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The Finance in the Capital Market and Credit Rating in Uzbekistan

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［Uzbekistan］

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1. Financial/Capital Market in Uzbekistan

Uzbekistan has enjoyed relatively strong economic growth in recent years because of a favorable export environment and prudent fiscal and monetary policies. Current account balance has been positive for the last 9 years except for 2001 and as a result, the foreign exchange reserves are estimated to have risen to approximately 10 billion dollars. But, from the second half of 2008, the economy started slowing as the global economic downturn is impacting the economy (Table 1).

The domestic financial sector was not directly affected due to the isolated and underdeveloped nature of the financial system. The banking sector and capital market in Uzbekistan is not yet well developed. The government has taken a gradual approach in economic reform. Similarly, reforms in the banking sector and capital market are slowly undertaken. The deposit base and penetration (ratio of loans and assets to GDP) are one of the lowest in CIS countries. As indicated in Figure 1, credit to economy/GDP and broad money /GDP are quite low. Credit to economy was about 38% of GDP in 2001, however, it declined to around 14% in 2007, which was low compared to other CIS countries. The state-owned banks are predominant in the banking system (Figure 2). Over half of the assets, capital, and loan portfolio in the Uzbek banking are possessed by state banks. The banking system is concentrated in Uzbekistan since the five largest banks own 70% of assets. Government guaranteed loans are still significant, albeit they are declining every year (Figure 3).

Table 1: Uzbekistan Profile

	2000	2001	2002	2003	2004	2005	2006	2007	2008
POPULATION (mn)	24.3	24.7	25.1	25.5	25.8	26.2	26.5	26.9 '	27.2*
GDP per capita (US$)	556.0	466.0	382.0	396.0	465.0	547.0	643.0	830.0	1026.0*
GDP (US$ bn)	13.7	11.6	9.6	10.1	12.0	14.3	17.0	22.3	27.9*
GDP real growth	3.8	4.2	4.0	4.2	7.7	7.0	7.3	9.5	9.0*
Consumer prices	25.0	27.2	27.3	11.6	6.6	10.0	14.2	12.3	12.7*
Trade balance ($ mn)	494	186	324	835	1202	1447	2055	2348.0 '	3440.0*
Merchandise exports, fob	2935	2740	2510	3240	4263	4757	5842	6791.0 '	10030.0*
% change over previous year	N.A	4.6	-8.4	29.1	31.6	11.6	18.0	42.9	47.7*
Merchandise imports, fob	2441	2554	2186	2405	3061	3310	3787	4444.0 '	6590.0*
% change over previous year	N.A	4.6	-14.4	10.1	27.3	8.1	16.0	49.2	48.3*
Current A/C balance ($ mn)	215	-113	117	881	1215	1949	2933	4267.0 '	4472.0*
% of GDP	1.6	-1.0	1.6	8.9	10.0	13.7	18.4	19.2 '	16.8*
Reserves ($ mn)	1273	1212	1215	1659	2146	2895	4604	7413.0 '	10145.0*
(Months of imports)	5.2	4.6	5.1	5.1	6.3	7.4	7.9	10.2 '	11.6*
External Debt ($ mn)	4634	4876	4798	4249	4322	4133	3853	3913.0 '	4095.0*
% of GDP	34.2	43.6	50.3	42.0	36.2	29.1	22.7	17.6 '	15.4*
% of Exports	157.9	177.9	191.1	131.1	101.4	86.9	65.9	57.6	40.8*
Debt Service Ratio (%)	25.9	26.8	25.2	21.3	17.1	14.1	12.7	8.6 '	7.6*
Yield on 6 month treasury bill	17.1	17.1	17.1	11.0	11.6	12.4	11.8		
RSE Index (end-period)								87.0	97.0
Exchange rate (Sum/$, average)	236.6	422.9	885.0	995.5	999.2	1072.3	1219.8	1263.7	N.A

Notes: Symbol ' indicates estimated and * indicates provisional figures.
Source: ADB, IMF, World Bank

Figure 1: Financial Intermediation in Uzbekistan

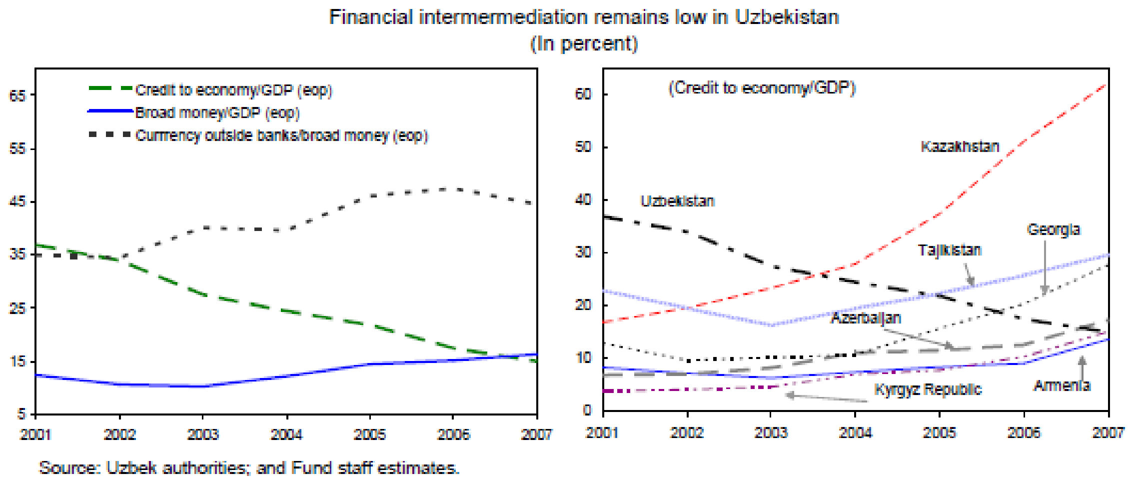
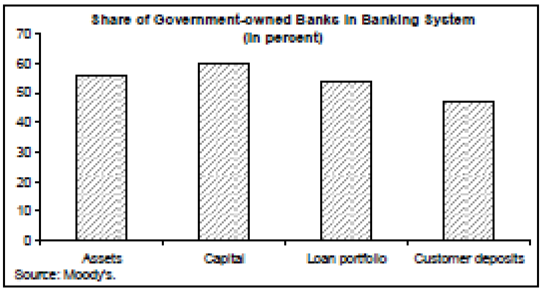
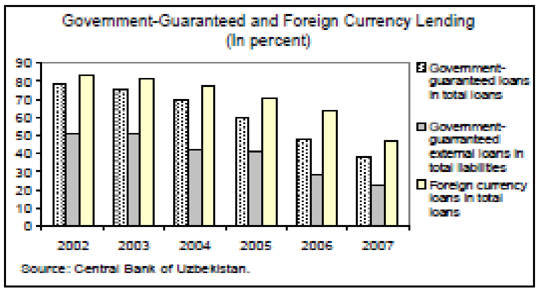


Figure 2: Share of state-owned banks



Source: IMF

Figure 3: Government-guaranteed loans



Source: IMF

(1) General feature of the capital markets in Uzbekistan

Uzbekistan had to start from the scratch in building the capital markets, since markets for government debt, enterprise debt, and equities were absent when the country became independent in 1991. The capital market in Uzbekistan is at the inception stage and still very small. In 2006, capitalization of equity market was only 1.6 billion dollars, equivalent to 10.2% of GDP. In Central Asia, the Kazak capital market is the most developed, where capitalization of equity market was 56.6 billion dollars, equivalent to 70.4% of GDP in 2006 (Table 2 & 3). Equity issues have begun during 1990s in the process of mass privatization and de-monopolization. The majority of equity issues were carried out by non-listed companies, while the equity issues of listed companies were not so significant.

There were 1925 joint stock companies registered in Uzbekistan in 2007, of which 75 % are state-owned. The nominal value of the shares of all joint stock companies amount to $2.5 billion equivalent. At the end of 2007, only 10 companies were listed on the Republic Stock Exchange Tashkent (RSET). However, the number has increased to 18 as of end of June 2008, albeit very small. The majority of the listed companies are commercial banks, most of which are state owned or controlled. In 2007, 163 shares amounting to approximately $380 million equivalent were issued, of which $301 million (1.4% of GDP) equivalent were not related to privatization. The largest issuer was the oil and gas company Uzneftegazkazibchikarish ($77 million equivalent), followed by Uzpromstroybank ($56 million), Pakhtabank ($50 million), Gallabank ($30 million), Mikrokreditbank ($17 million), and Chirchikskiy Transformator Plant ($14 million). Altogether, 18 banks issued shares which amounted to $196 million equivalent in 2007. By sector, banks were the most active equity issuers. This is because capital requirements for banks have been increased and banks were required to sell at least 25% of issues through the stock exchange. In Uzbekistan, only a small amount of shares are issued through the stock exchange; only $38 million equivalent was raised at the exchange in 2007. It is estimated that the amount of capital raised in 2007 was about 1 % of GDP.

Secondary market is characterized by thin turnover. In 2007, less than 9,000 transactions took place at the stock exchange, namely, around 40 on average per trading day. An additional 1,200 transactions occurred at the formal OTC market. In terms of amount secondary market trading was equivalent to mere $71 million equivalent, of which the stock exchange accounted for 86% and the rest was by the OTC market. Foreign investors are allowed to invest in the stock exchange and they are mainly from EU, Korea, German, US, and Russia. Approximate share of foreign investor turnover is 15%. RSET began to calculate a share index called "Tasix" from 2000. As volumes of trades and share prices remain volatile, the index fluctuation has been extremely high. The index was 107 on May 7 in 2007, declined to 20 on September 7 in 2007, rose to 513 on September 8 in 2008, fell to 97 on December 8 in 2008, and again rose to 663 on January 9 in 2009, indicating volatile and speculative market.

Table 2: Capital market in selected countries (2006)

	Equity market capitalization		Corporate bond in circulation	
	US$ billion	%GDP	US$ billion	%GDP
Central and West Asia				
Uzbekistan	1.6	10.2	0.0	0.2
Kazakhstan	56.6	70.4	12.2	15.0
Kyrgys Re.	0.1	3.1	0.0	0.1
Georgia	0.7	8.9	0.0	0.0
Armenia	0.1	0.8	0.0	0.0
Other Asian countries				
China	2426.3	90.9	397.9	14.9
India	818.9	90.4	20.8	2.3
Indonesia	138.9	38.1	6.8	1.9
Thailand	139.6	67.7	36.9	17.9
Malaysia	235.4	158.0	60.9	40.9
Pakistan	45.5	35.3	0.5	0.4
Philippines	68.4	58.5	1.5	1.3
Vietnam	9.1	15.0	0.4	0.7

Source: ADB, IMF, World Bank, national securities market regulators

Table 3: Equity Markets (2007)

	Kazakhstan	Kyrgyz Republic	Uzbekistan
Number of joint stock companies	2,200	909	1925
of which state owned	75%	40-6%	75%
of which open	n.a.	909	most
of which public	n.a.	71 b	788 c
Number of listed companies	69	10	10
Capitalization (official)	$54 billion	$150 million	$1.6 billion
as percent of gross domestic product	51%	4%	9%
Number of equity issues	144	77	163
Total amount of equity issues	$4.1 billion	$57 million	$380 million
of which aimed at capital mobilization a	$2-3 billion	$35 million	$220 million
Number of companies traded at exchange	73	200-300	420
Secondary market volume	$6.7 billion	$150 million	$71 million
as percent of capitalization	13%	24% d	4%
Transactions per day at main exchange	22 e	20	40

a ADB staff estimates.
b With more than 200 shareholders and traded
c With more than 800 shareholders.
d Only shares of listed companies.
e 2006
Sources: ADB, national securities market regulators and exchanges.

Bond market is at an early stage of development. Bond market is comprised of government, central bank bills and corporate bonds. Prior to 1996, there were no debt instruments. In March 1996, 3 month treasury bills were issued for the first time, and 6 month treasury bills were issued in the following year. Central Bank also issued bills. The major aim of the government in issuing T-bills was to finance budget deficits using non-inflationary source. The Central Bank issued bills in an attempt to conduct open market operations to influence market liquidity and market interest rates. In addition, the government started to issue 9 month and 12 month treasury bills during 1998-1999. The number of issues and the volume of shorter treasury bills have been on the decrease since the introduction of longer maturity bills and more than half of treasury bills are now accounted for by maturity in excess of 12 months. However, access to treasury bills was restricted to legal entities and residents of Uzbekistan. According to the Central Bank, the market in treasury bills was very shallow with only 19% of the outstanding stock held by the non-bank public in January 2005. This is due primarily to (1) low yields compared to inflation and the high return on holding foreign currency notes ; (2) the absence of permission for banks to sell the bonds to the public outside the auction; and (3) the non-existence of repurchase agreement operations between banks and the public based on the T-bills in banks' portfolios. Consequently, the development of government securities is limited and they do not provide benchmarks due to illiquid secondary market.

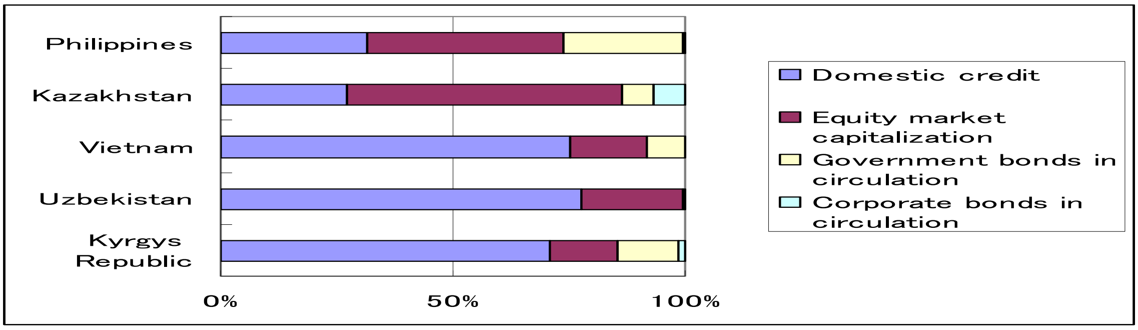
Corporate bond market did not exist until 1999, when only a small amount of corporate bond was issued for the first time. During 2000-2001, the bond was issued, but in small amounts. Corporate bond market was somewhat invigorated from 2002, as regulatory changes removed restrictions on the size of corporate bond issues. However, the corporate bond market is hampered due to poor market infrastructure, limited institutional investors and lack of creditworthy private companies.

In recognition of the importance to develop an orderly, fair and efficient capital market for resource mobilization, intermediation and investment opportunity, the government obtained a Technical Assistance[1] from the Asian Development Bank in 2003.

(2) Financial markets and corporate finance

As capital market is not yet developed, banks play a predominant role in corporate finance in Uzbekistan. As shown in Figure 4, credit market is the main source for corporate finance followed by equity market, and bond market is still insignificant in corporate finance. In Central Asia, Kazakhstan is the most developed country in equity and bond market.

Figure 4: Channels of local currency funding (end-2006)



Source: ADB, BIS, World Bank, national statistics, calculated by the author.

Banking sector assets were equivalent to 33% of GDP in Uzbekistan in 2007. This figure is substantially low compared to 92% of GDP in Kazakhstan, but slightly higher than that in the Kyrgyz Republic. The banking sector is highly concentrated and segmented. As of the end of 2007 there were 28 banks including 5 banks with foreign participation (Table 4). The Uzbek banking sector is concentrated; large state-owned financial institutions with three fully state-owned banks accounting for 56% of total assets and 60% of total capital of the entire banking system. The National Bank of Uzbekistan, a state-owned bank, is the largest commercial banking institution in Uzbekistan, and state banks are virtually the agents of the government in implementing the government development strategy. While there are private banks and banks with foreign participation they are still small niche players. The non-performing loans ranged between 3.0 and 10.9 % during 2000-2006. However, they are presumably higher because, in principle, banks do not have to make provisions against government guaranteed loans. The banks are closely monitored by the government, which imposes non-core functions including tax withholding and financial oversight

[1] Technical Assistance to the Republic of Uzbekistan for "Development of the Capital Market" (TA No. 4146-UZB, approved in July 2003 for $200,000).

of firms on the banks. Therefore, the confidence in the banking sector is very low in Uzbekistan, resulting in low deposit rates and low intermediation. International financial institutions are of the view that the banking sector needs to be reformed so as to become one of the key drivers of the economy. The goal of the reforms is to attain a reliable banking system, which can provide business enterprises and sectors of economy with sufficient financial resources. In order to materialize this, the banking sector is required to gain confidence and trust as well as reducing the intervention by the state. Trend of interest rates, inflation rates, and domestic credit during 2000-2007 is presented in Table 5.

Table 4: Banking sector indicators

	2000	2001	2002	2003	2004	2005	2006	2007
Number of banks (with foreign participation)	34(6)	38(6)	35(6)	33(5)	31(5)	29(5)	28(5)	28(5)
Asset share of state-owned banks (%)	77.5	80.4	73.7	70.0	67.6	65.2		
Non-performing loans (%)	3.0	5.1	8.5	10.9	9.3	8.9	7.3	

Sources: IMF, EBRD, Center for Economic Research

Table 5: Interest rates, inflation rates, and domestic credit

	2000	2001	2002	2003	2004	2005	2006	2007
Refinancing rate (%)	42.6	24.0	30.0	26.7	29.7	24.3	20.0	15.0
Treasury bill (6 months) rate	17.1	17.1	17.1	11.0	11.6	12.4	11.8	
Deposit rate	18.8	21.2	26.0	23.0	18.5	15.5	15.0	
Lending rate	27.6	27.6	33.4	28.1	21.2	19.9	21.0	
Consumer prices (% change)	25.0	27.2	27.3	11.6	6.6	10.0	14.2	12.3
Domestic credit (bln sum)	983	1961	2798	3127	3410	3853	4100	
Domestic credit (% change)	88.8	90.8	40.9	11.8	9.0	13.0	6.4	

Sources: IMF, EBRD, Center for Economic Research

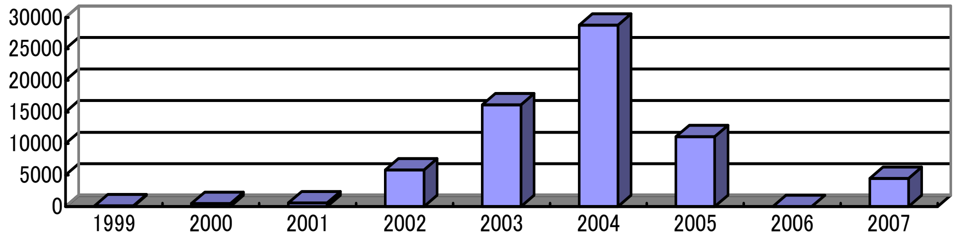
The development of commercial banking in Uzbekistan has been affected by direct government intervention in foreign exchange and financial markets. Initially, the rule limiting enterprises to hold accounts with only one bank was introduced, which seriously undermined competition among banks. Moreover, enterprise deposits were allowed to be withdrawn only for the payment of wages and travel expenses in accordance with quarterly cash plans. Both rules were abolished at a later stage (in 1998 and 2002, respectively), which should improve competition among banks and increase the trustworthiness of the banking sector. However, market-based finance remains largely underdeveloped and banks play only a limited role in the intermediation of domestic savings.

(3) Bond markets in Uzbekistan

The Uzbek government first introduced treasury bills as a first step to develop the bond market in 1996. Following the issue of short-term T-bills, the government introduced medium-term treasury bonds with eighteen month maturity terms in 2005 in the wake of the decision by the government to issue government securities with maturities of up to five years. At the end of 2006, government bonds in circulation amounted to $37 million equivalent, indicating a mere 0.22% of GDP. Maturity periods were further extended to two and three years in 2007. Twenty seven government bonds equivalent to $33 million (0.1% of GDP) were issued in 2007, while circulated government bonds amounted to $41 million equivalent at the end of 2007. In spite of some progress in terms of number and maturity, the government bond market is still very small. The investors are mainly state owned or controlled banks, state owned firms, and other financial institutions such as state owned insurance companies. Banks and insurance companies are required by the government to hold a specified percentage of their reserves and assets in government securities. Because of this, nominal yields of government securities are very low and real rates are negative. Although there is no public information, yields of government securities are substantially lower than those of corporate bonds and negative in real terms.

Corporate bond market came into existence only in 1999. After a vey slow start with mini-size corporate bond, the market for corporate bonds picked up during 2003 and 2004. The peak was in 2004. There were 23 issues of corporate bonds in 2004 worth around 29 billion sum ($26 million equivalent). But, the market has shrunken since 2005 due to defaults of a few companies (limited liability companies). The number of bond issue decreased to 21 issues worth 11.1 billion sum in 2005, and only one issue was made in 2006. These defaults exposed serious gaps in the regulatory and supervisory framework. The government announced a new regulation following the defaults, in that only open joint stock companies that have complied with specified financial performance ratios over the preceding three years can issue bonds up to a total amount equivalent to their capital. The corporate bond market has recovered somewhat in 2007, with two primary bond placements worth 4.5 billion sum, one by a pharmacy company and the other by Capital Bank. The bond of Capital Bank had a maturity of ten years. In total, 101 corporate bonds equivalent to $71 million were issued in Uzbekistan during 1999-2007 (Figure 5). The volume of corporate bonds in circulation had reached a peak in 2004 at $40 million (0.35% of GDP) equivalent. At the end of 2007, 33 bonds amounting to $20 million equivalent were in circulation (Appendix 1). While the primary placement was on the decline, the volume of transaction in the secondary market has been on the increase during 2005-2007 partly to compensate for the poor primary market. Corporate bonds used to be traded at both the stock exchange and interbank, however, trading at the stock exchange was suspended in the beginning of 2008. Trading was thin with only three transactions totaling $600,000 equivalent in 2007.

Figure 5: Corporate bond issue in Uzbekistan (million sum)

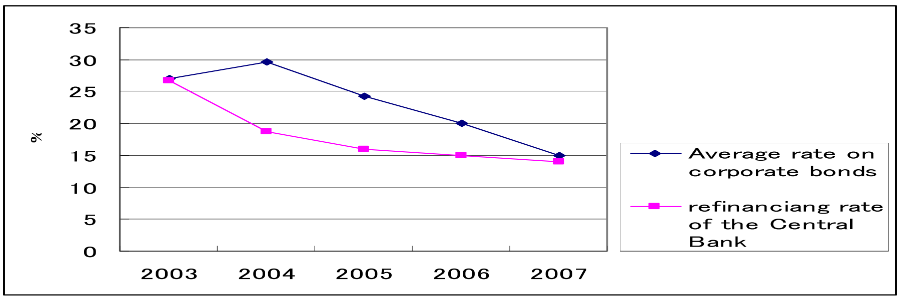


Source: Center for Coordination and Control of the Securities Market

Ministry of Finance (MOF) is a regulator of sovereign bonds and the MOF formulates a policy on regulation of government securities. Central Bank of Uzbekistan (CBU) is a basic regulator on banks. Commercial banks must be rated every year for the purpose of transparency and development of banking in accordance with the 'Laws on rating of commercial banks'. The law was enacted for the healthy development of banking sector as banks are expected to issue more bonds in the future. CBU also regulate bill of exchange issued by banks and companies. Center for Coordination and Control of the Securities Market (CCCSM) is a registry of every bond issue. It checks the criteria and coordinates with CBU. Regulation was issued in February 2007 to regulate the credit rating agency with a view to establishing elaborate rating methodology and profitability assessment. CCCSM checks the adequacy of rating from the viewpoint of business solvency, profitability, and financial stability. CCCSM believes that rating should be simple and clear.

Central Bank gradually reduced the refinancing rate over the 2003-2007 periods subsequent to a decline in inflation. Average rate on corporate bonds was in general higher than the refinancing rate of the Central Bank during 2003-2007. While there was a significant difference between the two rates between 2004 and 2006, they became vey close in 2007 (Figure 6). This indicates that tapping the bond market is cheaper than borrowing from the banks. However, it does not necessary proceed this way because quite a few firms are able to borrow from the state-banks under government sponsored lending scheme. Consequently, issuers of corporate bonds are mostly private firms.

Figure 6: Average rate on corporate bonds and refinancing rate of the Central Bank



Source: Center for Coordination and Control of the Securities Market

(4) Constraints on development of bond market

The bond market is a crucial component of a well functioning financial system. The market provides an alternative to firms in securing necessary financial resources. Besides, it is an important instrument for the functioning of the Central Bank in conducting monetary policies. Open market operations are little used by the Central Bank because the magnitude of the securities is limited and access to them is restricted. The bond market in Uzbekistan remains underdeveloped. The scope, volume and liquidity of bonds traded are limited. While there has been some advancement in the development of bond market, there are a number of constraints to further develop the market.

The market for government securities has improved over the years in terms of maturity; however, it has made little progress in terms of access to the market, transparency, and liquidity in the secondary market. Secondary market is of crucial importance since it provides a benchmark for other financial instruments in the country. The development of corporate bond market vitally depends on the accelerated process of privatization. Although privatization of small and medium sized companies has been more or less accomplished, privatization of large scale companies is halfway. In addition, institution building measures like introduction of adequate legislation, the development of market infrastructure and enhancing the investment literacy of general public as well as strictly selected government bank lending to priority sectors are required for the development of corporate bond market in Uzbekistan.

Non-bank institutional investors (NBFI) have also to be developed. An expansion in the activities of NBFI can become a vital vehicle in the accumulation of savings and stimulation of investment conducive to underpin economic growth. At present, major institutional investors are banks. As the government put emphasis on the development of the banking sector, the non-bank financial institutions remained in a nascent stage of development. Few legislative and regulatory documents exist which regulate the activities of non-banks. Currently, there is only one state insurance company "Madad", and approximately 30 private insurance companies exist. However, the variety and quality of its services are rather limited and total insurance sector assets were equivalent to $150 million (less than 1% of GDP) at the end of 2007. Premiums collected in 2007 were equivalent to $56 million (0.3% of GDP). There is a good possibility that insurance sector might become major institutional investors along with banks, provided adequate regulatory and legal framework is put in place.

The 13 investment funds had total net assets equivalent to $2.4 million at the end of 2007. The pension system has remained in an embryonic stage of development with only one state-owned pension fund with assets equivalent to 0.1% of GDP. However, it is not allowed to invest in corporate securities. The state pension fund has to be reformed in parallel with the creation of private pension fund to ensure that pension funds play an important role for the development of bond market in Uzbekistan.

(5) Corporate debt market

As mentioned above, major financial resources for corporate financing are bank loans. The dominance of banking sector in corporate finance is a reflection of underdevelopment of other sources of debt instruments. Certificate of deposits (CD) and corporate bonds are issued by banks and enterprises, but, they are small amounts. One of the reasons for the slow development of debt instruments is the government sponsored policy-based loan program, by which corporate sectors can avail at low interest rate.

Bond market accounts for a mere 0.2% of GDP in 2006. Corporate debt market has to be developed in order to provide additional sources of corporate financing. Since the yields of corporate bonds are relatively high, they can become good investment. The past experiences of defaults are acting as deterrent to buy corporate bonds. Information disclosure and accounting standards have to be improved. At the same time, credit rating system needs improvement to send a right signal to investors.

Corporate bond is regulated and supervised by the CCCSM, which belongs to State Property Committee (SPC). CCCSM was created by presidential decree in March of 1996 under SPC, and replaced the State Commission on Securities established under the Ministry of Finance in 1995. In 1998, CCCSM became a full member of the International Organization of Securities Commissions (IOSCO), a private organization that promotes adoption of international best practice standards of securities regulation among its members. Pursuant to IOSCO membership requirements, CCCSM conducted a self-assessment of its compliance with IOSCO principles and identified, among others, the following gaps that need to be addressed:
(i) methodology for providing clear and comprehensive interpretations of laws and regulations to the public; (ii) professional staff training; (iii) development of self-regulating organizations (role and regulations); (iv) development of investigation and surveillance techniques; (v) coordination with NBU on regulation of bank securities activities; (vi) disclosure requirements for issuers, including collective investment schemes, accounting requirements, and effective sanctions for noncompliance; and (vii) protection of minority shareholder rights. With respect to compliance with the IOSCO principle on the operational independence of the regulator, CCCSM has not committed to the timing for full implementation. It is vitally important that CCCSM implements the measures necessary to stop the gaps identified with a view to sound development of corporate bond market.

(6) Relevant organizations/institutions

The National Depository Vaqt was established in 1994 as part of the securities market infrastructure. It acted as the major registration and depository system in Uzbekistan up to 1999.

However, with the government Resolution ‘On establishment and activities of a Central Depository’, a two-tier system of depositories was introduced in May 1999 and the Vaqt was downgraded to the status of a tier-two depository. Since 2000, the number of private depositories has increased to more than 30 entities, including 12 subsidiaries of the National Depository Vaqt. With increased competition the market share of Vaqt steadily decreased.

The National Institute of Credit Histories (NIKI) was established with the participation of the Central Bank of Uzbekistan. All of the Uzbek banks are required to contribute to and can receive data on borrowers from the NIKI database.

2. Credit Rating agencies in Uzbekistan

(1) General features of credit rating agencies

Credit rating in Uzbekistan is still at an early stage of development. There are three credit rating agencies, namely, Ahbor Rating, Prime Rating Services, and Saipro. However, there is little information on Prime Rating Services and Saipro.

Ahbor Rating was established in 1996 by Uzbekistan Banking Association in conjunction with an enactment of the “Law on Development of Banking Sector” (See Table 6 for profiles of Ahbor Rating). It is a closed stock company, wholly owned by Uzbekistan Banking Association. Because of this, there may be a possibility of a conflict of interest. The main purpose of establishment of Ahbor Rating is to provide infrastructure for future list companies and to invite investors from abroad. Ahbor Rating does not rate government enterprises. Rating services started in 2007. Between the periods of 1996-2006, Ahbor Rating was mainly analyzing banks, insurance companies, providing consultancy services, etc. in addition to defining credit rating methodology.

The services of credit ratings involve the followings groups of clients:

• Commercial banks, insurance companies and other financial institutions;
• Debt securities of banks and other financial institutions;
• Bonds and other promissory securities of enterprises of non-financial sector; and
• Corporate management in financial institutions.

Saipro was set up in 2006 and focuses mainly on insurance companies. Prime Rating was established in 2007, but it is alleged to have a problem because it mainly rates the subsidiary companies of shareholders for the purpose of fund raising.

As the history of credit rating started in 2007, the number and type of ratings is still small and the rating is mostly concentrated on entity rating. Corporate bond issue rating is limited because a small number of corporate bonds are issued each year. Therefore, it might be said that credit rating agencies are at the stage of developing rating skill. Credit ratings of Ahbor Rating appear at Appendix 1. With respect to the transition matrix, it is shown as indicative only since total number of ratings as well as rating history in Uzbekistan is not significant (Table 7).

Table 6: Profiles of Credit Rating Agencies in Uzbekistan

	Ahbor Rating
1 Year of establishment	**1996**
2 status/nature	Independent Uzbek agency (by Uzbekistan Banking Association)
3 Ownership structure	Uzbekistan Banking Association
4 Covered issues	2 issues and 29 issuers (November 2008)
5 Major activities	
①credit ratings and risk assessment;	Rating responsible for Local scale (local currency) under two categories: long-term and issuer ratings
-Rating schemes	①Debt instruments ②Issuer Rating
-clients/ assigned bodies	Corporate sector companies; Banks/Financial institutions; Insurance companies
- others	Promissory securities of enterprises of non-financial sector
②Economic / industrial researches	responsible by Ahbor-Rating
③management advisory services	Corporate management in financial institutions
④Others	
6 Rating Methodology	Factors considered:
	External environment and sector risks; Market position of company and efficiency of its activity; Quality of management; Financial indexes of company (estimation of stability of profit and cash flow; structure of capital and debt of company, quality of its assets and liquidity; investment criteria)
7 Mapping (long-term)	①Long-term (uzA++〜uzA), ②Long-term(uzB++〜uzB); ③Long-term(uzC++〜uzC), □ Long-term(uzD)
8 Rating Outputs	Transition study
9 Major focus on rating and analysis	Assess future cash generation capability and debt servicing ability of the issuer. An in-depth study of the external environment and sector as well as an evaluation of the strengths and weaknesses of the company
10 Special features	Russian credit rating agency (AKM) assisted in developing credit rating methodology. Fitch provided credit rating seminar for three days in 2005.

Source: Abhor Rating

Table 7: Transition Matrix of Abhor Rating

	Amount of issuer's	Upgrade	Default	
			2007	2008
uzA++	1	-	-	-
uzA+	5	-	-	-
uzA	7	1	-	-
uzB++	10	-	-	-
uzB+	-	-	-	-
uzB	6	-	-	1
uzC++	2	1	-	-
uzC+	-	-	-	-
uzC	-	-	-	-
uzD	-	-	-	-

Invesnment degree
Speculative degree

Source: Abhor Rating

(2) Rating methodologies

Russian credit rating agency (AKM) assisted in developing credit rating methodology. Fitch provided credit rating seminar for three days in 2005. However, credit rating methodology is, in general, simple compared to other credit rating agencies in the Asian countries.

(a) Banking sector

Rating methodology of commercial banks includes 25 factors, among which profitability and capital are important and approximately 40% is allocated to qualitative factors and 60% to quantitative factors. The rating methodology of banks is based on comprehensive analysis of factors which influence financial stability of commercial banks. Credit level, market, liquidity, quality of loans, currency and reputation risks as well as efficiency of their management are the key elements in rating analysis. Basically, the following factors are considered for bank rating:

- Economic and operating environment;
- Current tendencies and prospects for development of banking sector;
- Market position of bank and prospects;
- Transparency of activity and efficiency of internal control;
- Financial indexes.

(i) An economic and operating environment

An economic and operating environment where bank operates largely affects its solvency. In the process of analysis, the basic macroeconomic indexes and prospects of the economy such as dynamics of the real growth of GDP, value of external trade, investments in economy, stability of exchange rates, etc. are examined. The analysis of aforementioned factors indicates potential of banks. Banks, operating in favorable economic conditions, get better chance to have a high degree of solvency due to possibilities of generating large and stable profits at less level of financial risks, than banks functioning in unstable economic conditions.

(ii) Current tendencies and prospects of development of banking sector

This section includes careful analysis of current status of development of the banking system taking into account past and future prospects, since success of a bank is directly related to the financial market situation, in particular, potential for expansion of intermediary activity. The research on tendencies of total assets, property asset, credit, client deposits, level of concentration of assets and capital (at least for the last 3 years) is the basic constituent of analytical process.

(iii) Market position of bank and prospects

In an analysis of market position of a bank, all basic factors determining the scale of its activity in the domestic and international markets will be taken into account. The study of these factors allows to examine the stage of development of business which directly influences the result of its financial activity. Solidity of a bank's position in the market and its ability to influence market, including its share in assets, credit portfolio, and deposit base of banking sector are also estimated. Investment criteria are important part of analysis for the estimation of stability of bank's position in the market. The indexes of investment activity of a bank are also taken into account, including the scale of investment activity in financing real sector of economy and investment in non-financial assets.

A comparative analysis is conducted on the branch networks, mini-banks, client base, and geographical diversification of activity. Business directions of a bank (corporate, retail business and etc.) are also studied whether a bank possesses the market niche, can protect the market position, and captures the new segments of business.

(iv) Transparency of activity and efficiency of control system

Within the framework of rating analysis, the degree of transparency of bank activity which reflects the level of access to financial reporting and information on bank is evaluated. The efficiency of control system is also estimated by means of analysis of quality of financial information and authenticity of the given financial reporting.

(v) Financial indexes

Financial indexes are employed to conduct comparison of activity of different banks. The following financial indexes are utilized:

- Adequacy of capital;
- Quality of assets and risk management;
- Profitability and efficiency;
- Liquidity.

(v-1) Capital adequacy

In determination of credit rating of bank, the capital adequacy plays a key role because a capital serves as protection of depositors and creditors of bank, its further growth, and provides room to accommodate the risks. The asset's growth rate and share capital are compared with a view to assess a bank's strength of the capital base. The analysis of capital adequacy of a bank examines normative requirements of the Central bank, and they are compared with analogous indexes of other local banks.

(v-2) Quality of assets and management risks

Analysis of structure of bank assets including off-balance assets is conducted. The primary purpose of analysis is a determination of concentration of credit risks and level of diversification, which facilitate the objective estimation of asset's quality of bank. Credit portfolio is examined to check credit risk. The credit is analyzed from the viewpoint of the terms of redemption, types of credits, geographical location of borrowers, industry, and currencies of loan. During the analysis of credit portfolio, the size of problem credits is examined including written-off credits. The proper indexes of a bank are compared with analogical indexes of other comparable banks. The sufficiency of loan's collateral and provisions for possible losses on credits are examined. The magnitude of written-off assets and bank experience on recovery of overdue credit debt are also assessed.

Taking into account an activity of banks at interbank money market, a size and dynamics of interbank credits and deposits, the terms of their redemption, the level of concentration and solvency of borrowers are assessed. With the purpose of more objective estimation of credit risk, contingent liabilities and commitments such as guarantees, letters of credit, liabilities on loan and derivatives are also examined.

(v-3) Profitability and efficiency

The analysis of profitability provides information on the degree of success of a bank and serves as a factor determining its solvency. For the purpose of profitability analysis, volume and dynamics of income are evaluated. The estimation of diversification and stability of profit sources and a potential of a bank to get an income in the future is assessed. The profitability indexes are compared with analogical indexes of other local banks.

(v-4) Liquidity

In liquidity analysis, absolute size of liquid assets broken down by categories and their dynamics in assets are assessed. Deposit base taking into account a volume, terms of retail and corporate deposits, and the ability of a bank in securing liquidity from such sources as capital markets, credit lines and credits of refunding of Central bank are compared. The important part of an analysis is an estimation of liquidity ratios, which are compared with other local banks. For more objective estimation of liquidity risk, the efficiency of asset and liability management is also taken into account as well as the quality on asset and liability management.

(b) Corporate sector

Four integral factors characterizing the different aspects of an enterprise's activity are examined:

• External environment and sector risks;
• Market position of a company and efficiency of its activity;
• Quality of management; and
• Financial indexes of a company.

(i) External environment and sector risks

The analysis of sector/branch allows to identify the risks of a change of external environment on its activity, which can render substantial influence on its profitability, quality of assets, requirement in investments and eventually on its ability to serve debt obligations. The following branch characteristics are analyzed:

• Status of a sector and rates of growth for the last 3 years;
• Potential of growth of a sector and projection of volume of sale/production;
• Sensitivity of a sector to economic cycles;
• Dependence on world markets, import, and level of state patronage; and
• Basic factors of competitiveness in a sector.

(ii) Market position of a company and efficiency of its activity

Current market position of a company and prospect of its changes in a stress situation is evaluated. A number of factors which affect cash flow of company are checked:

• Dynamics of market share of a company for the last 3 years;
• Diversification of business of a company which become sources of generation of profits;
• Diversification of client base and flexibility of the distributing system;
• Competitiveness in costs;
• Access to resources (raw material, financial);
• Degree of dependence on the largest suppliers;
• Technical level of facilities and efficiency of producing goods and services.

(iii) Quality of management

Management quality can be assessed based on an ability of management to forecast possible changes in external environment, to utilize the advantages of a company, and to develop and realize an adequate strategy. In the analysis of management quality the following is examined:

• Development strategy of a company taking into account existing and expected changes in conditions of company's activity;
• Long-term and short-term plans of a company;
• Financial policy of management;
• Experience of management on realization of tasks and plans;
• Control system on implementation of decisions including quality of financial reporting;
• Principles of co-operation of management with shareholders, parent company and/or affiliated companies; and

• Transparency of a company.

(iv) Financial indexes

The analysis of financial indexes of a company includes the estimation of stability of profit and cash flow, their sufficiency for satisfaction of internal necessities of a company and its debt service, the structure of capital and debt of a company, and quality of its assets and liquidity. The current and perspective values of the proper financial indexes are assessed. The analysis of financial indexes of a company is conducted taking into account of a particular branch of a company and makes comparison with the average branch-wise indexes, and also with specially selected group of companies of branch.

The special attention will be paid to estimation of financial flexibility of a company, i.e. its ability to maintain adequate liquidity for meeting obligations even in stress conditions. For this purpose, current and future liquidity as well as solvency of a company is examined. Solvency of an enterprise is assessed on the following five basic factors:

• Liquidity ratios
• Indexes of capital structure (coefficients of stability)
• Coefficients of profitability
• Coefficients of business activity
• Investment criteria

(3) Differences of domestic credit rating agencies and major foreign credit rating agencies

In the past, Uzbek banks and corporate sector have issued very few bonds in the international markets. As such, it is pretty difficult to evaluate the locally rated bonds and entities with those by international credit rating agencies. There has been no sovereign rating yet of Uzbekistan. It appears there exists a substantial difference between them. For example, Asaka Bank, which is considered one of the best managed state-owned commercial banks in Uzbekistan and a candidate for privatization, was rated uzA+, second highest ranking, by Abhor Rating, while it was rated B by Fitch Ratings. Likewise, National Bank of Uzbekistan, which is the largest state owned commercial bank, was rated uzA+ by Abhor Rating, while Moody’s assigned it financial strength rating (BFSR) of 'E+', long and short-term local currency deposit ratings of 'Ba3/Not Prime', and long-term and short-term foreign currency deposit ratings of 'B3/Not Prime' with a stable outlook., indicating a gap between the local credit rating agency and the international credit rating agency. Rating scale of long-term bond of Abhor Rating is shown in Table 8.

Table 8: Rating scale of long-term bond of Abhor Rating

Class A - high level of solvency	Class C - low level of solvency
uzA++	uzC++
uzA+	uzC+

uzA Class B - satisfactory level of solvency uzB++ uzB+ uzB	uzC Class D - unsatisfactory level of solvency uzD

Source: Abhor rating

(4) Problems to be addressed for expanding local credit ratings

The history of corporate bond issue in Uzbekistan is very short and credit rating started only in 2007. The corporate bond rating is, accordingly, at the nascent stage of development. There are some problems to be addressed in order to expand the local credit ratings. First, the government has to accelerate the process of privatization as the number of creditworthy private companies is not sufficient. Second, directed lending program has to be reduced as the companies can borrow at below market interest rates, which hinders the development of bond market. This has distorted the financial market. Third, local credit rating agencies themselves have to enhance their capability in order for the public to rely on their rating for investment decision. Technical cooperation from the international credit rating agencies is a possible solution.

3. Problems to be solved and the outlook of Uzbek capital market

(1) Constraints and actions for development of corporate financial markets

The financial markets essentially play a key role in encouraging savings and creating effective mechanisms of their transformation into investment. As it stands, financial markets in Uzbekistan do not function as they are desired. The solution to this problem requires major advancements in financial market reform in order to increase the intermediary role that financial institutions play. The banking sector, which dominates the financial market, has to be reformed to strengthen its role. The main reform agenda are indicated below:

- To raise confidence of the population and in the banking system by removing non-core functions of banks, including the obligation to report transactions to tax and customs authorities which negatively affect public confidence in the banking system and encourage cash transactions;
- Intervention in the credit allocation by the government has to be substantially reduced in order for the development of the market interest rate structure based purely on credit assessment; and
- Privatization of the state-owned banks has to be accelerated, while segmented nature of the banking system has to be dismantled;

Bond market is underdeveloped in Uzbekistan. Although the maturity of government bonds has been extended, the number and volume is insufficient to provide benchmark and participants in sovereign bonds are small. In addition, yields on government bonds appear significantly low compared to inflation rate. Moreover, trading is virtually non-existent and there is little public information and statistics on sovereign bonds. These drawbacks hindering the sovereign bond market has to be addressed with a view to give a clear benchmark to corporate bonds.

Corporate bond market development was initiated at a later stage. Since corporate bond market is in the early stage of development, the following actions are deemed to be required:

- Notable expansion of the primary corporate bond market through the privatization of state–owned enterprises and creation of new joint-stock companies;
- Creation of conditions for the accelerated expansion of a secondary market through the adoption of a uniform law "On the Securities Market";
- Institutional investors have to be developed, in particular, insurance companies and pension funds as well as investment funds;
- Establishment of an adequate corporate governance system in accordance with international standards; and
- Improvement in the training and professional development of specialists for bond market.

(2) Problems to be solved for credit rating in Uzbekistan

As mentioned, credit rating started in 2007 in Uzbekistan. Credit rating agencies are at the stage of developing the rating skill, but, the quality of rating is yet to reach the level of international standard. Investors are interested in getting trustworthy and independent credit information. It takes time and efforts to enhance the quality of credit rating. Rating experiences facilitate the development of rating skill and more frequent issue of corporate bonds is sure to serve this purpose.

Saipro and Prime Rating have been set up only quite recently and three credit rating agencies apparently have their preferred sectors. Although it is difficult to predict the future course of credit rating in Uzbekistan, there might not be so much competition among the three credit rating agencies if prevailing practice continues. As to the largest credit rating agency in Uzbekistan, Abhor Rating, which is owned by the Uzbek Banking Association, is under criticism because there is a potential conflict of interest. It is important to dispel this concern by diversifying the shareholder base, preferably by inviting accredited foreign credit rating agency.

(3) Outlook and prospects for expanding the local debt markets and credit rating activities

There is a good potential for developing the local debt markets and credit rating activities, provided that existing constraints are removed. The government acknowledges the importance of an effective local debt markets in strengthening the conduct of monetary policy, providing opportunity for fund raising and investment as well as facilitating economic growth. However, Uzbek government takes the gradual approach in reforming the financial market, unlike the neighboring Kazakhstan, whose financial market has developed quite rapidly.

The local debt market size is still small. Majority of the problems that have constrained local debt market development in Uzbekistan are policy, legal, and regulatory related issues that can be addressed by the government and regulatory body. At the same time, market infrastructure as well as developing the institutional capacity for pricing has to be improved in order to further develop the local debt market.

In the immediate and foreseeable future, it is unlikely that local debt market would rapidly expand. Consequently, lots of efforts are needed for the development of local debt market which would facilitate the introduction of Asian regional bonds in Uzbekistan.

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Appendix 1: Credit rating by Ahbor Rating

«AHBOR-REYTING»

RATING LIST

COMMERCIAL BANKS

Bank	Rating	Date	Last update
OJSC "Credit-Standard"	uzA	October 2008	-
JSC "Ipoteka bank"	uzA+	August 2008	-
OJSICB "Ipak Yuli"	uzA	August 2008	November 2008
OJSCB "Samarkand"	uzC++	July 2008	October 2008
OPJSCB "InFinbank"	uzB	July 2008	October 2008
JSC "Aloqabank"	uzB++	June 2008	October 2008
JSC "Pakhta bank"	uzA+	March 2008	November 2008
Bank "Asaka" OJSC	uzA+	December 2007	September 2008
JSC "Uzpromstroybank"	uzA+	December 2007	September 2008
GC "Halq banki"	uzB++	December 2007	September 2008
JSCB "Mikrokreditbank"	uzB++	December 2007	September 2008
JSC "Kapitalbank"	uzA	December 2007	September 2008
JSC "Savdogarbank"	uzB++	January 2008	October 2008
OJSC "Turonbank"	uzB++	December 2007	October 2008
CJSC "UzKDB Bank"	uzA	January 2008	September 2008
POJSB "Trustbank"	uzB++	December 2007	September 2008
POJSC "Alp Jamol Bank"	uzB++	December 2007	September 2008
POJSC "Ravnaq bank"	uzB	January 2008	October 2008
POJSC "Universalbank"	uzB	January 2008	October 2008
POJSC "Uktambank"	uzB	January 2008	October 2008
POJSC "Turkiston"	uzC++	January 2008	September 2008

INSURANCE COMPANIES

	Rating	Date	Last update
GJS "Kafolat"	uzA	September 2008	-
NCEII "Uzbekinvest"	uzA++	June 2008	November 2008
IIC "IShONCh"	uzB++	June 2008	November 2008
IC "ARK SUG'URTA"	uzB	September 2007	March 2008
"Standard Insurance Group"	uzB++	June 2007	May 2008
GJSIC "Uzagrosug'urta"	uzB++	May 2007	May 2008

NON-BANKING FINANCIAL ORGANIZATIONS

	Rating	Date	Last update
Credit union «ASR»	uzA+	August 2008	-
Leasing company "Baraka"	uzA	December 2008	

CORPORATE BOND ISSUERS

	Rating	Date	Last update
JS «Dori-Darmon»	uzA	June 2007	May 2008
JS "Ikrangmet"	uzA	October 2008	

RATING WATCH

	Rating	Date	Overlook
ЧОАКИБ «Туркистонбанк»	uzC++	January 2008	Evolving