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Research Article

DERIVATIVES' MARKET AS AN ESSENCE FACTOR OF INTEGRATION INTO INTERNATIONAL CAPITAL MARKET IN TERMS OF GLOBAL DIGITALIZATION PROCESSES

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Abstract

The article focuses on the possibilities of bonds market in terms of pandemic. We have studied the measures, taken to increase the number of operations in bonds markets, also new methods in involvement of investors into the stock market of Uzbekistan.

Keywords

Bonds market, pandemic terms, IPO and SPO practices, stock market, stock market capitalization, derivatives, emission, trend model, stock transactions.

Introduction

Today, given the main pace of development of the market of financial instruments in the global, regional and national economy, the issue of implementing derivatives appropriate to the financial market of Uzbekistan remains relevant. Options contracts are the most suitable in the derivatives market in Uzbekistan. This tool, which is available in law but almost never used in practice, is convenient for investors and can minimize risk. There is some work being done in Uzbekistan to build a derivatives market, but they are not enough.

For example, in February 2019, the Uzbek Republican Commodity Exchange (UZEX) took another significant step to further develop international relations and trade in the derivatives market of Uzbekistan. UZEX became a full member of the Association of Futures Markets (AFM).

For UZEX, joining AFM opens up new opportunities for development of stock trading, introduction of a futures market, expansion of the range of tools offered for stock trading, formation of a system for entering into futures and forward transactions on the stock exchange, and strengthening of international relations.

The main goal of joining the association is expansion of partnerships, development of international, interbourse relations, improvement of the organizational structure, identification of priority directions in development.

The main goal of the Association is to support creation of new derivatives and related markets, as well as the organization of international conferences in order to encourage communication between members and strengthen their relations. But we do not know the impact of this membership until now. There is no official reports o statistics related to derivatives market of Uzbekistan. As one of the developing countries, Government should not be a blind eye to this issue.

What does Uzbek law say about derivatives?

Derivative transactions are not governed by Uzbek law as a separate class of specific commercial transactions. Any cash-settled derivative transactions fall within the regulation of currency law as a transaction associated with an inbound / outbound flow of foraign currancy proceeds. This implies that an Uzbek counterparty participating in a crossborder derivative transaction should comply with Uzbekistan's foreign exchange control. For a non-Uzbek counterparty, the major implications of this could be that (i) the derivative transaction may trigger certain registration requirements that must be met in order to make it enforceable against the Uzbek counterparty; and (ii) a withholding tax payable at the source in Uzbekistan may arise as a result of income received under the derivative transaction.

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THE MAIN FINDINGS AND RESULTS

Uzbek currency laws allow Uzbekistan-licensed banks to enter freely into cash-settled derivative transactions within the limits of their foreign currency exposure. The Central Bank of Uzbekistan (CBU) is a "Frankenstein-type" hybrid institution. CBU participates in derivative transactions to the extent that they are compatible with its function as a national reserves manager (including of gold bars and foreign currency). Quasi-bank institutions (microcredit, microfinance and credit union institutions, investment and pension funds, insurance companies) are not holders of a banking license and therefore are not covered by the above provision relating to ordinary operational banks. Companies and other non-financial institutions can enter into hedging transactions to hedge their risks involved in the underlying loan agreements. Other types of derivative transactions are problematic due to the limitations of foreign currency laws.

A good market practice established in Uzbekistan is using an ISDA Master Agreement as an umbrella agreement governing cross-border derivative transactions. Modifications to the ISDA Master Agreement template are required to meet certain provisions of Uzbek laws. Such modifications are reflected in the schedule of the ISDA Master Agreement and may vary depending on the nature of the Uzbek counterparty. The most common amendments include adding certain tax details of the Uzbek counterparty, adding a list of the documents that need to be delivered by the non-Uzbek counterparty for claiming a reduction in withholding tax in Uzbekistan, and updating the definition of "Bankruptcy" to comply with Uzbek law.

However, we can see that our government is using a piece of advice from international experts. It is written on a recommendation report that experts do not recommend that an equity derivatives market is implemented until Uzbekistan is approaching Emerging Market Status (EMS).

Current Uzbekistan legal framework covering securities market and payment systems seems to be silent on this issue and both concepts. This increases the risk associated with participation in the CSD securities settlement systems - in particular where there will be a close connection between such systems and payment systems, as recommended in this.

In order to provide for a uniform application of a regulatory framework to strengthen confidence in the transparency across the financial market in Uzbekistan, new transparency requirements are needed. They should be calibrated for different types of financial instruments, including equities, bonds, and derivatives, considering the interests of investors and issuers, including government bond issuers.

Experts think the government should create a Joint Venture Sovereign Wealth Fund with co-investors from various stakeholders locally and abroad, similar to what has been done in Korea and other Asian markets. A separate technical assistance (TA) programme should be undertaken for the design of such an investor, with the specific deliverable of creating the entity. The SWF should be licensed and overseen by the CMDA, invest primarily in domestic securities. It should eventually be licensed to invest abroad, after Emerging Market Status is achieved. At that point, there needs to be hedging capabilities and associated derivatives legislation in place.

The international capital market is an integral part of the financial system of any developing economy. Despite the objective limitations of domestic sources of financing, large enterprises and banks in Uzbekistan are currently paying more and more attention to debt financing in the international capital markets. Statistics confirm a steady increase in borrowing in this market. The issue of Eurobonds is part of both the state strategy and an effective tool for attracting borrowed capital to the country's economy.

The issue of sovereign Eurobonds served as a good benchmark and became a starting point for national corporate borrowers in the international debt capital market.

Eurobonds	
Sovereign 2 emissions 1,555 bln. USD	**Corporative** 3 emissions 900 mln. USD

In February 2019, the Republic of Uzbekistan received an international credit rating (BB-) for the first time in its history and placed sovereign Eurobonds on the London Stock Exchange. The bonds were placed in a double tranche of 500 mln. USD with maturities in 2024 and 2029. The coupon rates for five-year securities are set at 4.7% per annum, and for ten-year securities at 5.3% per annum.

In November of the same year, Uzpromstroybank successfully placed 5-year corporate Eurobonds in the amount of 300 mln. USD, with a coupon rate of 5.75% per annum. In November 2020, the National Bank for Foreign Economic Affairs issued corporate Eurobonds in the amount of 300 mln. USD with a maturity of 5 years and a coupon rate of 4.85% per annum. Further, in November 2020, Ipoteka Bank also successfully placed 5-year corporate Eurobonds in the amount of 300 mln. USD with a coupon rate of 5.50% per annum.

The second issue of sovereign Eurobonds by the Republic of Uzbekistan was held in November 2020. This issue differs from the previous issue in that the first tranche of 10-year sovereign Eurobonds in the amount of 555 mln. USD was in hard currency, while the second tranche was denominated in Uzbek soums in the amount of 2 trln. UZS with a coupon rate of 14.5% per annum for 3 years with maturities in 2023.

The corporate bond market began its active development in 2000. In the period from 2000 to 2008, the debt market actively gained momentum and developed. However, as a result of the global financial crisis in 2008, the Uzbek corporate bond market also experienced a downturn and a crisis that lasted for more than 12 years.

Thus, as of December 1, 2020, only 10 bond issues of 4 issuers were registered on the organized market (RSE "Toshkent"). The total volume was about 302 bln. UZS. The main issuers of corporate bonds are commercial banks, their share is approximately 91.7% of the total issue volume. The share of the leasing company “Uzbek Leasing International” in the total issue volume is 8.3%.

Emitter	Volume (bln.soums)	Interest rate	Date of placement	Date of expiration
“Uzbek Leasing International”	8	18%	24.02.2020	05.03.2021
“Uzbek Leasing International”	8	19%	24.02.2020	04.03.2022
“Uzbek Leasing International”	9	20%	24.02.2020	03.03.2023
“Uzpromstroybank”	17,06	2,25%	29.12.2010	04.01.2021
“Uzpromstroybank”	10	2%	10.08.2012	15.08.2022

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“Uzpromstroybank”	50	Central Bank refinancing rate +2%	05.12.2019	03.12.2022
“Uzpromstroybank”	50	Central Bank refinancing rate +3%	05.12.2019	30.11.2024
“Uzpromstroybank”	50	Central Bank refinancing rate +4%	05.12.2019	28.11.2026
“Asia Alliance Bank”	50	Central Bank refinancing rate +4%	16.07.2019	15.07.2026
“Kapitalbank”	50	Central Bank refinancing rate +5%	24.04.2020	21.05.2027

Table 1. The main emitters of bond placement in Uzbekistan

According to the RSE "Toshkent", the volume of trading on the bond market for 9 months of 2020, compared to the same period in 2019, increased by 71%. It is important to note that the 3-year bonds of “Uzpromstroybank” and the 7-year bonds of Asia Alliance Bank were successfully placed. The largest trading volume for 9 months of 2020 was made with 3-year bonds of “Uzpromstroybank”, which amounted to 34.4 bln. soums. The bonds of Asia Alliance Bank were fully placed, the trading volume for 9 months amounted to 13.3 bln. soums. Bonds emitted by “Kapitalbank”, as well as “Uzprostroybank”'s 5- and 7-year bonds, were not put up for auction.

Most banking sector bonds are linked to the Central Bank's refinancing rate. At the same time, the bonds of JSC “Uzbek Leasing International” with fixed coupon payments look quite competitive, especially against the background of the fall in the refinancing rate of the Central Bank.

The secondary market of corporate bonds does not provide liquidity for investors, which is one of the main barriers to the development of the debt market.

The countries of the eurozone will continue to massively support the economy affected by the coronavirus pandemic. Debt problems will be resolved once the recovery from the crisis begins.

Despite the growing budgetary arrears, Germany and other eurozone countries intend to continue to provide great assistance to the economy in the fight against the coronavirus pandemic. In the current and next year, its volume should remain unchanged. Only when the economy recovers will it be possible to solve the problem of the increased debt.

It is necessary to closely monitor the development of the pandemic and to increase the rate of vaccination. EU-agreed assistance in the fight against the consequences of the pandemic in the amount of 750 billion euros is a historic opportunity, and ambitious reform plans can give a real impetus to modernization.

The European economic aid package was agreed in the summer of 2020, but the EU is not yet ready to implement it, as plans have not been completed on where the funds should be directed. In addition, many countries still have to ratify the legal framework so that the European Commission can attract borrowed funds for the program.

In a statement, the Eurogroup indicates that in 2020, 19 eurozone states sent financial assistance to their economies in the amount of 8 percent of GDP. In addition, measures were taken to increase liquidity - for example, secured corporate loans - at 19 percent of production. This was financed mainly by new debt. At the same time, the rules of the European Stability Pact concerning public debt and budget deficits were suspended. The European Commission wants this situation to last until 2022.

Having survived the 2020 pandemic, financial markets are starting the new year in a state of déjà vu. Just like 12 months ago, bonds and stocks open the year in a state of extreme overbought. The coronavirus has left deep scars on the global economy and it will take a long time before they heal. However, the markets managed to recover from the fall in March, amid the first wave of coronavirus, and ended the year very successfully. Investors in the American stock market, who have held out since the beginning of the year, have managed to make double-digit profits. Those who invested in bonds also made good money. The S&P 500 index for the year rose 16%, the global MSCI World index added 14%. The yield on the Bloomberg Barclays Global Bond Index was 9%.

The stock market rally reflects a bullish outlook for corporate earnings and growth in 2021.

Vaccinations are expected to halt the epidemic and promote recovery. Governments and central banks will maintain incentives to support the process until consumers and businesses start spending their savings during the quarantines. Strategists are confident that investors should switch from overvalued US stocks to emerging markets, cyclical industries such as the banking and energy segments, and small and mid-cap companies. That shift has already begun, and the growing companies are not just those that have benefited from the pandemic. Since November, investors have actively rushed to the lagging segments, buying up shares and bonds of companies that traditionally benefit from reflation.

The recovery in economic activity will lead to an increase in long-term rates and make market participants think about how long the central banks will buy bonds and keep the economy on life support. According to IMF forecasts, in 2021 the world economy will grow by 5.2%. If expectations are met, the rejection of incentives will become the hottest topic of discussion in economic circles.

Central banks have collapsed interest rates and thereby lowered the risk premium throughout the financial system. For example, the real profitability of 10-year government. US bonds, taking into account inflation, has long been kept close to -1%. A year ago, this yield was close to zero and, accordingly, it is reasonable to assume that it will return there in 2021. In this case, overvalued shares will go down.

There are several drivers for the entry of private investors into the market. Firstly, there is more free time due to the massive transition to remote work - there is an opportunity to devote time to investments. Decreased rates on bank deposits - this made deposits unprofitable. The availability of financial instruments has also increased, Internet services are developing, marketplaces and stock stores appear. The market continues to grow, and the influx of investors will continue. Market in Investments requires a purely individual approach. You need to select tools for investing according to your personal goals, timing, currency structure of expenses, taking into account your own unique temperament, so as not to jump out of investments with losses on drawdowns. The dynamics of bond funds is calmer, equity funds are more dynamic: on average, over several years they grow five times faster than inflation. Investments in fund units provide a balance between risk and return.

The American market will continue to experience capital inflows, which will allow its key indices to rise by 10-12%. Despite the political instability in the US, the S&P 500 continues to grow. Investors are no longer paying attention to Trump-related news and will soon receive new incentives from Joe Biden. The aid package will include direct payments to Americans ($ 1400), as well as funding to help the United States, including the purchase and transportation of vaccines. The total volume of the new aid package may be about $ 2 trillion, that is, twice as much as the previous one. This is very positive for the markets.

What situation is going on at national securities market? The National Bank for Foreign Economic Affairs of the Republic of Uzbekistan JSC emitted 5-year Eurobonds worth $ 300 million on the London Stock Exchange, and thus it has become a full-fledged participant in the international capital market. It is important to note that we need to take measures to further develop the banking system and the capital market, including in order to attract long-term investments from commercial banks and the need to enter international capital market.

The international capital market plays an important role in ensuring stable economic growth in the country and large-scale attraction of foreign investment. The successful placement of sovereign Eurobonds of the Republic of Uzbekistan in 2019 opened up new prospects for entering international markets for local enterprises, as well as for the National Bank.

Today, the National Bank is the leading bank in the republic in attracting funds from financial institutions and modernizing leading sectors of the economy, financing investment projects of priority and strategic importance. The debut issue of Eurobonds by National Bank was carried out jointly with internationally recognized underwriting banks such as Citibank (USA), Natixis (France), SMBC Nikko (Japan) and Gazprombank (Russia).

On October 14, 2020, on the recommendations of financial advisers based on investor proposals, the first interest rate of return was set at 5-5.25% (low-5%) and the opening of the order book was announced at 08:15 London time. At 17:00 hours London time, the interest rate and coupon of international bonds issued by the bank were determined. Due to the high demand from investors and the fact that this is twice the volume of issue, the final cost of the coupon, amounting to 4.85% per year, during trading decreased by 0.30% of the initial interest rate. Such a successful placement of Eurobonds by the bank testifies to the positive assessment of the reforms carried out in the country by international investors.

The securities market is an important means of attracting free funds to the economy and mobilizing them for investment processes. The first stage of the reforms carried out in this direction was the creation of the Agency for the Development of the Capital Market at the beginning of this year. The issuance of government bonds was resumed. However, the mechanism for issuing securities and selling them on the stock market is used ineffectively. The total amount of shares on the stock market is 25 trillion soums, which is less than 6 percent of the gross domestic product. For example, this figure is 188 percent in Singapore, 112 percent in Malaysia, 34 percent in Russia. This year, government bonds were sold only to commercial banks through the currency exchange. The number of professional participants in the stock market does not even reach 100. In this regard, it is planned to develop a strategy for the development of the stock market for 2020-2025. It is planned to bring the ratio of securities in free circulation to GDP to 10-15 percent by the end of 2025.

Currently, the state owns 85 percent of the shares of 605 joint stock companies. Of these, only 5 percent are traded on the stock market - shares of 105 companies. At the meeting, instructions were given to increase the types of securities on the capital market based on world practice. Measures are considered to increase the demand for securities, to attract foreign exchanges, brokers and banks to participate in the domestic stock market. The issues of focusing on the stock market of a certain part of the assets of insurance companies, allowing banks to purchase highly liquid securities on the primary market were discussed.

The need to strengthen the protection of the rights of investors and minority shareholders, to improve the procedure for payment and collection of dividends was noted. It was also instructed to improve corporate governance, switch to international financial reporting and international audit standards.

The development of the sphere also depends on the qualifications of specialists and the financial literacy of the population. Today, only 300 specialists with a relevant certificate of qualification operate in the country. In developed countries, thousands of people work in this area.

Conclusion

If we think about the bond market perspectives, we can constate the following. In spite of everything, in 2019-2020, the corporate bond market received a significant impetus to development. On July 21 this year, the President of Uzbekistan signed a law allowing limited liability companies (LLC) to issue and place corporate bonds.

This change in the law allows the LLC to diversify the structure of debt capital or completely abandon bank lending. It is also worth noting that in some cases bonds can be issued without collateral, provided that the amount desired to be attracted is within the company's equity capital.

For this reason, one can predict and expect an active entry of companies into the debt market. It would be correct to inform the owners and management of the LLC about alternative sources of financing, including through the issue of corporate bonds. Presumably, the future volume of the corporate bonds market will be from 300 to 500 billion soums.

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