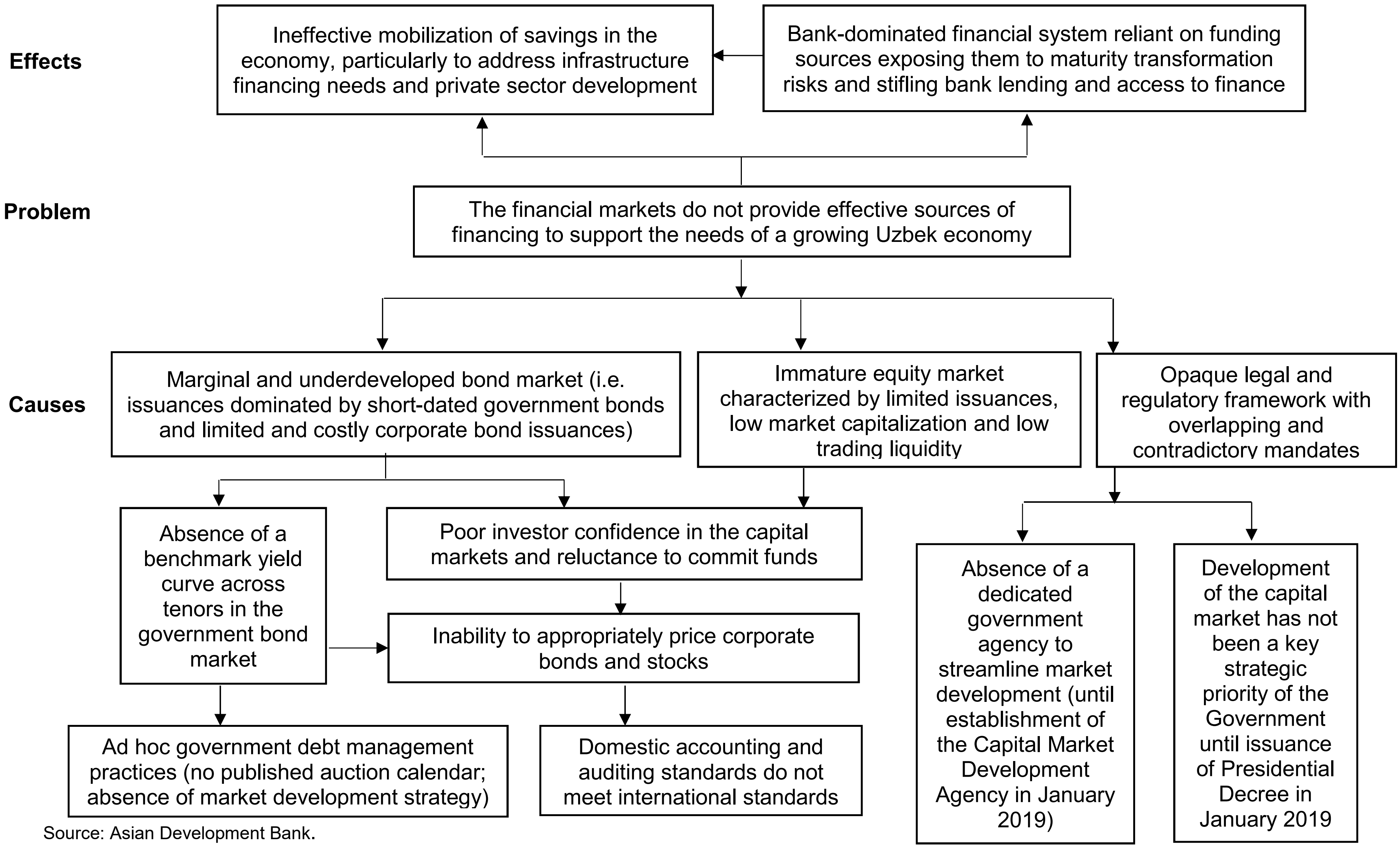
Country's Overarching Development Objective
Well-functioning financial system that supports basic capital and investment needs and the country's long-term economic objectives (Roadmap of Reforms of Uzbekistan, 2019–2021)[a]

Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting Mechanisms	Risks
Effect of the Reform Greater capacity and size of the financial markets	By December 2022: a. Free float stock market capitalization as a percentage of gross domestic product increased to at least 4% (2019 baseline: 0.5%) b. Corporate bond issuance as a percentage of total amount of outstanding corporate securities increased to at least 1% (2019 baseline: 0.33%) c. Daily liquidity in the equity market increased to $0.5 million (2019 baseline: $0.2 million) d. The number of listed companies in the equity market increased to 170 (2019 baseline: 132 listed companies)	a.–d. The State Committee of the Republic of Uzbekistan on Statistics	Shift in political priorities results in loss of buy-in for implementing critical reforms. Macroeconomic downturn
Reform Areas 1. The legal and regulatory structures for the development of the securities market have improved	**Indicative Policy Actions** By July 2020: 1.1 Proposal to amend the joint stock company law submitted by the Cabinet of Ministers to the Parliament (2019 baseline: law not amended) 1.2 Proposal to amend the securities law submitted by the Cabinet of Ministers to the Parliament (2019 baseline: law not amended) 1.3 Proposal to amend the companies law submitted by the Cabinet of Ministers to	1.1–1.6. Ministry of Finance, Central Bank of Uzbekistan, and Capital Market Development Agency reports	Delays caused by sudden changes in administrative procedures, ministry leadership, and/or major staff turnover

Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting Mechanisms	Risks
	the Parliament (2019 baseline: law not amended) 1.4 Code of Corporate Governance amended (2019 baseline: not amended) By July 2022: 1.5 Rules on the primary auction market for government securities issued (2019 baseline: not issued) 1.6 Rules for corporate bonds issued (2019 baseline: not issued)		
2. The supply and demand of securities have increased	By July 2020: 2.1 Auction calendar for government securities on a biannual basis issued (2018 baseline: not issued) 2.2 Tashkent municipal bonds issued by June 2020 (2019 baseline: none issued) By July 2022: 2.3 At least five state-owned enterprises are partially listed (2019 baseline: not listed) 2.4 Covered bonds issued by June 2020 (2019 baseline: not issued)	2.1–2.4. Ministry of Finance, Central Bank of Uzbekistan, and Capital Market Development Agency reports	
Budget Support Asian Development Bank: Subprogram 1: $100 million (regular ordinary capital resources loan) Subprogram 2: $100 million (regular ordinary capital resources loan) Technical Assistance Special Fund (TASF 6): $500,000			

[a] Government of Uzbekistan. 2019. *Roadmap of Reforms of Uzbekistan, 2019–2021.* Tashkent.
Source: Asian Development Bank.

PROBLEM TREE



Source: Asian Development Bank.

LIST OF LINKED DOCUMENTS

http://www.adb.org/Documents/LinkedDocs/?id=53161-001-ConceptPaper

1. Initial Poverty and Social Analysis
2. Technical Assistance for Program Preparation