

Trading of Russian Derivatives: Is the Russian Market Becoming More Mature?

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Introduction

The Russian bear has seen a long bull run in the equity market with the RDXxt® USD Index increasing by more 530 percent since 2003. With a market capitalisation of over USD one trillion, Russia has evolved into an important global equity market. This performance has again attracted investors from abroad who left the Russian market after the 1998 crisis.

However, or because of this, the equity derivatives market is not that developed. One reason is that the legal framework in Russia classifies derivatives as gambling; common risk management features, such as a central counterparty meeting international standards, are not yet in place. Besides, Russian assets were highly undervalued: Fund managers just bought stocks and got a high positive return. Hedging the risk was not necessary in the view of most managers. Additionally, high spreads and high premiums due to the high volatility reduced the demand further. Since 2006, the picture seems to have changed. The growing demand for derivatives can be seen in the high increase of volumes at FORTS¹. Additionally, EDX and Eurex have launched derivatives based on Russian Depository Receipts as well as Russian equity indexes.

Macroeconomic Framework

The Russian economy is still growing fast and the prospects for the future are promising.

Russia is the world's ninth largest economy in terms of GDP (real purchasing power)². The growth rate for 2006 was 6.5 percent and it is expected to rise around 6 percent per annum until 2010³. Backed by high commodity prices, Russia is running a high trade account surplus which is likely to continue. The foreign reserves have reached the world's third highest level of more than USD 250 billion.

While oil and gas is responsible for more than 60 percent of the exports, other sectors like retail services and telecommunications are growing faster than the overall economy. This is reflected in consumer consumption indicating that the population benefits from the economic growth. Additionally, inflation decreased from 20.2 percent in 2000 to approximately 9 percent in 2006⁴. It is expected to decline further to about 6 percent in 2010 according to the Russian Ministry of Economic Development.

As a further driver of growth, Russia is expected to join the WTO this year⁵. In November 2006, Russia signed a bilateral trade agreement with the US which is viewed as the door opener for the WTO. To comply with the terms and conditions of this agreement the liberalisation of financial market legislation is expected soon. In 2004, a similar agreement has been signed with the EU.

¹ Futures and Options on RTS exchange. Additionally, EDX and Eurex have launched derivatives based on Russian Depository Receipts as well as Russian equity indexes.

² See <https://www.cia.gov/cia/publications/factbook/rankorder/2001rank.html>

³ See www.kommersant.com, March 12, 2007, "GDP outlook upgraded to 6.2 Percent"

⁴ See <http://www.imf.org/external/pubs/ft/scr/2006/cr06431.pdf>

⁵ See The Moscow Times, April 5, 2007, "Gref Calls WTO Top Priority This Year", page 1

Another important factor for the economic development and the modernisation of the financial markets will be the presidential election in 2007 when a successor to Vladimir Putin has to be found. Depending on the outcome some views might change, thus having an impact on the Russian market.

Stock Market Development in Russia and Abroad

The positive economic trend is mirrored in the high performance of the Russian equity market.

In Russia the main stock market is MICEX, the Moscow Interbank Currency Exchange. The market share of MICEX is above 80 percent for the entire Russian equity market. In 2006, the trading volume increased to approximately USD 556 billion from USD 33.5 billion in 2001⁶.

Due to the mentioned restrictions in the Russian financial legislation, the London Stock Exchange (LSE) became the preferred market for foreign investors. Currently, almost 30 Russian companies are listed in the form of Depository Receipts on LSE⁷. The investment in Depository Receipts was – and for certain institutions still is – the easiest access to the Russian market given that a Russian entity is necessary to buy a domestic ordinary share. On the other hand, Russian companies get easy access to international capital by being listed in London. The high interest of international investors can be seen in the LSE trading volume, which trebled from around USD 74 billion in 2005 to more than USD 218 billion in 2006.

Derivatives Market Development in Russia

Trading derivatives in Russia had been very popular until the currency crisis in 1998. Many Western banks were trading non-deliverable forward contracts (NDF)⁸ with Russian banks. During the crisis, Russian banks refused to accept the agreed obligations. The claims of foreign banks were rejected in court as NDF contracts were regarded as a form of gambling. As a result Russian banks didn't have to fulfil their obligations. Many people think this ruling saved the Russian banking system from collapse and it clearly undermined the legal foundation of derivatives trading in Russia.

Last year a new gambling rule was introduced raising concerns among derivatives market participants. The aim of the change was to increase supervision and control over casinos. The Civil Code's Article 1062 explicitly states that no judicial protection is granted for claims based on wagers. Though the law excludes futures and forward contracts, an amendment to avoid a potential risk was demanded. With the support of the Federal Services for the Financial Markets, the Duma considered this issue and approved the amendment on December 20, 2006. However, the Federation Council has voted down the bill⁹ leaving derivatives market participants uncertain.

Another concern for derivatives market players is the corporate governance of Russian companies. Besides the mentioned general issues, the way information is provided to the market by the companies raises special issues for derivatives trading. For example, it is common practice that a company announces a dividend without a rate, or the announcement is made after the payment date. As a result, the option premiums include this kind of risk. On the other hand, options on Russian underlyings are in general European-style, eliminating some of the dividend risk.

⁶ See <http://www.micex.com/profile/years/>

⁷ Including Evraz, which is listed as a Luxembourg corporation

⁸ A NDF is a cash settled contract for a currency purchase and sale, usually used for hedging. For settlement the difference between the current and a pre-defined rate is paid.

⁹ See <http://www.prime-tass.com/news/show.asp?topicid=76&id=412667>

FORTS Market

Despite this situation the derivatives market has recovered and the volumes are growing. As of today, FORTS has become the major derivatives marketplace in Russia, offering derivatives on equities, indexes, currencies and commodities. In 2006, the number of traded contracts increased to 89.6 million contracts from 34 million contracts in 2003¹⁰.

Given the experience of the Russian currency crisis in 1998, FORTS has created its own clearing house which is established as a separate legal entity – the RTS Clearing Centre (RCC). It functions as a central counterparty to all traded derivatives' contracts. The self-developed risk management has a three-tier protection.

	Balance ¹¹
Initial Margin	USD 300 million
Contingency Fund ¹²	USD 8.2 million
Clearing House Reserve Fund	USD 6.4 million

Derivatives Market Abroad

The growing liquidity and interest in Russian derivatives was also closely followed by European exchanges. The Austrian Derivatives Exchange (OETOB) started its offering of index derivatives on the RDX[®] Index (based on Depository Receipts) and RTX[®] Index (based on ordinary shares) a couple of years ago. Though the liquidity on the exchange is rather limited (42.465 traded contracts¹³ in 2006), the RDX[®] Index and RTX[®] Index are accepted benchmarks in the OTC market.

Other derivatives exchanges like Eurex and EDX are just entering the arena. Driven by the growing OTC derivatives business in London, Eurex and EDX have recently launched futures and options on single stocks and indexes based on Russian Depository Receipts. The reference market for the underlying is always the LSE, where all available securities are USD-denominated.

Compared to the clearing system in Russia the risks in Western Europe are minimised given the risk management experience, higher reserves and developed infrastructure. The clearing house is one of the main benefits the Western exchanges can offer to this market. Trading between Western and Russian banks is often limited in the OTC market. Russian banks have in general lower credit lines compared to their Western competitors. Therefore, trading on-exchange with a central counterparty opens up more potential to trade this market as it will bring down the costs of trading.

Another aspect is the transparency of the market. While most derivatives trading is done OTC and the number of players are rather small, on-exchange trading can improve the quality and transparency of the price picture. Further, it is very likely that more market participants will start trading Russian derivatives due to an exchange offering. And, as a consequence, this should add more liquidity to the cash market and further increase the overall market efficiency.

¹⁰ See www.rts.ru

¹¹ As of August 17, 2006

¹² Aggregated deposits of members

¹³ See http://www.wienerbourse.at/prices_statistics/statistics/yearly/index.html

Conclusion

From a macroeconomic view, the prospects for further growth in Russia and as a consequence for the financial markets, are looking promising. This is especially true for the cash market – but what about exchange traded derivatives?

Compared to the late 90s the environment for derivatives trading has improved. RTS has already established a central counterparty, although the reserves are relatively small compared to its European peers. Some risks stay – one is the missing amendment of the gambling law. In this respect, trading on Western European derivatives exchanges is considered more secure.

Nevertheless, the Russian government is working to further improve the financial legislation towards Western standards and therefore the Russian derivatives market is becoming more mature and getting closer to international standards.