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IMPERATIVE CONDITIONS TO DEVELOP DERIVATIVES MARKET IN UZBEKISTAN

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ABSTRACT

The article is devoted to analyze the imperative conditions for developing the market of financial instruments (derivatives) in terms of Uzbekistan. It is also studied the legislative basic of securities market regulations and mechanisms of implementation the new instruments adapted to national conditions.

KEYWORDS: *Derivatives, Securities Market, Stock Market, Financial System, Legislative Regulations, New Financial Instruments Implementation.*

INTRODUCTION

Today, given the main pace of development of the market of financial instruments in the global, regional and national economy, the issue of implementing derivatives appropriate to the financial market of Uzbekistan remains relevant. Options contracts are the most suitable in the derivatives market in Uzbekistan. This tool, which is available in law but almost never used in practice, is convenient for investors and can minimize risk. **[1]** There is some work being done in Uzbekistan to build a derivatives market, but they are not enough.

For example, in February 2019, the Uzbek Republican CommodityExchange (UZEX) took another significant step to further develop international relations and trade in the derivatives market of Uzbekistan. UZEX becamea full member of theAssociation of Futures Markets (AFM). **[2]**

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

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

The main goal of theAssociation is to support creation of new derivatives and related markets, as well as the organization of international conferences in order to encourage communication between members and strengthen their relations. But we do not know the impact of this membership until now. There is no official reports o statistics related to derivatives market of Uzbekistan. **[3]** As one of the developing countries, Government should not bea blind eye to this issue.

What does Uzbek law say about derivatives?

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

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

A good market practiceestablished in Uzbekistan is using an ISDA Master Agreement **[4]** as an umbrellaagreement governing cross-border derivative transactions. Modifications to the ISDA Master Agreement templateare required to meet certain provisions of Uzbek laws. Such modifications are reflected in the schedule of the ISDA Master Agreement and may vary depending on the nature of the Uzbek counterparty. The most common amendments includeadding certain tax details of the Uzbek counterparty, adding a list of the documents that need to be delivered by the non-Uzbek counterparty for claiming a reduction in withholding tax in Uzbekistan, and updating the definition of "Bankruptcy" to comply with Uzbek law.

However, we can see that our government is using a piece of advice from international experts. It is written on a recommendation report that experts do not recommend that an equity derivatives market is implemented until Uzbekistan is approaching Emerging Market Status (EMS). **[5]**

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

In order to provide for a uniform application of a regulatory framework to strengthen confidence in the transparencyacross the financial market in Uzbekistan, new transparency requirements are needed. They should be calibrated for different types of financial instruments, including equities, bonds, and derivatives, considering the interests of investors and issuers, including government bond issuers. **[6]**

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

The issue concerning the development of the derivatives market in Uzbekistan has not yet appeared in official publications. Therearea number of reasons for this. Firstly, there is lack of understanding of derivatives, both by the financial communityand the regulatory bodies. There is only one official document in Uzbekistan which has ever even mentioned derivatives. The second reason is the low level of development of the securities market, which serves as a basement role for financial derivatives. Some can argue that thereare still currencies and commodities which can be used as a benchmark for derivatives, like the most successful trades in Russia (Iakovlev, Danilov, 1997). However, therearealso an additional number of constraints in the case of Uzbekistan leading to theabsence of derivatives. The national currency of Uzbekistan is still not fully convertible, causing theabsence of currency forwards. In the case of the commodities, the reasons are quite obvious − problems in regulation and lack of knowledge. However, it is with commodities that I see the prospect of development of the derivatives market in Uzbekistan. In general for transition economies the following barriers for derivatives markets can be presented (Kilcollin, Frankel, 1993):

- Awareness and understanding of derivatives;
- Domestic laws and regulations inhibiting such investments;
- Limits on access to brokerage services;
- Cost of entering a new market;
- Increased risks;
- Lack of adequate infrastructure;
- Lack of customers.

In developed countries derivatives markets fulfil important roles of price discovery and hedging opportunities. Therefore I see the future of the derivatives market in transition economies in general and in Uzbekistan in particular, as at least a long-run prospect. **[7]**

	-Q4	2019-Q1	2019-Q2	2019-Q3	2019-Q4	2020-Q1	2020-Q2	2020-Q3	2020-Q4	2021-Q1
Deposit-taking corporations, except the central bank	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
General government	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Other sectors	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
of which: other financial corporations	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Financial derivatives (other than reserves) and employee stock options	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Other investment	21 874,4	21 869,8	24 073,2	24 127,7	25 514,6	26 106,1	26 539,9	28 854,7	30 816,0	31 161,5
Other equity	0,0	0,0	0,3	0,3	0,3	0,3	0,6	0,6	0,6	1,2
Debt instruments	21 874.4	21 869.8	24 072.9	24 127.4	25 514.3	26 105.7	26 539.2	28 854.1	30 815.3	31 160.3

Table.4.1. Source: International investment position of Uzbekistan million USD, end of period.

As you can seea statistical report of the Central Bank of Uzbekistan. There is no derivatives in international investment position of Uzbekistan. **[8]**

Some banks in Uzbekistan also offers services with derivatives instruments such as foreign exchange swaps – foreign exchange operations with the obligatory reverse transaction with the value date forward. Swap transactions are conducted in major foreign currency pairs USD/UZS and EUR/UZS. If necessary, theexperts of the Treasury Department of the Bank may offer advice on such operations. **[9]**

As approaches to solving these issues, theauthor proposes that:

• the inclusion of the concept of 'derivative financial instruments (derivatives)' in the content of Article 3 as a separate definition in the list of basic concepts of the Securities Law **[10]** should be jump-started;

• the law-making body should dismiss the term 'derivative securities' replacing it with the concept of 'derivative financial instruments (derivatives)';

• the law-making body should adopt a new regulatory legal act, the subject area of which will cover relations related derivative financial instruments (derivatives) only.

Despite the low efficiency of the securities market in the Republic of Uzbekistan, the government is taking all measures to develop this sector. Undoubtedly, such measures as capital market development, international stock market activity, IPO and SPO operations, introduction of derivatives, and engagement of investors to the securities market will increase its efficiency. In the foreseeable future, our republic will beable to create more favorable financial and investment markets, a global stock market and reach global competitiveness, and more favorable conditions for domestic and foreign investors.

It is obvious that despite the ongoing processes of globalization of the country's economy, with the convergence of national legal systems and the unification of law in the field of financial legal standards, the tasks associated with this change remain unresolved.

As approaches to solving these issues, theauthor suggests: acceleration, inclusion of the concept of "derivative financial instruments "derivatives" in the content of Article 3, as a separate definition in the list of basic concepts of the securities law; the legislator's rejection of the term "derivative securities" by replacing the concepts of "derivative financial instruments "with derivatives";

theadoption by the legislator of a new regulatory legal act, the subject area of which will be purely relations related to derivative financial instruments "derivatives".

Derivative financial instruments, "derivatives", have becomea new form of alternative, super-liquid investment for several decades. As a type of financial instruments, the"derivative" is designed to optimize business risks, and by creating new capital to promote profit extraction.

Currently, it is impossible to imagine the global financial world without such a component as a derivative financial instrument (hereinafter referred to as PFI). In the legal science of foreign countries, the term PFI is designated by the term "derivatives" (from theEnglish - derive - to occur, to deduce), is identical to the term PFI.

The obvious continuous increase in the role of derivative financial instruments in theeconomies of states requires them to take timely measures to create conditions for the sustainable development of the market of derivative financial instruments, in this regard, creates an objective need for the scientific validity of these processes.

CONCLUSION

A derivative is a financial contract whose value is derived/reliant on the value of an underlying asset, hence why it is called a “derivative” contract. The underlying asset may be a commodity, bond, equity, interest rate, market index, currency or real estate. Interestingly, there are different views on the validity and permissibility of derivatives from the Islamic perspective by sharia scholars or jurists. Even where sharia scholars have found the derivatives are objectionable, their reason for objection also differs.

The derivatives market has grown rapidly in recent years as the benefits of using derivatives, such as effective risk mitigation and risk transfer, have become increasingly important. The derivatives market is huge—much bigger than the stock market when measured in terms of underlying assets. The value of the assets underlying outstanding derivatives transactions is several times the world gross domestic product. Competing for business, both derivatives exchanges and OTC providers, which by far account for the largest part of the market, have fueled growth by constant product and technology innovation. The statistics that are collected for the two markets are not exactly comparable, it is clear that the over-the-counter market is much larger than the exchange traded market.

To deliver maximum benefits to its users and to the economy, the derivatives market must meet three prerequisites: derivatives trading and clearing must be safe, the market must be innovative and it must be efficient[15]. Market participants, policy makers and regulators should support the providers in the derivatives market to ensure these prerequisites.

There are wanted and unwanted risks in the derivatives market. Both the OTC and exchange segments have arrangements in place to mitigate unwanted risks, although these are inherently more effective in the exchange segment. The main reason for using derivatives is to gain exposure to a “wanted” risk. This usually is a market risk that either could compensate for an opposite risk (hedging) or that an investor wants to benefit from for investment purposes – via the positive evolution of market prices. However, as with other financial instruments, there are also "unwanted" risks associated with derivatives trading that investors seek to avoid. These unwanted risks are counterparty, operational, legal and liquidity risks. The different risks that market participants face can ultimately lead to systemic risk, that is, the failure of one counterparty having adverse effects on other market participants, potentially destabilizing the entire fi nancial market. A primary concern of all stakeholders, including regulators, is to limit systemic risk to the greatest extent possible.

This dissertation discusses the role of derivatives in major economic systems, from their entry into financial markets. At the same time, important issues of development of such markets in our country will be covered. if we look at scientific research, there are significantly fewer scientists in developing countries who have studied or are studying derivatives as a financial instrument. The main reason for this may be the lack of such markets in practice. but it should be noted that the derivatives market (although they are not without its drawbacks) is important for countries.

A group of leading scholars who have studied the securities market in our country writes that the derivatives market will not develop in Uzbekistan until the development of the equity market. I think the main problem in our country is the problems in the judicial sphere. Because any businessman or investor should look at the legal basis of financial contracts in the country before working with them. In our law, the word derivatives are used only in the article called basic concepts. We need to adopt legislation related to derivatives and accelerate the work to create a legal framework for them.

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