UZBEKISTAN

CREATING FINANCIAL MARKETS:
A REVIEW OF THE FINANCIAL SECTOR

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ABBREVIATIONS AND ACRONYMS

GDP - Gross Domestic Product
GKI - State Property Committee
IMF - International Monetary Fund
MOF - Ministry Of Finance
NDS - National Depositary for Securities
PIF - Privatization Investment Funds
PPS - Private Participation Shares
SCSSE - State Committee on Securities and Stock Exchanges

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UZBEKISTAN
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This report is based on findings of a mission that visited Tashkent in October 1995. Members of the mission were Messrs./Mmes. Michael Fuchs (Task Manager), Esen Ulgenerk (Banking), Vincent Polizatto (Supervision and Regulation) and Mark St. Giles (Capital Markets). Messrs. Alain Druet (Rural Finance) and Gregory Jedrzejczak (Capital Markets) also visited Tashkent and contributed to the Review.
This Review of the financial sector in Uzbekistan is based on work undertaken between October 1995 and June 1996. It was discussed with the Government of Uzbekistan in June 1996, but subsequently, fundamental changes have taken place in the framework for macroeconomic policy in Uzbekistan. Most significantly, during the last quarter of 1996, the authorities imposed a number of new restrictions on the foreign exchange market and increased monetary financing of the fiscal deficit considerably. These policy moves are cause for concern, both for macroeconomic stability and for development of the financial sector.

This deterioration of macroeconomic conditions has already undermined the successful stabilization measures previously taken by the Government. There is also a serious danger that the prospects for increased reliance on a market-based financial sector and for expanding foreign trade and investment will be thwarted. Monetary finance of fiscal expenditures is already being reflected in higher inflation and the erosion of confidence in financial assets. The restrictions imposed on the availability of foreign exchange distort the foreign exchange market and have broad consequences for the functioning of other financial markets in Uzbekistan.

Nonetheless, despite the deterioration in the macroeconomic environment and the imposition of new restrictions on foreign exchange, the structural and institutional aspects of the Review remain valid. Although implementation of the recommendations will have become more difficult, the Review still presents a coherent analytical framework for financial sector reform. However, successful implementation of the recommendations is now more difficult and will need to be preceded by renewed macroeconomic stabilization and accompanied by ongoing structural reforms.
EXECUTIVE SUMMARY

1. The Uzbek economy has started on the historic process of transition to a market economy. The Government has already implemented a number of policies that are essential to establishing a market-based economy: the economy has made progress towards stabilization and a privatization program that ensures broad public participation is being prepared. To support the Government's stabilization policy and facilitate the move toward a market economy, concomitant transformation of the financial sector will also be necessary. The Uzbek authorities have expressed keen interest in the World Bank's policy advice on designing a strategy for the reform of the financial sector. While acknowledging that important reforms have already been undertaken in a number of key areas, this Review sets out comprehensive proposals for initiating the process of transition to a market-based financial system.

2. As the banks are the major financial institutions in Uzbekistan, the main focus of the Review is on establishing a market based banking environment. At present the sectoral banks are burdened with poorly performing loans and do not function according to market principles. Reform of the banking sector will support the Government's stabilization policies by establishing more transparent and tighter budget constraints on state-owned enterprises. It will support structural reform by ensuring more economic allocation of resources to enterprises and households. Since the reform of the banking sector involves fundamental institutional and regulatory change, it will take time and it is important that the Government does not delay implementation. The three central elements of the reform strategy proposed in this Review are to establish the conditions for the emergence of a competitive and efficient financial sector; to improve the legal and regulatory environment for financial sector activity; and to develop and implement a strategy for restructuring the sectoral banks.

3. The Review also proposes a strategy for establishing a competitive and stable capital market, which is essential for the realization of the Government's privatization program. Nonbank financial intermediaries and contractual savings institutions (pension and insurance funds) are beyond the scope of the report. Although reforms in these areas will also be necessary, this second layer of financial institutions will not be able to contribute significantly to market-based financial sector activity unless the authorities first reform the banking system and take steps to establish capital markets. Reform of the financial sector will only prove to be possible, if enterprise privatization proceeds rapidly, providing the base of market oriented clients for successful banking.

Prerequisites for financial sector reform financial system

4. High inflation in 1993 and 1994 and the freezing of bank deposits during the currency conversion seriously shook confidence in the Uzbek financial system. The size of the financial system in relation to domestic production became much smaller. Following the initiation of comprehensive stabilization measures in late 1994, however, inflation has fallen rapidly and the shrinkage of the financial system has come to a halt. But it will take time to restore confidence in financial markets. Maintaining low inflation will be fundamental to this process.

5. Several policy reforms in other areas are required if financial markets are to play a more meaningful role in allocating resources within the economy. Financial markets will only improve resource allocation if prices and interest rates reflect underlying supply and demand. They will be unable to perform their role in allocating resources among alternative uses if prices are subject to controls or are distorted. Important sources of price distortions include state orders (which oblige producers to make deliveries at below-market prices), foreign trade restrictions, high and varied customs duties and lack of competition in key markets.
Necessary reforms for development of the financial system

6. This review identifies three areas of financial sector reform, which are essential to create an environment for financial sector development. These reforms should be undertaken in the near term, because without reform in these areas market-based financial market activity – including the growth of new, privately owned financial institutions – will not take place.

Dismantle the distinction between cash and noncash

7. The distinction between cash and noncash transactions must be dismantled. It will be impossible to restore confidence in the financial system unless enterprises and households are given full access to their bank deposits in cash on demand. Limits on the availability of cash result in price differentiation between cash and noncash transactions. This gives rise to incorrect pricing and arbitrage transactions, and reduces credit intermediation through the financial system. With the introduction of market-based macroeconomic policies the distinction no longer fulfills the function of restraining demand. Thus the authorities should take immediate action to fully liberalize access to cash sums below a certain threshold. Cash withdrawals above this threshold would also be honored immediately, but they would be reported to the authorities. Reporting will allow the authorities to follow up in cases of suspected misuse of cash (such as for black market trading) and other forms of tax avoidance.

Increase banks’ access to loanable funds

8. Enhancing the role of financial markets will also require allowing banks to assume risks of intermediating credit. The functioning of markets depends on decentralized decision-making and risk-taking. If banks are to compete in the market for credit intermediation, they will need to reap the benefits and suffer the consequences. To make this possible several policy changes will be required:

- The authorities’ tight control on the supply of loanable funds to the banks will have to be reduced. The Review supports the Central Bank’s goal of further reducing the size of required reserves and paying interest on required reserves, thus reducing the burden of reserve requirements on bank earnings.

- The Central Bank currently imposes a blanket loan loss provision on all banks. This requirement is equivalent to a tax, because it applies to the banks irrespective of the actual state of their loan portfolios. After the new accounting system has been implemented, making sufficient loan loss provisions will primarily become the responsibility of the banks and the provisioning requirement should be removed.

- The burden of these requirements on bank liquidity could be reduced considerably by enabling the banks to consolidate their reserves in a consolidated account with the Central Bank. Recent improvements in the payments system ensure that payments take place on a gross and nearly real-time basis. Improving bank liquidity management would require further upgrading of the payments system and investment in banks’ management information systems. If banks are to undertake netting transactions the authorities will also have to abandon attempts use the payments system as a means of controlling transaction flows.
Improve the legal framework for financial transactions among private parties

9. The third essential area of reform concerns improving respect for and enforcement of private property rights and the legal and regulatory framework for financial transactions. Reforms in these areas are essential to enhancing respect for financial contracts among private parties. These reforms should be given high priority, since they will take time to implement. This Review highlights the importance of an adequate legal framework, but a detailed plan for legal reform lies beyond the scope of the Review.

10. In several areas the authorities have promoted reform, such as establishing bankruptcy courts and preparing a new civil code. A new company law was also recently passed by the Uzbek parliament. Nonetheless there is a need to ensure that these laws are coherent, internationally acceptable and enforceable. A legal framework, which establishes respect for private ownership and contracts among private parties, is essential to private sector activity.

- The civil code should cover private property rights and contracts
- The commercial code should apply to all commercial transactions
- Court procedures should support the enforcement of unsecured claims
- Banks need improved access to realizing collateral
- Centralized registries need to be established to record ownership and liens
- A law should be passed that encourages lenders to loan against collateral in the form of movable property that is in the hands of the borrower.
- Bankruptcy and liquidation proceedings should be streamlined and procedures should be developed for in-court and out-of-court settlement among disputing parties.

Reform of the regulatory environment

11. The second area of reform addressed in the Review is improving the regulatory environment for financial sector activity with the purpose of improving transparency in and enhancing the stability of the financial system. Transparency is needed to guard against imprudence and fraud in financial transactions. Sound regulatory practices will improve the stability of the financial system.

Introduce international accounting standards

12. Introducing revised bank accounting standards consistent with international standards is an essential step toward improving transparency. The Central Bank is developing and implementing revised accounting standards for banks. Implementing these new standards will improve transparency about the financial situation of the banks. The reporting needs of the Central Bank will also be fulfilled by the accounting system. Implementation of the new accounting standards should be given high priority, as it is a difficult process. Some assistance of foreign experts may be needed.

13. The Central Bank has resolved to pay for international audits of all Uzbek banks for the financial year 1996. Provided the audits are carried out according to well-designed terms of reference, this useful initiative will provide essential inputs to designing the necessary restructuring of the banking system. Furthermore, to promote the training of audit professionals, the Central Bank should specify requirements for the minimum frequency and content of bank audits and for the qualification of auditors. New bank accounting methods can also be used to promote the introduction of new accounting techniques for enterprises.
Redesign prudential supervision

14. Bank supervisors should no longer be required to control the allocation of credit. Instead bank supervisors should be trained to assist in preserving the soundness of the banking system. To fulfill this new role the Central Bank will need to change the emphasis of banking supervision – moving from control of banking activities to encouraging prudent behavior. The revision of the Central Bank’s supervisory role depends on:

- Implementing and testing the authority vested in the Central Bank by the recently enacted laws on the Central Bank and on banking. The revised legal framework supports the Central Bank in its role as supervisor. The Central Bank has initiated the process of asserting its new authority by preparing revisions of supervisory regulations and accounting standards. The Central Bank will need to build further on its expertise in these areas assisted by foreign consultants. The Central Bank will also have to demonstrate that it has sufficient authority to enforce the revised regulatory requirements and apply sanctions where appropriate.

- On-site supervision should move from the control of transactions to the surveillance of banking risks. The most important element of on-site supervision is evaluating the quality of banks’ loan portfolios and the adequacy of loan loss provisions. The new accounting framework will help on-site supervisors assess the adequacy of banks’ loan loss provisions. It is envisaged that revised practices for on-site supervision will be fully implemented within two years, coinciding with the implementation of the restructuring plans for the major sectoral banks (see below). For other banks implementation of revised on-site supervisory practices should be given high priority.

- In implementing off-site supervision the Central Bank is dependent on the information submitted in the accounts of the banks. Only when a new accounting framework consistent with international standards has been implemented and the banks have developed their management information systems will it be possible to fully revise off-site supervision. To support this type of analysis the prudential norms currently administered by the Central Bank will need to be revised.

- To fulfill its role as supervisor the Central Bank will need to attract and retain qualified staff. The Central Bank should design and implement a coherent training program for bank supervisors and develop career paths to make careers in supervision attractive.

Improve transparency in bank licensing

15. At present bank licenses are granted based on nontransparent criteria. Although the licensing process is intended to be objective, the fact is that only those banks that are officially sponsored, are likely to meet the requirements on capital resources, access to banking premises, and so on. Immediate steps should be taken to revise current licensing practices to encourage the establishment of new private banks:

- To make the criteria and procedures for bank licensing more transparent it is recommended that they be made public in a licensing manual.

- A two-stage licensing process is recommended to reduce the financial risks of prospective bank licensees. Preliminary approval of applications should be given prior to the applicants having to invest in premises, equipment, and other facilities. Recent attempts to revise the
licensing process have resulted in burdensome licensing procedures. The result is a dual approval process rather than a two-stage procedure.

- The recently revised licensing process stipulates that bank capital should consist only of fully paid-in capital and that this capital should be available before registration of the bank. The authorities have, however, still to address the weak capital base of the existing banks.

- The banks' foreign exchange business should no longer be subject to separate licensing.

**Strengthen prudential norms and supervision**

16. It is an integral part of the regulatory function of the Central Bank to maintain the stability of the financial system. In the immediate future the Central Bank will have to cope with the structural problems in the banking sector resulting from the problems of transition from a socialist to a market economy. A reform strategy is proposed below for the large sectoral banks (Pahtabank and Promstroibank), the state banks, and the new sectoral banks that were recently split from Pahtabank and Promstroibank. However, the Central Bank also needs to develop the supervisory capacity to identify and deal with other banks, some of which are or may become problem banks. Implementing internationally accepted loan loss provisioning practices is an essential step toward improving the safety and soundness of the banking system. All banks should be required to accumulate sufficient capital to cover their provisions and meet the Central Bank's risk-weighted capital adequacy requirement within a two-year period. In the interim period sanctions should be imposed to restrict the activities of banks that are unable to meet these standards. To ensure transparency, procedures for dealing with problem banks should be formulated in a manual defining criteria for enhanced surveillance of problem banks and remedial actions to be taken. A policy framework should be developed that specifies when a bank has failed and the steps to be taken in connection with the bank's orderly closure.

**Postpone the introduction of deposit insurance**

17. It is strongly recommended that the authorities postpone plans to introduce a system of deposit insurance. The danger is that deposit insurance would weaken financial discipline by eliminating the incentive for depositors to assess the viability of the banks where they deposit their savings. Moreover, bank managers would be less astute in their management of risks.

18. Since the banking system is in distress and the supervisory capacity of the Central Bank is underdeveloped, the costs of introducing deposit insurance for all banks are likely to be large and unmanageable. Given the current state of banks, the danger is that broadly based deposit insurance would involve major budgetary outlays for the Government. Thus introduction of a deposit insurance scheme should wait until the restructuring of the banking system and the upgrading of the Central Bank's supervisory functions are completed.

19. The Government recently announced plans to compensate depositors at the savings bank, Narodnybank, for the high level of inflation experienced since 1992. Such a scheme will not necessarily improve confidence in the banking system, however, because compensation is made solely at the discretion of the authorities. Confidence in the banking system cannot be restored by instituting discretionary compensation for past inflation, but depends on increased faith in future Government policies. By implementing the compensation scheme the Government may also be establishing a dangerous precedent for future bailouts of household depositors.
Encourage banks to act as independent and responsible economic agents

20. It is important that banks become independent economic organizations acting in their own best interests. They should be encouraged to assume responsibility for their own decisions.

21. The authorities should **discontinue credit insurance financed by state-owned insurance companies**. Such schemes move credit risks from the banks back to the state. If banks are to act as independent agents, they must take responsibility for their lending decisions.

22. The accountability of bank managers and owners will be enhanced by **allowing banks to deduct actual losses and provisions for specific loan losses from their earnings before paying taxes**. By introducing this deduction the authorities will be supporting the safety and soundness of the banking system. The authorities will also be reducing the long-run fiscal costs of bank restructuring.

23. Increasing the role of the financial system also rests on establishing a market-based banking environment. Large sectoral banks continue to dominate the Uzbek financial sector. Many recently established banks are also owned by the state or state-owned enterprises, preserving the state's dominant role in credit intermediation. These new banks have inherited many of the inefficiencies of banks under socialism serving as the treasuries of state-owned enterprises and as the agents of the tax authorities. They have little in common with banks in a market-based environment. In order to move to a market-based financial system the sectoral and state banks will have to be restructured and given greater autonomy. Another important element in financial sector reform is to **enhance the role of the private sector** in credit intermediation through the privatization of state banks and the entry and expansion of new private sector banks.

24. If banks are to establish themselves as responsible, independent economic agents acting in the best interests of their clients, it is important that they be relieved of their role as tax collection agents of the Government. The role of banks as tax inspectors also overburdens the payments system and seriously restricts competition among the banks, since each enterprise is required to settle all banking transactions with only one bank.

The strategy for reforming the banking sector

**Sectoral banks**

25. **Serious distress in the banking sector.** The willingness of private owners to put capital at risk is an essential ingredient of a market-based banking system. The discipline of the market-place is undermined if banks with an insufficient capital base are allowed to continue in operation. The Uzbek banking sector is in serious distress, and major restructuring will be necessary if banks are to operate according to market principles. The level of distress is much more serious than revealed by local accounting practices. Some recapitalization of the major sectoral banks, Promstroibank and Pahtabank, has already been undertaken, but it is far from sufficient. The danger is that any new capital will be quickly eroded unless sanctions are imposed on those banks, which are in financial distress.

26. **Improving financial discipline of the large sectoral banks and recombining the recently established sectoral banks.** The dominant role of the sectoral banks and the insignificant role of private banking in Uzbekistan make it essential that the large sectoral banks exercise financial discipline towards their enterprise clients. If banks are to promote the efficient allocation of resources, they and their borrowers must be subject to financial discipline. Several of the new, small, highly-specialized sectoral banks were split from the large sectoral banks. These banks have inherited bad loans with highly
concentrated risk profiles and are not viable. It is recommended that they be recombined with their parent banks or liquidated. The solvency of the other sectoral banks is also doubtful. They will be subject to the procedures for problem bank management (outlined above) to be implemented by the Central Bank.

27. **A two-stage restructuring scheme for the two major sectoral banks.** The Review proposes a two-stage restructuring process for the large sectoral banks, which is designed to be completed within two years. During the first stage, the "isolation period", strict financial discipline will be imposed on the banks. The purpose of isolating the banks is to prevent further deterioration of their financial situation. The proposed isolation process has several components:

- Central Bank funds will be made available to the banks only according to a predefined and declining schedule. Following the isolation period no more Central Bank funds will be made available to the banks.
- During isolation the banks will not be allowed to accept any new household deposits or issue new certificates of deposit.
- The isolated banks will no longer be allowed to pay dividends to their shareholders.
- During the isolation period any incremental lending by the banks to delinquent borrowers would have to be based on detailed recovery plans approved by special debt recovery units within each bank.

28. The policy of gradually reducing the supply of Central Bank funds is consistent with the government’s commitment to gradual economic reform. But continued access to Central Bank funding - even on a declining schedule - will allow the banks to continue to lend to bad debtors during the isolation period. Thus the more restricted the banks’ access to Central Bank funding, the smaller will be the fiscal cost of restructuring the banks.

29. **Immediately after the banks have been isolated – within the first six months of the isolation period – the banks will be required to present the authorities with detailed restructuring plans.** These plans will be based on a complete review of the banks’ lending portfolios and will include provisions for replacing the management and improving the governance of the bank. Debt collection units will also be established within each bank. The authorities will need to support the debt collection efforts of the banks by developing the legal, regulatory, and institutional infrastructure for debt collection. **The future viability of the banks will be defined by the success of their debt collection efforts.**

30. The second stage in restructuring concerns the future of the banks after the two-year isolation period. Before the end of the isolation period the banks will be required to submit plans for their recapitalization for approval by the authorities. The restructured banks will be required to fulfill the Central Bank’s prudential requirements. Approval of the restructuring plans will be contingent on the banks’ ability to fulfill these requirements. The restructuring plans should include plans for the downsizing of the banks, the rationalization of their operations, and their privatization and partial liquidation. Any plans for recapitalizing the banks should be implemented only on the strict condition that their owners (currently state-owned enterprises) have already been privatized and/or new outside private capital has been raised. To ensure broad ownership of the banks by outsiders the enterprises that own the banks should be included in the privatization investment funds scheme. If the banks are unable
to submit restructuring plans satisfactory to the authorities before the end of the isolation period, the liquidation of the banks would be initiated.

31. The need to acquire new banking skills. In fulfilling these restructuring plans the banks will need to acquire banking skills, especially in areas such as work-outs on nonperforming loans and credit risk assessment. To gain these skills the banks will need to develop programs for transferring skills. Such programs could take the form of joint ventures with a reputable foreign bank, long-term twinning relationships with a foreign bank, management consultancy arrangements with a foreign bank or outright sale of the majority of the bank’s shares to foreign banks.

32. Maintaining crop finance during the isolation period. Pahtabank currently performs an important function in providing working capital for crop finance to rural communities. To ensure that this function continues to be fulfilled during the isolation period, Pahtabank should continue to provide finance for agricultural crops as an agent of the Government. The funds for crop finance should be supplied by the Government as an explicit fiscal transfer. Pahtabank would be instructed to discount bills secured by future agricultural crops; the size of the fiscal transfer would correspond to the value of discounted bills. After the isolation period the Government should announce a program for the gradual reduction of this discount facility and make the facility available to all banks serving rural areas.

33. Splitting Pahtabank into local entities may be a viable option. Pahtabank’s current structure is decentralized. The regional offices and branches enjoy a large degree of autonomy in their operations. In restructuring the bank the authorities should consider transferring the bank’s business and premises to local banking entities. With a partial or full write-off of existing obligations and share capital it may be possible to find new owners and managers willing to keep the branches in operation as local banking entities. However, if they are to become viable, these local entities need to diversify their lending over a wide range of rural lending activities. To facilitate this restructuring option the sectoral banks that were recently split from Pahtabank would have to be recombined with Pahtabank. Alternatively, the authorities should seriously consider liquidating Pahtabank. Provided the authorities move towards a more liberal banking environment and liberalize trade and prices of cotton, the provision of finance to the lucrative cotton-producing sector will be commercially attractive for the emerging private banking sector.

32. The smaller sector banks. Economic problems among the sector banks are not confined to the two large sector banks and the recently spun-off sectoral banks. Several other sectoral banks are also experiencing economic problems. They should be put under enhanced surveillance and made to comply fully with the Central Bank’s prudential requirements. If they are unable to fulfill these requirements, they should not be allowed to continue in operation.

Stimulating the supply of credit to the private rural sector

34. The sectoral banks are unable to fulfill the financing needs of the rural sector due to the specialized nature of their lending, their lack of market-based banking skills, and the burden of their bad loans. Diagnostic audits of the sectoral banks reveal that these bad loans reflect lending to uneconomic agroprocessing and agroindustrial enterprises, and are largely unrelated to agricultural production. During the transition period credit for financing crop production will continue to be made available through Pahtabank. In the medium term reform of rural finance would follow from increasing the role of private farming enterprises, restructuring the sectoral banks, and establishing private, market-based financial institutions serving agriculture.
35. Improving access to finance in rural communities depends both on private sector development and developing the institutional infrastructure for rural credit. A number of bottlenecks hinder private sector development:

- Only small portions of collective farms have been transferred to private farmers, who continue to be bound by profile restrictions. Private farmers inherit the assets and liabilities of the state farms but are not allowed to transfer or pledge property rights. They are unable to undertake restructuring involving the sale of assets or borrowing against security in land.

- Although the Government is committed to reducing state orders on cotton and grain, state orders currently impose heavy implicit taxation on the production of these crops.

- The monopolization of the wholesale distribution system. Even the part of the farmers’ crops that is not designated for state orders must be sold to state monopolies. The monopolization of the distribution system constrains the supply of credit to agricultural producers.

- Remaining export tariffs on primary agricultural produce reduce the income of the rural community, while protecting the processing industry. The Government plans to abolish these export tariffs by the end of 1996.

36. In the medium term a self-sustaining system of rural finance will require the development of legal and institutional infrastructure. The authorities should:

- Develop reliable systems for registration and transfer of land and equipment leases.

- Improve the legal and regulatory framework for trading and enforcing private ownership rights, establishing transparent systems for trading and enforcing ownership rights.

- Develop the legal and institutional framework for locally based, cooperatively owned financial institutions.

The savings bank and the National Bank

37. The savings bank, Narodnybank, and the foreign trade bank, the National Bank, are accorded privileges such as exemption from certain Central Bank prudential requirements and a virtual monopoly in their respective areas of business. If there is to be competition in the provision of banking services, it must take place on a level playing field. Thus, these privileges must be dismantled.

38. The savings bank. Since the savings bank, Narodnybank, continues to enjoy privileges in the form of deposit insurance and exemption from the prudential norms of the Central Bank and taxes, the bank competes with commercial banks on unequal terms. The deposit insurance enjoyed by Narodnybank’s depositors was confirmed in 1996 by the implementation of a Government-financed scheme to compensate these depositors for the effects of past inflation. Until the authorities resolve to treat Narodnybank as any other bank it is recommended that a "narrow" banking model be adopted for Narodnybank. The bank’s lending should be limited to investment in Government securities and on-lending to other banks. In the medium term – once the bank’s privileges have been removed and the operations of the bank have been rationalized – the authorities should consider privatizing the bank as a going concern or selling off its branches to other banks interested in building capacity in the market for household deposits and payment services.
39. **The National Bank.** More than two-thirds of the National Bank's business is conducted on behalf of the Government or with the support of Government guarantees. Other banks should be encouraged to compete for this business on an agent basis, for example in processing donor funds and Government-guaranteed import credits. The bank should be required to comply fully with the Central Bank’s prudential and reserve requirements. Reserve requirements should be applied to foreign currency deposits in just the same way in which they are applied to Sum deposits. Once its balance sheet is restructured to remove the Government-related business, the National Bank should be an attractive proposition for private investors. After the portfolio of the bank has been restructured, the Government should privatize the bank without undue delay by including the bank in the privatization investment funds scheme.

**Encouraging the growth of the private banking sector**

40. The number and size of privately owned banks in Uzbekistan is small. Some private banks are well-managed and have the potential to survive and grow in the new environment. After restructuring and privatization this may also be true of some of the sectoral banks. However, the establishment of a market-based banking environment is severely constrained by a shortage of banking skills. The slow development of market-based banking skills is largely attributable to policies that constrain the growth of financial sector activity. As mentioned above, these constraints – the distinction between cash and noncash, the small size of loanable funds made available to the banks, and the weak legal and regulatory environment for private financial transactions – severely inhibit growth in financial markets. The growth of market-based banking depends on reforms in these areas.

41. Together with these reforms it will be necessary to upgrade the banks’ technical knowledge of market-based banking skills. The authorities should encourage the development of market-based banking skills by making the licensing process more transparent (as discussed above) so as to facilitate the entry of new, privately owned banks. Skills transfer can also be increased by facilitating foreign entry and by removing barriers to joint ventures with foreign banks. Twinning arrangements with foreign banks and the sale of local banks to foreign banks would also help promote necessary skills transfer.

42. By demonopolizing foreign trade finance, which is now largely the domain of the National Bank, and by fully liberalizing foreign trade activities, which are still dominated by state-run trading organizations, the authorities would significantly increase the interest of foreign banks in the Uzbek banking environment. Finally, the banks could be encouraged to acquire market-based banking skills by building incentives into the programs for subsidized credit that were established in 1995 (see below).

**Is there a role for credit subsidies?**

43. Establishing a market-based banking environment will take time. To ease the burden of high borrowing costs, the authorities have established two schemes for providing targeted fiscal subsidies to private enterprises: post privatization support and the Business Fund. It is the Government’s intention that the larger of these schemes – the Business Fund – should be discontinued after three years. Since the Uzbek financial system was used to channel subsidized credits until recently, the danger with these schemes is that they constitute a new form of subsidized credit and introduce new distortions.

44. In their current form these subsides are detrimental in several ways. They support the building of capacity for assessing credit risks outside the banking sector. They deprive banks of potential new areas of business and they will be difficult to unravel unless their life span is clearly limited.
45. The subsidization scheme should be redesigned to promote the development of technical banking skills during the transition period. The Government is advised to establish a cofinancing arrangement with the banks (through the Business Fund) and at a market rates (by the banks). Those banks participating in the scheme would be actively involved in the lending decisions under the cofinancing arrangement. To promote the upgrading of technical capacity of the banks, the authorities should develop minimum accreditation requirements for banks that are admitted to the scheme. Such requirements would stimulate the process of skills transfer, which is essential to the future development of the financial sector in Uzbekistan.

Capital market development

46. Capital market development is also essential to the Government’s privatization program. The success of the privatization scheme and improved corporate governance of enterprises depends on the development of an active secondary market in enterprise shares and in privatization participation shares in investment funds. Without a secondary market in enterprise shares and privatization participation shares, there will be no incentive for professional management of investment funds.

47. To improve the transparency and efficiency of secondary market trading it is recommended that a call-auction trading system be adopted. At a call auction trades in stocks are called successively, thus assembling all trades and creating the greatest possible liquidity. To enhance liquidity it is also important that transaction costs be kept to a minimum. For trades taking place off the exchange, the emphasis should be on ensuring wide dissemination of information on trading volumes and prices. Unnecessary price movements can be prevented by introducing rules that suspend trading sessions if prices move by more than a predetermined amount.

48. To cope with increased trading activity and reduce settlement risks it is recommended that the National Depositary be upgraded to provide a full range of services in connection with the registration of ownership and transfer of dematerialized securities. The upgrade should also enable the depositary to service a much larger number of issuers and investors and considerably larger trading volumes.

49. The State Commission on Securities and Stock Exchanges was established in October 1995 with broad representation from security market participants and regulators. This representation was narrowed in April 1996, however. The commission is now organized as part of the State Property Committee, which weakens its autonomy and can create conflicts of interest because the State Property Committee is also the main supplier of equity to the market. The authorities should reestablish the balance on the commission to ensure the broadest possible representation. In the future the Commission should set guidelines for security market activity. Once these guidelines have been developed, the commission should pass on responsibility for enforcement to self-regulating organizations. Eventually the authorities should consider integrating the supervision of all financial sector activities in a commission with broad representation. In balancing its responsibilities for regulation and promotion of the activities of the stock exchange the Commission should be careful not to overregulate or set standards, which are so high, that trading activity is stifled.

50. The development of a market for fixed-income securities is essential for capital market development, providing an alternative to money market and equity investment. The Government initiated the sale of Treasury Bills in March 1996. Treasury securities should continue to be issued on a regular basis to build confidence in this segment of the capital market. The authorities should encourage secondary trading of Treasury bills by allowing the banks to trade outside the weekly auction and to increase trading with non-banks. Once the market is established the Ministry of Finance should issue six-month bills and eventually longer bonds.
## FINANCIAL SECTOR REFORM: A MODEL FOR ACTION

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<thead>
<tr>
<th>Area of Reform</th>
<th>Short Term</th>
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<tbody>
<tr>
<td><strong>A. Enhancing the role of the financial sector</strong></td>
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<tr>
<td>Increasing confidence in the financial system</td>
<td>Dismantle the distinction between cash and noncash</td>
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<tr>
<td>Increasing banks’ access to loanable funds</td>
<td>Phase in the payment of interest on required reserves</td>
<td>Replace the loan loss requirements imposed on all banks with loan loss provisions reflecting each bank’s expected losses</td>
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<td>Reduce the liquidity requirement currently imposed on banks</td>
<td>Discontinue any control over or verification of transactions</td>
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<td>Encourage banks to improve intrabank liquidity management and to establish interbank netting</td>
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<td>Improving the legal and regulatory framework for financial transactions</td>
<td>Implement a uniform civil code for private property rights and contracts</td>
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<td>Implement a uniform commercial code for all commercial transactions</td>
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<td></td>
<td>Promulgate law on collateral applying to movable and immovable property</td>
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<td></td>
<td>Streamline enterprise bankruptcy and liquidation proceedings, including practices for out-of-court settlement</td>
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<td>Improve liquidity in the market for real estate and banks’ access to selling collateral</td>
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<td><strong>B. Improving transparency and enhancing financial stability</strong></td>
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<tr>
<td>Accounting standards</td>
<td>Undertake planned audit of Uzbek banks for financial year 1996 according to international accounting standards</td>
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<td>Complete implementation of new accounting standards</td>
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<td>Obtain technical assistance from foreign experts</td>
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<td>Assert Central Bank’s supervisory authority</td>
<td>Enforce authority vested in the Central Bank under the recently enacted banking and Central Bank laws to:</td>
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<td>- issue supervisory regulations</td>
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<td>- specify accounting standards</td>
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<td>- require disclosure of information</td>
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<td>- impose sanctions on banks</td>
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<td>Area of Reform</td>
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<tr>
<td>Banking supervision</td>
<td>Implement reformed on-site banking supervision, focusing on safety and soundness, assessment of loan loss provisions, and evaluation of future earnings</td>
<td>Reform off-site supervision standards to be implemented under the new accounting system</td>
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<td>Design and implement training programs and career paths for bank supervisors</td>
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<tr>
<td>Licensing of banks</td>
<td>Increase transparency by publishing manual of licensing practices</td>
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<td></td>
<td>Introduce two-stage licensing process with simplified, less burdensome licensing requirements</td>
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<td>Insist that bank capital be fully paid before registration and for all existing banks</td>
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<td>Discontinue separate licensing of banks' foreign exchange business</td>
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<td>Problem bank management</td>
<td>Develop a special capacity within the Central Bank's for problem bank management</td>
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<td>Define criteria for identifying problem banks and sanctions to be imposed on these banks</td>
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<tr>
<td>Deposit insurance</td>
<td>Postpone the introduction of deposit insurance until the sectoral banks have been restructured and until the Central Bank has the supervisory capacity to assess bank solvency</td>
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<tr>
<td>Giving banks greater autonomy and responsibility</td>
<td>Discontinue credit insurance funded by state-owned insurance companies</td>
<td>Relieve banks of their role as tax collectors.</td>
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<td>Allow banks to deduct actual losses and provisions for specific losses from earnings before tax</td>
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<td>Enterprises should be allowed to open settlement accounts with more than one bank</td>
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<td>Area of Reform</td>
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<td>C. Restructuring the banking sector</td>
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<tr>
<td>The large sectoral banks (Pahtabank and Promstroibank)</td>
<td>Impose strict financial discipline by isolating the banks:</td>
<td>Undertake restructuring during the two-year isolation period:</td>
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<td></td>
<td>- Make Central Bank funds available, but according to a predefined declining schedule</td>
<td>- Implement restructuring of the banks so that they meet the Central Bank’s prudential requirements</td>
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<td>- Do not allow the banks to accept household deposits or issue certificates of deposit</td>
<td>- Downsize and rationalize the operations of the banks</td>
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<td>- Do not allow the banks to pay dividends to shareholders</td>
<td>- Undertake partial liquidation and full privatization</td>
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<td>- Do not allow the banks to lend to delinquent borrowers unless detailed recovery plans have been approved by the banks’ special recovery units</td>
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<td>Six months after the initiation of isolation period the banks would be required to design and get approval for restructuring plans, including:</td>
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<td>- Undertaking a complete review of the banks’ loan portfolios</td>
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<td>- Replacing the management of the banks</td>
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<td>- Improving the governance of the banks</td>
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<td>- Establishing debt work-out units</td>
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<td>Transfer banking skills using one of the following:</td>
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<td>- Entering into a joint venture with a foreign bank</td>
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<td>- Entering into a twinning relationship with a foreign bank</td>
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<td>- Hiring a foreign bank as a management consultant (with fees related to the bank’s earnings)</td>
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<td>- Outright sale to a foreign bank</td>
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<tr>
<td>Crop finance and the restructuring of Pahtabank</td>
<td>Provide fiscal subsidy to Pahtabank enabling it to discount bills of exchange secured in future crop production.</td>
<td>Dismantle discount facility after the conclusion of the isolation period.</td>
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<td>Consider restructuring Pahtabank by splitting the bank into local and regional entities</td>
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<tr>
<td>New sector banks</td>
<td>Recombine the new sectoral banks split from Pahtabank and Promstroibank with their parent banks to produce banking units with more diversified loan portfolios</td>
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<td>Area of Reform</td>
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<td><strong>D. Stimulating rural credit</strong></td>
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<tr>
<td>Private sector development</td>
<td>Facilitate the transfer and pledge of property rights</td>
<td>Dismantle the state order system</td>
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<td>Abolish export tariffs on agricultural produce</td>
<td>Demonopolize the wholesale distribution system in agriculture</td>
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<td>Legal and institutional infrastructure</td>
<td>Establish a system for registration of ownership and transfer of ownership</td>
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<td>of land and equipment</td>
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<td>Establish transparent systems for trading and enforcing property rights</td>
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<td>Develop a institutional and legal framework for cooperatively owned</td>
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<td>financial institutions</td>
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<td><strong>E. The Saving Bank and the National Bank</strong></td>
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<tr>
<td>The Savings Bank (Narodnybank)</td>
<td>Adopt a &quot;narrow&quot; banking model, limiting the bank to investments in</td>
<td>Privatize the bank either as going concern or by selling off its branches</td>
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<td>Government securities and on-lending to other banks</td>
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<td>Prepare strategy and undertake restructuring based on:</td>
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<td>- Downsizing of the overextended branch network</td>
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<td>- Fee collection for payment services rendered</td>
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<td>- Removal of Government guarantee on deposits and exemption from taxes</td>
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<td>- Removal of exemptions from the Central Bank's prudential requirements</td>
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<td>Area of Reform</td>
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<tr>
<td>The National Bank</td>
<td>Restructure the balance sheet of the National Bank by:</td>
<td>Sell bank to private investors</td>
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<td>- Completing transfer of Government foreign exchange reserves to the Central Bank</td>
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<td>- Allowing other banks to compete for the agency business of the Government and for lending guaranteed by the Government</td>
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<td>Require the National Bank to pay taxes and fulfill the Central Bank’s prudential and to maintain reserve requirements on deposits denominated in foreign exchange</td>
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<tr>
<td>Encourage growth of the private banking sector</td>
<td>Undertake policy changes that promote financial market activity (see section A) and revise the Central Bank’s bank licensing practices (see section B)</td>
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<td>Remove requirement that local investors have a majority stake in foreign joint ventures</td>
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<td>Encourage local banks to use foreign banks as management consultants (with fees tied to bank earnings)</td>
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<td></td>
<td>Encourage sale of banks to foreign banks and twinning arrangements with foreign banks</td>
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**F. A role for credit subsidies?**

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<tr>
<th>Area of Reform</th>
<th>Short Term</th>
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<tbody>
<tr>
<td>The Business Fund and State Property Committee on-lending</td>
<td>Ensure that all subsidies are strictly on-budget and have a definite &quot;sunset&quot; clause</td>
<td>Dismantle subsidies within three years</td>
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<td></td>
<td>Design subsidies that stimulate the development of banking skills by involving accredited banks in cofinancing scheme</td>
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<td>Area of Reform</td>
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<tr>
<td>Treasury bill market</td>
<td>Continue to issue Treasury Bills according to a regular timetable</td>
<td>Once a three-month market is established, issue six-month bills and longer maturity bonds</td>
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<td>Encourage development of a secondary market in Treasury bills</td>
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<td>Encourage banks to transact Treasury bills outside the auctions and with non-banks</td>
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<tr>
<td>Equity market and market in privatization shares</td>
<td>Promote secondary market trading by:</td>
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<tr>
<td></td>
<td>- Establishing a call-auction market for shares</td>
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<td></td>
<td>- Keeping the transaction costs of exchange trading to a minimum</td>
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<td></td>
<td>- Ensuring wide dissemination of information on trading volumes and prices of all trades (on and off the exchange)</td>
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<td>Security market regulation</td>
<td>Establish commission for security market regulation with broad participation of market participants and regulators.</td>
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<td>Refrain from over-regulation of the securities market and pass responsibility for enforcement to self-regulatory organizations</td>
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<tr>
<td>Registration of trades and transfer of ownership</td>
<td>Upgrade National Depositary for Securities to service much larger number of issues and trade volumes</td>
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<tr>
<td>Financial conglomerates</td>
<td>Require financial conglomerates engaged in banking to set up separately capitalized subsidiaries</td>
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<td>Ensure that ownership structures are transparent and information on ownership is public</td>
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CHAPTER 1

THE ROLE OF FINANCIAL SECTOR REFORM

1.1 At the time of the breakup of the Soviet Union Uzbekistan inherited an economic system based on centralized control of production and the allocation of resources. Under Socialism this system had provided significant economic gains in the form of industrial investment and the provision of social services, but high costs of coordination and control made the system inherently inefficient. Over time these inefficiencies became more apparent as productivity, returns on investment, and growth rates fell.

1.2 The role played by the financial system in socialist economies was very different from the role it plays in market economies. Under Socialism the financial system consisted of a few large banks that distributed resources to ensure the fulfillment of production plans. The fundamental feature distinguishing banking in socialist systems from banking in market economies is that banks did not make any independent lending decisions. Moreover, they had no incentive to develop tools – such as risk management and project screening and selection – for assessing the income and solvency of their borrowers. Banks were restricted to budgetary and control functions, collecting, distributing, and generally controlling the use of resources in the economy. Banks also performed a number of essential planning tasks for their enterprise clients, including many that are usually performed by the enterprise sector in market economies, such as budgeting and fulfilling enterprise cash needs, accounting for transactions undertaken, controlling payments and receipts, and calculating and paying enterprise tax liabilities.

1.3 These weaknesses in the incentive structure were replicated at the enterprise level. Enterprise managers focused on meeting production targets set by central planners. Enterprises, shielded from competitive pressures, were not required to assess the market for their products. Their performance was measured not by the demand for the products they produced but by their ability to fulfill plan targets. Performance measures were not related to financial returns – all resources were consolidated centrally and distributed according to plan targets. Production suffered as a result, because enterprises were not rewarded for innovation, improved quality, or efficiency gains.

The essential role of privatization, and the need for new rules and institutions

1.4 The formerly socialist countries of Eastern Europe and the Soviet Union have embarked on a process of transition toward decentralized market economies based on private ownership. In market economies private ownership plays an essential role in providing incentives and serving as the basis for decision-making. Without private ownership it is impossible to achieve the efficiency and production gains associated with decentralized decision-making in market economies.

1.5 Uzbekistan initially adopted a cautious case-by-case approach to privatization. As was the case in other formerly socialist states, this approach advanced slowly. To consolidate the reform process, in late 1994 the Uzbek Government committed itself to developing a mass privatization scheme. During 1995 the Government developed a privatization scheme based on private participation shares issued by investment funds. The funds will be given access to borrow from a special credit line based on the number of participation shares they sell. This credit line will supplement the proceeds the funds receive from the sale of participation shares, allowing them to bid for the shares of newly privatized enterprises. This scheme, which was implemented on a pilot basis in December 1996, is both innovative and sound. It ensures that privatization will become widespread and thus is essential to the entire transition process.

1.6 Establishing decentralized market mechanisms involves much more than privatization, however. The transition from plan economy to market requires systemic and comprehensive change.
The behavior of private enterprises will need to be guided by an entirely new set of rules and institutions. Most fundamental among these new rules will be respect for the right to private property. Little will be gained if private owners are subject to coercion by the state or risk being deprived of their property due to theft. Unless private property and contracts involving private parties are respected and sanctions are enforced, privatization will achieve little. Establishing enforcement and dispute resolution mechanisms will take time, since these need to be based on tested legal institutions and practices. Legal and institutional development will also be necessary in many other areas, several of which are essential to the functioning of the financial sector, such as developing company, collateral, and mortgage laws and a well-defined civil code.

The importance of decisive reforms

1.7 The main problem during the transition is that market institutions are not yet in place. Yet the previous mechanisms for planning have been abolished. Thus the economy finds itself at a critical juncture. Uncertainty, deficient property rights, inadequate information, and lack of skills constrain the emergence of profitable economic activities to replace the rapidly falling output of weak enterprises. Initially the tendency in the countries of the former Soviet Union was to support existing structures by providing subsidies to the enterprise sector. Despite this support, enterprises experienced increasing difficulties in maintaining production and falling demand for their output, and continued support for their activities resulted in high levels of inflation.

1.8 Uzbekistan’s fall in output was smaller than that in other countries of the former Soviet Union. Output dropped an estimated 16% in Uzbekistan during 1991-94, compared with an average decline of 49% in the other countries of the former Soviet Union. This smaller drop partly reflected the preferences of the Uzbek authorities, who maintained an emphasis on socialist control mechanisms and production modes. Sustained output was also facilitated by Uzbekistan’s rich endowment of natural resources, including the country’s main exports, gold and cotton. Experience from other formerly socialist countries of Eastern Europe and the former Soviet Union suggests that those countries, where liberalization has been more rapid and comprehensive, experienced earlier output declines but also enjoyed an earlier and stronger recovery. Growth has typically returned after three years of sustained liberalization.

1.9 In late 1994 the Uzbek Government embarked on a number of reforms to accelerate the transition process, and in 1995 a successful stabilization program was implemented. Credit policies were tightened dramatically, resulting in reduced inflation and enhanced financial discipline. New private enterprises were initially hurt the most by these new stabilization policies. The burden also fell on state-owned enterprises, but these generally had easier access to credit – in the form of loan extensions or arrears – than did private enterprises. Thus the stabilization reforms may initially appear to have crowded out the very activities they were intended to promote. Accordingly, there could be reason to doubt the wisdom of the reform strategy, and the temptation might be to freeze the reform process and introduce new subsidies. This would be an extremely risky development. Although transition frees enterprises from the planning routines of the socialist state, these enterprises are not yet subject to the discipline of the market-place. The danger is that prolonging the transition will result in a protracted period of low or negative growth in output. As the experiences of other transition economies have shown, decisive transition leads to a more rapid return to stable, positive economic growth. Stalling the reform process results in a protracted period of uncertainty and delays the introduction of market-based practices and institutions.
The financial system's role in the transition process

Improving confidence in the financial system

1.10 As in other countries of the former Soviet Union, high inflation in Uzbekistan (until early 1995) was associated with a rapid reduction in the value of financial claims and a massive transfer of wealth from creditors to debtors. The development in the value of financial claims relative to GDP is illustrated in Figure 1.1. The profile in Uzbekistan is similar to that experienced previously in Russia. The figure also shows that financial intermediation is relatively low in Poland relative to the Czech Republic. The Czech authorities were more successful in reestablishing confidence in financial claims, because inflation was much lower than in Poland and banking sector reform was more decisive. The implementation of the Uzbek Government's stabilization policies should help restore confidence in the financial system – provided that these policies are durable. Increased confidence in the financial system will, however, also depend on reform of the banking system. Enhancing the role of the financial system and reforming the banking system are the central themes of this review. As the financial system develops, access to credit will improve and the allocation of resources will become more efficient. Cross-country evidence confirms that countries with well-developed financial systems (including banks, capital markets, and nonbank financial intermediaries) grow faster and more consistently than those with poorly developed systems. A well-developed financial system also helps countries adjust to economic shocks.
Creating a capital market to enable exchange of private property rights

1.11 Finance is particularly important during the transition period, because transition involves large reallocations of resources and ownership. Together with the implementation of the investment fund privatization scheme, rapid development of capital market institutions will be required to facilitate the transfer of newly acquired property rights in Uzbekistan. Unless the new owners are able to transfer property rights, they will not be able to exercise corporate governance. The development of an efficient trading environment will also be necessary if the new owners are to be able to realize the returns on their investments or guard against forecast losses by relinquishing ownership.

Creating financially independent and responsible financial institutions

1.12 Restructuring of the banking system is also vital to the success of transition. In Uzbekistan the large sectoral banks are predominantly owned by state-owned enterprises. Only as their enterprise owners are privatized will these banks acquire the incentives of private entities. Even after privatization incentives will only change if laws and institutions are developed that enforce respect for contracts among private parties and enable dispute resolution. Furthermore, financial institutions must be held accountable for their decisions. Managing market risks is a complex task, and in some cases institutions will not be successful. Although competition will result in improved efficiency, for some less-efficient institutions failure and closure are inevitable.

1.13 The sectoral banks have begun to realize that lending risks are large and that the legal and institutional environment for debt recovery is weak. Yet they continue to provide finance to nonviable state-owned enterprises. They no longer have access to subsidized finance, and the Central Bank excludes banks that are unable to honor their payment obligations from the interbank credit auctions. Nonetheless, even banks that are excluded from the auctions are occasionally given access to borrowing from the Central Bank. Moreover, they generate funds to provide loans to nonviable enterprises by capitalizing interest on loans and rolling over the principal on bad loans. This kind of behavior undermines bank solvency, crowds out lending to viable enterprises, and – due to the dominant position of the sectoral banks – the stability of the banking system.

Using financial markets to facilitate the transition

1.14 Rather than adopting noncommercial policies and delaying reform, banks should become agents in monitoring state-owned enterprises and imposing financial discipline. This process will also require the active commitment of the authorities to bank restructuring and liquidation. Moreover, the authorities need to further liberalize financial sector activities. Only where regulations are absolutely necessary should new, non intrusive mechanisms for monitoring financial activities consistent with decentralized resource allocation and decision-making be implemented. Finally, increasing the role of privately owned bank and nonbank financial institutions is vital to the transition to a market-based financial system. Increased private activity can only be accomplished by facilitating entry and doing away with the remaining financial controls of the former plan environment.

Addressing the need for comprehensive financial sector reform

1.15 The package of recommendations proposed in this review is designed to introduce a market-based financial system. Piecemeal or half-hearted implementation of these proposals is unlikely to be effective and will prolong the transition. During transition financial systems are forced to operate in
limbo, between the plan and market environments. The danger is that a period of protracted uncertainty will continue to drain confidence in the financial system, damage economic welfare, and postpone return to stable, positive economic growth.
THE FINANCIAL SYSTEM:
DEVELOPMENTS IN MONEY AND CREDIT

The Uzbek authorities tightened monetary policy considerably in 1995, but the effects of the tight policy were compromised by the noncommercial practices of banks. As a result there has been no growth in the size of the financial sector, and the enterprise sector continues to accumulate arrears. These developments were caused by the lack of financial discipline in enterprises. Imposing hard budget constraints is an essential precondition for market-based financial intermediation. This depends crucially on developing respect for property rights and contract agreements as well as in-court and out-of-court bankruptcy procedures.

The banking sector continues to be dominated by state-owned banks and banks owned by state-owned enterprises, and a strategy should be developed to prepare the restructuring of the large enterprises as part of the reform process (see Chapter 5). However, the main challenge now facing the authorities is to foster growth, competition and efficiency within the privately owned segment of the banking industry. This goal cannot be accomplished by splitting sectoral banks into smaller, even more specialized units or by establishing new sector banks.

Arrears are a major source of credit to the enterprise sector. During 1995 the growth of interenterprise arrears was equivalent to 70% of the growth in broad money. Stemming the growth of arrears depends on the implementation of hard budget constraints. As long as enterprises (and their creditors) believe that the Government will eventually bail them out, they will continue to accumulate arrears instead of making timely payments. Banks should be extremely cautious in guaranteeing enterprise promissory notes.

Macroeconomic stabilization and financial markets

Macroeconomic stabilization has already led to significant economic improvements

2.1 Uzbekistan experienced a marked improvement in a number of significant macroeconomic measures in 1995, (Table 2.1). After successive years of economic contraction, the economy is expected to return to mild positive growth in 1996. The Government’s fiscal deficit (measured on a cash basis) fell in 1995 and is expected to be further reduced (as a percentage of GDP) in 1996.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP growth (percent)</td>
<td>-11.1</td>
<td>-2.3</td>
<td>-3.5</td>
<td>-1.2</td>
<td>1.3</td>
</tr>
<tr>
<td>Consolidated fiscal balance</td>
<td>-18.4</td>
<td>-10.5</td>
<td>-7.1</td>
<td>-4.1</td>
<td>-3.2</td>
</tr>
</tbody>
</table>

* Estimated
Source: IMF.

2.2 The significant improvements in the economy in 1995 and 1996 reflected a major shift in the Government’s stabilization policies, which were initiated toward the end of 1994. Between October 1994 and March 1995 the Central Bank of Uzbekistan gradually raised its lending rate (the refinance rate) from
Inflation dropped rapidly in response to this monetary squeeze and tight fiscal policies (Table 2.2). As inflation fell the refinance rate was gradually reduced. From July 1st 1996 the Central Bank reduced the refinance rate to 6% per month, equivalent to 80% a year and since August 1996 the refinance rate has been set at 4% a month, equivalent to 60% a year. Since real interest rates were negative until the summer of 1995 confidence in the value of financial assets was severely undermined. Restoring confidence in financial assets will take time and will depend on the success of the Government's stabilization and financial sector reform policies, as evidenced by other countries that have experienced high inflation.

Table 2.2  As Monetary Policy Tightened, Inflation Fell

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Inflation (percentage change)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Year-on-year</td>
<td>1,291</td>
<td>383</td>
<td>117</td>
<td>51</td>
</tr>
<tr>
<td>Quarter-on-quarter</td>
<td>78</td>
<td>21</td>
<td>14</td>
<td>13</td>
</tr>
<tr>
<td>The quoted Central Bank refinance rate (percent)</td>
<td>225</td>
<td>300</td>
<td>7</td>
<td>7</td>
</tr>
<tr>
<td>Effective refinance rate (percent per year)</td>
<td>686</td>
<td>1,355</td>
<td>125</td>
<td>125</td>
</tr>
<tr>
<td>Domestic credit (percentage of GDP)</td>
<td>15.2</td>
<td>14.2</td>
<td>8.9</td>
<td>11.4</td>
</tr>
<tr>
<td>Broad money (percentage of GDP)</td>
<td>14.7</td>
<td>14.9</td>
<td>12.1</td>
<td>16.8</td>
</tr>
<tr>
<td>Bank deposits in local currency (percentage of GDP)</td>
<td>7.2</td>
<td>8.0</td>
<td>5.5</td>
<td>7.3</td>
</tr>
</tbody>
</table>

Note: GDP figures for 1994 have been inflated to end-of-period prices. GDP figures for 1995 and 1996 are annualized quarterly figures.

Stabilization policies are only partly reflected in bank lending

2.3 To some extent the effect of the Central Bank's high lending rate in 1995 was compromised because a large share of credit in Uzbekistan was intermediated by banks at rates considerably lower than the refinance rate. Lower rates reflected a number of factors. First, in 1994 the Central Bank did not channel all its lending to the banks at interest rates equivalent to the refinance rate, and some of this credit was rolled over into 1995. Since April 1995 Central Bank credit has only been made available at the refinance rate, which is the minimum interest rate at the credit auctions. Second, banks owned by the state and state-owned enterprises were not subject to financial discipline and were willing to engage in bilateral on-lending agreements with other banks at interest rates that were considerably lower than the refinance rate. To prevent banks from lending at noncommercial interest rates in October 1995 the

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1/ As interest was paid on a monthly basis, the effective annual refinance rate rose from 311% in October 1994 to 1,355% in March 1995 (see Table 2.2).
Central Bank issued an order prohibiting bilateral lending among the banks outside the credit auctions. Third, the sectoral banks were also willing to on-lend their deposits to their shareholders at rates below the refinance rate. Noncommercial objectives continue to motivate commercial banks to lend bilaterally and to their shareholders at low interest rates.

2.4 The changes in the Central Bank’s credit policies were accompanied by changes in the behavior of commercial banks. The commercial banks were initially reluctant to follow the dramatic rise in the Central Bank’s lending rate and later were reluctant to reduce interest rates as quickly as the Central Bank. Commercial banks also maintained varied spreads, with average effective margins between their borrowing and lending rates of 50-150% a year. In the fourth quarter of 1995 the commercial banks were typically lending at rates of 7.5 - 10% a month, equivalent to effective annual rates of 138 - 214%. Depending on the banks’ assessment of their credit risks, interest rates could be as high as 14% a month. These large margins can be justified because the banks bear a considerable burden in the form of nonperforming assets and are subject to a considerable tax on their earnings in the form of non-interest-bearing reserve requirements. Larger margins were achieved by exercising "stickiness" in response to the dramatic changes in the official refinance rate.

The financial system is shrinking

2.5 As in other economies that have experienced high inflation and negative real interest rates, the level of credit intermediated through the financial system in Uzbekistan is relatively small (Figure 2.1). Broad money – the total of bank deposits and cash in the economy – averaged 14% of GDP in 1995; bank deposits denominated in domestic currency were equivalent to only 7% of GDP. These deposits are predominantly enterprise deposits. Only about 8% of total deposits originate from household savings, largely in the form of deposits in the savings bank, Narodnybank. The low level of confidence in the value of domestically denominated monetary assets has made alternative means of payment – barter, payment in kind, payment in dollars – increasingly common. Until recently real interest rates on bank balances were negative, providing an incentive to accumulate negative balances in the form of loans and overdue balances with banks or in the form of arrears to other enterprises and the tax authorities.

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2 Since most interbank lending is arranged on an interbranch basis, prohibiting interbank lending outside the credit auctions also encourages banks to manage their liquidity internally. They should also become more aware of their interbank credit risk exposures. In principle banks should not, however, be discouraged from trading outside the auction (over-the-counter).

3 In a static model of a market-based environment, where banks have 30% nonperforming assets, required non-interest-bearing reserves of 30%, and inflation is 100%, the banks will need a margin of about 145% if they are to earn a 5% return on equity and offer a zero real return on deposits. This stylized model of a market-based banking environment has only limited relevance to Uzbek banks because the dominant sectoral banks continued to operate as noncommercial entities. Average spreads were lower because banks often paid negative real deposit rates, rolled over nonperforming loans, and depleted their capital base by honoring dividend obligations.

4 The distribution of deposits as between household and enterprise deposits changed as of the first quarter of 1996 due to the decision of the Government to compensate household depositors for inflation in the period since January 1st, 1992. These compensation funds were transferred to Narodnybank during the first quarter of 1996, but households will only have access to them in equal installments over the next ten years. The first installment was made available on the 1st of July 1996.

5 Factors other than high inflation and negative real interest rates have also eroded confidence in the value of monetary assets. As argued in Chapters 3 and 4, constraints imposed on access to cash and the role of banks as tax inspectors have also undermined confidence in the banking system.
Figure 2.1 Broad Money as Percentage of GDP

![Bar chart showing broad money as percentage of GDP for different groups and Uzbekistan.]

Group 1 Czech Republic, Hungary, Poland, Slovakia, and Slovenia.
Group 2 Albania, Bulgaria, Estonia, Latvia, Lithuania, and Romania.
Group 3 Kazakhstan, Kyrgyz Republic, Moldova, and Russia.
Group 4 Armenia, Azerbaijan, Belarus, and Ukraine.
Source: IMF and World Bank database

*Enterprise funding is occurring through escalating interenterprise arrears*

2.6 In the immediate future the danger is that rising real interest rates will not be accompanied by enhanced financial discipline. Enhanced discipline is essential because real borrowing costs are now high and will need to remain positive for some time so as to cement confidence in the Government's stabilization policies. When real returns were negative enterprises were able to improve their financial situation by accumulating debt and arrears. The switch from negative to positive real interest rates has reversed the situation. This change is a potentially serious threat to the financial stability of enterprises. Those nonviable enterprises that have enjoyed the erosion of their debt liabilities due to inflation will experience acute cash-flow problems as they become caught in a spiral of escalating indebtedness. These enterprises have been allowed to continue to operate despite their liquidity and solvency problems. As yet they are not subject to hard budget constraints.

2.7 Interenterprise arrears grew rapidly during 1995, accounting for 70% of the growth of broad money (Table 2.3). Such growth suggests that interenterprise arrears were a major source of credit to the enterprise sector. Other countries of the former Soviet Union have experienced similar patterns of rapid growth in interenterprise arrears following the tightening of monetary policy and the withdrawal of fiscal subsidies. Data collected by the Central Bank in connection with the isolation exercise suggests that arrears growth in 1995 was predominantly among enterprises, and that growth in arrears to the fiscal

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*To some extent growth in trade credits and payment arrears might reflect arrears in normal trading relationships among enterprises. The authorities should not stifle normal trading patterns. The development of normal trading relationships are, however, unlikely to have given rise to the kind of growth in arrears experienced in 1995.*
authorities and on bank loans was insignificant. However, starting in July 1995 the authorities allowed interenterprise debts to be settled in the form of promissory notes, provided that these notes were guaranteed by a bank. In the third quarter of 1995 alone promissory notes equivalent to 14 billion Sums were issued by the banks (equivalent to the growth in broad money during that quarter). Although enterprises should be given access to trade credits, banks should be extremely cautious in guaranteeing enterprise payments. Banks lack credit risk assessment skills, and it is doubtful whether they are able to assess their risk exposure in guaranteeing enterprise payments.

2.8 Although to little apparent effect, the Uzbek authorities were aware of the dangers of rising interenterprise debts and took a number of steps during 1995 designed to enhance financial discipline within the enterprise sector. First, in May 1995 it was decreed that payments are considered timely only if they take place within sixty days of the delivery of goods and services, and that enterprises must prepay at least 15% of the value of goods purchased. Second, the Central Bank has intensified its monitoring of commercial banks' correspondent accounts, punishing banks that experience payment delays. Third, the tax authorities have been instructed to penalize the managers of enterprises who accumulate arrears outside the banking system.

2.9 In addition to these measures the Government is committed to promoting enterprise restructuring and to preventing the continued build-up of arrears in the economy. The Government has decided to target a group of 30 of the largest debt-ridden enterprises on the basis of both the stock and growth of their arrears in early 1995. These criteria are intended to reflect the potential impact of continued accumulation of arrears by these enterprises in the economy. The Government is committed to privatizing or liquidating these enterprises according to a time-bound action plan.

Table 2.3 Interenterprise Arrears Grew Rapidly in 1995

<table>
<thead>
<tr>
<th></th>
<th>January 1 1995</th>
<th>January 1 1996</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interenterprise accounts payable</td>
<td>31.4</td>
<td>121.7</td>
</tr>
<tr>
<td>Interenterprise arrears</td>
<td>2.6</td>
<td>32.5</td>
</tr>
<tr>
<td>Arrears/payables (%)</td>
<td>8</td>
<td>27</td>
</tr>
<tr>
<td>Arrears/GDP (%)</td>
<td>2</td>
<td>7</td>
</tr>
</tbody>
</table>

Source: Goskomprognostat and IMF.

2.10 Several factors explain the growth of interenterprise arrears. First, enterprise managers may be trying to maintain a certain level of production even though there is insufficient demand for their products. Second, enterprises may be having trouble gaining access to credit from financial intermediaries – since they are ill-equipped to make decisions about credit assessment and risk management, banks may be inclined to refuse the legitimate credit needs of enterprises. Third, the large increases in relative prices and uncertainty during the transition period may have caused enterprises to stop paying each other in anticipation of a Government bailout. Although the Government has announced that it will not undertake any netting of claims, enterprises may not be convinced of the Government's resolve. A clear "no bailout" policy may only become credible over time.

2.11 The growth of interenterprise arrears is symptomatic of the current stage of the transition process, where enterprises are not yet accustomed to hard budget constraints and are attempting to avoid introducing the discipline these constraints impose. If enterprises are to accept responsibility for their
financial claims, the administrative procedures already taken by the Uzbek authorities (paragraph 2.8) will need to be supplemented by structural changes. Property rights will need to be clearly defined and legal institutions developed to enforce these rights. Furthermore, in those cases where debt is not repaid the ultimate sanction of bankruptcy will need to be enforced. Bankruptcy criteria and procedures – both in-court and out-of-court procedures – need to be streamlined with a view to enforcing the restructuring or closing of insolvent enterprises. As discussed in Chapter 3, financial sector development depends crucially on establishing respect for property rights and enforcement of contracts.

High concentration of banking activity

2.12 In 1991 the Uzbek branches of Soviet banks were converted into state or joint stock banks. In 1992 a two-tier banking sector was established with the adoption of the Law on Banking Activity. The Central Bank was formed from the local branch of the Soviet Gosbank. The Uzbek banking sector continues to be dominated by three banking institutions, that were the three largest sectoral banks under the Soviet system (see Annex A). These are Promstroibank, the industrial bank; Pahtabank, the cotton bank (which has assumed most of the assets of Agroprombank, the former agricultural bank); and the National Bank, formerly the foreign trade bank. The National Bank’s dominant position can be attributed to the fact that its balance sheet is predominantly denominated in foreign currency and includes a sizable portion of the Government’s foreign currency reserves. The concentration within the banking sector becomes even more apparent when the savings bank, Narodnybank, and four more banks are included (Table 2.4).

Table 2.4 Sectoral Banks Dominate the Financial Sector
(percentage market shares as of October 1 1996)

<table>
<thead>
<tr>
<th>Bank</th>
<th>Assets</th>
<th>Loans to enterprises and individuals</th>
<th>Enterprise current account balances</th>
</tr>
</thead>
<tbody>
<tr>
<td>Promstroibank</td>
<td>21.6</td>
<td>14.9</td>
<td>27.7</td>
</tr>
<tr>
<td>Pahtabank</td>
<td>15.0</td>
<td>19.9</td>
<td>13.8</td>
</tr>
<tr>
<td>National Bank</td>
<td>39.7</td>
<td>49.1</td>
<td>23.7</td>
</tr>
<tr>
<td>Narodnybank</td>
<td>11.7</td>
<td>0.8</td>
<td>1.9</td>
</tr>
<tr>
<td>Tadbirkorbank</td>
<td>0.9</td>
<td>0.7</td>
<td>4.4</td>
</tr>
<tr>
<td>Savdagarbank</td>
<td>1.2</td>
<td>1.1</td>
<td>2.6</td>
</tr>
<tr>
<td>Gallabank</td>
<td>2.2</td>
<td>5.5</td>
<td>1.8</td>
</tr>
<tr>
<td>Turonbank</td>
<td>1.3</td>
<td>0.3</td>
<td>1.4</td>
</tr>
<tr>
<td>Other</td>
<td>6.5</td>
<td>8.5</td>
<td>22.7</td>
</tr>
<tr>
<td>Total</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Source: Central Bank of Uzbekistan (see Annex A).

\[\text{The ownership of the foreign exchange reserves on the National Bank’s balance sheet was transferred to the Central Bank at the end of 1995.}\]

\[\text{These new banks were established to service specific economic subsectors: Tadbirkorbank (established in 1993) serves the private farming sector, Savdagarbank (1994) serves state trading enterprises, Gallabank (1994) is the grain sector bank and is a spinoff from the former agricultural bank, and Turonbank (1990) was established for water resource management. Data on the date of establishment and major shareholders of the banks is in Annex A, table 1.}\]
2.13 As of October 1, 1996, there were 28 banks in Uzbekistan. In accordance with the Government's gradual reform policies the authorities have been careful in licensing new banks. In all, only 28 new banks had their licenses approved during 1993-95. The aim has been to prevent the establishment of poorly managed, undercapitalized banking organizations that might threaten the stability of the financial system. Given the current concentration within the banking sector, the main challenge now facing the authorities is to foster growth, competition, and efficiency within the privately owned segment of the banking industry. As yet private banks do not play any significant role in the intermediation of credit.

Dominance of public-sector banks

2.14 As privatization is still in its early stages, bank ownership is still predominantly in the hands of the state or state-owned enterprises (Table 2.5 and Annex A, table 1). Only two larger banks, the National Bank and the Savings Bank (Narodnybank), are directly owned by the state. The traditional sectoral banks, Promstroibank and Agroprombank, have been transformed into open joint stock companies and their ownership has been divested. However, this divestiture has been largely to the state-owned enterprises served by the banks.

Table 2.5 Large Banks are Owned by the State and State-Owned Enterprises

<table>
<thead>
<tr>
<th>Type of bank</th>
<th>Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>State banks – entirely state owned</td>
<td>4</td>
</tr>
<tr>
<td>Sector banks – established by decree and license of Central Bank, initially majority state and state enterprise ownership</td>
<td>15</td>
</tr>
<tr>
<td>Universal banks – licensed by Central Bank with mixed private-foreign and state-state enterprise ownership</td>
<td>4</td>
</tr>
<tr>
<td>Private banks – licensed by the Central Bank; mainly private ownership</td>
<td>5</td>
</tr>
</tbody>
</table>

Source: Central Bank of Uzbekistan (see Annex A).

2.15 Most of the new banks were established according to decrees issued by the Government and were initially capitalized by the ministry or Government agency representing the segments of the economy that they were intended to serve. The motivation for the establishment of these banks appears to have been to serve the interests of specific economic subsectors accorded high priority by the Government. As in the case of the traditional sectoral banks the ownership of these new banks has gradually been divested to state-owned enterprises. Thus they continue to be indirectly owned by the state. Several of

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Two new state banks, Asakabank and Zaminbank, were established by a Presidential decree in 1995. These banks were established to support the activities of the Uzbek joint venture with the Daewoo corporation of South Korea and mortgage of real estate respectively. As is the case with the specialized sector banks (see below in the text), the danger is that these banks are too highly specialized and will not be able to survive in a market environment. In the case of Asakabank the only purpose for creating a bank to service the interest of a specific corporation would appear to be to channel favorable access to credit.
the new banks established by Government decree were carved out from the large sectoral banks. As discussed in Chapter 4, these banks are so highly specialized that they would be unable to operate in a market environment.

2.16 Although their combined market share remains very small, there are two other categories of banks. The first is universal banks established by private organizations, two of which are foreign joint ventures, UTbank (an Uzbek/Turkish joint venture) and Uzprivatbank (joint venture with Mees Pierson). The second category is banks established with the capital of private firms. Several of these banks, which are mainly situated in provincial towns, operate on a cooperative basis.

2.17 The current structure of the Uzbek banking sector is not conducive to building a healthy financial sector. The banking sector continues to be dominated by the large state and sectoral banks. As further explained in Chapter 5, the large sectoral banks are in poor financial shape, and the economic well-being of the large state banks depends on economic privileges, such as access to Government-guaranteed business, tax exemptions and leniency as regards reserve requirements and prudential regulations. A number of the new sectoral banks are very small and highly specialized. Several of these new banks are already suffering economic problems associated with the undiversified, specialized nature of their loan portfolios. The number of private banks is small and their market share is insignificant. Enhancing the role of the private banking sector is a prerequisite for establishing market-based financial intermediation in Uzbekistan.

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10 During 1995 the Government divided Agroprombank into three new banks: Pahtabank (the cotton bank), Gallabank (the grain bank), and Mevasebzevatbank (the fruit and vegetable bank). From Promstroibank the Government carved out Alokabank (telecommunications), Legcombank (the light industry bank), and Tashjilsolzbank (social housing).
CHAPTER 3

NECESSARY MEASURES FOR ENHANCING THE ROLE OF THE FINANCIAL SECTOR

3.1 The Uzbek authorities have already taken several important steps to move from a financial system dominated by the sector banks to one with many competing suppliers of financial services. The Central Bank no longer issues directed credits to specific banks at below-market interest rates. Since April 1995 the Central Bank has participated in the interbank credit auctions – supplying and withdrawing credit at the refinance rate, which is the minimum rate at the auctions. During 1995 the Central Bank also started to issue certificates of deposit and since March 1996 the Ministry of Finance has conducted regular auctions in Treasury Bills. The introduction of these instruments allows the Central Bank to conduct a more flexible, market-oriented monetary policy. Though enterprises are still required to conduct all their banking business with one bank, since the beginning of 1995 they have been able to freely choose which bank they do business with.

3.2 Although significant, these measures are not sufficient to allow competition between various parts of the financial sector. As outlined in Chapter 1, the financial system can only fulfill its role in allocating resources if information on prices is allowed to flow freely from one part of the financial system to another. The introduction of the credit auction mechanism was the first step toward introducing market-based credit intermediation. As long as the auctions remain a free process, and not subject to manipulation, interest rates at the auctions will reflect the demand for credit in the economy. As long as market participants are free to act on the prices at the auctions, the auctions will contribute to improving resource allocation.

3.3 This line of reasoning can also be applied to other financial markets such as the markets for foreign exchange, Treasury Bills and Central Bank certificates of deposit. They can also be applied to financial markets as a whole, not just the market for banking services. As enterprises become accustomed to supplementing internally generated funds with funds from financial markets, they will need to compare the costs of borrowing from banks and raising funds through the issue of bills, bonds and shares. To make such comparisons meaningful the principles ensuring competition and transparency need to be applied broadly to all components of the financial system. Experience from Western market economies has shown that efforts to regulate or restrict resource allocation by erecting barriers within the financial system are counterproductive because they distort market signals and are easy to evade. The same is true in Uzbekistan. Now that the authorities have begun to move toward a market-based financial system, the distortions created by various barriers to the smooth functioning of financial markets will generate significant misallocation of resources, and will need to be addressed.

3.4 Several important factors continue to restrain competition among banks in the provision of financial services and seriously inhibit the role of banks in the intermediation of credit. This chapter focuses on three factors, that are considered serious impediments to the efficient functioning of financial markets in Uzbekistan: the distinction between cash and noncash transactions, constraints placed on the banking sector’s access to loanable funds, and an inadequate legal and institutional framework for banking operations. If there is to be progress in the reform of the financial system, all three will need to be addressed in the immediate future.

\[1\] On occasion, however, the Central Bank has used a "credit line" facility to make credit available to individual banks with specific liquidity needs at the auctions. The interest rate on drawing under such a facility is also the minimum auction interest rate.
Dismantling the distinction between cash and noncash

Uncertainty about free convertibility of deposits into cash drains confidence in the banking system and seriously hampers the development of financial markets. It is strongly recommended that Uzbek authorities take immediate steps to remove the distinction between cash and noncash and the requirement that enterprises do business with only one bank.

Maintaining separate cash and noncash accounts has enormous resource misallocation costs

3.5 The distinction between cash and noncash Sums is an important factor inhibiting the development of financial markets. Cabinet of Ministers resolution 356, issued in July 1995, forbids enterprises from withdrawing cash for purposes other than the payment of wages, pensions, and travel expenses. There also appear to be nonformal regulations restricting the ability of households to withdraw cash. Whether the constraints are formal or nonformal, the important issue is that access to cash is limited. 12

3.6 It may well be that these restrictions on obtaining cash serve useful functions during transition, for example containing inflationary pressures and reducing tax avoidance and currency speculation. But restraining cash withdrawals also introduces a distinction between cash and noncash assets, that seriously hampers financial sector development.

3.7 Cash is mainly used for household retail transactions. However, once they have deposited their cash in a bank, households may have to apply for cash withdrawals and experience delays in their ability to withdraw it. Enterprises have to justify their cash needs and must settle all transactions other than wage payments using noncash assets. The significant unsatisfied demand for cash has led to the emergence of illegal arbitrage between the two submarkets. The limited supply of cash and the attempts of the authorities to control the use of cash may result in private sector activity increasingly taking place on an unrecorded basis outside the banking system (for cash only) or in the form of barter.

3.8 The separation of cash and noncash also causes price distortions with enterprises selling the same goods at different prices for cash and noncash. Since noncash is used at the wholesale level and cash is used at the retail level the relationship between wholesale and retail prices is distorted. This gives rise to misinformation, arbitrage transactions, disintermediation, and barter trade. In different subsectors of the economy various implicit exchange rates exist between noncash and cash. This variation leads to serious waste in the banking sector – banks have expanded their branch networks mainly to improve their access to cash resources.

The distinction, once useful, now impedes financial sector reform

3.9 The distinction between cash and noncash used under the Soviet system served a number of important functions. With the move to market, however, these functions should be carried out differently. First, since most consumer goods are purchased for cash, the distinction was intended to reduce inflationary pressures by restraining access to cash resources. A market-based framework for monetary policy has no need for anti-inflation policy based on restricted access to cash. In a market

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12 Resolution 356 was officially rescinded in the second quarter of 1996, but there has been no evidence of changed practices. For example, a Presidential Decree of August 9th, 1996, on “Tax, Enterprises and Banks” is based on the continued close monitoring of the cash supply. Article 3 of the Decree states that “all retail trade and service enterprises shall deposit their cash receipts into banks on a daily basis”.

economy the public’s preference for holding cash – rather than goods or investments – is normally interpreted as a sign of confidence in the value of the currency, that is, low inflation. Since the authorities adopted tight monetary and credit policies in late 1994, inflationary pressures in Uzbekistan have subsided dramatically. If the authorities maintain the current restrictive monetary stance, the inflationary pressures arising from the removal of the distinction between cash and noncash would be small and temporary, subsiding as financial reintermediation takes place.

3.10 The distinction between cash and noncash is also used as an instrument of control for the tax authorities, who rely on daily reports on enterprise expenses and incomes to assess enterprise tax liabilities. The tax authorities also require that enterprises use only one bank so that they can follow the financial flows to and from their accounts. As a result of this control over enterprise payments banks are not able to undertake interbank netting of their transactions and their competition for enterprise customers is curtailed. Recent improvements in the payments system enable interbank payments within the regions to be processed and settled almost on a real-time basis. Payments between two regions are normally cleared and settled within one or two days. But banks’ inability to net transactions among each other overloads the payment system and reduces the ability of banks to undertake liquidity management. Banks should also be encouraged to process their own interbranch payments internally so as to improve their liquidity management. Each bank would then need to maintain just one consolidated account at the regional branches of the Central Bank.

3.11 The tax authorities should move away from using transaction data for tax assessment purposes, relying instead on the financial statements of banks and their enterprise clients. High priority is being given to implementing market-based accounting and auditing techniques for enterprises and banks. Once these new accounting practices are in place, the tax authorities will be able to base their tax assessment on audited enterprise accounts. The broader implementation of these techniques will take time. As outlined below, the authorities should consider developing interim measures to maintain fiscal revenues that relieve the banks of their role as tax inspectors and allow the authorities to dismantle the distinction between cash and noncash.\(^\text{13}\)

3.12 Finally, the distinction between cash and noncash allows the authorities to contain speculative pressures against the currency, because enterprises and individuals have only limited access to cash Sums with which to buy foreign exchange. Since their access to cash is constrained, enterprises are obliged to purchase goods according to the terms of bilateral trade agreements – even when the same goods are available much more cheaply on the cash market. Following the liberalization of the access of individuals to purchase foreign currency in July 1995, the premium between the curb exchange rate and the official rate narrowed considerably. But in October 1995 the authorities again sanctioned a dual exchange market by allowing the exchange rate at the currency bureaus to diverge from the official, auction-determined exchange rate, thus stemming the demand for cash dollars. Although attempts were made to keep the bureau rate close to the auction rate, over the summer of 1996 the exchange rate at the auction and the bureaus was allowed to diverge more considerably so as to stem increased demand for foreign exchange. Measures were also taken to constrain demand for foreign exchange by permitting only “high priority” imports. Together these measures resulted both in a widening of the spread between the auction and bureau exchange rates and in the rapid depreciation of the curb rate for Sums. While the authorities maintain a distinction between domestic and foreign trade undertaken on a cash and a noncash basis, the excess demand for cash is likely to persist and the dual exchange rate system will be preserved.

\(^{13}\) Two means of coping with the fiscal revenue issue are to reduce the emphasis on enterprise taxation (putting greater weight on indirect taxes as sources of revenue) and developing reporting requirements based on enterprise accounts rather than payment records delivered by banks.
Reintermediation of financial flows requires liberalized access to cash

3.13 During the transition period the authorities are understandably concerned about black market trading - regardless of whether this trading takes place in Sums or dollars. But restraints on cash withdrawals tend to lead to the creation of dual markets (whether in Sums or foreign exchange), which seriously distort the market mechanism and price information, thereby leading to the misallocation of resources in the economy. Dual markets also hinder the resolution of fundamental macroeconomic problems because they introduce new price distortions and they conceal and postpone necessary market adjustments without contributing to the resolution of economic imbalances. The Central Bank recently introduced a number of measures to eliminate the differences between cash and noncash settlements. Among these measures is an order giving banks access to the cash equivalent of the balance on their domestic correspondent accounts and an order allowing enterprises to cash checks equivalent to the positive balances on their settlement accounts. These measures are insufficient, however, and the distinction between cash and noncash continues to be a major impediment to the reintermediation of financial flows and financial sector adjustment.

3.14 One measure that would prevent these distortions and thwart illegal trading would be to fully liberalize access to cash Sums below a certain threshold by allowing cash demands to be honored immediately and automatically. Above this threshold cash withdrawals would still be honored immediately but would be reported to the authorities, allowing the authorities to follow up in cases of suspected misuse. As in most market economies the authorities should be given access to bank statements if they have reason to believe that submitted tax returns are incorrect. But only in those cases, where the authorities' requests are supported by court orders, should banks be obliged to submit information on client accounts.

Reducing constraints on the availability of loanable funds

A number of steps should be taken to increase banks' access to loanable funds. Most important, the Central Bank should pay interest on the banks' required reserves. In addition, over the medium term the size of the combined reserve requirements should be gradually reduced.

Required reserves severely constrain banks' ability to on-lend funds

3.15 The intermediation of financial flows through the banking system is also inhibited by the constraints placed on the availability of loanable funds. At present banks are required to honor several kinds of reserves. The first is the statutory non-interest-bearing reserve requirement equivalent to 25% of the banks' clearing account and deposit account balances. This requirement was reduced from 30% to 25% in 1996. The burden on bank earnings could be reduced further if the Central Bank paid interest on the deposited reserves or further reduced the size of the required reserves.

3.16 Until recently banks were also required to maintain non-interest-bearing deposits at the Central Bank's clearing centers equivalent to their clearing balances. This requirement ensured that all banks were able to honor their payment obligations without incurring overdrafts on their clearing accounts with the Central Bank. In 1995 risks in the clearing and settlement of payments between the banks were

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14 It should be noted that limiting access to cash does not prevent illegal trading. Limiting access to cash will only increase the premium on illegal trades, thus augmenting the rewards to insiders who have privileged access to cash.

15 This order gives enterprises access to cash provided that they can justify and document their cash needs.
reduced significantly due to the recent modernization of the payments system and the liquidity requirement was dismantled in 1996. The one-time release of liquidity was offset by the sale of Central Bank Certificates of Deposit and by Central Bank purchases at the credit auctions.

3.17 Since mid-1995 banks have been required to maintain so-called regulation funds for overdue loans, a precautionary reserve to cover possible future losses. This mechanism allows the Central Bank to debit the correspondent accounts of the banks for up to 30% of their total liabilities minus their interbank borrowings (the funds generated from enterprises and households). Every month banks report their overdue loans (customer by customer) to the Central Bank. If a loan is 60 days past due a fund allocation equivalent to 25% of the value of the loan is required. For 90 days the requirement is 50% and for 180 days, 100%. If a bank does not have sufficient funds in the regulation reserve, the Central Bank may disallow it from participating in the interbank credit auctions. The earmarking of reserves to cover overdue loans and the sanctioning of banks with insufficient regulation funds are useful interim measures. However, they reduce the funds available all banks, even those that are not burdened by large portfolios of bad loans. Since it does not reflect the nature of banks’ loan portfolios, this reserve requirement inhibits new entrants from gaining market share.

3.18 The two remaining reserve requirements constitute an excessive burden on the earning potential of the banks and deprive them of capacity to extend loans. After adjusting for these requirements banks may be left with only about 40% of their deposits and internally generated funds to on-lend. Although statutory and liquidity reserve requirements can be used as tools of monetary control to restrain inflation and to support the prudential regulation, requirements of the size imposed on the Uzbek banks seriously constrain banks’ earning capacity. Substantial resources are removed from the banking system and channeled through the Central Bank. Thus the banking system is still more akin to a mono-banking environment than a two-tier, market-based system.

3.19 It should be noted that the supply of loanable funds continues to be constrained by certain features of the payments system. As outlined in paragraph 3.10 banks do not undertake netting of interbank payments or manage their own liquidity at the Central Bank on a consolidated basis. This discourages the banks from managing liquidity and ties up loanable funds.

Recommendations to improve the supply of loanable funds

3.20 The Central Bank should be encouraged to pay interest on the banks’ statutory reserves. This would ease the burden of the reserve requirements. Alternatively, the share of deposits required for the reserves could be lowered. In either case adjustments should be phased in so as not to undermine the control of monetary aggregates.

3.21 Once the new bank accounting framework is implemented, banks should be permitted to deduct loan loss provisions from their taxable income before tax (within certain limits) and the Central Bank should eliminate the regulation reserve. Banks would assume responsibility for making sufficient

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16 These reserves can be regarded as sizable general reserves. The deductions in the contingent reserves can only be regarded as an interim measure, because they are calculated on the basis of ex post, already ascertained losses. When banks implement the new accounting system, they will be required to build reserves to guard against future anticipated losses.

17 The payments system is further discussed in Chapter 4.

18 The issue of deducting loan loss provisions is discussed in Chapter 4.
provisions for their bad loans in accordance with banking supervision requirements, and the Central Bank would no longer need to impose a blanket provision on all banks. The Central Bank is committed to introducing tax-deductible loan-loss provisions and to dismantling the precautionary reserve to cover future losses. The Central Bank should differentiate the required size of banks’ clearing balances to reflect the solvency of individual banks. As the quality of the Central Bank’s supervision of banks improves, it should drop this requirement.

Improving the legal and regulatory framework for financial transactions

A number of important changes are needed to improve the legal and regulatory framework for financial transactions:

- A civil code should be implemented regarding private property rights and contracts.
- A commercial code should be applied to all commercial transactions.
- Court procedures need to be established to support the enforcement of unsecured claims.
- Banks need to be given improved access to realizing collateral.
- Centralized registries need to be established to record ownership and liens.
- A law should be passed that encourages lenders to use movable property that remains in the hands of the borrower as collateral.
- Bankruptcy proceedings should be streamlined and procedures should be developed for out-of-court settlement among disputing parties.
- Steps should be taken to improve liquidity in real estate markets and to improve banks’ access to taking possession and selling collateral.
- The state should stop providing insurance to cover banks’ credit risks. Managing these risks is essential to market-based banking.

Civil and commercial codes are essential for well-functioning financial markets

3.22 As noted in Chapter 1, the most fundamental legal and regulatory requirement in a market-based economy is respect for and enforcement of private property rights and contracts. Unclear civil laws on contracts and private property rights and unclear commercial rules on the use of financial instruments, the calculation of interest on financial instruments, and other commercial practices hamper the development of financial markets and give rise to unnecessary disputes between debtors and creditors. In several areas the authorities have already embarked on significant reform of the legal system. Bankruptcy courts have been established and a new civil code is under preparation. A new company law was recently passed by the Uzbek parliament. Nonetheless there is a need to ensure that these laws are coherent, internationally acceptable and enforceable. This Review highlights the importance of the adequacy of the legal framework, but a detailed plan for legal reform lies beyond the scope of the report.

Court procedures are needed to support enforcement of unsecured claims

3.23 In market economies banks base their lending on the prospective future cash incomes of their borrowers. Collateral is a secondary form of credit enhancement. In assessing credit risks banks focus predominantly on whether borrowers have sufficient collateral rather than on evaluating their prospective

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19 Rules for classifying loans were recently stipulated in a decree issued by the Board of Directors of the Central Bank (of July 20th, 1996). However, a number of issues still remain unresolved. These relate to (a) the accounting treatment of loan losses, (b) the banks' access to deducting reserve allocations from tax, and (c) the definition of reserves relating to expected rather than actual accounting losses.
cash flows. Banks in Uzbekistan should be encouraged to lend not only to private parties who have access to tangible assets capable of being pledged, but also to the much larger pool of potential borrowers who do not own such assets. Banks' unwillingness to lend against cash flow may reflect inexperience in assessing economic returns and credit risks, but it also reflects weaknesses in the legal system.

3.24 Dispute resolution mechanisms need to be established for those cases where property rights and contracts are not respected. In market economies banks rely on simple and efficient debt collection mechanisms. Banks know that if a borrower does not pay, they can use the courts to obtain a quick (and usually uncontested) judgement against the borrower. If such judgements are not respected, they can be used as justification for the court to seize and sell the borrowers' property or for asking the court to declare the borrower insolvent. Judgements on unsecured claims brought by banks also serve an important signaling function in market-oriented financial systems. The fact that a judgement has been obtained is normally published and provides valuable information for other potential lenders and for credit reference agencies.

**Banks need improved access to collateral**

3.25 In order to undertake financial transactions in a market-based environment, it will be necessary to develop a legal and regulatory framework for the use of collateral and recovery on loans in cases of default. If financial institutions are to assume a more active role in managing credit risks, it is essential that they be able to manage these risks by having access to collateral that they can claim and realize in the event of default. Even where collateral is held by the bank, the borrower may claim that the bank is not entitled to enforce its collateral claims. A well-functioning court system is needed to resolve such disputes.

3.26 The current framework for foreclosure on collateral works relatively well when private borrowers are involved, but it specifies that state-owned enterprises cannot pledge the property they own. Since most bad debtors are wholly or partially state-owned, the banks have no recourse in the case of these firms. The simple solution to this shortcoming would be to allow state-owned enterprises to pledge their assets. Otherwise it will be difficult for banks to play a more significant role in credit intermediation based on commercial lending criteria without serious progress on enterprise privatization.

3.27 A law on the mortgage of real estate has been promulgated, but there is no law concerning other forms of collateral. These laws should stipulate fast and inexpensive means of recovery and sale of collateralized assets as well as dispute resolution mechanisms supported by the court system. The law on collateral should also encourage lenders to make loans secured by collateral in the form of movable property that is held by the borrower, such as tractors, livestock, machinery, and so on.

**Reliable registration of ownership rights and mortgage and collateral claims is essential**

3.28 A prerequisite for using security in the form of collateral is being able to establish evidence of ownership in the form of titles and liens. Although the Ministry of Justice maintains a record of titles and liens on real estate based on information supplied by notaries, this system is not working as well as it should. The system is weak partly because the notaries do not always file information on sales or pledges of property in a timely manner and partly because enterprises are only allowed to borrow from one bank. Thus it is difficult for an enterprise to pledge the same collateral to more than one bank, and the bank has little incentive to formally record its lien. The risk inherent in not recording ownership and liens in a timely and reliable manner will become more apparent once greater competition is introduced into the financial system. Furthermore, improving records of ownership and lien could contribute significantly to improving access to credit. Such access would be particularly useful for newly started
enterprises without the credit histories on which financial institutions normally base their assessments of creditworthiness. The authorities should take steps to establish computerized registries for recording ownership rights and all contracts specifying claims against these rights. Registries of this kind will be essential for the future development of housing finance and the supply of finance to the rural sector (see Chapter 7).

**Taxation and accounting practices need to facilitate the liquidation of collateral**

3.29 Other factors hindering the development of an effective framework for debt recovery are the tax treatment of the proceeds from the sale of collateral and the lack of a sufficiently liquid market for real estate. At present, once a property has been obtained through foreclosure, banks are often unable to dispose of the property at a reasonable price. Accounting and taxation practices make it difficult for the tax authorities to accept a sale value that exceeds the book value of the collateral. It is also difficult to establish a reliable market value for collateral due to underdeveloped markets for real estate and other mortgageable assets. Revising enterprise taxation and accounting practices and augmenting the supply of tradable real estate (through privatization) would significantly improve banks' access to realizing collateral at a "fair" value.

**Simplified bankruptcy procedures are needed for in-court and out-of-court settlements**

3.30 A Law on Bankruptcy was promulgated May 5, 1994. The law prescribes the conditions and priority of claims with respect to individuals and enterprises in bankruptcy, as well as rules for compulsory or voluntary liquidation of bankrupt enterprises. According to the law creditors may initiate bankruptcy proceedings against debtors, whose debt is overdue for more than three months or whose debt exceed the value of their assets. The law does not apply to enterprises financed under the state budget.

3.31 The system of special economic courts has jurisdiction over bankruptcy cases. A bankrupt enterprise has the right to apply to the court to suspend proceedings for up to eighteen months in order to attempt a turnaround with financial assistance. Most cases have been brought to the courts by banks since these are usually among the main creditors. By January 1996 bankruptcy proceedings had been initiated against 150 enterprises, of which 58 had been declared bankrupt by the Supreme Economic Court. Restructuring was initiated in 17 cases.

3.32 It is important that bankruptcy proceedings have been put in place and that enterprises are being declared bankrupt. But given the amount of bad debt within the banking system, the number of cases brought to the courts thus far has been small. This may change as more enterprises are privatized and greater financial discipline is imposed. Declaring enterprises to be bankrupt is, however, only the first stage. If declarations of bankruptcy are to be useful, simple and streamlined procedures for enterprise restructuring and liquidation need to be established. The effectiveness of these procedures will require the full support of the court system. The rulings by the courts will set precedents for in-court and out-of-court settlements among disputing parties. Clear criteria should be introduced for determining insolvency and assessing the claims of creditors. Rules should be established giving secured creditors priority over Government claims. In cases where restructuring initiatives are taken by enterprise creditors, workable voting rules should be established to ensure that restructuring is not hindered by minority claims but that the interests of minority creditors are respected. If creditors are to initiate enterprise restructuring, they will need to be able to sell enterprise assets according to simple procedures and without undue delay. It is important that asset values can be easily realized and that assets can be

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21 These data were published by the official Uzbek newspaper, *Narodnoye Slovo*, on January 12, 1996.
assigned to alternative, more productive uses. Reforms in these areas will be essential if banks are to assume a role in enterprise restructuring (see Chapter 5).

State-funded credit insurance inhibits development of the banking sector

3.33 Lacking experience in evaluating credit risks, banks in Uzbekistan generally try to find collateral or other forms of security for their lending. Since banks have trouble realizing collateral, they have started accepting guarantees from third parties or other banks and using credit insurance to cover their credit risks. Guarantees are not always a reliable source of security for the banks. In several cases referred to the commercial courts, guarantees from other banks have not been honored. As an alternative to collateral and guarantees the use of credit insurance has become more widespread. This is an unfortunate development because the banks are passing on their credit risks to insurance companies. Given their intimate knowledge of their customers’ finances, banks should have a comparative advantage in assessing credit risks. Moreover, credit risk assessment is an essential banking function in a market economy. Even though banks still have much to learn about market-based banking, their skills should be superior to those of insurance companies.

3.34 It is of serious concern that credit insurance is provided predominantly by two state-owned insurance companies, Gostrakh and Uzinvest. In effect the authorities are indirectly assuming the major risks of the banking system and opening the door to moral hazard because banks are in a position to grant loans without being held responsible for the associated credit risks. Thus the insurance reduces the incentive of banks to acquire credit risk assessment skills. There is a serious danger that banks will continue to refer their risks to Government-sponsored organizations, much as they did under the system of directed credits. If the authorities are serious about establishing credit markets, immediate steps should be taken to discontinue state-run credit-risk insurance schemes.
4.1 The Uzbek authorities are aware that the move from a system based on state control of financial transactions to a competitive environment creates the potential for abuse. Instead of improving efficiency and the allocation of resources, financial sector participants may be tempted to engage in imprudent or fraudulent transactions. In guarding against such behavior the guiding principle is to improve transparency regarding the regulation and execution of financial transactions. Greater transparency gives both the authorities and economic agents easier access to the information that is needed to assess risk in economic transactions.

4.2 This chapter focuses on a number of measures designed to improve transparency in the banking sector. These measures are all intended to guard against misuse of the financial system and reduce the risk of financial instability. The purpose is to define the foundations of and accepted practices for banking sector activity, including the accounting framework and licensing, regulation, and supervision of financial institutions. Although these measures, if they are successfully implemented, will improve the safety and soundness of the financial sector, they are insufficient to preserve the stability of the financial system as a whole. Experience from developed market economies confirms that the causes of financial instability are almost always related to poor macroeconomic policies and misguided regulations rather than to the irresponsible behavior of individual economic agents.

Accounting and auditing

The Central Bank has revised the accounting standards for banks. Although implementation of these standards is a complex task that will require the assistance of foreign experts, it should be given the highest priority. To promote the training of audit professionals the Central Bank should set requirements on the frequency of audits, the content of the audits, and the qualifications of the auditors. The Central Bank should also promote the introduction of revised enterprise accounting.

Introducing international accounting standards is a sizable task

4.3 Creating an efficient accounting and auditing framework using market-based techniques is an essential step toward improving transparency in the banking sector, making it possible to monitor the profitability and soundness of banking operations. The authorities have embarked on the process of introducing internationally accepted accounting standards for the banking sector. Assisted by international accountants financed under the World Bank’s Institution Building Loan the Central Bank has developed a new chart of accounts for commercial banks. This chart of accounts is expected to meet all international accounting standards and to be consistent with international practices regarding financial reporting. The new chart of accounts is being implemented on a pilot basis in two banks, Promstroibank and the National Bank, and it was the original intention of the authorities that all banks adopt the new accounting standards as early as January 1st, 1997. Experience from other countries suggests that switching from one accounting system to another is a very time-consuming and resource-intensive process. This is confirmed by preliminary experience with the pilot banks in Uzbekistan, suggesting that it will take two or three years to implement the standards in all banks. Although it is very valuable that the authorities have given high priority to the introduction of the new accounting framework, the size of the task should not be underestimated. Considerable resources will need to be devoted to staff training.

Chapter 6 makes proposals for creating a suitable infrastructure for the development of capital markets.
and the development of computer software to facilitate the implementation of the project. Working with foreign experts, the Banking and Financial Academy – to be funded by the recently established Banking Association – could design and execute a program for training in bank accounting skills.22

All banks to be subject to international audits

4.4 As a valuable interim measure the Central Bank has decided that all banks in Uzbekistan will be audited according to international accounting standards for the 1996 financial year.23 The Central Bank has committed to paying for the first annual audits and envisages that these audits will be carried out by accredited international auditors. The audits will be useful in introducing the banks to international accounting and auditing procedures. They will also provide an assessment of the current state of the banking industry, which will be very useful in designing the restructuring strategy for the banking sector (see Chapter 5).

Measures should be taken to accelerate the development of an auditing profession

4.5 A law on auditing was promulgated in 1992, but this law relates to auditing in general and not specifically to banks or financial institutions. Only one local firm, Uzbankaudit, performs statutory audits of commercial banks and these are conducted according to local rather than international standards. Foreign accounting firms are involved in auditing local banks and have started training local staff. The development of an auditing profession will most likely rest, in part, on the ability of foreign firms to transfer knowledge of international auditing concepts to local counterparts. It is recommended that the Banking Association fund intensive training in auditing techniques.24

4.6 To accelerate the process of developing a local auditing profession it is recommended that the Central Bank – working with the international accounting advisors – develop a reporting accountant approach. The Central Bank should establish the scope, content, and frequency of the audit program and audit reports and develop a framework to evaluate the qualifications of auditing firms. A list of approved auditors would then be established. Developing an audit profession will require considerable assistance from Western auditing experts and extensive training of local auditors. These auditors would be responsible for checking reports, reporting material findings, evaluating loan portfolio quality and loan loss provisions, and performing other important tasks as specified by the Central Bank. The Central Bank should insist that all banks publish annual audited accounts. During their annual review the auditors

22 According to Cabinet of Ministers Resolution 427 (November 9, 1995) the Banking Association has been given the mandate to redeploy funds equivalent to the tax exemption granted to banks through the end of 1997. Many of the activities proposed in the resolution would be more appropriately assigned to private enterprises, and should not be performed by a banking association. In the area of training the association should seek to draw on the expertise of the international accountants currently designing the new accounting framework. In implementing the training the association should coordinate its efforts with the European Union’s Technical Assistance to the Commonwealth of Independent States program, which is already engaged in implementing a revised accounting framework for the enterprise sector and in the training of bankers in Tashkent.

23 Central Bank decree no. 20 of July 20th, 1996, sets out the terms of the proposed audits.

24 Cabinet of Ministers Resolution 427 (November 9, 1995) proposed that some of the earmarked funds being channelled to the Banking Association be used to create audit companies. Although it is important to create an audit profession, it would be unusual for a banking association to establish audit companies. It would be more appropriate for the authorities to require that banks be audited by independent auditors according to international standards. Initially these auditors might have to be provided by international accounting firms. However, domestic specialists would quickly acquire similar skills and provide the same services at competitive rates.
should also be required to verify the banks' half-yearly account statements. To make sure that the audit statements are reliable, the auditors should be appointed by the banks' supervisory boards, and the managers of the banks should be held liable for misinformation or withholding relevant information.

4.7 The reliability of bank audits depends to a great extent on the quality of information on a bank's major clients and on developing auditing standards for commercial enterprises. The Central Bank could help accelerate this process by providing guidance to banks on the need to obtain current and satisfactory information on borrowers from a loan's inception to its repayment. For large loans such information should be audited. Increasing the demand for such services should support the development of the auditing profession. The proposed reporting account approach will complement the development of an effective on-site supervisory capacity in the Central Bank, since the audit reports will be valuable in providing direction for the Central Bank's supervisory initiatives.

4.8 Revising the accounting framework is the first essential step toward creating greater transparency within the financial system. Thus producing meaningful and reliable information on the activities of banks should be a priority for the supervisory authorities. Published accounting information will also support the corporate governance exercised by bank depositors and shareholders.

**Prudential supervision**

In exercising banking supervision the Central Bank needs to implement a major change in emphasis – moving from controlling banking activities to encouraging prudent behavior. The role of supervisors is no longer to monitor the allocation of credit, but to assist in preserving a sound banking system. The revised Central Bank and banking laws should help the Central Bank carry out its supervisory functions – its right to issue supervisory regulations, specify accounting standards, and require disclosure of information. The Central Bank is in the process of revising banking supervisory procedures in accordance with the revised legal framework.

On-site supervision should move from the control of transactions to the surveillance of banking risks. An important role for on-site supervisors is assessing the adequacy of bank loan loss provisions. It is envisaged that revised practices for on-site supervision will be fully implemented within two years, to coincide with the implementation of plans for restructuring of the major sectoral banks (see Chapter 5). For other banks implementation of revised on-site supervisory practices should be given high priority. It will not be possible to implement revised off-site supervisory practices until revised bank accounting standards (consistent with international standards) have been implemented. Finally, a coherent training program for bank supervisors should be designed and implemented. It will be important to attract and retain qualified staff.

Supervision helps ensure sound banking practices, but it cannot prevent bank failures

4.9 As in many market economies the responsibility for prudential supervision of the banking system in Uzbekistan rests with the Central Bank. Bank supervisors are supposed to enforce meaningful rules that support shareholders and depositors in monitoring the risks of market failure, thereby enhancing the safety and soundness of banks. Market failure in banking results from the inherent riskiness of banking operations, which makes it difficult to rely on bank shareholders and depositors to exercise corporate governance – even if they are well-informed. Moreover, the risk exposure of banks is difficult to monitor, since it can change rapidly.

4.10 Proper supervision is difficult to achieve. In a market economy bank failures cannot be avoided because banking – like all other economic activities – involves taking risks. If bankers take
imprudent risks, they risk depleting their capital base and eventually being forced to discontinue their operations. Since banks are highly leveraged and redeploy depositors’ savings, however, banks are unlike other economic entities. The role of bank supervisors is to restrain banks from taking risks that are so large that their capital base is in danger of being wiped out, thus endangering the funds deposited by households and enterprises. Still, supervisors must tread carefully. If bankers are not allowed to take prudent risks they will not be able to earn a sufficient return on shareholders’ capital – and so will go out of business.

4.11 Experience from developed market economies shows that even the best supervisors have trouble predicting the riskiness of banking operations and hindering banking crises. In transition economies the task of supervision is even more difficult. Supervisory techniques are still being developed in these countries, and it is difficult to train and retain qualified supervisors. Nonetheless, encouraging sound banking practices and enforcing observance of these practices will improve the functioning of the banking system and protect the interests of shareholders and depositors.

Revising the Central Bank’s supervisory function

4.12 Under Socialism the Central Bank’s supervisors collected information in order to control the allocation of resources in the economy. The vestiges of this control mentality are still evident in the Central Bank, as evidenced by its focus on monitoring the validity and purpose of payment orders. Although the Central Bank is revising its regulatory function, resources are also still used to ensure compliance with economic requirements and ratios, which are unrelated to the major risks of bank operations in a market environment. As a general principle the allocation of resources in a market economy is determined by competition between private entities. Supervisors should interfere in the market mechanism as little as possible, because intervention results in market distortions and can have high costs. These costs can be in the form of price distortions and lost efficiency or overt costs.25

4.13 The new banking laws vest authority for banking supervision with the Central Bank, but as yet this authority remains largely untested. Several measures need to be taken to revise the Central Bank’s role and function as bank supervisor. First, the authority vested in the Central Bank by the new legal framework will need to be confirmed. Revised supervisory regulations and practices will need to be implemented and tested.26 Second, the Central Bank’s supervisory and licensing activities should be clearly directed at preserving the safety and soundness of the banking sector. Third, the Central Bank will need to develop the expertise to deal with problem and failed banks. Supervisors will need to focus on the financial condition, performance, and prospects of banks and develop effective remedies for dealing

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25/ The savings and loan crisis in the United States is an example of a banking crisis that was inadvertently caused by restrictions imposed on the interest rates that these institutions were allowed to pay on their deposits. The managers of the savings and loans were accustomed to the protection offered by these restrictions, and when these restrictions were lifted the managers were unable to manage the institutions’ risks in a competitive environment. Salvaging the institutions was a major cost that had to be borne by the U.S. taxpayers.

26/ The Central Bank law sets out the sanctions available to the Central Bank as supervisory authority with greater clarity than the subsequently enacted banking law. If the sanctions in the Central Bank law are superseded by the weaker legal foundation provided by the banking law, this will significantly weaken the hand of the Central Bank in carrying out its functions as supervisor. Normally the sanctions to be applied by the Central Bank vis-à-vis the banking sector would be specified in the banking law.
with insolvent banks. The changes in the supervisory role of the Central Bank relating to these areas are outlined below. Bringing about these changes will require considerable resources in the form of staff training and career development. These organizational and training issues are discussed in greater depth in Annex C.

4.14 The legal foundation for the Central Bank’s revised supervisory role. The newly enacted Central Bank Law, which was passed by Parliament on December 21, 1995, vests considerable authority in the Central Bank. Important provisions in the law give the Central Bank the authority to classify bank assets and demand the formation of adequate reserves to cover losses. The law also gives the Central Bank the authority to stop distressed banks from paying dividends, to require the reorganization of banks, and to withdraw banking licenses.

4.15 A revised banking law, the law on Banks and Banking Activity, was enacted on April 25th, 1996. This law contains many significant improvements over the previous law from 1992. For example, the special status of the National Bank is eliminated, thus promoting a more level playing field for banking institutions. The law also permits only one form of bank ownership, the joint stock company.

4.16 The main deficiency of the recently enacted banking law is its failure to sufficiently articulate provisions in the essential areas of bank reporting, bank accounting and bank inspection. The law is not specific concerning the Central Bank’s right to issue implementing regulations and specify accounting requirements, the obligations of banks to provide financial information to and submit to inspections by the Central Bank, and remedial measures available to the Central Bank. It would have been desirable to describe these matters in the banking law so that banks are made aware of their precise responsibilities and to impress upon the banks that the scope of the authority of the Central Bank as supervisor is beyond doubt. The law would also have benefitted from provisions establishing administrative autonomy of the banks and their managers so as to confirm the operational independence of bank managers and their duty to place the interests of their banks and their customers before their own.

4.17 Revising the role of on-site – supervision-replacing control with risk surveillance. On-site examination of banks by the Central Bank is currently much more akin to auditing than to bank examination. The majority of resources are used to inspect compliance with reporting requirements and economic norms and to assess branch networks and individual transactions. This bottom-up approach needs to be replaced with supervision of strategic decision-making and risks, thereby supporting the safety and soundness of the banking system. The Central Bank’s on-site supervision should monitor how banks identify, measure, and control banking risks by assessing banks’ policies, risk management systems, management information systems, internal accounting and administrative controls and strategic, financial, and operational plans. Other important elements of on-site supervision involve evaluating the quality of banks’ loan portfolios, the adequacy of loan loss provisions and debt writeoffs, and the ability of bank...
management to cope with these issues. The supervisors should be in a position to recommend action that will improve banking culture, enhance corporate governance, and strengthen management systems. A number of measures designed to improve the on-site functions of the Central Bank are proposed in Box 4.1.

**Box 4.1 Measures designed to improve the Central Bank’s on-site supervision**

Several measures could be considered to expedite the process of replacing the current control-oriented function of on-site supervision with supervision based on safety and soundness considerations:

- The focus should be on establishing prudent policies, systems, and controls within the banks using a top-down approach, rather than working bottom-up at the transaction level. The United States has adopted a system of standardized criteria for evaluating banking risks called CAMEL risk components. These criteria refer to Capital adequacy, Asset quality, Management, Earnings, and Liquidity as well as to the banks’ asset and liability management. The Central Bank has shown interest in adopting such a framework but has not yet done so.

- Supervision of banks should take place on a consolidated basis rather than branch by branch with a focus on banks’ overall financial condition, performance, and prospects. It is, for example, only possible to assess a bank’s ability to absorb losses through capital and reserves on a consolidated basis; this cannot be done at the branch level.

- In line with the reorientation of the supervisory functions of the Central Bank, staff resources should be redeployed so that examination staff are available to concentrate on inspecting those offices where banks have their greatest risks.

- The Central Bank should adopt formal written examination procedures. The procedures would include a standard format for examination reports, an examination manual, and a set of policies relating to examination processing and follow-up. The aim should not be to replace the judgement of the examiner but rather to document work performed, to train less-experienced staff by providing a step-by-step methodology, and to ensure consistency in the scope of work performed by the various examination teams. A standard report format will also ensure that the Central Bank has the information it needs to make necessary decisions and that examination findings are communicated to the bank in a manner that is consistent and uniform between examiners.

4.18 Following the enactment of the new banking laws the Central Bank has embarked on the process of revising the regulatory foundation for off-site supervision. According to protocol no. 20 of July 20th, 1996, banks are required to classify their loans according to five categories reflecting loan quality. The protocol is an important first step, but several issues still need to be clarified before this loan classification system can be successfully implemented. First, the loan categories reflect ascertained loan delinquency rather than prospective risk of loan delinquency. Loan-loss provisions should be forward-looking and relate to banks’ forecast risks. Second, banks will not set aside loan loss provisions while the tax status of these provisions remains unclear. As yet the Ministry of Finance has not committed to allowing banks to deduct provisions from tax (see Section on the taxation of banks below). Third, the protocol envisages that all banks will accumulate sufficient capital over the next three years so as to be able to cover their provisions and fulfill the Central Bank’s capital requirements. Not all banks can be expected to earn sufficient profits to achieve this and the Central Bank will need to specify contingency plans for these banks. Finally, the protocol is particularly weak on the subject of loan recovery, which the banks are encouraged to pursue through the judicial system. Experience to date demonstrates that the enforcement of the law in this area is cumbersome and difficult. Measures will be
needed to be taken to improve the process of debt recovery and banks should be encouraged to recover
debts from their borrowers under the civil code (simple debt recovery) rather than through bankruptcy
proceedings alone (see Chapter 3).

4.19 Although the number of staff employed in the supervision of the banking system appears to
be adequate, in order to fulfill the needs of market-based bank supervision the staff will need to be
retrained and redeployed. However, in order to ensure that supervisors are able to develop their capacity
within these areas, a coherent and intensive training program supervised by foreign experts will be needed
(see paragraph 4.23).

4.20 For those banks included in the restructuring plans outlined in Chapter 5 it is envisaged that
revised practices for on-site supervision will be fully implemented within two years – that is, at the time
of the implementation of the restructuring plans. For other banks implementation of revised on-site
supervisory practices should be given high priority. Until revised on-site supervisory practices have been
implemented, the capital adequacy of these banks remains doubtful.

4.21 Developing off-site supervision requires a revised framework for bank accounting and
reporting. The purpose of a well-developed off-site surveillance system is to function as an early warning
system of individual banks’ risk exposures and systemic risks. At present the Central Bank’s off-site
supervision capacity is still in its formative stages. The focus is on ensuring compliance with economic
norms and reserve requirements rather than broader safety and soundness concerns. But many of the
norms are not meaningful, because they do not reflect the major risks of banks. As a result each oblast
(region) undertakes off-site examinations, partly to monitor the validity and purpose of payment orders
and to ensure that enterprises use cash for approved purposes only.

4.22 Better off-site supervision of banks will require implementing a new chart of accounts
consistent with international standards. At this stage it is important to ensure that the reporting
requirements of the off-site supervisors are met by the new accounting system. Until this system is
functioning reliably and providing the necessary information it will be difficult to upgrade the Central
Bank’s off-site supervision capacity. Implementation of the accounting framework is also a prerequisite
for upgrading of banks’ management information systems.30

4.23 Once the new accounting and reporting systems are in place off-site supervision of banks
should take place on a consolidated basis. Off-site supervision at the oblast level will no longer be
meaningful. The task of off-site supervisors will be to develop a database on the basis of banks’
prudential reports, from which standard and ad hoc analytical reports can be prepared. These reports
should compare a bank’s performance using ratio, trend and peer group analysis to identify potentially
harmful trends and problems before they have an opportunity to seriously damage a bank or the banking
system. To support this type of analysis the prudential regulations currently administered by the Central
Bank will need to be revised (see Annex E). The Central Bank recognizes the need to strengthen off-site
supervision and has recently engaged foreign consultants (financed under the World Bank’s Institution
Building Program) to assist with automation and the design of software for analysis.

30 Since mid-1994 the banks have been given a tax holiday. Initially the saved taxes were made available to the
banks to purchase computer equipment, and could therefore contribute to upgrading their management information
systems. Cabinet of Ministers Resolution 427 (November 9, 1995) extends the tax-holiday and states as an explicit
objective that the saved taxes be made available to implement automation systems for internal bank operations. The
Government’s intention is to provide funds for the considerable capital expenditures required of the banks during
the transition period. In market economies banks are normally required to fund the automation of their management
systems so as to generate the reports required by the authorities.
4.24 Training bank supervisors and retaining supervisory staff are essential. Currently training in both off-site and on-site supervision is inadequate. Training is largely conducted on an ad hoc basis, taking advantage of opportunities domestically and abroad provided by the foreign donor community. These training activities, while increasing awareness, are not sufficient to transfer the skills needed to carry out complex supervisory tasks. The pressing need to develop on-site examination capability can be accelerated by creating training teams led by foreign advisers, mixing classroom instruction with on-the-job coaching in the actual conduct of banking examination. Over the medium term it will be necessary to develop a formal in-house training program developed by Uzbek instructors. Building expertise in bank supervision will also depend on making the supervision function a career choice within the Central Bank. Since considerable resources will be required to train supervisors, career development paths within the supervision function of the Central Bank should be developed to make it attractive for staff to remain in the department or return to the department after rotation within the bank.

The licensing of banks

Criteria and procedures for the licensing of banks must be made more transparent. They should be made public in a licensing manual. This section recommends that a two-stage licensing process be adopted to reduce the financial risks of prospective bank licensees. In addition, to ensure that banks have sufficient startup capital, bank capital should be fully paid before banks are registered. To encourage diversification and growth of the private banking sector, the requirement that Uzbek shareholders should have a majority stake in any foreign joint ventures should be removed. Finally, the authorities should move away from issuing separate licenses for foreign exchange activities.

Bank licenses are at present mainly granted to insiders based on nontransparent criteria

4.25 Maintaining a safe and sound banking system is to some extent determined by the requirements imposed by the authorities on new entrants. These requirements should be neither so onerous that they prevent entry nor so lax that they encourage unsound practices. Although a number of new banks have been licensed in Uzbekistan in recent years, the licensing criteria used by the authorities are nontransparent and often are not related to the viability of proposed banking projects.

4.26 In 1993 and 1994 twenty eight new banking licenses were approved by the Central Bank. However, most of these banks were sponsored by Government ministries or agencies, or initiated according to Government decrees. Although the licensing process is intended to be objective, the fact is that only those banks organized with official sponsorship are likely to fulfill the requirements on capital resources, access to banking premises and the like. Further, it is unlikely that the Central Bank will openly oppose applicants supported by Government decree. The tendency, therefore, remains for new banks to be licensed for specialized activities that support Government policies.

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31. In October 1995, for example, the U.S. Agency for International Development conducted a fifteen-day program on banking surveillance. General banking courses are also available at a regional bankers' training center supported by the European Union's Technical Assistance to the Commonwealth of Independent States program.

32. Each trainee would be given a major functional area of responsibility using written examination procedures as a step-by-step training tool. Once the examination was completed, the team would move to another bank, where functional responsibilities are rotated. Completion of a training team cycle along these lines will not ensure a cadre of competent examiners, but it will provide a solid base on which examiners can build knowledge, skills, and experience.

33. Two more banks were licensed during the first nine months of 1995.
4.27 At present licensing decisions are based on the commitment of initial capital and the completion of documentation requirements. The documentation requirements include a license application from the proposed bank’s chairman, a copy of the minutes of the organizational meeting of shareholders, a draft charter for the bank, a business plan, and information on the financial position of the large shareholders and the suitability of the proposed management. The Central Bank also solicits the opinion of the local Central Bank branch where the proposed bank would be located, as well as of the local authorities. Applications may be refused due to inadequate documentation, the unsatisfactory financial position of the large shareholders, the unsuitability of the proposed management, or the inadequacy of office space.

Creating greater openness and transparency in access to bank licenses

4.28 Several weaknesses in current licensing practices need to be addressed. First, the granting of bank licenses should be a privilege, not a right. The Central Bank should be allowed to refuse to issue a banking license – regardless of the sponsors of the proposed institution – if the proposed bank does not fit within the Central Bank’s view of the financial system. The Central Bank should be encouraged to make judgements on the probable feasibility of the institution and the soundness and capabilities of the founders and all senior managers, not just the top management.

4.29 Second – as stipulated in the recently revised guidelines on bank licensing – capital should be fully paid-in before registration. It remains unclear whether this requirement has been implemented for existing banks. In 1995 noncash capital was limited to 10% of minimum authorized capital (currently 16 million Sums), but no limit was placed on the size of in-kind capital contributions beyond this minimum. It makes little sense for banks to use assets as capital if these assets cannot be used in the banking business and management has not had the opportunity to make an investment decision. Further, the values assigned to such assets are determined by shareholders and bear little relationship to the value the assets might realize in a liquidation situation.

4.30 Third, the Central Bank should consider a two-stage licensing process in which it grants preliminary approval based on its initial review of the application, after which the applicants can obtain banking premises, equipment, and other facilities required to conduct their activities. This approach would relieve prospective applicants of the burden of investing large sums of money without having reasonable assurance that a final license will be granted. At present only those with wealthy or powerful sponsors can afford to risk applying for a banking license, since the investments required before a decision is reached are considerable. The basic licensing decision should be based on qualitative assessments of the capabilities of the proposed managers, the business strategy, the proposed capital structure, and the pro forma financial plan. The final approval of the banking license should be issued after capital is fully paid-in, appropriate banking premises and equipment have been procured, , and key officials have been employed, and the bank’s charter, business plan, operating policies, and organization have been adopted and approved. To ensure greater transparency and fairness in its licensing decisions

34 These requirements are specified in the minutes no. 6 of the Board of the Central Bank of March 1st, 1996, "Guidelines on Establishment and Closing of Commercial Banks".

35 According to the recently published Guidelines for Establishing and Liquidating Banks (Central Bank decree of March 1st, 1996) a two-tier licensing procedure is to be introduced in Uzbekistan. However, as this process is described in the guidelines the first tier will provide little support to the prospective founders, because the same issues (such as financial soundness of the founders, business plan for the proposed bank, skills of managers etc.), which require approval in the first tier, also require approval in the second tier. The danger is that this will result in dual rather than two-tier licensing.
the Central Bank should develop and publish a licensing manual that clearly defines licensing criteria and procedures.

4.31 Currently, the minimum paid-in capital requirement for opening a domestic bank is 16 million Sums, equivalent to about US$425,000. The required capital is US$5 million equivalent where foreign investment is a third or more of the total authorized capital. Until recently Uzbek shareholders were required to hold at least 51% of the shares in any foreign joint venture, thus discouraging the establishment of foreign joint ventures. This requirement was not included in the law on banking and no longer applies.

4.32 Three types of foreign exchange licenses are currently issued by the Central Bank's foreign exchange department. As banking skills and practices improve these licenses should be unified and the bank's licensing activities should be moved to the bank supervision department, which is responsible for issuing domestic banking licenses. Rather than restrict access to foreign exchange, the Central Bank should introduce limits on open foreign exchange positions. Opening foreign correspondent accounts and otherwise engaging in covered transactions are reasonable activities that banks should be allowed to engage in without having to obtain special licenses or permission.

**Problem bank management**

Within the Central Bank's supervision department a special unit has been set up to develop criteria for defining problem banks and methods for dealing with these banks. Procedures for dealing with problem banks should be formulated in a manual defining criteria for enhanced surveillance of problem banks and remedial actions to be taken. A policy framework should be developed that specifies when a bank has failed and the steps to be taken in connection with the bank's orderly closure.

**Building capacity for identifying and dealing with problem banks**

4.33 The problems of transition from a plan to a market economy are reflected in the poor financial condition of many commercial banks. Although the Central Bank has recently established a special unit for dealing with problem banks, the Central Bank has not yet adopted a formal policy for dealing with such banks. As yet problem banks are defined loosely as those that violate "economic norms", having high levels of delinquent loans and interest, or being illiquid (as reflected by deficient balances in the banks' correspondent account with the Central Bank). The Central Bank does not compare the volume and severity of a bank's problem assets to its capital in order to assess solvency.

4.34 Three issues are involved when dealing with problem banks. The first is to resolve the structural issues that are currently affecting the banking sector (see Chapter 5 and Annex B). The second issue is to establish and test the Central Bank's authority to take real action against problem banks as specified in the recently enacted laws on the Central Bank and on banking (see above). The third issue involves building the supervisory capacity to deal with problem banks. Clearly, resolving current problems will have little meaning unless the authorities develop procedures to reduce the risk that these problems will recur. To ensure fairness in the application of these procedures and the cooperation of the banks the Central Bank should publish a manual detailing procedures to be applied to problem banks.36

36/ The Central Bank is in the process of drafting guidelines on the liquidation of banks. The focus in the text is on identifying and dealing with banks before they need to be liquidated. Liquidation of larger banking institutions should be a last resort, as the process of declaring banks insolvent and initiating liquidation procedures will in itself tend to undermine confidence in the banking system.
4.35 Thus there is a need to establish more formal criteria for defining a problem bank and pursuing corrective measures. Problems affecting the solvency of a bank need to be identified at an early stage, when corrective actions have a greater chance of success. Most supervisors in other countries would consider a bank to be a problem if half its capital and reserves were represented by problematic assets. Delaying the recognition of a problem bank until after bad assets exceed capital and reserves is too late, and can lead to excessive risk-taking among bank managers. Once a bank has been identified a problem bank, it should be excluded from the interbank market and access to Central Bank funds should be restricted. This is essential so as to prevent contagion and preserve confidence in the banking system. Some further proposals for improving problem bank management are outlined in Box 4.2.

Box 4.2 Designing a policy to cope with problem banks

To identify and deal with problem banks at an early stage, a formal policy for problem banks should be established. This policy should outline several key items:

- The specific authorities and responsibilities of supervisors charged with handling problem banks. The policy should also specify systems and methodologies for defining a problem bank. Criteria should be developed for defining the economic situation of banks - including the size of their capital base relative to their assets, the quality of their assets, and the competency of management.

- Mandatory corrective actions that are tied to problem bank status. These would include, for example, the use of enforcement measures such as cease and desist authority to outline the specific remedial actions to be undertaken by the bank. These actions could include a change in management, restricted lending and growth, prohibitions on dividends, requirements to increase capital, and so on.

- A requirement that problem banks submit monthly progress reports to demonstrate their efforts to correct problems, particularly in collecting or otherwise strengthening classified assets where asset quality is a problem.

- The need for frequent visits to and examinations of problem banks by supervisors and auditors, unless it can be demonstrated that the deterioration within the bank has stabilized.

- The importance of frequent meetings between the bank's board of directors and management and supervisors to discuss the status of corrective measures being undertaken.

- A definition of when a bank has failed. Traditionally, banks are considered technically insolvent when the value of assets is less than the value of liabilities. However, some supervisory authorities intervene and close banks when capital has declined to 2% of assets (after first calculating the provisions to be made and losses to be recognized). This approach provides a slightly larger cushion of assets to offset payments made to depositors.

- When a bank fails, it should be closed. A formal policy should outline the basic steps in closure, the appointment of a receiver, and the alternatives for quickly resolving the failure. This would include allowing a third party to assume the assets of the banks against payment, depositor payoffs, liquidation, supervisory merger, etc. The conditions for each approach should be detailed.

- Depositor and other creditor preference rules should be established. The policy should outline who is to be protected and to what extent.

4.36 To build appropriate staff skills for dealing with problem and failed banks, it is necessary to train competent examiners. In this regard technical assistance provided by foreign advisers experienced in
problem bank management and failure resolution would be invaluable. Such assistance will also be a vital constituent of the bank restructuring strategy proposed in Chapter 5.

Deposit insurance

It is strongly recommended that the Government postpone plans to introduce a deposit insurance system:

- Introducing deposit insurance is not adequate to restore confidence in the banking system.
- The costs of deposit insurance are likely to be large and unmanageable – at a time when the banking system is in distress and the supervisory capacity of the Central Bank is underdeveloped.
- Deposit insurance removes risks from depositors and banks and reduces financial discipline in the banking system, further raising the potential costs to the Government budget.
- The special status of Narodnybank's deposit insurance would have to be rescinded before introducing insurance for other banks.

Confidence in the banking system cannot be increased by introducing deposit insurance or by compensating depositors for past events

4.37 The authorities have expressed interest in establishing a deposit insurance fund as a means of restoring confidence and attracting depositors back into the financial system. Concern over the safety of deposits is, however, far from the only factor influencing whether individuals deposit money in a bank. Other factors affecting deposit mobilization include the erosion in the value of deposits due to inflation, banks' obligations to withhold taxes and provide information on depositor funds to the tax authorities, and delays experienced in withdrawing cash from bank deposits.

4.38 The Government recently announced plans to compensate depositors at the savings bank, Narodnybank, for the high level of inflation experienced since 1992. This compensation scheme is unlikely to improve confidence in the banking system, however, because compensation is made available solely at the discretion of the authorities. Confidence in the banking system cannot be restored by issuing discretionary compensation for past inflation, but depends on increased faith in future Government policies. By implementing the compensation scheme the Government may be setting a dangerous precedent for future bailouts of household depositors. Moreover, the Government is in no position to guarantee the real value of bank deposits.

Deposit insurance removes risks from the banks and weakens financial discipline

4.39 The creation of a deposit insurance fund without an effective framework of bank supervision and prudential regulation would be ill-advised. Insurance would weaken discipline in the financial system because depositors would no longer feel the need to assess the viability of the banks where they deposit their money. Since their funds will be covered by the insurance scheme in the case of a bank failure, depositors would have little incentive to discern among banks and bank managers to limit their risks.

Narodnybank's special access to deposit insurance would have to be removed

4.40 A deposit insurance fund would create explicit liabilities for the Government. At present the Government has considerable flexibility as to whether and to what extent it protects depositors. This applies to all bank liabilities except those in Narodnybank, where deposits carry an explicit Government guarantee. A more extensive system of deposit insurance would remove this flexibility and increase the
obligations of the Government. In any event the authorities will have to clarify the position of the Narodnybank before setting up a deposit insurance scheme. Narodnybank currently enjoys cost-free deposit insurance from the state. This insurance must be removed to create a competitive market for household deposits – until such time as it may be appropriate to extend some form of deposit insurance to in all banks.

Deposit insurance can weaken confidence in banks

4.41 With the financial system in considerable distress, it is important that an insurance fund be adequately funded. In the absence of adequate funding, payments to depositors and other costs of dealing with failed banks would ultimately be borne by the Government. If the deposit insurance fund failed to promptly make funds available to insured depositors it would discredit the fund and create further distrust in the financial system. Thus if a deposit insurance fund is created, its obligations must be limited and it must be properly capitalized from the start and have recourse to borrowing from the state budget.

Plans to introduce deposit insurance are premature

4.42 Further issues relating to the legal and operational framework for establishing a deposit insurance scheme are discussed in Annex F. However, due to the significant potential fiscal burden it would impose, the Government would be ill-advised to establish a deposit insurance fund at this time. This effort should await the revision of the Central Bank's supervisory practices and prudential standards and the elimination of systemic risks caused by the distressed sectoral banks.

The taxation of banks and the role of banks as agents of the tax authorities

The tax system should be designed to support the safety and soundness of the banking system. Banks should be able to deduct actual losses and provisions for specific loan losses from their earnings before paying taxes. This would lead to greater accountability on the part of bank managers and owners and reduce the long-run fiscal burdens of bank restructuring.

If they are to establish themselves as responsible, independent economic agents acting in the best interests of their clients, it is important that banks be relieved of their role as tax collection agents of the Government. The role of banks as tax inspectors also overburdens the payments system and seriously restricts competition among banks.

4.43 Uzbek banks are normally held liable for corporate income taxes assessed at a flat rate of 35%. Between July 1994 and December 1995 a tax holiday was granted to banks to allow them to invest in the computerization of their activities. This exemption was extended until the end of 1996 to provide funds for a comprehensive banking system development program. The amount of tax that is due is still calculated and recorded by the banks. The tax authorities then ensure that the tax savings are

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27/ Other taxes to be paid by banks such as property, land, and transport taxes are not burdensome. Banks are exempt from value-added taxes and other financial transaction taxes.

28/ According to Cabinet of Ministers Resolution 427 (November 9, 1995) the funds made available as a result of the tax exemption can be used by the Banking Association and by commercial banks to develop training services for the banking sector, including bank automation and construction. Some of the functions mentioned in the decree would be better provided by the banks themselves, since they are services that the banks would compete to provide in a more open banking environment. Other functions (such as insurance, leasing, investment banking, and auditing) that the association was designated to undertake clearly lie in the domain of private commercial activities.
used for the purposes for which the tax holiday was granted. In using the funds to computerize the banking system, the Central Bank acts as a central purchasing unit for acquiring computers, peripherals, and software. There is evidence that ear-marked tax relief has given rise to wastage in the form of over-investment in the designated categories of expenditure, for which tax-funding was made available.

Deducting loan loss provisions before paying taxes should not increase the long-run fiscal burden

4.44 The only significant issue relating to the taxes paid by banks concerns the deductibility of loan loss provisions. Under the existing tax regime banks can deduct transfers to a general risk fund in an amount equal to 20% of taxable income. The transfer to the risk fund is made from after-tax profits, such that the deduction is not reflected in net profits. These transfers are limited to 25% of authorized capital. On July 20th 1996, the Central Bank issued a decree on classification of loans and the creation of loan-loss provisions. It will be difficult to enact this decree without implementing the planned reform of bank accounting and introducing tax-deductability for bank loan loss provisions. Currently the tax authorities are reluctant to permit banks to make loan loss provisions that are based on portfolio quality rather than taxable income and that are likely to be much larger. They reason that the Government should not be responsible for the mistakes made by banks.

4.45 However, permitting banks to deduct loan loss provisions will lead to greater financial accountability and discipline on the part of owners and managers, since bad lending practices will be reflected in poor earnings and smaller dividends. In extreme cases banks will show losses and dividends will not be paid. Thus banks will have an incentive to make loans on a sounder basis and to prevent the accumulation of bad assets.

4.46 By preventing losses from accumulating in bank balance sheets, the Government will avoid the high costs of bank restructuring that might otherwise be needed to protect depositors, other banks, and the integrity of the payments system. Thus the long-term benefit to the budget of permitting tax-deductible provisions should outweigh short-sighted concerns of maintaining tax revenues by preventing the tax deductibility of loan loss provisions.

4.47 Moreover, the fiscal costs of allowing for the tax deductibility of loss provisions would be mitigated by limiting the amount of the deductions. Banks should be limited to deducting actual losses and provisions for specific losses. Any general provisions that the banks might find it prudent to make would not be tax deductible. The authorities could also put a cap on total deductions for loan provisions.

Banks will not be independent economic units if they are required to act as tax inspectors

4.48 In their relationship with their clients banks are obliged to calculate the amount of taxes that must be withheld from enterprises on the basis of activity within their accounts. The banks then transfer enterprise resources to special accounts for taxes. Each day banks forward to the tax authorities, as well as to the taxpayer, an accounting record of these transfers. To instill greater confidence in their independence as financial intermediaries and improve client confidentiality, it is important that the banks be relieved of these policing duties. The monitoring of tax liabilities should be carried out by the tax authorities on the basis of enterprise tax returns supported by audited accounts.

\[2\] This is another example of a function that would be the domain of the banks and not the Central Bank in a competitive banking environment.
Making banks act as tax inspectors undermines client confidentiality and the efficiency of the payments system, and restricts competition

4.49 Significant improvements have recently been made to the interbank clearing and settlement systems. Most payments are now processed electronically and clearing times have fallen, thus reducing float and uncertainties. Intra-regional payments are now processed and settled eight times a day. Inter-regional payments which are exchanged in batch are normally cleared and settled within one or two days. Banks are better able to manage their liquidity, as the system allows them to transfer funds more quickly within and across regions and they have access to the balances of their Central Bank accounts on almost real-time conditions.

4.50 Despite these important improvements the payment system is over-burdened, because banks continue to function as monitors of enterprise transactions for the purpose of tax-control. Due to this obligation banks are discouraged from developing multilateral netting arrangements such as clearing houses. So that enterprise transaction data can be assembled by the authorities, even small value payments are processed through the new real-time gross settlement system. Although the authorities no longer control the "legality" of transactions as under the plan economy, all noncash payment order activity is monitored for taxation purposes. This prevents the banks from fully realizing the efficiency gains from the modernization of the payment system. Obliging the banks to undertake this control function also has broader consequences. It results in loss of confidentiality and undermines confidence in the banking system. As outlined in Chapter 3, the authorities' access to information on customer accounts should be limited to those situations, where misuse is suspected and a court order is issued justifying the need for access to customer accounts.

4.51 In order to enable the banks to fulfill their role as monitors of enterprise tax liabilities each enterprise is required to settle all banking transactions with one bank. If an enterprise wishes to switch its settlement business from one bank to another, the enterprise is obliged to switch all its business. Under these circumstances it is very difficult for enterprises to make banks compete for this business, e.g. by collecting alternative quotes from different banks. The restriction also reduces the banks' incentives to service their clients well or seek to attract new customers to the bank. The restriction should be removed, because it collides directly with the objective of creating competition within the banking sector.

4.52 The payment system is also burdened by the banks' inability to undertake intrabank netting. As yet only Promstroibank has installed systems for intra-bank liquidity management. Other banks maintain separate correspondent accounts with the Central Bank clearing centers for each of their branches at the district (rayon) and regional (oblast) levels. Banks will need to take the necessary steps to process their own payments within the regions. Eventually the banks should maintain only one account with the Central Bank's regional centers, thus considerably reducing the burdens imposed on the payments systems.

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40 The role of the banks as agents of the tax authorities was confirmed in a Presidential decree of August 9th, 1996. According to this decree "at the request of the tax authorities, banks shall provide information on financial operations of their clients necessary for monitoring the fullness and correctness of their tax payments". In Western economies the presumption is that the tax authorities have to justify any such intrusion on client confidentiality.

41 In addition to collecting taxes banks are obliged to control enterprise export and import contracts (for eligibility and over/under-invoicing) and the availability of enterprise payrolls (so as to monitor the supply of cash). These control functions are excessively burdensome for the banks.
CHAPTER 5

STRATEGIES FOR DEVELOPING THE BANKING SECTOR

Bank insolvency: the urgent need for a strategy

The move to market requires a system in which private owners are willing to put their own capital at risk. The discipline of the market-place is undermined, however, if banks with an insufficient capital base are allowed to continue in operation. Accordingly, the signs of distress in the Uzbek banking sector indicate the need for major restructuring, if banks are to operate according to market principles.

The disciplining effect of private ownership

5.1 The banking sector will only be able to fulfill its role as an intermediary in a competitive market economy if both banks and their customers are subject to the discipline of private ownership and corporate governance. If bank ownership continues to be dominated by the state and state-owned enterprises, it will be impossible to establish true corporate governance. As things stand, when enterprises or the banks that they own get into financial difficulties, the enterprises can turn to their owner - the state - to supply financial assistance. Only under private ownership will bank managers be held responsible for the consequences of their decisions - on whether and on what terms to make loans to enterprise customers, whether to extend or foreclose on overdue loans, how best to extract the full value from collateral, and so on. Private ownership creates a system of evaluation and sanction on the part of banks relative to their customers and the banks' shareholders relative to bank managers. The risks - potential gains and losses - associated with this system are the essential checks and balances of any market economy. As enterprises and banks become subject to the discipline of private ownership, banks will be able to play an essential role in transmitting the financial discipline of the market-place.

5.2 Private ownership in itself will not ensure good corporate governance, however. The risks involved in banking are so considerable that even responsible outside owners have trouble gaining insight into the daily operations of banks. Thus, as described in Chapter 4, corporate governance exercised through private ownership needs to be supported by measures that improve the transparency of banking operations and the supervision of banks' safety and soundness.

Continued operation of insolvent banks is giving rise to serious distortions

5.3 It is difficult to imagine how nonviable banks could fulfill their role in a market economy. An insolvent institution would depend on subsidies for its survival and would therefore not be subject to the full discipline of the market-place. The question of the viability of financial institutions during transition is a difficult one. Transition entails a major reorientation of the fundamental structure of the economy and brings major changes in any number of relative prices, making it difficult to evaluate the viability of bank customers and the return on lending. Key elements in transition include the privatization and restructuring of enterprise customers, the introduction of market-based enterprise accounting, the elimination of state orders (under which customers are obliged to surrender produce at below-market prices), and the unraveling of distortions caused by the monopolization of distribution systems. The important question is how to involve the banks as catalysts in this process. If insolvent banks are allowed to continue to operate, what incentives will they have to impose the discipline of the market on their customers and themselves, and to transform themselves into market-based organizations?

5.4 In a market economy preserving the value of shareholders' capital and earning a return on capital are the main incentives for enterprises, including banks, to function rationally. For insolvent institutions this is simply not the case. Insolvent banks that are allowed to stay in business have an
incentive to channel funds to problematic borrowers to prevent the failure of the borrower or the recognition of losses on the accounts of the bank. Such institutions sustain the lack of payments discipline within the economy and in the absence of restructuring, should not be allowed to continue to operate. They distort the normal process of financial intermediation because their nonperforming assets fail to generate sufficient cash flow to meet their funding costs, forcing them to maintain abnormally high loan interest rates. These distortions discourage even customers with viable projects from seeking funding from the banks and intensify pressures on the authorities to establish alternative, subsidized sources of funding. The Uzbek authorities are experiencing this chain of events, and in 1995 two schemes were initiated for using the proceeds from privatization to fund subsidized lending.42

**Local accounting practices do not reflect the banking sector’s serious distress**

5.5 Data on the banking sector in Uzbekistan confirm that the sector is in serious distress and in need of restructuring. According to data provided by the Central Bank, overdue payments of principal on loans as of October 1, 1996, were equivalent to 11.5% of total loans, considerably in excess of the size of the paid-in capital of the banking system.43 In several of the major sectoral banks overdue payments on principal were greater than the paid-in capital of the banks. For the two major sectoral banks (Promstroibank and Pahtabank) these insolvency problems may be partly attributed to seasonal factors relating to the cotton harvest.44 Considerable capital injections by major shareholders in Promstroibank and Pahtabank during the past year were insufficient to establish positive capital (net of overdue principal) in these banks, even according to current Uzbek accounting and prudential standards.45

5.6 However, due to the inadequacies of current Uzbek accounting standards these data grossly underestimate the true level of distress within the Uzbek banking sector. Two essential factors contributing to this underestimation are the capitalization of overdue interest by refinancing overdue loans with new loans according to renegotiated loan agreements, and insufficient loan loss provisioning based on loan installments that are already shown as overdue on the banks’ accounts (rather than on prospective total losses). Recently completed audits completed under the World Bank’s Institution Building Loan for 1994 using international accounting standards reveal that Agroprombank and Promstroibank would require a total of nearly 6 billion Sums in new capital contributions to be brought up to the internationally recognized level of minimum capitalization (Table 5.1). The capital requirement of the two banks at the end of 1994 was equivalent to 4.6% of GDP (equivalent to US$240 million).

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42 This lending is undertaken by the State Property Committee and the Business Fund. As explained in Chapter 8, though the Committee and the Business Fund channel their funds through the banks, the banks act only as payment agents. The entire credit risk is borne by the Committee and Madad, a state-owned insurance company.

43 These data exclude the National Bank because its equity is denominated in foreign currency. As of October 1, 1996, the paid-in equity of the banking system (excluding the National Bank) was 1,327 million Sums (equivalent to about US$26 million). Total loans were 48.4 billion Sums; overdue principal was 3.7 billion Sums.

44 The importance of seasonal factors should not be exaggerated, as it was not confirmed by recent data. Compared to October 1995 overdue principal in Promstroibank and Pahtabank was almost unchanged as of end-April 1996, but overdue interest had increased substantially in Pahtabank. The solvency problems of the two major sectoral banks is discussed in a separate section below.

45 During the fourth quarter of 1995 capital injections amounted to 1.0 billion Sums in Pahtabank and 0.5 billion Sums in Promstroibank. Despite these capital injections paid-in capital in both banks was still considerably smaller than the size of overdue loan interest and principal as of October 1st, 1996.
### Table 5.1 The Major Sectoral Banks are in Serious Distress (end - 1994)

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Agroprombank</th>
<th>Promstroibank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Required loan loss provisions according to internationally accepted standards (percentage of total loans)</td>
<td>37.5</td>
<td>30</td>
</tr>
<tr>
<td>Required loss provisions</td>
<td>3.0</td>
<td>2.6</td>
</tr>
<tr>
<td>Current paid-in capital and reserves</td>
<td>0.5</td>
<td>0.2</td>
</tr>
<tr>
<td>Current capital (A - B)</td>
<td>-2.5</td>
<td>-2.4</td>
</tr>
<tr>
<td>Required capital</td>
<td>0.6</td>
<td>0.4</td>
</tr>
<tr>
<td>Capital deficiency (-C + D)</td>
<td>3.1</td>
<td>2.8</td>
</tr>
</tbody>
</table>

Note: Required capital and capital deficiency are calculated based on minimum requirements. Capital deficiency is calculated based on an 8% capital requirement for professionally run, well-managed, and sound banks in a market economy. A higher requirement would seem advisable in Uzbekistan.

Source: Diagnostic audits.

**Restructuring efforts face formidable challenges**

5.7 Ascertaining the precise size of the major sectoral banks' insolvency is, however, only the first step. The real issue at hand is changing the incentive structure within these banks so that they become market-based organizations. Providing new capital may allow banks to continue to function, but will it change the nature of their operations? Experience from a number of other countries that have committed capital to the recapitalization of their banking systems, including Poland and Hungary, suggests that the answer is no. Unless a detailed restructuring and privatization plan is designed that changes the incentives for managers, banks may continue to channel funds to borrowers who are unwilling or unable to repay. Essential elements in designing bank restructuring plans are described in Box 5.1.

5.8 In Uzbekistan borrowers are already financially squeezed due to the Government's successful stabilization program during 1995. Indebted enterprises are experiencing less erosion of their nominal debt burdens due to lower inflation. Enterprises' access to alternative sources of funds has been curtailed due to discontinued budget financing of state enterprise losses. The pressures on banks to bail out overindebted enterprises have intensified considerably. Thus there is considerable risk that any capital used to replenish banks will be quickly eroded.
Box 5.1 Three Stages in Designing a Strategy for Bank Liquidation and Restructuring

1. The diagnostic stage

In the first stage, the diagnostic stage, the financial condition and operating performance of the banks are assessed. Once the extent of the problems is known with reasonable certainty, the process of determining restructuring plans can begin. The diagnostic process should start with an evaluation of portfolio quality so that the amount of problem loans, actual and potential losses, and their causes can be determined. Once actual and potential losses have been estimated, the banks’ solvency can be determined and their future viability assessed. Diagnostic studies financed by the World Bank’s Institution Building Loan have already been completed for the largest Uzbek banks – Promstroibank, Pahtabank and Narodnybank. The results of these studies are incorporated in the specific recommendations for these banks outlined in the following sections of this chapter. The process of determining portfolio quality and bank solvency as well as the advantages and drawbacks of several models of financial restructuring are described in Annex B.

2. Financial restructuring

To minimize the problems that failed banks cause, it is important that they be restructured or liquidated in a timely manner. As part of this process it is necessary to allocate losses. If the authorities choose to restructure rather than liquidate insolvent institutions, losses can be allocated in a variety of different ways among the depositors, creditors and other liability holders, shareholding enterprises, other owners, and the Government. However, experience from a number of countries shows that where the authorities have sought to restructure major insolvent banks, the Government usually has to bear a significant portion of the financial burden. This risk clearly applies to transition economies, where the state is directly or indirectly (through state-owned enterprises) a major shareholder of the banking sector. For this reason the Government may find liquidation to be the most attractive option. Although liquidating major sectoral banks may be disruptive, it is an option that must be given serious consideration. Among the smaller sectoral banks liquidation will not threaten the stability of the financial system and will serve to clearly demarcate the transition from a culture of channel banks and subsidized finance to a market-based banking culture.

Where the Government is prepared to invest in the financial restructuring of the banking sector, it will be necessary to carve out the bad assets on the balance sheets of the banks. These carved-out assets will need to be replaced with good assets, probably initially marketable Government securities, that provide a sufficient yield to ensure that the banks can attain profitability. Here it is essential that the authorities build safeguards into the restructuring process so that the bad loan portfolios of the banks are dealt with efficiently. Unless these loans are foreclosed or restructured, there is a danger that they will continue to burden the banking system, most likely resulting in renewed demands from the banks for financial support from the Government. Stringent collection efforts should therefore be undertaken to recover funds from problem borrowers.

3. Operational restructuring

Fundamental changes in the management culture of the surviving banks are necessary if they are to be able to operate in a market-based environment. It is almost certain that replacing the former banking culture will require removing several layers of bank management. The new management will need to develop strategic plans for the business of the bank, including targets for key financial variables (such as the return on assets, market share, asset growth, and resource mobilization) and targets for the business activities of the bank (types of products and services to be provided and discontinued, markets to be served, and branches to be opened and closed). To fulfill these goals new banking skills will need to be developed in areas such as financial planning and the development of management information systems. Acquiring these technical skills will take time and require considerable investment in training.
A strategy for the sectoral banks

5.9 The dominant position of the sectoral banks and the insignificant role of private banking in Uzbekistan make it essential to impose financial discipline on the large sectoral banks. Most of the new, small sectoral banks have concentrated risk profiles and are not viable. They should be merged, restructured or liquidated.

5.10 The two-stage restructuring process for the large sectoral banks described below is designed to be completed within two years. The first stage of the restructuring process – the isolation period – consists of imposing strict financial discipline on the banks. After six months the banks would be required to submit restructuring plans for Government approval based on a complete review of their lending portfolios. The second stage in restructuring concerns the future of the banks after the isolation period. Prior to the end of the isolation period, which is intended to last up to two years, the banks would be required to submit plans for their future capitalization. The restructured banks would be required to fulfill the full prudential requirements of the Central Bank.

Financial discipline should be imposed on the large sectoral banks

5.11 The strategy proposed below recognizes that the major sectoral banks are the only large lending organizations in Uzbekistan. Although the authorities should take steps to encourage the entry of new private banks, it will take time before the new private banking sector is able and willing to undertake significant lending. During the transition period the sectoral banks will continue to play an important, though declining, role. The important issue is to impose financial discipline on these banks during the transition, and to restrain them from misallocating resources and further draining confidence in the financial system.

5.12 To engage the larger sectoral banks, Promstroibank and Pahtabank (formerly Agroprombank), in the transition process a two-stage strategy is proposed. During the first stage of restructuring – the isolation period – strict financial discipline would be imposed on the banks and they would be required to undertake detailed reviews of their loan portfolios. After six months the banks would submit detailed restructuring plans – based on these reviews – for Government approval. Implementing these plans constitutes the second stage of restructuring and should be completed within the two-year isolation period. At the end of this period the banks would be required to fulfill all the prudential requirements of the Central Bank. Restructuring will involve downsizing the banks, rationalizing their operations, privatization, and partial liquidation.

5.13 If new capital is to be injected in the banks, it is essential that the restructuring plans incorporate privatization. Unless the banks are transferred to private ownership, a change in incentives is unlikely and capital injections will improve the solvency of the banks only temporarily. Bad debts are likely to continue to accumulate. Since Promstroibank and Pahtabank are owned by state-owned enterprises, the corporate governance of these banks would best be improved by privatizing the enterprises that own them using the privatization investment funds scheme currently being prepared by the Government thus ensuring broad ownership of the restructured banks. The implementation of the mass privatization program currently under preparation should be seen as an integral part of the Government’s strategy for supporting the restructuring of the large sectoral banks.

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46 Recommendations for supporting entry of new banks are presented later in this chapter and Chapter 8. A complete revision of the Central Bank’s licensing practices is also required; see Chapter 4.

47 These plans are described in more detail later in this chapter.
The large sectoral banks continue to operate as channel banks

5.14 Promstroibank and Pahtabank are similar in a number of ways. Both banks previously acted as agents of the Government in carrying out directed lending programs. They continue to function as accounting organizations rather than banks, unable to monitor commercial risks or function as profit-making entities. Both banks have major problems with their loan portfolios. They are by tradition the dominant supplier of loans within their market segments, and are highly dependent on the interbank market and the Central Bank for their funding. Both are mainly owned by state-owned enterprises, who are also their major customers. The senior managers of both banks are appointed by the Government and the banks are organized so that their branch offices have considerable autonomy in decision-making regarding loan policy and the use of funds. To some extent the banks' head offices evaluate the operations of the branches, but as long as the branches maintain a positive cash flow the branch managers are allowed to retain their autonomy. There is limited consolidation of branch accounts, and information is only made available to the head office with delay. This decentralized structure precludes rational, coordinated decision-making.

Banks are not able to function as commercial entities

5.15 Promstroibank services large industrial and construction enterprises. The bank's loan portfolio is heavily concentrated in a small number of state enterprises. According to diagnostic audits prior to provisioning for loan losses Promstroibank achieved a return on equity of only 17% in 1994 (compared with inflation of about 1,500%). The diagnostic audits recommended loan loss provisioning equivalent to 30% of Promstroibank's loan portfolio.

5.16 Pahtabank, which has traditionally serviced the agricultural sector, still has a market share of nearly 90% of credit outstanding to the sector. Its loans are about equally divided between agricultural production and agroprocessing. Pahtabank's solvency problems are at least as big as those of Promstroibank: according to the diagnostic audit for 1994 the bank was operating at a loss even before making provisions for loan losses. The audit recommended loan loss provisioning equivalent to 37.5% of Pahtabank's (then Agroprombank) loan portfolio.

Agroprocessing is a major source of the sectoral banks' losses

5.17 At the time of the diagnostic audits part of the estimated losses of the sectoral banks may have reflected seasonal impacts on the banks' loan portfolios and late payments for state purchases of cotton products from to the 1994 harvest. Payment for 1994 state orders only took place in June 1995. However, the diagnostic audits of Promstroibank and Pahtabank indicated that the major source of loan losses in the sectoral banks lies in agroprocessing rather than agroproduction. About 80% of

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44 The chairman and vicechairmen of both banks are appointed by the Cabinet of Ministers acting on the recommendation of the Bank Council and the chairman of the Central Bank.

45 Promstroibank has 14 regional offices and 47 branch offices. Pahtabank has 13 regional offices and 187 branch offices.

46 Reflecting this division of responsibility both banks have sizeable staffs (each numbering about 6,000 employees) but small main offices (less than 200 employees).

47 Not all agricultural production is profitable. Thirty-five percent of Pahtabank's loans are to fruit and vegetable producers, who have experienced serious economic difficulties in recent years.
Pahtabank’s bad debt can be attributed to agroprocessing. Agricultural production in Uzbekistan is dominated by cotton producers. Since cotton is an internationally traded commodity, cotton production would appear to be a profitable activity, even given such impediments as state order requirements and the monopolization of wholesale trade.  

**Restructuring Promstroibank**

Strict financial discipline should be imposed on Promstroibank for a two-year period (the isolation period) while a restructuring plan is prepared and implemented. Given the bank’s dominant position in providing credit to certain sectors, the authorities may decide to supply Central Bank funds to the bank during isolation, but this should be done according to a predefined declining schedule.

Based on a complete portfolio review the bank would submit a restructuring plan to the authorities within six months of isolation. The plan would include provisions for improving governance, establishing a debt collection unit, and (partially) liquidating or recapitalizing the bank. The authorities will need to support the bank’s debt collection efforts by developing the legal, regulatory, and institutional structure for debt recovery. Any recapitalization plans should be explicitly linked with the privatization of the bank.

5.18 According to the results of the diagnostic audit Promstroibank is severely undercapitalized; the following plan of action is recommended to prepare the restructuring of the bank. The problems associated with Promstroibank’s loan portfolio should become transparent during 1996, since the bank is included in the pilot program for the implementation of the new bank accounting framework. Promstroibank’s management wants the bank to remain as a wholesale corporate bank serving large enterprises. In this area Promstroibank’s only formidable competitor is the National Bank, which benefits from not having inherited a large portfolio of nonperforming corporate loans.

**Short-term isolation will facilitate restructuring**

5.19 As an interim measure the authorities should implement a two-year isolation period. The purpose of the isolation would be to provide "breathing space" while plans for Promstroibank’s future are designed and implemented. During isolation the bank would be allowed to continue to service clients in clearing and settlement services, account services, loan monitoring, and so on. But the following constraints would be introduced to impose financial discipline on the bank’s operations:

- The bank would not be allowed to accept any new household deposits or issue new certificates of deposit.
- The bank would not be allowed to pay dividends to its shareholders.
- Any incremental lending to delinquent borrowers would have to be based on detailed recovery plans approved by a special debt recovery unit within the bank.
- The bank would be required to reduce its reliance on Central Bank funding according to a preagreed schedule.

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92 These issues are discussed further in Chapter 8
5.20 The implementation of these measures is sanctioned by the recently enacted Central Bank Law and confirmed in the revised Law on Banking Activity (see Chapter 4). However, given Promstroibank's importance for the industrial sector, the bank's isolation would need to be understood as an integral part of the Government's reform policy designed to support the growth of a viable private financial sector. Successful implementation will require the full commitment of the Government. In recognition of the dominant position of the bank in providing finance to certain sectors of the economy, the isolation plan would allow the Central Bank to continue providing refinance credit to the bank during the isolation period, but according to a preagreed declining schedule. Gradually reducing the supply of credit made available through the sectoral banks would promote the growth of new financial institutions. The isolation would not be lifted before plans for restructuring or liquidation of the bank were implemented. The policy of gradually reducing the supply of Central Bank funds is consistent with the Government's commitment to gradual economic reform. But continued access to Central Bank funding - even on declining schedule - will allow Promstroibank to continue lending to bad debtors during the isolation period. It is essential that the bank adopt stringent loan-recovery practices. Unless such practices are rigorously applied, the danger is that access to Central Bank funds during the isolation period will increase the eventual fiscal cost of restructuring the bank.

Implementing the restructuring of the bank

5.21 During the isolation period the managers of the bank will need to develop and implement plans for the future of the bank. Several alternative methods for restructuring or partially liquidating the bank will need to be considered by the bank's management. These plans - including well-defined benchmarks for their implementation - should be approved by the Central Bank within the first six months of the isolation period. During this period the bank's management will be required to prepare a complete portfolio review of the bank based on international accounting standards as specified in the Central Bank's new accounting guidelines. The review would allow the bank to prepare a balance sheet according to international standards, confirming the capital deficiency of the bank after writing off the bank's losses against shareholders' capital. Using this portfolio review as a reference the management will then be required to prepare medium-term plans for the reconstruction of the bank, so that the bank is upgraded to fulfill the Central Bank's prudential norms within the two-year adjustment period. Vital elements in the restructuring process will include:

- Changing the governance mechanisms within the bank. A new management would be appointed to carry out the approved restructuring plan. Fulfillment of the plan would also be closely monitored by the authorities. A new independent board should also be appointed. The majority of the members of the board should be outsiders - not involved in the daily business of the bank and not subject to the suasion of the Government.

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53 According to Articles 51 and 53 of the Central Bank law, the Central Bank is entitled to "classify bank assets by their quality and demand formation of adequate reserves for covering possible losses." In the case of violations of prudential requirements the Central Bank can "demand that a bank take measures to recover its financial situation, including modifying the structure of its assets, cutting operational costs, stopping payment of dividends to shareholders, replacing the management of the bank or its branches, reorganizing the bank, or liquidating the branch."

54 Central Bank decree no. 20 of July 20th, 1996, initiates this process by requiring full audits of all Uzbek banks according to international accounting standards for the financial year 1996.
**Internal subdivision of the bank into two operations.** Two separate functions would be instrumental to implementing the restructuring of the bank. The first function would deal with the burden of substandard enterprise loans. The second function would prepare and implement the restructuring of the bank with the purpose of securing the bank's long-term survival.

(a) **Bad debt resolution.** For all assets ranked as below standard or satisfactory the bank would immediately establish decentralized debt collection and work-out units to collect on problem loans, reschedule some loans, or write off interest due. This process would be based on a case-by-case review of the bad loans. Debt collection is a specialized, new role for banks in Uzbekistan, and the work-out units will need considerable technical assistance in debt collection practices (see below). The authorities will also need to be committed to providing the necessary legal and institutional infrastructure, (see Chapter 3). Box 5.2 summarizes the process of debt collection as it was developed in Poland.

(b) **Strategic planning and reorganization.** A separate function within the bank would concentrate on managing the bank’s performing loans and implement the approved strategy for the future of the bank. This function would be responsible for restructuring the bank to service its future core business activities. Given the size of loan writeoffs, a major element of restructuring would be downsizing and rationalizing the banks' activities. Institutional development will be instrumental to ensuring the bank's future viability. The adoption of strict credit assessment criteria will also be essential.

**Defining the structure of the surviving institution.** Eighteen months after the start of the isolation period the bank would be required to define its capital needs based on alternative strategies for the future of the bank as a going concern. The bank would be required to fulfill all the Central Bank’s prudential requirements, including the minimum capital requirements, within the two-year isolation period. The greater the success of the bank's management in collecting on bad debts and in restructuring the bank, the smaller will be the incremental capital requirement and the greater will be the potential for the bank to continue operating.

**Will it be possible for the bank to establish a capital base and build sufficient banking skills?**

5.22 The bank's managers would finalize the plans for the privatization or partial liquidation of the bank and present these plans to the Central Bank for approval eighteen months after the start of the isolation period. Any restructuring plans involving recapitalization of the continuing part of the bank would need to be coordinated with plans for bank privatization. The bank management would be required to present plans for recapitalization of the bank - through merger of the bank or share issue to local or foreign partners. If the management fail to secure a sufficient capital base for continuing the operations of the bank as a whole or in part, the authorities could consider injecting new capital into the bank, but only at the time of its privatization. But given the expected fiscal burden associated with a state-financed recapitalization of the bank, a more attractive option for the authorities would be to mandate the orderly liquidation of the bank.

5.23 The restructuring of Promstroibank will require the bank's management to make decisions regarding the operations of the bank, especially regarding work-outs on nonperforming loans and credit risk assessment. To fulfill these functions the bank will need to rapidly achieve international banking standards. Thus skills transfer to the bank is a vital consideration. To gain the requisite skills the bank will need to form a joint venture with a reputable foreign bank, enter a long-term twinning relationship
with a foreign bank, hire a foreign bank under a management consultancy arrangement (with success fee paid in share options of the bank), or sell the majority of the bank's shares to a foreign bank. If the bank is to be restructured rather than liquidated after the isolation period, the timely implementation of one of these schemes will be necessary to ensure intensive training in market-based banking skills.

5.24 The success of the loan collection function during the adjustment period will determine the bank's capital needs and future viability. If there is to be a future for the bank, it is essential that the authorities support the implementation of the work-out process by facilitating proceedings for bankruptcy and loan foreclosure resulting in the liquidation of collateral. Thus success of bank restructuring will depend on further development of the legal, regulatory, and institutional framework for debt recovery (see Chapter 3).

Box 5.2 Polish Experience with Bank-Led Enterprise Restructuring

In advanced market economies creditors are important agents of restructuring. Getting creditors to play that role takes financial incentives, adequate information, skills and strong legal powers in debt collection, debt work-out, and liquidation processes. Poland provides an example of a transition economy that emphasized creditor-led restructuring, adopting simplified procedures to promote the role of banks.

In 1993 Poland adopted a bank-led "conciliation" process that empowers banks to negotiate workout agreements with problem debtors. All creditors are bound by the deal if agreement is reached among those creditors holding more than half the value of the outstanding debt. Enterprise managers are required to put forward reorganization plans that creditors negotiate and vote on. Restructuring normally takes place according to out-of-court settlements, though the courts may get involved in approving final agreements and handling appeals.

In Poland bank-led reorganizations have been concluded much more quickly than cases involving liquidation. Strong firms are more likely to enter and emerge successfully from reorganization, while weak firms are more likely to fail in reorganization or to file directly for liquidation. The process of out-of-court settlement has also promoted critical institution-building in the banks (particularly their work-out departments). The approach depends, however, on establishing strong collateral laws and institutional practices for monitoring the operational as well as the financial restructuring of enterprises.

In order to accelerate institutional development seven Polish banks were twinned with foreign banks. The twinning involved extensive technical assistance over a three-year period and aimed to strengthen banking skills in all areas. As a result of the twinning (which will also be used in Russia and the Ukraine) significant transfer of know-how and upgrading of skills were achieved. Twinning is a useful complement to a bank's desire for institutional change, but it is no substitute for a clear, commercially viable strategy on the part of a bank's owners and managers.

Restructuring Pahtabank

Pahtabank should adopt a two-stage restructuring plan similar to the one proposed for Promstroibank. While Pahtabank is being restructured, it should continue to provide crop finance for agricultural producers acting as an agent of the Government. The Government should provide these funds as an explicit fiscal transfer. Pahtabank would be instructed to discount bills secured by future agricultural produce. Following the isolation period this discount facility would be made available to all banks serving the rural community and be gradually reduced.
The authorities should consider finding private owners for the local branches of the restructured bank. If these local entities are to be viable, however, they will have to be able to diversify their risks. Diversification will only be possible if the recently established sector-specific banks are recombined with Pahtabank. Alternatively, the authorities should seriously consider liquidating Pahtabank. Provided the authorities move toward a more liberal banking and foreign trade environment, the provision of finance to the lucrative cotton-producing sector will be commercially attractive for the emerging private banking sector.

The bank should be isolated while restructuring plans are prepared

5.25 During 1995 Agroprombank was split into three specialized banks: Pahtabank (the cotton bank), Gallabank (the grain bank), and Mevasezevatbank (the fruit and vegetable bank). According to the diagnostic audit for 1994, Agroprombank was insolvent. The successor banks have been further weakened because their assets are concentrated in agriculture subsectors. The core of Agroprombank’s bad assets remains with Pahtabank, whose solvency problems need to be addressed by the authorities. As with Promstroibank, it is recommended that Pahtabank be isolated while a review of the loan portfolio is carried out and a plan for the restructuring of the bank is prepared (see above).

Crop financing is essential

5.26 To ensure that crop producers have access to seasonal crop financing during the isolation period, the Central Bank – acting as the agent of the Government – should continue to provide liquidity to Pahtabank on a strictly controlled basis. The bank’s financing requirements for crop finance need to be clearly identified and separated from the liquidity requirements arising from delinquent servicing of loans (predominantly to agroprocessing). One way of achieving this would be to allow Pahtabank to discount bills backed by future production commitments made by farmers. Given Pahtabank’s branch network and knowledge of potential production on individual farms, it would be appropriate for Pahtabank to continue functioning as a payment agent for crop financing. The financial resources and any subsidies for crop financing should, however, be provided explicitly through the state budget. This function should not burden the balance sheet of Pahtabank or other banks involved in seasonal crop finance. After the isolation period the discounting facility would be made available to all banks serving the rural areas and reduced according to an announced schedule.

Restructuring or liquidation?

5.27 Only a small fraction of Pahtabank’s liquidity problems can be attributed to seasonal factors related to crop finance – 70% of its bad loans are in the agroprocessing and trade sectors rather than in cotton production. In agricultural production Pahtabank is serving the state-owned producers and not the growing private sector farms, which use other banks. By mid-1995 a number of smaller banks were already competing for the potentially lucrative finance of cotton production, and competition for this business will increase provided the authorities undertake reforms to establish a more liberal banking

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[^5]: By discounting bills Pahtabank (acting as an agent of the Government) will be able to provide liquidity to farmers with security in future output. Prices for agricultural products are subject to considerable volatility, however, and the bills should be designed so that this price risk remains with the farmers. The purpose of the discounting mechanism is not to reduce the risks of agricultural production, but to ease the liquidity situation of farmers during the crop cycle.

[^6]: This breakdown of the bad loan portfolio is provided in the diagnostic study of Agroprombank (end-1994).
environment. There is a danger that Pahtabank may be left specializing in unprofitable lending to the agroprocessing industry. An important question to be considered in preparing restructuring plans for Pahtabank will be the cost of salvaging a sector-specific bank burdened with the traditions and bad loans of the former command economy relative to the benefit of the incremental value-added that this bank may provide to financing the cotton sector. While a restructuring strategy is implemented the danger is that the bank will continue to lend to bad debtors. The fiscal cost of restructuring is likely to be high relative to the cost of liquidating the bank. Since cotton production is profitable its financing should prove to be an attractive area of business for the emerging private banking sector. Thus it is possible to make a strong case for orderly liquidation of Pahtabank.

Finding new owners for regional or local branches

Pahtabank's current structure is decentralized. Its 13 regional offices and 189 branches enjoy a large degree of autonomy in their operations. They have their own balance sheets and income statements. They define their own credit policies, and are obliged to adjust their lending and expenditures to the resources they generate. This local autonomy is not reflected in the structure of the bank's shareholdings or in the uniform dividends paid to all shareholders. In restructuring the bank the authorities should consider transferring the bank's premises and staff to local banking entities. With a full writeoff of existing obligations and share capital it may be possible to find new owners and managers willing to run the branches as locally owned, separate banking entities. Provided the local branches cover a wide range of farming activities, these local entities could be run as credit unions or on a cooperative basis (see Chapter 7). But if they are to be viable, these local entities will need to diversify their lending risks over a wide range of rural lending activities; they will not be viable if they concentrate their lending in specific subsectors. Establishing a broad lending portfolio would require unraveling the risk concentration resulting from the recent split of Agroprombank into three specialized banks.

The small sectoral banks – unable to survive in a commercial environment

The new sectoral banks that were spun off from the large sectoral banks should be recombined with their parent banks. They are too specialized to be viable, and the danger is that they have inherited the management culture of their parents. Economic problems among the sectoral banks are not confined to the two large banks and the spun-off banks. Several other small sectoral banks are also experiencing economic problems. They should be put under enhanced surveillance and made to comply fully with the Central Bank's prudential requirements. If they are unable to fulfill these requirements, their banking licenses should be withdrawn.

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57 Necessary reforms for establishing competition are outlined in Chapter 3.

58 Tadbirkorbak, which serves the new private farming sector, already has a large branch network. The potential role of Pahtabank and other financial intermediaries in supplying finance to rural communities is discussed in Chapter 7.

59 Cotton production is profitable, despite the heavy tax imposed on cotton farmers by the state-order system.

59 The head office does not have the capacity to monitor the whole network and is unable to coordinate liquidity policy or function as a corporate treasury. Thus the decentralized structure partially reflects weaknesses in internal management information systems.
5.29 The Uzbek authorities have tried to reduce the role of the two large sectoral banks by spinning off segments of the banks’ business into more sector-specific banks. Three banks have been spun off from Promstroibank: Legcombank (light industry), Tashjilsoltzbank (social housing), and Alokabank (telecommunications). Two banks, Gallabank (wheat) and Mevasezvatbank (fruit and vegetables), have been spun off from Pahtabank (previously known as Agroprombank). These are among the many banks established by Government decree (see Chapter 4). Although these smaller units may have the advantage of being more focused on serving specific industries, there is a danger that they will become the "pocket" banks of the enterprises within these industries. The rationale behind the spin-offs is unclear. In some instances the banks appear to have been established to assume responsibility for segments of the bad loan portfolios of the larger sectoral banks – equivalent to work-out units. In other cases, despite their highly sector-specific loan book, the authorities have encouraged them to diversify their risks and become universal banks.

5.30 The solvency of the spun-off banks is highly questionable, since they have inherited undiversified loan portfolios that were created under the Government’s directed credit policies. There also seems to be little reason for the incentive structure in the new banks to be markedly different from their parents, especially since the new banks are owned by other state-owned banks or state-owned enterprises. Thus the new banks will most likely have insufficient banking skills to allow them to restructure and diversify their loan portfolios. Given their weak institutional structure, the most expedient course of action would be to recombine these banks with their parent banks.

5.31 Among the other sectoral banks paid-in capital as of October 1, 1995, was smaller than recorded overdue principal in Tadbirkorbank, Savdogarbank, and Uzprofbank. The situation of these banks will become transparent once audits are carried out for 1996 according to international accounting standards. Undercapitalized banks should be regarded as problem banks and be made subject to enhanced surveillance (see Chapter 4). It may be possible to make a case for restructuring some of these banks. But since they do not pose any systemic risks, the authorities should consider withdrawing the banks’ licenses unless they are able to comply fully with the Central Bank’s prudential requirements within an agreed period.

The savings bank: creating competition for household deposits

A "narrow" banking model should be adopted for Narodnybank, the savings bank. Since the bank continues to enjoy privileges in the form of implicit deposit insurance and exemption from the prudential norms of the Central Bank and taxes, it competes with commercial banks on unequal terms. Until these privileges are removed the bank’s lending should be limited to investment in Government securities and on-lending to other banks. The bank should be prohibited from expanding its lending to commercial entities. In the medium term – once the bank’s privileges have been removed and its operations have been rationalized – the authorities should consider privatizing the bank or selling off its branches to other banks interested in building capacity for household deposits and the provision of household payment services.

5.32 Until early 1994 the state savings bank, Uzserberbank, was required to maintain a 100% reserve requirement with the Central Bank against all household deposits. It was the Central Bank’s responsibility to place these funds with other banks. This reserve requirement was then abandoned and Uzserberbank was permitted to place excess funds with other banks both through the interbank auctions and through bilateral agreements with other banks. Uzserberbank was also allowed to start lending to legal entities. A September 1, 1995, decree changed the name of Uzserberbank to Narodnybank (the People’s
Bank) and outlined plans for a capital injection of 100 million Sums from the state budget. The bank will thus continue as a state-owned organization with the chairman being appointed by the Cabinet of Ministers, which also approves the appointment of other senior staff.

The bank's deposit base is dwindling

5.33 Narodnybank functions predominantly as a cash collection and disbursement agency servicing the household sector. It currently holds 85% of Uzbekistan's household deposit base. The bank has nearly 2,500 cash collection and disbursement units and 8,500 staff, most of whom are employed in the 14 regional and 200 district offices (only 100 staff are employed at the head office). During 1995 Narodnybank considerably modified the terms offered on household deposit accounts to make these deposits more attractive to households. The interest on several categories of deposits is now closely related to market rates of interest as reflected in the Central Bank's refinance rate. Nonetheless, the bank has trouble attracting deposits due to recent erosion in the real value of these deposits caused by inflation, the freezing of deposits (most recently in connection with the introduction of the Sum in the summer of 1994), and periodic shortages of cash, which result in considerable delays in honoring household withdrawal demands. Due to the disintermediation of household savings the assets of Narodnybank accounted for only 4.7% of the assets of the banking system as of October 1, 1995. In dollar terms the real value of the bank's deposits are a fraction of their 1990 value. With a reduced depositor base and escalating operating costs the viability of the bank has been seriously jeopardized.

The savings bank enjoys important special privileges

5.34 Nearly 90% of Narodnybank's loans are to other banks, 3% are loans to individuals, and 8% are loans to enterprises. The end-1994 diagnostic audit of the bank recommended provisions amounting to 10% of loans outstanding. However, the adequacy of these provisions depends on how one assesses the risks borne by the bank in lending to other banks, several of which may be insolvent. If, as the Government hopes, Narodnybank is to become a commercial bank, then these risks need to be taken seriously. It is unreasonable to rely on the Government to bail out the insolvent sectoral banks, or on the Government guarantee that now applies to Narodnybank's household deposits. Similarly, the bank's earnings are augmented due to exemption from taxes. The bank should be required to comply fully with the Central Bank's prudential norms. If the bank is to function as a commercial institution it needs to

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61 The bank's capital totalled 4 million Sums prior to this injection. The decree also provides a plan for the future activities of the bank stipulating that the bank will open another 600 branches and undertake a rapid automation and training program. Finally, the decree makes Narodnybank exempt from all taxes until 1999 and encourages the bank to increase its commercial lending activities.

62 In February 1996 the bank's deposit base was increased because the Government decided to index deposits from 1992 with a factor of 4000. The indexed deposits are worth 36 billion Sums, but only 10 percent will made available (in the latter half of 1996). This decision clearly has serious fiscal consequences. A windfall compensation of this kind, where cash continues to be withheld from the public, is unlikely to restore confidence in Narodnybank. As a result of the compensation scheme the deposits of Narodnybank rose from 3.9% of total bank deposits in October 1995 to 6.2% in April 1996.

63 Government Resolutions 146 (March 18, 1994) and 234 (May 3, 1994) specify that the status of Narodnybank should be equivalent to other banks.

64 This guarantee of household deposits gives Narodnybank a preferential status not enjoyed by its competitors. The Government's commitment to depositors of Narodnybank was recently confirmed by the compensation scheme made available to household depositors to compensate them for the effects of past inflation.
be able to address its credit risks and function in the absence of these privileges. These changes are also necessary if the authorities are to create a more level playing field in the market for household banking.

As yet the savings bank has not abused these privileges

According to the diagnostic audit Narodnybank was able to cover its costs in 1994. The bank had positive net income even after deducting the recommended 10% of total loans as loan loss reserves. The bank’s favorable earnings profile reflects the bank’s privileged status and the fact that a large segment of its deposit base is comprised of core, low-cost deposits. In contrast to savings banks in the majority of formerly socialist countries Narodnybank has largely avoided business outside its areas of expertise, such as commercial lending. The bank also has only limited obligations of a quasi-fiscal nature – such as providing subsidized housing finance.

The savings bank’s activities should be restricted

In accordance with the diagnostic audit a “narrow” banking strategy is recommended for Narodnybank’s future operations. So that Narodnybank can become a viable entity under competitive market conditions, the authorities should insist that the bank concentrate on its core retail banking business and refrain from expanding its lending to legal entities. Any excess funds should be invested either in Government securities or placed on the interbank market using the credit auctions. While operating as a narrow bank the management of the bank will need to design and implement a strategy for the future of the bank, operating on a level playing field.

Is there a role for the savings bank in the medium term?

Narodnybank currently serves as a cash collection and payment agency whose efficiency is severely hampered by its low level of computerization – even relative to other Uzbek banks. Major changes in the operational structure of the bank will be needed if it is to be viable in a competitive environment. Transforming Narodnybank into an efficient retail banking organization specializing in household payment intermediation would require considerable investment in information systems, the automation of banking services, and in a sizable technical assistance program.

The bank’s organizational structure would also need to be rationalized, concentrating all strategic decisions at an expanded head office and down sizing its overextended branch network. In developing a strategy for the future of the bank it will be necessary to assess the future viability of the bank’s operations. Were the bank to charge fees for the services it currently provides free of charge, such as consumer payment services, purchasers of these services might find it advantageous to use other banks or private contractors. For those services remaining within the bank, the management would need to develop new products for its customers. In assessing the future viability of the bank the effect of

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56 The Ministry of Finance issued the first series of Treasury Bills in March 1996, see Chapter 6.

57 Trades at the credit auction bear an implicit Central Bank guarantee. Trading exclusively through the auction would tighten credit discipline and liquidity management routines within Narodnybank. Since branches of the bank would no longer be allowed to lend to other banks, the commercial viability of the bank would also improve. Currently Narodnybank still on-lends to other banks at interest rates below the interest rate at the credit auctions.

57 It now takes forty-five days for the bank to consolidate its accounts.

58 Remote access points could be replaced by a giro-system run by the post office.
removing any burdens currently imposed by the state should be taken into consideration. The bank should, for example, no longer be required to provide housing finance at subsidized interest rates. If the bank continues to administer subsidized housing programs as the agent of the Government, it should receive an explicit state subsidy to cover the interest rate subsidy and administration costs.

5.39 Once the viability of the bank is assessed, two restructuring options should be considered by the authorities. The authorities could eliminate the privileges enjoyed by the bank, and allow other banks to compete on a level playing field in the market for retail deposits. The bank's narrow mandate could then be broadened. Following the rationalization of the bank's operations the bank could then be privatized. This option assumes that the bank will be able to attract buyers willing to make sufficient investment in upgrading the bank. If this is not the case, the authorities should consider selling the branches of the bank to other banks and encouraging these banks to compete in the market for household deposits. In the medium term these private banks, local cooperative banks, or credit unions should be able to compete in providing the full range of household banking services currently provided by Narodnybank.

The National Bank: creating competition for foreign trade finance

The National Bank conducts more than two-thirds of its business on behalf of the Government or with the support of Government guarantees. Where appropriate, other banks should be encouraged to compete for this business, for example in processing donor funds and Government-guaranteed import credits. All Government-related business should be removed from the bank's balance sheet. So as to create a level playing field it is important that the authorities remove any advantages enjoyed by the bank as regards prudential regulation and reserve requirements. After the National Bank's balance sheet has been restructured it should be an attractive proposition for private investors. It should be possible to privatize the bank fairly soon.

Less than a third of the bank's loans represent credit exposure on the bank's own behalf

5.40 Until recently the National Bank (formerly Uzvnesheconombank) enjoyed a monopoly over all foreign currency operations. Although several banks have recently been issued licenses to engage in foreign currency business, state enterprises are still encouraged to use the state-owned National Bank. Until January 1996 the National Bank also administered part of the Government's foreign exchange reserves. It continues to be the sole agent for Government-guaranteed credit and donors' foreign currency credit lines. As of October 1995, 80% of the bank's assets were in foreign currency. This high proportion of assets denominated in foreign currency has led to considerable growth in the relative size of the bank's balance sheet, which accounts 40% of the total assets of all Uzbek banks. This comparison, however, considerably overstates the amount of the business conducted by the bank. Of the National Bank's loans, two-thirds are direct loans on behalf of Government or made in connection with Government guarantees to foreign banks or export credit agencies regarding payments on imports receivable. Less than a third of the bank's loans represent credit risk exposure on the bank's own behalf. Many of these loans carry Government guarantees and the bank's exposure is predominantly to state-owned enterprises.

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69 A Presidential Decree (June 27, 1995) stipulated that the currency reserves will be moved to the Central Bank on of January 1, 1996. This does not preclude the National Bank from managing the reserves under an agency or trust agreement. The Central Bank law enacted on December 21st, 1995, confirms the role of the Central Bank in owning and managing Uzbekistan's foreign exchange reserves.
The bank is taking steps to acquire market-based banking skills

5.41  The National Bank has been audited according to international accounting standards since 1993. According to these audits the bank is adequately capitalized. Most of the bank's capital — US$200 million of US$236 million — is in the form of a loan from the Cabinet of Ministers. The bank's earnings are supported by low-interest-bearing funding provided by the Government and state enterprises. The management of the bank has adopted a conservative policy regarding loan provisioning. Even without the capital contribution provided by the Government, the bank might be adequately capitalized according to international standards, because the larger part of its loan portfolio carries Government guarantees and its foreign exchange balances are held with banks of good international standing.

The bank enjoys important privileges that should be removed

5.42  The National Bank is the first bank in Uzbekistan to have started converting its existing accounting plan and accounting practices to internationally acceptable standards. The bank's management is also eager to adopt international standards for internal operational policies and procedures. The bank plans to acquire the necessary skills and training needed to upgrade its operations by using foreign correspondents, participating in foreign joint ventures, on-lending funds from the European Bank for Reconstruction and Development, and so on. The bank also hopes to establish contact with foreign partners and thereby enable skills transfer. Although this appears to be a sensible strategy, there is no need for the authorities to continue to protect the National Bank's access to fees from these lines of business. Instead of channeling export guarantee business and donor funds through the National Bank, the authorities should allow other banks to bid for these tasks. As other banks become more active in foreign exchange business, the National Bank's income from this source will also be subject to increasing pressure. The Government should also downsize the bank by removing the bank's preferential access to state-related business, including the management of foreign exchange reserves and state-guaranteed foreign currency lending. Any remaining competitive advantages enjoyed by the National Bank resulting from exemption from the Central Bank's supervisory authority should be removed, bringing the bank under the full supervisory authority of the Central Bank in terms of both reserve requirements and prudential regulations. Currently foreign exchange deposits are exempt from reserve requirements. As

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20 In contrast to the major sectoral banks and Narodnybank, two-thirds of the National Bank's staff (of 1,500) is employed at the head office, allowing for more specialization within the bank and better coordination of decision-making.

21 The availability of export guarantees should be monitored by a Government export guarantee agency.

22 According to the Central Bank, all foreign exchange accounts of the cotton industry were transferred from the National Bank to Pahtabank in late 1995. This reduces the monopoly status of the National Bank. The authorities should, however, be aware that moving the accounts of a whole industry form one bank to another does little to enhance competition in the market for foreign exchange services.

23 The National Bank could act as an agent for the Government in these areas, but the overall responsibility for reserve management and Government borrowing should be vested in the Central Bank. In a two-tier banking system these areas of responsibility cannot be vested in any commercial bank without distorting competition. This rule applies not only to the ability to earn fee income, but also to access to knowledge of the Government's intentions regarding exchange rate and liquidity (interest rate) policies.

24 The principle of equal status and treatment of all banks is upheld in the recently enacted banking law. This is an important improvement as compared to the banking law from 1992, since the special status given the National Bank now no longer applies.
the National Bank's deposit base is predominantly denominated in foreign exchange, this gives the bank a significant competitive advantage. Once the balance sheet of the National Bank has been restructured, the bank should be an attractive proposition for private investors. It should be possible to privatize the bank fairly soon.

Foreign entry: encouraging growth of the private banking sector

The number and size of privately owned banks in Uzbekistan is small. Some private banks are well-managed and have the potential to survive and grow in the new environment. Following restructuring and privatization this may also be true for some of the sectoral banks. However, the establishment of a market-based banking environment is severely constrained by a shortage of banking skills.

The authorities can encourage the development of market-based banking by broadening the role of private ownership, making the bank licensing process more transparent, and removing barriers to foreign trade. Joint ventures with foreign banks, twinning agreements with foreign banks, and sale of local banks to foreign banks can all contribute to promoting the necessary transfer of skills.

Financial sector development rests on enhancing the role of the private sector

5.43 Since 1993 the authorities have licensed a number of new banks. Few of these banks are privately owned, however. The new banks are mainly new sectoral banks in that they are owned indirectly by the state (through state-owned enterprises or state-owned banks) and are not subject to the full financial discipline of the market-place. Under this form of ownership the banks can still rely on either direct state support or support in the form of a bailout by their state owners. Due to their preferential financial status the new sectoral banks are not burdened with the full risks involved in making banking decisions and have fewer incentives to develop market-based banking skills. Moreover, they may crowd out private banks, thereby discouraging private investors from committing capital to the sector. Thus the development of a market-based banking sector in Uzbekistan depends crucially on broadening the role of private ownership.

5.44 To some extent competition already exists among the emerging private banks in Uzbekistan, but the authorities should take steps to support the development of this small sector. Nurturing the environment for private banking activity will involve improving the enabling environment (Chapter 3) and the financial sector infrastructure (Chapter 4). Of particular importance in encouraging foreign entry will be simplification of the licensing process and removal of any remaining barriers to foreign trade, such as the distinction between cash and noncash and the licensing and monitoring of the purchase of

\[20^2\] Though they are not directed specifically at foreign banks, the Uzbek regulatory environment is burdensome and discourages new entrants. Greater entry will require simplification and greater transparency in the licensing process as well as deregulation of the banking environment. Currently regulations restricting the availability of real estate for banking premises, prescribing the layout of banking offices, and so on perform the role of "hidden" barriers to entry. These issues are discussed in Chapters 3 and 4.
Liberalizing foreign trade will also facilitate private sector capital accumulation, which is essential for expansion of private sector activity during the early stages of transition.

**Improving banking skills through training and foreign joint ventures**

5.45 The authorities should also take measures designed to accelerate the acquisition of market-based banking techniques. The transfer of essential banking skills will require resources for training and technical assistance, making the process unlikely to take place without the encouragement of the authorities. Two approaches are possible. The authorities could encourage technical training programs within the banking community. This approach is discussed in Chapter 8 in connection with proposals for reforming the recently established subsidized credit programs.

5.46 Another approach to enhancing the transfer of banking skills is to encourage foreign banks to invest in the Uzbek banking industry through joint ventures. By attracting foreign joint venture banks, the authorities will contribute to enhancing the transfer of banking skills and technical knowledge of market-based banking. The Uzbek authorities should take measures to encourage the establishment of foreign joint venture banks. The demonopolization of trade finance and full liberalization of foreign trade activities would contribute significantly to this process. The authorities should also encourage the sale of domestic banks to foreign partners. If the domestic bank were reorganized and made sufficiently attractive, investment in a domestic bank could be made a condition for the entry of a foreign partner.

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Cabinet of Ministers Decree No. 95 of March 13, 1996, establishes new routines for monitoring the use of foreign exchange. These routines are complex and burdensome making it cumbersome to import goods other than on a consignment or cash basis. As of October 1st, 1996, a number of measures were taken to reduce imports to Uzbekistan. Among these were new import duties and prior registration of all imports with the Ministry of Foreign Economic Relations.
Lauching the market for fixed-income securities

6.1 Establishing a stock market framework will be essential to the privatization of state-owned entities. The ultimate objective, however, should be to develop a broad base for capital market activities. If individuals and institutions are to be able to diversify their investments, they need to be able to choose among more risky investment instruments – such as enterprise equity – and instruments yielding various kinds of fixed incomes – such as bonds, bills, and marketable certificates of deposit. Treasury securities should be issued on a regular basis to build confidence in this segment of the market.

6.2 During 1995 the Uzbek authorities took the first steps toward establishing a market in fixed-income securities. The Central Bank periodically sold certificates of deposit to withdraw liquidity from the banking system. In March 1996 the Central Bank auctioned the first issue of Treasury Bills on behalf of the Ministry of Finance and Treasury Bills have been issued on a monthly schedule since then. Secondary trading among the banks takes place at weekly interbank auctions. Treasury securities should continue to be issued on a regular basis to build confidence in this segment of the capital market. The authorities should further promote secondary trading by encouraging banks to trade outside the weekly auctions and by encouraging sale of Treasury Bills to nonbanks. Once the market in three-month issues is well-established, the MOF should issue six-month bills and eventually longer bonds. To improve market transparency it is important that all the interest rates quoted by the Central Bank – whether at the credit auction, for certificates of deposit, or for Treasury Bills – be expressed as effective compounded annual rates.

Postprivatization capital markets

Secondary market trading in enterprise shares and in private participation shares is essential to the success of the Government’s privatization scheme and to improved corporate governance of enterprises.

6.3 The development of the equity market in Uzbekistan is still at an early stage. The market in the stock of privatized enterprises and is small in terms the variety, number, and volume of available products. Market participants are not sophisticated by Western standards. Their profits often result from Governmental concessions rather than from undertaking commercial risks. Markets are segmented, nontransparent and illiquid, with inefficient trading structures and settlement procedures. The slow pace of capital market development is closely linked to the privatization approach that has been used until recently. Privatization has taken place through the mechanical allocation of shares of state-owned enterprises transferred into joint stock companies among the Government, employees, potential foreign investors, and public offerings. Designated share owners have had little incentive or opportunity to trade the shares that they received through the initial allocation.

The market in Central Bank CD’s has not been liquid, possible reasons being that the interbank market is predominantly for three month credit (similar to a CD maturity) and lack of familiarity with discount paper. There has been a general lack of clarity regarding the effective interest rate on various interest-bearing assets and liabilities, because there are no generally accepted standards regarding the calculation of compound interest.
Secondary market trading is vital to the success of the Privatization Investment Funds

6.4 In the future secondary markets in enterprise equity will be shaped by the implementation of the privatization scheme, which will be based on Privatization Investment Funds (PIF's). PIF's will allow all adult citizens to participate in the privatization process by offering a special category of shares - Public Participation Shares (PPS's). The privatization scheme incorporates a number of factors that will stimulate the growth of PIF's and the sale of PPS's. The initial price of the PPS's will be low relative to the value of the underlying assets. Preferential credit will be extended to PIF's, allowing them to leverage the capital that they raise through the sale of PPS's. The PIF's will also benefit from unlimited downward flexibility in the price of the shares included in the privatization scheme. However, without proper development of secondary markets, the private ownership of shares introduced by the PIF's scheme would be frozen at its initial stage and the objective of the privatization scheme - accountability of companies to PIF's and the managers of PIF's to their private owners - would be jeopardized.

6.5 On December 6, 1996 the first (pilot) auction of companies was held. Shares of four companies were sold to four Privatization Investment Funds. Offering (and transaction) prices were lower than prices for the same shares offered through the Tashkent Stock Exchange. Participating PIF's oversubscribed significantly and bids were reduced pro-rata. Prior to the auction a number of preparatory steps were taken. Twenty PIF's and their management companies were licensed. More are waiting to be licensed. The process for selling PPS's to the public through a diversified network was initiated. The trading and registration/depository systems were fine-tuned and the authorities had begun a public education campaign. Five PIF's began to sell their PPSs and there has already been impressive demand from the public for the purchase of PPS's. As yet the investment funds have not been able to distribute their shares through Narodnybank, which is envisaged as the main future channel of distribution. The PIF's have resorted to innovative approaches to marketing their shares, selling shares directly to the public. Altogether the success of the pilot auction process is a very important initial step to developing capital markets in Uzbekistan.

6.6 In the context of the privatization investment funds it is important to realize that the objectives for capital market development will be somewhat different than those of more developed Western capital markets. The objectives should be to:

- Offer "customer friendly" divestiture of PPS's and enterprise shares by individuals who do not want to own them;
- Allow the PIF's to adjust their share portfolios;
- Improve corporate governance of privatized companies by introducing public accountability of corporate managers;
- Prevent fraudulent behavior (such as pyramid schemes);
- Enable private enterprises to raise capital once the markets mature.

6.7 The immediate objective will be to create a system facilitating the sale of PPS's by the initial beneficiaries, and thereby to establish market-based valuation of PPS's. Without a secondary market for PPS's the privatization scheme will generate few incentives for professional management of the individual PIF's. It is essential that the value of the PPS's reflects the success of the fund managers in stimulating corporate efficiency through their investment decisions. In the longer term, the development of a liquid and efficient secondary market for PPS's and enterprise shares is vital for the sustainability of the PIF's Scheme and improved corporate governance of privatized companies.

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28/ Initially at least 30% of the equity in each of 300 companies will be included in the privatization scheme.
Participation in the secondary market following privatization

6.8 The PIF's are expected to dominate secondary market activity, since the larger funds will manage more shares than any other single investor. The PIF's should facilitate the functioning of capital markets by allowing investors to own part of a diversified, low-risk portfolio of shares and thus encouraging citizens to invest in shares. PIF's will hold large share holdings in enterprises and making it easier for them to monitor, supervise, and influence the behavior of managers. But the funds also have the potential to hinder the smooth operation of markets, because they tend to trade off the exchange in large blocks of shares, thereby inhibiting transparency.

6.9 Postprivatization capital markets will likely have the following characteristics:

- **Products.** Initially the PPS's will likely be the most tradeable product. At this stage it is difficult to estimate how many PIF's will be established or what the issue volume of the PPS's will be. After the auction of shares the funds will most likely trade their shares, so as to consolidate and adjust their portfolios. Employees can also be expected to divest shares.

- **Investors.** The market will be dominated by three types of investors: investment funds (investing funds collected through the sale of PPS's and other investor subscriptions), insiders (managers and workers), and the owners of PPS's, who are owning securities for the first time and are assumed to be relatively unsophisticated investors.

- **Trade volumes.** Given the initial broad distribution of ownership, the volume of trading in PPS's will initially be bigger than is typical for an economy of Uzbekistan's size. Thus trading volume can be expected to stabilize at a significantly lower level after the initial rapid growth of share trading.

6.10 Not all companies included in the PIF Scheme or privatized by other means will need to comply with the requirements for publicly traded companies. Small companies with little interest in attracting outside investors should not be burdened with the costs of public disclosure. Companies can eventually be expected to fall into three groups: those able and willing to fulfill the requirements for public trading at the Tashkent Stock Exchange (perhaps a minority); these with shares traded on the over-the-counter market and following a less stringent set of requirements; and those without actively traded shares. The third group may become closed stock companies or be liquidated.

Development of market infrastructure

The trading system should be designed to promote liquidity and transparency, and to hinder excessive price movements. Liquidity will be enhanced by adopting a call-auction trading model and keeping transaction costs to a minimum. To achieve transparency, information on all trade prices and volumes should be disseminated as soon as trades are made. Excessive price movements can be prevented by introducing rules that suspend trading sessions if prices move by more than a predetermined amount.

The National Depositary should be upgraded to provide a full range of services in connection with the registration of ownership and transfer of dematerialized securities. The upgrade should also...

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79 It is expected that for the viability of the program at least 10 PIF's should be created and continue to operate as financially viable businesses, and at least 2 million individuals should buy PPS's.
enable the depositary to service a much larger number of issuers and investors and considerably larger trading volumes.

The basic institutions are in place, but require considerable development

6.11 Rudimentary market institutions - the Tashkent Stock Exchange, a National Depositary for Securities, a State Commission on Securities and Stock Exchanges - have been established. As yet, however, these institutions concentrate on servicing primary privatization offers and do not fulfill their function in facilitating secondary trading. In the near future the main regulatory, institutional, and technological challenges relating to the implementation of the privatization investment fund scheme will need to be addressed.

Developing the trading system

6.12 The Tashkent Stock Exchange is the only regulated market for share-trading (Box 6.1). It is essential that the exchange observe a number of principles regarding fair and open trading. The exchange should be open to all licensed brokers wishing to trade. Its trading mechanism and rules should focus on secondary trading (rather than primary sales), with trading in PPS's as a priority. Participating brokers should be encouraged to trade in PPS's for their own account or on account of their clients (within the legal limitations introduced by the decree on PIF's). The costs and fees of trading in PPS's should be kept to a minimum. In this connection it is advisable that the authorities help lower the exchange's startup costs by subsidizing some of its initial infrastructure costs (such as telecommunications).

Box 6.1 The Tashkent Stock Exchange

The Tashkent Stock Exchange is the only regulated market for share-trading in Uzbekistan. It was established in 1994 and is owned by the Expert Audit Center (51%) and Uzfininvest. In 1996 the Tashkent Stock Exchange received new premises and modern equipment. The Exchange is planning to open branches in major regions of the country integrated with the center through a real-time telecommunication network. At present nearly all trading activity on the Tashkent Stock Exchange is in the form of primary privatization offers (99 percent of turnover). Trading is organized on a callover basis with a caller (an Exchange official) offering shares on behalf of the State Property Committee (GKI) to 176 licensed member brokerage firms (exchange brokers) acting on behalf of their clients. Usually transactions are concluded at the seller's (GKI) price. Transactions are cleared and settled between the GKI and a final buyer without participation of the brokers or the Tashkent Stock Exchange. Settlement is both risky and slow. In some cases it takes as long as six months to settle a transaction (payment and transfer of ownership), which in an inflationary environment may result in heavy losses. The primary supply of shares by the GKI is significantly higher than the demand - only about 10 percent of offered shares have found buyers. In 1996 the market turnover has been flat or even negative in real terms.

There is a small unregulated off-exchange secondary market for shares of privatized companies. This market is also hampered by the cumbersome and risky settlement procedures.

6.13 To preserve simple procedures and facilitate supervision it is recommended that a consolidated, order-driven, single-price call auction system be established. Such a system maximizes turnover,
matches buy and sell orders as closely as possible, and minimizes price movements when compared with previous sessions. To stabilize prices it would be advisable to adopt a rule, that would suspend trading if prices moved by more than a predetermined amount (say, 10%) relative to the closing price of the previous session or if the disequilibrium between buy and sell offers was too big, (say, a five to one ratio). Each issuer would contract a specialist broker to ensure orderly market conditions.

6.14 Experience with mass privatization programs in other countries shows that the secondary market will have two segments: a market for blocks of shares traded between sophisticated investors (investment funds, strategic investors, institutional domestic and foreign portfolio investors, and so on) and a retail market for small amounts of PPS’s and enterprise shares traded between individuals.

6.15 The main challenge facing the block market is that the trading mechanism is likely to be opaque and price dissemination is likely to be poor. For example, in the Czech Republic and Lithuania as much as 80% of trading in shares from the mass privatization programs is done through block markets between investment funds with very little price dissemination. The concern here is not so much for the prudential safety of the trades – block trades normally take place between sophisticated investors, largely in the form of direct contracts without or with only limited intermediation of regulated trading systems. Rather the emphasis should be put on making sure that information on volumes and prices is disseminated after the trades have happened.

6.16 The main challenges for the retail market are in securing the safety and fairness of transactions and avoiding high transaction costs, market fragmentation, and high volatility of prices. Trading frequency and liquidity may vary substantially from share to share and over time for the same share. Also, some of the shares (companies) will be traded nationwide while others will be limited to local markets. Trading systems should be as flexible and open-ended as possible so that they are able to accommodate share-specific characteristics and unforeseen market developments.

Registering and transferring security ownership

6.17 Most emerging markets have introduced or attempted to introduce dematerialized shares. Dematerialized shares are preferable to physical paper certificates because transfer of ownership for dematerialized shares is relatively simple and cheap. Ownership can be transferred by making an entry in a computer database and does not require the transfer of paper certificates. Institutional arrangements for services such as share registration, custody, clearance, settlement, and transfer should seek to incorporate fully the benefits of new data collection and processing technologies. These technological advances make it possible to integrate all these services, rather than relying on delivery by separate agents.

6.18 The National Depositary for Securities could be used as the foundation for such an integrated approach. The current activities of the National Depositary for Securities and the proposed integrated approach are described in Boxes 6.2 and 6.3. An integrated depositary system would have two levels of accounts: accounts of licensed market operators (brokers, PIF’s, banks, and so on) and accounts of individual investors, whose entries are made by the markets operators. Commercial banks should be allowed to participate in the depositary system as nominee holders of shares for their clients. Eventually the National Depositary for Securities would keep securities in deposit for member organizations; prepare settlement of financial transactions between members and reconcile the accounts and supervise the operations of the clearing bank; settle securities transactions between exchange members; register data between sessions and submit them together to the exchange. At a single-price auction prices for each share are set only once per session.
on trade volumes and turnover; collect dividends and redemptions; and issue rules for the deposit-keeping activities of its members.

Box 6.2 The National Depositary

The National Depositary, "VAKT", was established in 1994 and is privately owned by six large shareholders and a number of small ones. At present it is the only registration and depositary system available in Uzbekistan. VAKT is designated by law as the exclusive depositary for PIF shares. Its main functions are to provide share registration, the dematerialized deposit of shares and transfer of ownership (settlement of securities) for transactions concluded through the Tashkent Stock Exchange. VAKT provides share registration services for over 4,000 fully or partly privatized joint-stock companies. There are over 230,000 individual investment accounts, most of which are inactive as the secondary trading is almost non-existent. VAKT has branches in each of the 12 regions, with communication links to the center.

Box 6.3 Integration of Institutional Arrangements

Where shares are dematerialized, the division of labor between the four traditional agents of book-entry systems – registrars, depositaries, custodians, and transfer agents – is disappearing. In some countries registration and depositary functions are offered by the same agents. The difference between registry- and depositary-based systems is mostly legal, concerning the location of proof of ownership. In the registry system the security-issuer is responsible for maintaining proper records of ownership. In the depositary system the responsibility rests with the agent accessing the depository.

The Korean Securities Settlement Corporation is a good example of an integrated system. It offers the following services: safekeeping of deposited securities, book-entry delivery of securities, book-entry pledges of securities, collection and payment of dividends, safe custody service, collection and payments of principal and interest on deposited bonds, physical receipt and delivery of securities from and to participants, clearance, settlement of transactions made on the Korean Stock Exchange, transactions netting, administration of beneficiary owners’ rights, transfer of registered shares, nominee functions, collection of securities transfer tax, and conversion of convertible bonds.

6.19 Similar solutions have proved to operate smoothly in other transition economies, combining both simplicity in the transfer of ownership associated with bearer shares and the security from theft and fraud associated with registered shares. Full dematerialization (book entry) and computerization should substantially reduce settlement risk and allow transactions to be settled within five days (T+5). To fulfill this function the National Depositary would need to be equipped for servicing much larger numbers of issuers and investors and considerably larger trading volumes. It is recommended that the State Property Committee bear some of the costs of upgrading the depositary’s technology and systems.

Supervision of security markets

6.20 The recently established State Commission on Securities and Stock Exchanges should set guidelines for security market activities. Representation on the commission was recently narrowed and responsibility for the Commission was moved from the Ministry of Finance to the State Property Commission, which also is the main issuer of enterprise shares. It is recommended that the authorities take steps to reestablish the balance on the commission to ensure the broadest possible representation. Furthermore, in balancing its responsibilities for regulation and promoting the activities of the stock exchange, the Commission should be careful not to overregulate or set standards of regulation, which are so high that trading activity is stifled.
Responsibility for enforcement of security market regulations should be given to self-regulatory organizations. So that these organizations are not able to thwart competitive pressure, all qualified market participants should be required to enroll as members of their respective self-regulating organization.

Eventually the authorities should consider setting up a consolidated supervisory authority for all financial sector activity.

6.21 A common problem in most countries of the former Soviet Union is poor enforcement of existing laws. Enacting modern laws following Western best practice is of little value if the laws are not enforced. Enforcement may be poor because of weak or nonexistent commercial courts or inefficient administration. It may also be in the interest of some managers of privatized companies and market operators to keep regulations vague and unenforceable. In Uzbekistan the authority to regulate, monitor, and enforce the behavior of market operators, to impose disclosure standards for publicly traded companies, and to license brokers, dealers, and other financial intermediaries (such as mutual funds) has been designated to the State Commission on Securities and Stock Exchanges (SCSSE). The commission was established in October 1995 with broad representation from security market participants and regulators. This representation was narrowed in April 1996, however. The commission is now a department within the State Property Committee, which weakens its authority considerably because the State Property Committee is also the main supplier of equity to the market. The authorities should take steps to reestablish the balance on the commission to ensure the broadest possible representation. The Commission should consist of representatives of Government agencies, the National Depositary, the Stock Exchange, and market participants (issuers, investor representatives, brokers and custodians). In contrast to similar regulatory organizations in the West, as in other transition economies the SCSSE is responsible not only for licensing participants and the supervision of the market, but also for market promotion and institutional development. There is an inherent conflict of interest in this dual function. It will be very difficult for the SCSSE both to ensure protection of investors — especially small and unsophisticated investors — and to promote business opportunities for professional market participants. There is a danger that the Commission might overregulate or set standards of regulation which are too high, thus stifling the activities of market participants.

6.22 Establishment of the SCSSE was a step in the right direction, but the committee should not be viewed as a regulatory solution. Its functions should gradually be delegated to self-regulating organizations. One of the basic principles of market economics is to leave as much regulation as possible to private parties and for the Government to regulate and control as little as possible. The main objective is to render capital markets fair, efficient, and transparent. A preferred option is to set simple principles and standards and to pass much of enforcement to participants, for example, through self-regulation or civil legal action. Exchanges, professional organizations of financial services providers, and organizations of investors and issuers should be encouraged to form self-regulating organizations. The SCSSE should supervise their activities and give them official recognition and status. The risk with self-regulating organizations is that they can also oppose competition by excluding interested parties, especially if their self-regulation is sanctioned or enforced by Government regulatory agencies without adequate oversight. To alleviate this risk all qualified participants should be required to enroll as members of their respective self-regulating group (brokers, advisors, fund managers, and so on).

6.23 In the longer term, integration of the supervision of all financial sector activities should be considered. With a relatively small financial sector, it may not make sense to have separate regulatory agencies, each with its own commissioners and general staff, responsible for each financial industry. One supervisory body could be responsible for securities, banking, and insurance issues. Different countries have adopted different approaches to this issue — devising the regulatory structure is only the means to
the end of effective financial regulation. Efficiency in financial regulation depends on the quality of the agency's staff. It is critical that the staff be large enough and of sufficient talent to handle the routine work of processing disclosure documents and license applications as well as the more difficult work of detecting and prosecuting securities fraud. Attractive salaries will be needed to attract and retain talented securities professionals.

The involvement of banks in capital market activities

To reduce systemic risks, banks engaging in nonbanking activities, including securities trading, should be required to set up separately capitalized subsidiaries. Ownership structures should be transparent and information on ownership should be publicly available.

6.24 Universal banking allows commercial banks to deal in securities in a broker/dealer capacity on the basis of a general banking license. Universal banks are able to buy a broad range of securities for their own account (within specified prudential limits). Banks generally have three main reasons for wanting to undertake security market activities: to diversify their earning capacity by engaging in new activities, to use their expertise in securities markets to expand their client relations, and to provide comprehensive services to (large) clients.

6.25 Within banking organizations that decide to engage in securities trading, it is advisable that security market operations be undertaken through independent subsidiaries. At present banks' security activities are not legally separated from other commercial banking activities in terms of management or cost-accounting. Banks' security operations will initially not be self-supporting, and they will need to cross-subsidize their securities' departments. Floating and dealing in the bank's own issues will probably be among the first security market activities undertaken by banks.

6.26 In the long run Uzbekistan will likely develop a system of control-oriented finance. Under this system banks or their subsidiaries will provide capital and managerial expertise to the enterprise sector. In return they will insist on monitoring and, if necessary, controlling the management to protect their investments. Being represented on the boards of directors of the enterprises that they own or control, banks may exert considerable influence and have access to privileged information. Where banks engage in brokerage or mutual fund business, they may also exercise control by lending and exercising voting rights on behalf of small investors.

6.27 Close relationships between banks and their clients have proved efficient in countries such as Germany, Japan, and the Republic of Korea. On the other hand strong and not always transparent links between organizations give rise to increased systemic risks, whereby problems in one financial market or institution can quickly spill over into other parts of the financial sector or other financial institutions. These risks are accentuated when financial conglomerates offer banking services as well as other financial services, such as insurance, funds management, foreign exchange services, and trade finance. In the event of a bank failure, experience from a number of countries shows, the authorities would seek to protect small bank depositors against losses that they were unable to anticipate or prevent. Should a large deposit-taking institution fail, the authorities may be called on to prevent a system-wide drain of

A Cabinet of Ministers Resolution of October 12, 1995 introduces the regulation of financial holding companies. The resolution rightly limits the activities of financial holding companies to holding shares of banks and other nonbank financial institutions, thereby prohibiting financial holding companies or any of their subsidiaries from undertaking commercial activities. The resolution does not, however, address the problems that may arise due to transactions between affiliated companies.
confidence in the banking sector. Separating the banking and nonbanking activities of financial conglomerates will help limit these potential costs and reduce potential system risks.

6.28 To monitor the separation of banking activities it will be necessary to devise rules to avoid potential conflicts of interest caused by cross-ownership. Ownership structures should be transparent and information on ownership should be publicly available. Rules should also be implemented to prevent the transfer of losses among companies within conglomerates, to prevent insolvency risks from spreading between different organizations belonging to the same holding organization.
CHAPTER 7

STIMULATING THE SUPPLY OF CREDIT TO THE PRIVATE RURAL SECTOR

The sectoral banks are unable to fulfill the financing needs of the emerging rural sector due to the specialized nature of their lending, their lack of market-based banking skills, and the burden of bad loans. The bad loans in sectoral banks reflect uneconomic agroprocessing and agroindustry, and are largely unrelated to agricultural production.

Improving rural communities' access to finance depends on private sector development in the form of:

- access to transfer and pledge property rights
- reduction in the burdens imposed on agricultural producers by state orders
- demonopolization of the wholesale distribution system
- reduction in the tariffs on exports of primary produce

To support the development of rural credit it is recommended that the authorities promote the establishment of:

- reliable systems for the registration of ownership and transfer of ownership of land and equipment
- mechanisms for enforcing and trading ownership rights
- a legal and regulatory infrastructure for locally based, cooperatively owned financial institutions.

Current finance of rural production

7.1 As in other countries of the former Soviet Union, increasing the supply of credit to private enterprises in rural communities is a major public policy concern in Uzbekistan. At present the sectoral banks continue to dominate the supply of finance to rural communities, servicing predominantly state-owned and newly formed collective farms. In April 1995 Agroprombank financed nearly 90% of loans outstanding to the agricultural sector; more than 70% of its loans were to state and collective entities. In August 1995 Agroprombank was renamed Pahtabank, the cotton bank, to specialize in the finance of cotton production. Some of Agroprombank's loan portfolio relating to grain producers was moved to Gallabank, and the intention is to allocate lending to fruit and vegetable producers to the newly established Mevasebzevatbank. Other banks involved in providing finance to the agricultural sector are Savdagarbank, which supplies finance to state-owned or state-related trading enterprises involved in agricultural distribution and warehousing; the National Bank, which provides finance in connection with the export of agricultural produce; and Tadbirkorbank, which provides finance to newly privatized farms.

7.2 A breakdown of Agroprombank's loan portfolio as of April 1995 reveals that only 48% of its total loans were to agricultural production. The rest went to agroprocessing industries and trade enterprises. Furthermore, only 15% of Agroprombank's bad loans can be attributed to agricultural production - the bank's bad loan portfolio is predominantly the result of lending to the agroprocessing industries.

\[\text{Data on Agroprombank derive from the diagnostic study of the bank undertaken according to international accounting standards financed by the World Bank's Institution Building Loan.}\]
industry. The bank’s lending to the cotton-producing sector appears to be profitable. Cotton is an internationally traded commodity, and there is already competition among banks to provide finance to the lucrative collective and state-owned cotton-producing sector. The profitability of fruit and vegetable production and to some extent wheat production is less certain.

7.3 Savdagorbank and the sectoral banks that were created from the former Agroprombank are burdened with bad loans and are heavily reliant on the Central Bank for their financial resources. As a result loan maturities reflect the maturity of the banks’ funding and not crop cycles or the depreciation of investments. In part the banks’ problems arise because of the highly specialized nature of their loan portfolios. Each bank is oriented to providing finance to specific subsectors within the economy. Specialization results in the banks’ earning potential being very sensitive to seasonal and cyclical factors. Such banks are unlikely to be sound in a competitive environment. These banks will therefore need to be liquidated or restructured according to the process proposed in Chapter 5. If they are allowed to continue to operate in their present form, they will not be able to play a meaningful and innovative role in rural finance. Furthermore, in their present form these banks will jeopardize the introduction of market-based banking practices.

Private sector development within the rural sector

7.4 As in the urban enterprise sector, the Uzbek authorities have adopted a gradual approach to the privatization of agricultural production. Although most state farms have been transformed into collectives, only small portions of the collective farms have been transferred to private farmers. Privatization takes place either through the sale of long-term leases or household plots. The dominant landowners are the collective farms, which still operate much as the former state farms. They have inherited the assets and liabilities of the state farms but are still bound by profile restrictions and are not allowed to transfer or pledge property rights. As a result the managers of collective farms that have assumed the net liabilities of the state farms are unable to undertake restructuring involving the sale of assets or borrowing against security in land, movables, or working capital. Improving access to the transfer and pledge of property rights is fundamental to the development of the financial system. Stimulating emerging private agriculture will also entail giving farmers access to finance for the purchase of long-term leases. These issues are further discussed below.

7.5 State orders that are honored considerably below world market prices continue to apply to the two major agricultural products, cotton and grain. Although the Government is committed to unraveling the state order system by 1997 for grain and by 1998 for cotton, in the interim period this system severely impedes earning capacity of the rural sector. In addition, the Government squeezed liquidity in the rural sector considerably in 1995 by postponing by almost a year payment for state orders of cotton from the 1994 harvest. Since the authorities stopped giving subsidized credits to agricultural producers in 1995, the decision to only gradually dismantle the state order system may in the interim have increased the net implicit taxation of agricultural producers. It is strongly recommended that the authorities reduce

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83 Cotton is profitable even with the current level of state orders, which are honored at below-market prices (see discussion below).

84 The profitability of fruit and vegetable production depends on investments in the packaging and process industries so as to reach international trade standards.

85 In the interim period the farmers also bore the risk associated with movements in the world market price for cotton.
the current heavy implicit taxation of the rural sector by accelerating the dismantling of the state order system.

7.6 Another factor severely constraining the development of private sector activity in agriculture is the monopolization of the wholesale distribution system. Even in areas where state orders have been reduced, wholesale distribution continues to be in the hands of state monopolies. Cotton products are still subject to export licensing, and producers do not have access to selling cotton at the Commodity Exchange. These factors result in producers receiving prices for cotton not subject to state orders that are similar to the prices for cotton under state procurement – about 50% of world market prices. The monopolization of the distribution system also constrains the supply of financial resources to agricultural producers, since there is no competition for the provision of trade credit either from suppliers or from wholesale buyers of agricultural produce. Rapid dismantling of the monopoly position of agricultural wholesalers is essential to improving the supply of financial resources to the rural sector.

7.7 Finally, the current structure of export tariffs is strongly biased against primary agricultural products such as cotton, wheat, maize, and rice. This bias results in an implicit subsidization of the agroprocessing industry, but shifts resources from being used to their comparative advantage in agricultural production. The Government plans to abolish export tariffs by the end of 1996, thus removing this source of resource misallocation.

Stimulating the supply of credit to rural communities

7.8 With their present management and institutionalization the sectoral banks are unable to address the future financing needs of emerging private rural production. These banks mainly service the state-owned and collective farms and the agroprocessing industries, rather than private producers, and the authorities need to encourage the growth of alternative sources of finance. Newly established private farmers are having trouble gaining access to long-term loans to enable them to fund long-term leases of land and equipment. Tadbirkorbank was established in 1993 to provide finance to the private agricultural sector and to small and medium-size private enterprises. Tadbirkorbank provides technical assistance to new private farmers to train them in accounting and finance and is eager to provide advances to private farmers for crop finance. Farmers, however, have been wary of borrowing due to the high level of market interest rates in 1995 and the short maturity of the loans offered. To ease farmers' access to credit the authorities have started to provide subsidies through the Business Fund and have announced the establishment of a mortgage bank. The subsidies provided by the Business Fund are disbursed by Tadbirkorbank. Although it is possible to make a case for providing subsidies to newly established farms,

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66 Several factors hindering the demonopolization of distribution systems in Uzbekistan are discussed in the World Bank's Agricultural Framework Paper, October 1995.

67 Another factor causing the revenue of producers to be so small is that foreign buyers have to make their purchases in local currency and document that the currency is bought at the official (noncash) exchange rate.

68 It should be noted that stimulating the growth of private financing of rural sector activity depends fundamentally on the same issues that apply to enhancing the role of the financial sector in general and developing the infrastructure for banking as (see Chapters 4 and 6).

69 Tadbirkorbank has 12,000 shareholders, primarily private farmers. The principal shareholders are the Republican Association of Private Individual Farms, farming entity Karnak and the Business Fund for small and medium-size businesses. As with many new banks, Tadbirkorbank is an example of the compartmentalization of the banking system. Though there clearly is a need to establish new financial institutions to serve the rural sector, such institutions will be much sounder if they also diversify outside this sector.
there is a danger that subsidization will become an entrenched benefit to the rural sector resulting in the distorted allocation of resources. Thus it is important that it be made clear from the start that the subsidy will be phased out according to a predefined schedule.\(^9\)

7.9 In September 1995 the Government issued a decree mandating the establishment of Zaminbank (Mortgage Bank) with the purpose of providing low-interest, long-term loans to farmers to enable them to purchase equipment at auctions.\(^91\) The bank also intends to support the development of private farms by lending against mortgages on the land-use rights that farmers have acquired. It may be possible to make these schemes work to the advantage of the rural community, especially with sufficient subsidies from the state budget. But essential prerequisites will be reliable registration regarding the ownership and transfer of ownership of land and equipment, land leases and mortgages on real estate and capital equipment. Improving the legal and regulatory framework for private ownership and establishing a transparent system for the trading of entitlement and for the enforcement of ownership rights will also stimulate private sector financing initiatives. Rather than enhancing the compartmentalization of the banking sector by establishing a new specialized bank,\(^92\) the authorities should revise the legal and regulatory infrastructure for the provision of mortgage finance. Mortgage finance will be more important to the supply of long-term finance to the rural sector than fiscal subsidies. Once the infrastructure for mortgage finance is in place, there is no reason banks should not compete for the business of providing mortgage finance on commercial terms. If subsidies are still made available, banks should be given equal access to obtaining them.

7.10 In addition to improving the infrastructure for private ownership within rural communities the authorities should establish a legal and institutional framework for locally based, cooperatively owned financial institutions. These institutions would lend to all sectors of the rural community, thereby diversifying their loans among a variety of products. They would be based on principles of mutual solidarity. Members' savings would be used to grant loans to other members, who would have to provide personal guarantees as security for their borrowing. Locally based institutions will have better knowledge of farming production and be better able to match loan terms with local financing needs based on crop cycles and equipment depreciation. In the absence of credit histories for new private farmers, local institutions should also be better able to assess private farmers' borrowing needs and their ability to repay their loans. With security in titles and other forms of collateral these local institutions should be able to provide long-term, variable interest rate loans for the purchase of leases and equipment.

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\(^9\) Designing a role for the banking sector and Government subsidies is discussed in Chapter 8.

\(^91\) According to the decree Zaminbank would be owned by the State Property Committee (50%), the Ministry of Agriculture (8%) and equal shares distributed among the National Bank, Promstroibank, Narodnybank, Pahtabank, Gallabank, Tadbirkorbank, Savdagorbank, and Mevasebzevatbank. As of October 1995 Zaminbank had not yet been licensed.

\(^92\) The danger is that banks which specialize in certain areas of business will be exposed to unmanageable risks.
CHAPTER 8

CAPACITY BUILDING WITHIN THE BANKING SECTOR:
A ROLE FOR SUBSIDIZED LENDING?

Establishing a market-based banking environment will take time. To ease the burden of high borrowing costs, the authorities have established two schemes for providing targeted fiscal subsidies to private enterprises. These schemes are detrimental because they:

- support building capacity for assessing credit risks outside the banking sector
- deprive banks of potential new areas of business, since they are supported by state insurance
- will be difficult to unravel unless they are supported by explicit "sunset" clauses
- distort credit markets, resulting in the misallocation of resources

Rather than channeling subsidies through credit markets, the authorities should provide explicit fiscal subsidies.

It is recommended that a cofinancing arrangement be introduced involving the Government and the banks. The Government would lend a portion of the subsidized resources through certain accredited commercial banks. This arrangement would promote the development of technical skills within the banking sector. Furthermore, those enterprises that are given credit under the arrangement would gain the reputation of being creditworthy, and their access to credit from private sources would be enhanced.

Tightening budget constraints and the Government's response

8.1 During 1995 changes in the intermediation of credit through the banking system in Uzbekistan were quite dramatic – reflecting the major shift in the Government's stabilization policies initiated toward the end of 1994. These changes resulted in a marked tightening of credit availability. Subsidized lending was discontinued and the interest rates charged by banks on their lending rose sharply, especially when corrected for inflation. By August 1995 the Central Bank refinance rate had been reduced to 125% (annual effective rate) but normal bank lending rates remained above 200%, while the annualized rate of inflation rate was only 25% in the third quarter of 1995. The sectoral banks, which still account for the majority of bank lending, have found that they need to maintain large spreads because they bear a considerable burden of nonperforming assets. Given the high interest rates charged by the sectoral banks, it is reasonable to assume that those enterprises that are still borrowing from these banks are predominantly state-owned enterprises, which are given preferential treatment and are not yet subject to a hard budget constraint. These enterprises anticipate either rolling over their loans or being able to accumulate arrears with the banks, other enterprises, or the tax authorities. The supply of credit to private borrowers is also inhibited by the slow development of secure private property rights, which results in banks placing severe guarantee and collateral requirements on new private borrowers.

8.2 The imposition of hard budget constraints in the enterprise sector is closely linked to the privatization scheme currently being prepared under the World Bank's Enterprise Reform Loan. Restructuring the sectoral banks according to the recommendations in Chapter 5 would contribute significantly to this process. As a hard budget constraint is gradually imposed on the enterprise sector, credit demand can be expected to fall. This should allow the authorities to reduce the refinance rate to a more reasonable level while maintaining an unchanged level of aggregate demand in the economy – thereby not endangering the success of the Government's anti-inflationary policies.
8.3 Eventually, as the financial sector reforms described in this review are implemented, the role of the sectoral banks as channels of credit to enterprises will be ceded to market-based institutions. Enterprises in need of external sources of funds will increasingly turn to the emerging private banks and capital markets. However, restructuring existing banking institutions and building new institutions will take time and, so as to ease the burden of high borrowing costs, the authorities have introduced two schemes that provide targeted fiscal subsidies to private enterprises. These schemes set a dangerous precedent because until recently the Uzbek financial system was mainly used to channel subsidized credits. The Government's policies should instead remove current subsidies and any new subsidies should be explicitly included in the state budget. It is of the utmost importance that any new subsidies be carefully designed and narrowly targeted, so as not to delay the transition process or promote renewed resource misallocation.

Post-privatization support should be redesigned

8.4 In late 1994 the State Property Committee (GKI) started to lend to enterprises in the form of "postprivatization support." Under this program credit programs are prepared by ministries on the basis of applications submitted by enterprises. The support available from the GKI is limited to 20% of the proceeds from the privatization of those enterprises that were formerly under the control of each ministry. This kind of support raises several concerns. First, the authorities define enterprises as privatized even if only a minority of enterprise shares are owned by non-state-owned entities. Thus the proceeds from "privatizing" minority shareholdings may be used to support enterprises that continue to function as state enterprises. Second, even though banks are used as payment agents, the lending is conducted based on the GKI's assessment of the creditworthiness of the enterprises. Third, the annual effective interest rate on GKI lending (currently between 50% and 100%) is far below current market interest rates. Most loans have a maturity of one year, and the maximum maturity is two years.

The Business Fund supports small business

8.5 The second initiative taken by the authorities to provide credit to the private sector is the establishment of the Business Fund. This fund, which started operations in 1995, receives up to 50% of the proceeds of privatization and 10% of the receipts of the employment fund for the purpose of lending to small, new private enterprises. In July 1995 the fund was incorporated with an initial capital of 10 million Sums with 100,000 fully paid-up shares owned by organizations, enterprises, and individuals. An initial injection of working capital of 100 million Sums was made by the Ministry of Finance. The fund has raised additional capital amounting to 14 million Sums through share issuance.

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24 It is unclear whether the schemes described below live up to this requirement. Initial capital is provided by the Government from the budget, but so far no agreement about the repayment of the capital has been finalized. In the absence of such an agreement the capital allocated to the subsidies becomes a revolving fund, and there will no longer be transparency regarding the size of the subsidy.

25 It is the intention that the banks should bear a minority 10% share of the credit risk of GKI lending.

26 The Fund initially was organized as part of GKI. It was transformed to the Business Fund by Cabinet of Ministers Decree 291 (July 26, 1995). The Business Fund serves six designated sectors: agroprocessing, farms, tourism, construction and building materials, local industry, and services.

27 Additional capital was raised by issuing ordinary and preference shares. Ten percent of the new issue was in the form of preference shares made available to employees and existing shareholders. These shares bear a guaranteed 100% minimum dividend, to be paid irrespective of profits. If there is no profit the dividends are to be paid out of the reserve fund. Though this level of dividends may be in line with dividends currently paid by
The Business Fund appears to be significantly undercapitalized if it is to engage in the risky business of lending to small business. The Government intends to make a contractual agreement with the Business Fund defining the terms (maturity and interest rate) for its on-lending through the fund. Without such an agreement the Business Fund would become a revolving fund for subsidized credit, which would undermine the temporary nature of the subsidy linked to the proceeds of privatization.

8.6 The Government’s aim in establishing the Business Fund is to expand employment for workers "released due to the process of privatization in the agricultural sector" who are unable to afford the credits provided by banks. The fund is allowed to undertake equity investments but has so far largely restricted itself to lending. Loans are long-term (maturities run up to ten years, with most being for five years), with a grace period of between two and five years, and made at effective interest rates as low as 15% - 40% a year. Tadbirkorbank acts as payment agent for the Business Fund but does not assume any of the risks of the fund’s operations. As in the case of the GKI’s post-privatization lending, most of the credit risk on lending from the fund remains with the state. The risks of the fund revert to the state because 85% of the value of its loans are insured by a predominantly state-owned insurance company, Madad, that was established specifically for this purpose.

*Dangers in providing subsidies through the banking system*

8.7 The Government intends for the funds available for on-lending through the GKI’s post-privatization support scheme and the Business Fund to be limited to the proceeds from privatization, which were on the order of 2.5 billion Sums in 1995. Of this sum 1.1 billion Sums was disbursed, corresponding to only about 6.5% of domestic credit expansion. Nonetheless, the subsidization of credit raises a number of important policy issues that the authorities must consider carefully. First, the question arises as to whether the GKI and the Madad insurance company have the expertise required to

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banks under Soviet accounting practices, with falling inflation the guaranteed dividend may result in a substantial drain on the Business Fund’s resources. Shareholders with an assured level of dividends also have fewer incentives to monitor the Business Fund’s activities.

The Business Fund intends to accumulate a reserve fund of 15% of capital, which would be equivalent to only 0.5% of total loans. Even taking into consideration the insurance cover provided by Madad, the loan loss reserve would be only 3% of loans. This reserve might be sufficient to cover the risks of a well-run commercial bank in a developed market economy, but it will not be sufficient for high-risk small-business lending in the current environment in Uzbekistan.

In addition to extending credit the Business Fund provides technical assistance in the preparation of feasibility studies. The decree that created the fund also sanctions a number of other activities that the fund would be allowed to undertake, all of which would normally lie within the domain of private banking. These include arranging leasing, securities management, trust management, and factoring and brokering services.

The shareholders of Madad are six banks and the Union of Entrepreneurs, the Association of Private Firms, and the Association of Business Women. These owners are unlikely to provide financial discipline while the Ministry of Finance continues to provide working capital (equivalent to ten times the value of the share capital) at zero interest rate.

These figures should be interpreted with care. The proportion of new credit intermediated through the Business Fund and the GKI may be bigger. According to accounting standards in the former Soviet Union, banks may keep nonperforming loans on their balance sheets indefinitely, with overdue interest accruing as income that will be realized in future periods. This distortion inflates the balance sheets of the banks and overstates the apparent growth of private sector credit.
assess the feasibility of projects. Second, credit risk insurance and direct lending to the private sector deprive the banks of the opportunity to acquire essential new banking skills in the area of credit risk assessment. Third, subsidized lending to a subsector of the economy leads to misallocation of resources due to market segmentation and the serving of vested interests. Once established, these may prove difficult to dismantle. Finally, the fundamental reason for recommending that the authorities discontinue the subsidization of credit is that the transfer of wealth from the Government (taxpayers) to borrowers introduces incentives for the misallocation of resources. Borrowers may still appear to make profits on projects that have a negative real rate of return using the true opportunity cost of capital. Given that there is a limited supply of savings in the economy, assigning part of these savings to projects with relatively low economic returns necessarily raises the cost of capital for other potentially viable projects. Rather than channeling subsidies through the credit markets, the authorities would be well-advised to provide explicit fiscal subsidies. Doing so would enhance both the allocation of resources among alternative uses and transparency regarding the use of fiscal resources.

Promoting capacity building within the banking sector

8.8 Despite these serious drawbacks, the Government is committed to providing subsidized credits to enterprises during the transition period. As part of the preparation of the World Bank's Enterprise Reform Loan the Government has indicated its willingness to phase out the subsidies over a three-year period (except for lending to especially distressed rural communities). The danger is that in the interim period the loans supplied by the GKI and the Business Fund at negative real interest rates and with a Government guarantee will lead to waste of resources and hinder the development of a well-functioning banking system. Payment discipline and respect for the primacy of the claims of debt holders are essential foundations for a market-based banking system.

8.9 To prepare for the eventual transfer of the tasks performed by the GKI, the Business Fund, and Madad to the private commercial banking sector, the authorities should develop an intensive program to develop technical skills within the banking sector. To promote this process access to low-cost funds should be linked to improvements in banks' technical capacities. Access to continued subsidies should be made contingent on the banks assuming an increased share of project lending risks. This approach would have the following benefits:

- The involvement of the commercial banks based on achieving certain technical benchmarks will provide incentives for the banks to improve their technical skills.
- Enterprises that are given credit under the arrangement will gain the reputation of being creditworthy, and their access to credit from private sources will be enhanced.
- The provision of an increasing share of commercially priced funds will help phase out the subsidy element in the Business Fund's lending.
- The involvement of the commercial banks could also be used to channel support to the banking system in the form of external lines of credit and institutional strengthening.

8.10 Accreditation criteria will have to be developed and technical assistance will be needed to improve the risk assessment and management capacities of banks. The goal of such efforts is to reorient

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To limit the extent of the interest rate subsidy during this period it would be desirable to specify in the contract between the Government and the Business Fund that the minimum interest rate for on-lending be at least zero in real terms (based on the level of consumer price inflation in the previous quarter). This would still leave the Business Fund with a subsidized source of funding, but this could be justified on the grounds that the target group (new small private businesses) are at present effectively excluded from bank credit.
the Business Fund into an organization providing business support services, with finance being passed
directly through the banking system. Such a scheme would also ensure the banks’ involvement in the
process of credit risk assessment at the earliest possible time. If such a scheme were to be supported,
several prerequisites would have to be met:

- Large amounts of technical assistance would be needed to train the Business Fund and Madad
  in market-based credit risk assessment and management skills.
- Agreement would have to be reached on the funding for technical assistance to the Business
  Fund, Madad, and the banks for training in risk assessment and related banking functions.
- Agreement would have to be reached on the interest rate of funds to be provided by the
  Government to the Business Fund. Interest rates should be positive, with a flexible premium
  for assessed risks.
- Agreement would have to be reached on a "sunset" clause for subsidized lending. This could
  be designed to coincide with greater availability of credit in the domestic banking system at
  reasonable real rates of interest. Alternatively, a schedule could be agreed that defines the
  time that it takes for the share of commercial bank lending to rise to 100% of lending provided
  by the Business Fund.
- All banks to be considered for accreditation would have to be subject to the external audit and
  monitoring systems being developed by the Central Bank.
- Based on the advice of external experts the Business Fund and the banks would institute
  market-based banking principles and techniques. The Business Fund would develop
  accreditation criteria for on-lending through the banking system.

8.11 The involvement of the banks could be achieved by establishing a cofinancing arrangement
through which the Government would lend to commercial banks a portion of the resources that are
currently being channeled through the Business Fund.102 These resources would be provided to the banks
at market interest rates (the Central Bank’s refinance rate). Loans to small businesses would then consist
of a combination of resources provided by the Business Fund at subsidized interest rates and the banks
at market rates. The banks would bear the full risks for the portion they are funding, and be free to set
the interest rate on their part of the loan. The borrower would face a weighted-average interest rate based
on the interest rate charged by the Business Fund and the banks. As banks started to benefit from the
technical expertise made available through the Business Fund and meet the Fund’s increasingly stringent
accreditation standards over time, the share of lending provided by the banks would be increased. Loan
applications would have to be approved by the accredited banks and the Business Fund, because both
parties are involved in the risk associated with the loan. Borrowers would not be allowed to borrow from
the Business Fund alone, since this would remove any incentive to use the combined resources.

102 The resources for the commercial bank’s share of the loan would have to be provided by the Government,
because banks currently have no alternative sources of long-term financing.