

The Russian Securities Market: 20 Years of Development

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1. Introduction

Since its birth in 1992 the Russian securities market has become one of five leading emerging markets. 20 years is enough to evaluate the results of its development.¹

At its peak in 2008 the capitalization of Russian companies was US\$ 1.5 trln. In 2006–2007 the indicator “capitalization/GDP”, had reached the average level of mature markets, exceeding many of them. The Moscow Exchange MICEX-RTS for many years has been the largest stock exchange in Eastern and Central Europe.

However the Russian stock market retains its salient characteristics, being one of the most volatile in the world: during the recent global financial crisis the shrinkage of the capitalization was the most drastic among the major markets. In July 2012 the capitalization of the Russian market was still 1,5 times less than it was at the peak in 2008 (Table 1).

Other segments of the securities market in Russia are tiny compared with the mature markets. The size of the domestic corporate bonds market in Russia in relation to GDP is 13 times less than the world average. The figures of financial institutions’ assets relative to GDP are lower than world average for insurance companies 13 times, private pension funds – 38 times, investment funds – 43 times (2010).

2. Instruments

2.1 Stocks

The first joint stock companies in Russia (banks, investment companies and merchandise exchanges) were being set up in 1989–1991. Up to the end of 1992 the shares of these 3 groups of issuers were the only stocks, traded in Russia. In fact the volume of this market in terms of capitalization did not exceed \$ 100–200 mln.

The real stock market started to emerge in Russia in the end of 1992 as a result of a large scale voucher privatization program. Tens of thousands of former state enterprises were transformed into joint stock companies and privatized. Now (2011) there are formally 533,935 joint stock companies, including 73,593 Public Limited Companies (who can issue shares to the public).² However, a little more than 300 of them are really public companies with shares traded in the market.

The Russian model of privatization was at a first glance mass privatization in line with that in Czech Republic. But in fact it was executed with very strong privileges for in-

1 1992 is a threshold year, due to the start of mass privatization and creation of joint-stock companies. However, first elements of the market financial system started to emerge earlier – in the end of the 1980s.

2 SPARK.

siders – managers and employees. Hence although each person got his voucher, that formally could claim 150 millionths a part of the enterprises being privatized, from the very beginning the management and employees got the lion's share of stocks in the new corporations.

In 1995, 1996 and up to the fall 1997 the Russian stock market was growing very fast. In terms of growth it was acknowledged as one of the best in the world. By autumn 1997 the capitalization of the Russian market had been, according to some estimates, \$150 bln.. The first blow was made by the Asian crisis. By the end of July the capitalization had fallen to 40–50 bln. Then came August, 17 (when the government declared moratorium on domestic debt repayment) and the market was completely ruined. In September 1998 the capitalization of the whole Russian market with all its natural monopolies was worth only \$10–20 bln. (much less than capitalization of Coca-Cola). The RTS index (RTSI) demonstrated one of the most dramatic fall (15 times!) in the history of stock exchanges.³ The pre-crisis historical maximum of the index was 572.00 (10/6/1997), minimum – 38.00 (10/5/1995), see Figure 1.

In 1999 the Russian stock market again became one of the best – the second or third in terms of appreciation (in fact due to the previous steep fall). In 2000 irrespective of very good economic situation, irrespective of oil and gas prices on the world markets the market finished the year in the red. This demonstrated the link of the Russian market with the US market, especially NASDAQ. However, 2001 reversed this trend. While all developed stock markets were falling, the Russian demonstrated strong growth – nearly 60% each year in 2001 and 2002. In 2003 again the market had risen by nearly 60%. In October 2003 the market had overcome the pre-crisis maximum. The rally continued into 2004 until in April 2004 the steady retreat began – by August to the level of October 2003. However, 2005 proved to be one of the best years for the Russian equity market – 83% rise! Only a few countries (Saudi Arabia, Colombia, Kazakhstan) performed better. The rally continued into 2006. The RTSI exceeded 1500 points in February. Both 2006 and 2007 were finished with 70% market rise (in terms of RTSI). Up to May 2008 the Russian stock market was on the rise (fuelled by soaring oil prices), striking nearly 2500 points, when it started rapidly contracting – to less than 500 points in January 2009. That was again the largest fall among the 20 major markets of the world.

The capitalization of the Russian stock market had fallen from \$1500 bln. in May 2008 to \$300 bln. in January 2009.

High volatility is a salient feature of all emerging markets. The daily standard deviation of the RTS index was 4.8% in 1998, 1.3–1.4% in 2005 and 2007 and 4.2% in 2008.⁴ It is a shortcoming, because high volatility is attractive only for a limited number of specula-

3 One of the 2 major Russian indexes. It has been calculated since September 1995. Now based on dollar prices of 50 shares of largest companies.

4 Russian Economy in 2008. Trends and Perspectives, pp. 509–510.

tive investors. The largest – conservative – investors (pension funds, large investment funds, insurance companies, large banks) beware volatility.

One of the features of the Russian stock market in the past was its weak connection with the production process (the commonly used term in Russian literature is “the real sector”). The issuance of stocks in Russia had been done with different reasons, but without the main – to attract new funds for investments. First it was privatization – distribution of property. Later it became the issuance stemming from the bookkeeping needs – to re-evaluate the capital of the firm. Thus they had purely technical character. The first IPO on the **domestic** market was made only in 2002 by an information company RBC (now one of the leading business information providers).⁵ In 2003 one more domestic IPO took place by a drugstore company “36,6”. Since 2004 the number of issues had increased substantially. However, the amount of money thus mobilized was limited (\$ 13–14 mln. in 2002 and 2003, \$ 300 mln. in 2004 and 2005, \$ 1.5 bln. and \$ 14 bln. in 2006 and 2007), especially if compared with some other emerging markets – especially China and India. More money was raised through equity issuance on the foreign markets in the form of depository receipts – nearly 50 bln. through 2000–2007. The crisis damaged this “money accumulation mechanism” and in the second half of 2008 the issuance had abruptly stopped. Only one IPO was executed in 2009 – **OJSC HSCI (Human Stem Cells Institute)**.

In 2010 the situation changed for the better: 12 IPOs took place, among them “Rusal” (the aluminium giant), “Protek”, “Transcontainer”, “Mostotrest”, “Mail.ru”. In 2011–10, including “Yandex” (the most popular search machine at the Russian segment of the Internet), “Nomos-Bank”, “Fosagro”, “Rusagro”.

However, the money thus accumulated in many cases was used to buy-out business from their owners, to refinance debts and to service the M&A transactions. A. Abramov writes: “Only small part of money, mobilized on the stock market, transformed into real investments (new fixed capital), promoting economic growth”. According to his calculations even in the best year for IPO – 2007 – out of the \$ 33 bln., received from IPO and SPO, only \$ 3.6 bln. or 10.9%, were really used for investments.⁶

The features of the Russian stock market are typical for emerging markets. The ownership of Russian companies is concentrated in the hands of controlling shareholders. In most cases these are government or private persons/managers. The latter are not always interested in the appreciation of the stocks of their companies, being confident, that the minority shareholders will not be able to dismiss them. They are only interested in managing the financial flows in their own interest. Under the present ownership structure the controlling owners are not worried not paying dividends, or paying low dividends to the shareholders. Up to the beginning of the 2000s in Russia paying dividends was

⁵ The first IPO was made in 1996 by the Russian mobile operator Vimpelcom at the NYSE in the form of ADRs.

⁶ Russian Economy in 2008. Trends and Perspectives, pp. 520–521.

rather an exception, than a rule. The situation is changing for the better, but still the dividend payout ratio in Russia is low compared to most developed markets – 19% for the 10 largest public companies in 2006–2009.

The industry structure of the Russian stock market capitalization reflects one of the main deficiencies of the present Russian economy the predominance of extracting industry. Oil, gas and electricity production provide 58% of Russian capitalization and 3 sectors (metals and financials included) – 85%. The share of manufacturing industry is negligible – 1.4%.

The shares of Russian joint-stock companies are issued **only** in registered, dematerialized form with par value.

2.2 Debt securities

In the majority of countries of the world the debt securities market is predominantly a government debt market. Russia in the 1990s was no exception. However, in Russia this predominance took rather ugly form in the past, because up to 1999 the corporate bond market didn't exist at all (Table 2).

Treasuries

The Government debt market is represented mainly by the OFZ (Federal Debt Bonds – medium and long-term interest-bearing paper). The short-term bonds (GKO or t-bills) have not been issued since the beginning of the 2000s. Before the 1998 crisis GKO's comprised 60% of the whole government domestic debt market.

The OFZs are issued in book-entry form (although formally the global certificate is available) and traded through the trading system of MICEX stock exchange (now Moscow exchange MICEX-RTS).

The financial crisis of 1998 with the GKO-OFZ being in its epicenter, when the government had to declare moratorium on all operations with the public debt for 3 months, completely ruined the market.

The sluggish trading in GKO-OFZ had resumed in January 1999 on the secondary market. In 2000–2001 there were only a few new issues of OFZs and GKO's of very limited volumes.

In 2002–2003 the Treasury resumed more active borrowings in the domestic market. Only medium and long-term bonds (OFZ) were being issued.⁷ In fact thanks to very

⁷ Russian Ministry of Finance.

high oil prices the budget didn't need these borrowings. The issuance took place in order to create instruments for the Pension Fund of Russia and private pension funds to invest their assets in. The YTM of the OFZs was extremely low: 4–7% in 2005–2008 (with the rate of inflation never being less than 9%). Only in 2009 the yield had temporarily risen to 10–11%. By the beginning of 2012 the yield had declined to 6–8%.⁸ The economic crisis and fall of oil prices made it necessary for the government to increase borrowings in the domestic market. During 2011 the size of the domestic government debt had risen by 43%, although it is still very low (less than 10% of the GDP) as compared to public debt in the countries with the developed markets (ranging from 80 to 230% for the G7 countries).⁹

The main investors in government bonds are banks, The Pension Fund of Russia, private pension funds and insurance companies.

The second most important group of government debt securities is composed of the bonds denominated in foreign currency. Chronologically we should place first the so-called minfin bonds (domestic foreign exchange bonds – OVVZ, the product of the securitization of the foreign exchange debt of the government to state enterprises), first issued in May 1993; but recently they had been redeemed completely.

The largest part of the government external debt is represented by Eurobonds. The first issue took place in autumn 1996, when Russia got credit rating BB- from S&P. That time they were trading at 9–10% YTM. In autumn 1998 some issues were being traded at 17% par with the yield to maturity of 50–55%. In the beginning of 2012 they were being traded with the YTM 3–6%. Now there are several issues outstanding worth 29.2 bln. (December 2011) with the largest one being the restructured debt of the former Soviet Union and Russia to the private banks (The London Club) – approximately \$ 20 bln.¹⁰

Municipal bonds

Russia has 83 sub-federal territorial entities – oblast, krai, republic. Moscow and St.-Petersburg are also included in this list. Before 1998 almost all sub-federal territorial entities issued debt securities. Many defaulted, some even on Eurobonds (Nizhny Novgorod). Now the number of issuers is short with the largest being Moscow and St.-Petersburg. However, the market is tiny (\$ 13 bln. in dollar terms) compared to developed markets.¹¹

⁸ The information is available on the Bank of Russia website (www.cbr.ru).

⁹ World Economic Outlook.

¹⁰ Russian Ministry of Finance (A).

¹¹ In the US it is nearly 4000 bln.

Private notes and bills

It is a very special, even unique, part of the Russian securities market. The reasons for its existence are many. One of them – the deficiency of money. The financial depth (M2/GDP) of the Russian economy is low if compared with the developed and many developing countries. One of the causes was and still is the very restrictive policy of the central bank – in November 1998 the financial depth was 16–17 %, by the end of 1999 – 22–24 %, in 2007–2010 40–43 %. In the developed countries it ranges from 50 to 100, in the developing – from 40 to 60 % (184 % in China).¹²

The proliferation of the bills and notes market in Russia was to some degree the reaction to this situation. The private bills and notes were fulfilling the functions of a unit of exchange – the way it was done in the XIX century.

To some extent the notes are used as substitutes to corporate bonds. Since, according to Russian legislation, they are not regulated by the Securities Market Act, the issuance of notes and bills is less cumbersome than the issuance of corporate bonds.

The estimates of this market are very approximate (\$ 20–30 bln.) The promissory notes predominate.

Corporate bonds

The domestic corporate bonds market is one of the youngest in Russia. In fact it emerged in 1999. It is still small in terms of value of securities outstanding. However, the number of issues was growing rapidly from 2000 and even the crisis of 2008 didn't stop (although slowed) this process.

In 2001 the Russian companies accumulated through ruble bond issuance 0.9 bln. in dollar terms, 2.5 bln. in 2003, 9.6 bln. in 2005, 27.5 bln. in 2008, 29.4 bln. in 2009 and 27 bln. in 2010.

Simultaneously, by the Eurobonds issues the Russian companies got \$ 0,6 in 2001, 8.0 bln. in 2003 and 40 bln. in 2008. The crisis completely closed this market for the Russian companies. It began to recover only in the second half of 2010. In March 2012 the outstanding debt of international private bonds of Russian issuers was \$ 136 bln.¹³

3. Institutions

The Russian financial system refers to the bank-based type with the bank assets forming more than 90 % of the total financial institutions' assets (save the central bank), Table 3.

¹² International Financial Statistics.

¹³ BIS.

The assets of the institutional investors are still tiny, although all types of such institutions exist in Russia.

The insurance companies, being very large investors on the developed markets, play very modest role in Russia. One of the reasons is probably very low loss ratio of Russian insurance companies (60%), stemming from very low share of life insurance in received premiums. As distinct from insurance companies in the developed markets, who earn money mostly through investing premiums, the Russian companies live entirely on premiums.

The private pension funds are institutions set up by most viable Russian corporations.

The most active institutions on the securities market are investment funds (in Russia they are organized as unit-trusts, Russian abbreviation – PIF). Just in 2001, the PIFs net assets value was only \$200–300 mln. The situation began to change drastically in 2002 and especially in 2003–2005. In December 2012 the net assets were \$14 bln. (naturally it is a very small figure compared to the US 11622 bln., or China’s 339 bln.).¹⁴ The lion’s share of the Russian funds refers not to genuine collective investment schemes (of open-ended type) but to closed-end types (Table 3). They accumulate the money of small number of entities and in many cases are used as a tax-optimization vehicle.

Only tiny proportion of Russian population invests their savings in securities, preferring bank deposits. Since investors in shares and investment funds are often the same, we estimate the number of individual investors in Russia as 0.8–0.9 mln. That is only 0.6–0.7% of Russian population.

Professional intermediaries

Both banks and securities firms (broker/dealers) are trading in the securities markets in Russia.

In terms of capital and assets the Russian banks are still small institutions. Only the largest state-owned Sberbank (Saving Bank), Vneshtorgbank and Gazprombank are more or less comparable with average banks of the developed countries. But even Sberbank in 2011 had capital of only \$32 bln. and 319 bln. in assets.¹⁵ None of them is in the list of 25 largest in terms of capital. In 2012 there were less than 1000 credit institutions in Russia (2500 in 1996) and their number continues to decrease further.

The number of securities firms (in Russia usually called “investment companies”) has decreased even more – from 5000 in 1997 to 700 now. These are mostly small companies with the capital not exceeding \$0.5–1 mln.).

¹⁴ Investment Company Institute.

¹⁵ Industrial & Commercial Bank of China \$ bln 124 and 2000 respectively (2010).

Both banks and securities firms are heavily concentrated in Moscow and St.-Petersburg. Nearly 50% of banks are registered in Moscow. The share of deposits in Moscow banks is 57% out of the total, in St.-Petersburg banks – 7%.¹⁶

Trading systems

The first stock exchanges were formally set up in Russia in the end of 1991. These were Moscow International Stock Exchange and Moscow Central Stock Exchange. Both no more exist. In 1992 there were 120 w(!) organizations, having a stock exchange license.

Now 7 organizations have a formal license of stock exchange, to be more precise – the license of a stock exchange or the organizer of trading.

However, practically all trading in securities is executed nowadays at 1 exchange: Moscow Exchange MICEX RTS, formed in late 2011 through the merger of 2 major Russian exchanges. The former (MICEX) was the leader in the spot market for stocks, bonds and foreign exchange, the latter (RTS) – in derivatives trading.

Traditionally, the Central bank of Russia and state-controlled banks had a decisive say in managing MICEX. However, the influence of the state is decreasing step by step. In February 2013 the Moscow Exchange is planning to make an IPO with the further decrease of the role of the Central Bank.

The united exchange embraces all segments of the securities market: stocks, bonds (federal, municipal, corporate), financial derivatives, some commodities. Technologically the exchange is highly competitive. The merger of the 2 exchanges made it possible to speed up creating a national central securities depository (its absence was considered to be one of the main obstacles in the development of the Russian market and Moscow becoming an international financial center).¹⁷ In 2011 the exchange held the 18th place in the world in share turnover.

The regulatory system

Initially (in 1991–1996) the nascent securities market in Russia was regulated by different government bodies with the Ministry of Finance being the number one in terms of functions. It was empowered to license broker-dealers (non-banks), registered representatives, investment funds, stock exchanges, to register securities issuance by all issuers save banks. However, from the very beginning Ministry of Finance shared its powers with the Bank of Russia, who had in fact a monopoly on supervising and regulating all banking activities, including securities issuance and trading.

¹⁶ Bank of Russia (B).

¹⁷ In 2009 the Russian Government issued a program, designed to create an international financial center in Moscow. A special working group was created headed by the former chief of the President's administration A.Voloshin (for more details see: www.mfc-moscow.com).

The absence of a powerful central regulator, the rivalry between the existing regulators, the scandals with the pyramid companies in 1994 – all that made clear the need to change the regulatory framework.

After the Securities Market Act was adopted in 1996, such a regulator in the Russian securities market was set up – The Federal Commission on Securities Market (FCSM). In 2000 the FCSM completely acquired the authority to regulate the securities business of all financial institutions, whether they are banks or non-banks. In March 2004 within the framework of the administrative reform the Commission was transformed into Federal Financial Markets Service (FFMS).

The FFMS is organized in line with the US SEC, although it has no SECs powers to investigate, subpoena power or power to administer oaths.

The FFMS is empowered to file registration statements of all issuers in Russia, save banks (these are filed with the Bank of Russia), federal government, sub-federal territorial entities, municipalities and Bank of Russia (these are filed with the Ministry of Finance).

The Service is licensing different types of operations (activities) on the securities market – brokers, dealers, portfolio managers (including pension funds), organizers of trading (including stock exchanges), registrars, depository and clearing organizations. An institution having a banking license from the Bank of Russia, has to get a license of a broker, dealer or portfolio manager to operate on the securities market from the service. The Service is empowered to levy fines on the issuers and securities industry professionals, if they violate the provisions of the securities laws or decrees.

In spring 2012 the functions of the FFMS were expanded: it became responsible for the insurance industry (previously that was a domain of a special insurance supervisory service, subordinated to the Ministry of Finance).

On the whole, the existing acts on the securities business in Russia are now very detailed and in conformity with the similar acts that exist in the OECD countries. First of all we should mention the Joint Stock Companies Act, The Securities Market Act, The Investment Funds Act, The Mortgage Securities Act, Pension Funds Act, Act on Clearing, Insider Dealing Act.

The last of the aforementioned acts, adopted in 2010, was being developed more than 10 years. Precisely its absence was an impediment in acknowledging the Russian market to be sufficiently regulated. The Act had introduced the criminal liability for insider dealing and manipulation on the securities market, that being in conformity with the existing international norms.

4. Conclusion

Evaluating the results, achieved in constructing the Russian securities market, we can mention the following positive results:

The necessary trading infrastructure has been constructed, that is now quite effective and developed even in comparison with the most mature markets.

The professional intermediaries and their staff are sufficiently competitive and can effectively fulfil their functions.

The legislation is detailed and up to the best international standards (although some lacunas exist).

However, the market still doesn't solve the mega task of being the money-machine, financing gross fixed capital formation.

To change this situation, it is necessary to reach macroeconomic stability (first of all, to decrease inflation rate to at least 4–5%), to provide tax stimulus for long-term investing in stocks and bonds and promote the financial education of people, including the work on publishing educational and professional literature explaining the advantages.

Appendix

Table 1: The structure of the Russian securities market by instrument, US\$ bln, end of year

	1998-07	2002	2004	2005	2006	2007	2008	2009	2010	2011
Treasuries	72	18	27	29,6	39,0	50,9	48,3	60,8	80,7	110
Central bank bonds	–		0,5	3	4,0	4,2	0,4	3,7	19,4	0,3
Minfin bonds (US\$-denominated)	11	10	7	7,1	5,7	4,5	1,8	1,8	1,8	0
Eurobonds of the RF government	9	35	35	31,5	30,9	28,6	27,7	26,2	30,5	29,2
Domestic municipal bonds	4	1,5	4	5,4	7,3	9,0	9,2	13,9	15,1	13,5
Intern. municipal bonds	2	0,9	0,9	0,9	1,0	1,1	1,3	1,3	1,3	0,6
Domestic corporate bonds	–	1,4	9,5	17	35	51,1	61,6	83,5	96,7	106,7
Corporate Eurobonds	–	3	25	34	63,0	94,3	115	99	115	133,1
Private notes and bills*	15	15	> 20	20–30	20–30	20–30	20–30	20–30	20–30	20–30
CDs		2,1	3,7	2,1	2,0	2,2	1,2	0,7	0,9	0,8
<i>Memo: Stocks</i>	<i>50</i>	<i>115</i>	<i>247</i>	<i>531</i>	<i>966</i>	<i>1334</i>	<i>346</i>	<i>762</i>	<i>1001</i>	<i>855</i>

Source: Bank of Russia, Ministry of Finance, CBONDS

Table 2: The Russian financial institutions

	Number	Assets US\$ bln
Credit institutions (functioning)	978 (1.01.2012)	1246
Broker-dealers (securities firms)	≈700	n.a.
Insurance companies	594 (30.09.11)	37 (premiums collected 2011 est.)
Private pension funds	158 (09.2011)	21,1 (reserves)
Investment funds	1273 (12.2011)	13,8 (NAV)
Open-end and interval	515	3,2
Bank trust funds	274 (12.2011)	0,2
Management companies	456 (31.12.2011)	
Stock exchanges	4 (7 licences of a stock exchange or organizer of trading) (01.2012)	
Registers	40 (02.2012)	

Source: Bank of Russia, Ministry of Finance, NAUFOR, CBONDS, FFMS

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