Russia: not depressed by financial crisis, but radically changed

Russia has suffered keenly in the global financial turmoil, and its derivatives market – booming until a year ago – is no exception. Volume in some products collapsed almost overnight. But as the world begins to talk of green shoots, is the Russian futures and options market showing signs of recovery? **Agnieszka Troszkiewicz** discovers that there is plenty of vigour in the market, with new contracts and hopes of regulatory and tax improvements.

September 2008: stocks tumbled around the world as Lehman Brothers collapsed. Russia's long oil-fuelled boom suddenly crumbled. Turmoil on the stockmarkets caused several Russian banks to default and seek bailouts.

Amid high volatility, many players withdrew from the Russian derivatives market, making it more expensive to trade – a vicious circle that led to a sharp contraction in activity.

"During the winter and spring, lots of banks actually stopped any activities in derivatives. It was a very difficult time," says Sergey Romanchuk, deputy head of treasury at Metallinvestbank in Moscow and president of ACI Russia. "For all instruments – exchange-traded, OTC – the interest to trade fell dramatically."

The Moscow Interbank Currency Exchange (Micex) suffered worst among the three main exchanges offering Russian derivatives. Its monthly trading volumes, driven almost entirely by the dollar/rouble future, collapsed from a record of 17.9m contracts in September to a mere 1.48m in November. They have recovered slightly since but are still nothing compared with the exchange's glory days. In July, 3.06m contracts were traded.

Micex declined to comment for this article. But it is clear that the slump in trading was due in large part to players shunning the market. Active participants had their limits cut, sometimes sharply. As volume and open interest fell, other traders backed away from the lower liquidity, while some who had planned to begin using the market postponed the decision.

Although some big houses started to trade derivatives in May and June this year, there have not been many newcomers, and many of those who were expected have yet to show up.

"Forts did not suffer from the financial turmoil. On the contrary, during volatile times the market brought new opportunities to investors," says Evgeny Serdyukov, head of Forts

Forts powers ahead

Yet across town, Futures and Options on Russian Trading System (Forts) has not had nearly such a bad time.

"Forts did not suffer from the financial turmoil. On the contrary, during volatile times the market brought new opportunities to investors," says Evgeny Serdyukov, head of Forts.

This confident line glosses over the fact that Forts' volumes halved between July and November 2008, from 28.3m contracts to 14.2m.

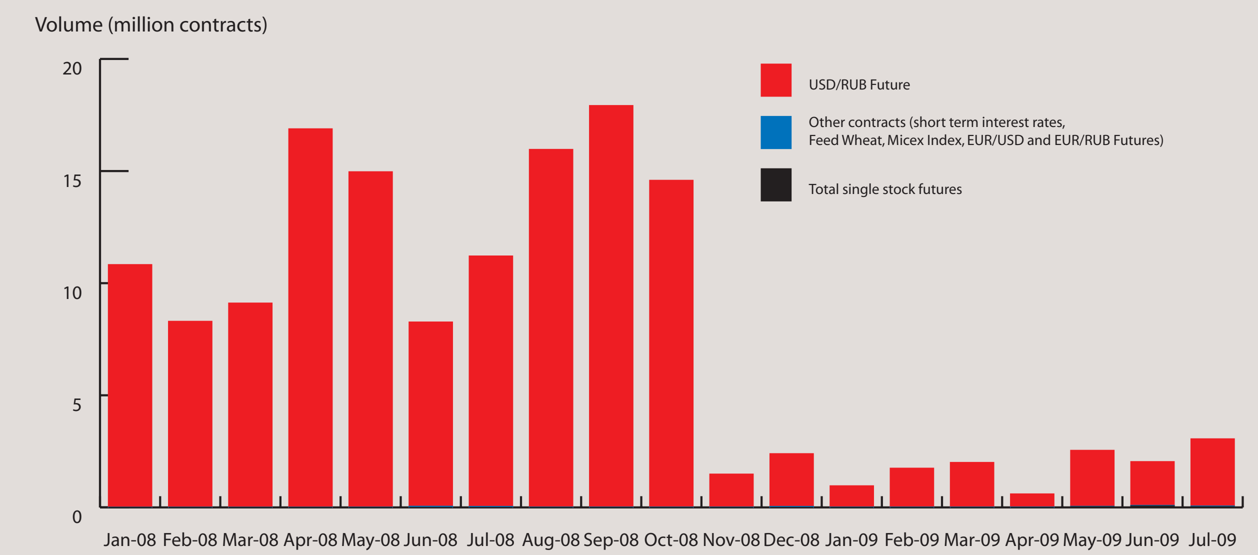
But Serdyukov has a point. Since February, Forts has recovered strongly, so that it has now left last year's highs far behind.

Each month from March to June this year, Forts set a new monthly trading record, culminating with 48.6m trades in June. The total in July was almost as high, at 46m. Total volume in January-July this year of 246m contracts has already surpassed the 230m contracts traded in the whole of 2008.

In Forts's case, high volatility seems to be attracting speculators. In particular, the exchange has pulled in many new retail investors.

Micex, dominated by large banks acting for clients wanting to hedge currency risk, has been more vulnerable to falling volumes. "Perhaps it was because of the immediate drop in client business that they cover," says

Micex: weakened dollar/rouble still dwarfs other contracts



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Mikhail Kazarin, head of derivatives and structured products at Rosbank in Moscow.

To put it another way, Micex was a one-trick pony. Its USD/RUB Future accounted for 100% of volume every year until 2006. In 2007 it began to win a smattering of trades in other futures: Compounded MosIbor Overnight, Three-Month MosPrime Rate and the Micex Index. Last year Feed Wheat and a euro/rouble contract came onstream. But the USD/RUB still accounted for 99.8% of trading.

Forts is much more diverse. Before the crisis its biggest products were the RTS Index Future, which made up 36% of trading in the first half of 2008, followed by a fast-growing equity options segment and several actively traded single stock futures: Sberbank, VTB, Gazprom and Lukoil. It also had dollar/rouble futures, gold and oil.

Like Micex, Forts was hit hard in one product. Its equity options business collapsed from 7.26m trades in July 2008 to 1.75m in August, 1m in September and a mere 314,000 in October. This segment has barely recovered: there were 1.5m trades in July 2009.

But Forts' other main products, especially the RTS Index Future, Sberbank, Gazprom and the USD/RUR Future, have all swelled since last year.

Currency wars

And Forts has also been proactive, launching several new contracts this year, including Russia's first futures-style options and euro/dollar and euro/rouble futures.

The currency contracts, introduced in February, have been especially appealing to retail investors, who are responsible for 70% of FX futures trades. EUR/USD traded 1.1m times in July, and EUR/RUR 66,000 times.

"The launch [of the euro futures] was successful because it was well timed," says Serdyukov, adding that the new contracts have met the needs of investors seeking to hedge securities or benefit from the volatile currency market.

Hedge funds, as well as private speculators, have found currency futures an attractive product in times of financial hardship. Kazarin says funds that normally trade credit derivatives have switched to FX and interest rate contracts.

> **"The main thing is, the market is moving. This is the main attractiveness for people who trade the markets. Liquidity is back, RTS Index futures have had new volume records. If you're talking about liquidity as a criterion of recovery, it's definitely here"**

Although most of this activity appears to be over the counter, hedge funds have been increasing their exchange-traded derivatives activity too.

There is also still demand from companies for hedging interest rate and FX risks.

Listed currency derivatives resumed trading in 2004 after the hiatus caused by the Russian bond default in 1998. Volume soared in just four years from 8.5m contracts a year in 2005 to 146m in 2008. At first, Micex had nearly all the volume but by 2008 Forts had captured 10% of the market.

The pattern this year is radically different. In the first seven months of 2009, there were 34m FX trades, suggesting that total volume this year is unlikely to reach three quarters of 2008's total.

But more startling than that, Micex's dominance has been overthrown.

In January-July 2009, there were 12.7m dollar/rouble trades at Micex and 11.96m in the equivalent future at Forts. Both are worth $1,000. Forts has almost reached parity in Micex's prize contract.

But Forts also had over half a million dollar/rouble options trades, 8.7m euro/dollar futures and a few in euro/roubles, giving it a market share of 63% in listed FX derivatives.

Although Micex has equivalent products to Forts's in euros/dollars and euros/roubles, Micex is nowhere in the former and far behind in the latter.

Russia's (almost) virgin territory: commodities

As the second biggest exporter of oil and a leading producer of many minerals, Russia is extremely rich in commodities. This presents a big opportunity for the listed derivatives market, which it is just beginning to exploit.

Forts now offers three energy products: cash-settled futures on Urals crude oil, launched in June 2006; Brent crude oil, launched in October 2008; and a physically delivered gas oil future (February 2007).

Forts also has futures on sugar, gold, silver, silver ingots, palladium and platinum, while National Mercantile Exchange, the commodity division of Micex Group, lists several classes of feed wheat futures. Nevertheless, volumes have been thin.

Trading bounces up and down, month by month, hitting a high of 1.4m contracts in March 2009 but usually staying between 500,000 and 1m.

But that masks a complete change in the composition of the market. In 2008 nearly all the volume was the gold future and option at Forts, with a growing contribution between February and September from its Urals crude oil contract.

But 2009 has been quieter for gold, especially since April, and Urals crude has vanished since February. The big winner has been the new Brent crude contract at Forts, less than a year old but now accounting for six out of seven listed commodity derivative trades in Russia.

Heading west

Nevertheless, Russian companies that have direct exposure to commodity price risk still mainly trade on foreign exchanges. Magmura Kamanova, account executive for industrial commodities (Russia and CIS) at Sucden Financial, a commodities broker, says Russian companies generally use CME, ICE Futures, Nymex, Comex and the London Metal Exchange.

"They prefer international exchanges, because they provide a wider range of products and better liquidity," Kamanova says. She points to the very limited amount of financial instruments traded on Forts, to a lack of expertise in pricing instruments and risk evaluation, and to the high counterparty risk in the OTC market.

Sucden opened a representative office in Moscow last year. Its Russian clients comprise producers, refiners, manufacturers, banks and mining companies, as well as consumers and speculators. The London-based broker is one of many firms that provide risk management services to Russian companies.

Fuad Huseynli, deputy global head of commodities at VTB Capital in London, says that the commodity derivatives market is lagging behind the physical commodities market, which, in his opinion, is "very well established".

"There is so much availability in the West… Lots of banks are very active on the Russian market at the moment, and those are big household names," he says. A lot of trades also take place in the European OTC markets.

Huseynli says that in the case of oil, pricing is highly dependent on international markets, especially dated Brent quotes or prices on Ice Futures Europe.

Platts, the energy information provider, carries separate pricing for Russian export blend crude oil (Rebco), also known as Urals. "The pricing mechanism is actually well established; it's very clear and very transparent and the volumes are there as well," Huseynli says.

Local pricing wanted

But Evgeny Kuteev, head of exchange-traded derivatives at Otkritie Securities in London, points to privately negotiated deals between counterparties. "There is no real open market or market mechanism to value the Urals [crude] in Russia.… Politically or legally and from the business point of view Russia is completely unprepared for open market mechanisms to create a fair price for oil and derivative products in Russia.

"For Russia, it would be a very huge advantage step to have liquid exchange-traded Urals futures to create a benchmark for Urals blend oil," he says.

The St Petersburg International Mercantile Exchange (Spimex), established only in September 2008, offers spot trading in oil products such as diesel, gasoline and jet fuel, but not crude oil.

"It's brand new so it's just picking up momentum," Huseynli says. "At the moment, it hasn't been widely used but it's a matter of time until many companies start looking at services that Spimex provides."

Private investors are among the most active participants in the Russian commodities market. Russian banks are prohibited from entering into physically settled commodity derivatives, with the exception of bullion.

But tax, again, is a factor that could be hindering the development of commodity derivatives. "There is no clear taxation system for private investors resident in Russia. This makes trading in commodities not very convenient, as the taxation system works best for either non-residents or for legal entities," says Evgeny Serdyukov, head of Forts.

It is common for market participants exposed to Urals oil to hedge using Brent oil contracts, the most liquid benchmark that is closest to Urals. But, as Tamer Amara, partner at Clifford Chance in Moscow explains, the tax authorities do not recognise commodity derivatives on oil as a direct hedge.

"What they say is that you produce Urals but still you take a hedge on the Brent oil forward. And the price of the two is roughly the same. The volatility of the market is roughly the same, because the price of one generally follows the price of the other. But the Russian tax authorities basically say that this is not a direct hedge, therefore we won't recognise it, and therefore you won't be able to deduct any losses resulting from that oil forward," Amara says.

The agricultural sector is further behind. Few grain producers have begun to include derivatives in their financial schemes, and there is some way to go before this happens. Market participants expect steady growth, rather than an explosion, in this area.

Serdyukov, however, is pleased with the progress in commodity derivatives so far. "We're looking for long term, sustainable volume growth which meets the needs of the underlying regional economies and allows international users to participate in Russian economic activity." ■

Confidence returns

All in all, nearly a year after the crisis hit, there is much for market participants in Moscow to be bullish about.

"The main thing is, the market is moving. This is the main attractiveness for people who trade the markets," says Evgeny Kuteev, head of exchange-traded derivatives at Otkritie Securities in London. "Liquidity is back, RTS Index futures have had new volume records. If you're talking about liquidity as a criterion of recovery, it's definitely here."

The OTC market has been less lucky. "Activity on the derivatives market is of course not normal," Romanchuk says. "First of all, because of the credit lines problems, the balance sheets of Russian banks are not clear. Banks don't want to have significant exposure with each other on OTC derivatives. We see some interest in moving the activity to the exchanges, but not very much."

London picks up options trade

Meanwhile, outside Russia, one exchange has benefited from investors' new enthusiasm for central counterparty clearing, since the Lehman implosion showed the risks of losing money if an OTC dealer goes bust.

EDX London, the derivatives division of the London Stock Exchange, has been enjoying record volumes at its Russian derivatives service. EDX offers single stock futures and options, as well as index contracts, on Russian equities listed on the LSE's International Order Book (IOB).

Set up in 2006, the service is meant to cater for banks active in trading Russian equities and over-the-counter derivatives. In July it handled a record monthly total of 4m Russian contracts, a 196% year-on-year increase. The notional value was nearly $5.5bn, while open interest hit a record of 13.4m contracts on August 10.

Futures and options based on the FTSE Russia IOB Index, which tracks the 10 biggest and most liquid Russian global depositary receipts traded on the LSE, are only a tiny part of that, but the 2,817 contracts traded in July was more than in the 11 previous months combined.

Lee Betsill, managing director of

"I don't think at the moment it is a very wide phenomenon for foreigners to come to the Russian derivatives market. But I think it's going to change," says Mikhail Kazarin, head of derivatives and structured products at Rosbank in Moscow

EDX London, attributes the success of the service "partly to the attractiveness of a joined-up offer on the LSE and EDX", which helped to ensure that the corporate actions processing was carried out effectively, and "partly to the fact that banks want to trade the products because EDX provides them with the benefits of a neutral service provider, with anonymity and central counterparty protection. It all comes down to security," he says.

Since the fall of Lehman Brothers, EDX's share of the Russian options market – once busy at Forts – has swelled to 80%-90%, compared with 30% before the Lehman collapse, according to Betsill. He believes that "the majority of what had been an OTC market in Russian derivatives now takes place on EDX".

The service has managed to attract not only Western banks but also Russian houses such as Troika Dialog and Renaissance Capital.

Georgy Mirel, director of equity derivatives trading at Troika in Moscow, says: "EDX is the best proposition for options traders on Russian DRs. We are very pleased with the quality of the service, which is professional and flexible at the same time. Trading and settling of options at EDX is convenient and allows us to centralise our positions and keep the credit counterparty risk to a minimum."

"International banks still prefer to trade in the European regulatory framework with a large clearing house like LCH.Clearnet," Betsill claims. "So when the Russian banks want to trade with international banks, they need to trade on EDX."

One interesting change on the horizon for the offshore Russian equity derivatives market is that Nasdaq OMX plans to launch in September a new Russian service competing with EDX's.

Legal wrinkles remain

Trading derivatives outside Russia is likely to remain an attractive option as long as Russia's own regulatory framework remains underdeveloped. And changes are arriving slowly.

Vladimir Sotskov, head of equity derivatives at UralSib Capital, investment banking arm of UralSib Financial Corporation, in Moscow, confirms that at the moment the majority of market participants trade offshore. They have registered offshore entities and trade derivatives either on EDX or OTC.

"They're not doing it in the Russian legal system. There are no reliable courts; legal protection is very low; the taxation is unclear and contradictory. All these changes are needed before the market moves to Russia," Sotskov says. "If I do options with my client, I mostly do it offshore in an offshore jurisdiction. I don't do it under Russian law. That's how all other big players in Russia do this as well," he says. The majority of UralSib Capital's clients that trade derivatives are registered offshore.

"It's easier to accommodate Isda in the UK than accommodate Russian law," Max Gutbrod, partner at Baker & McKenzie in Moscow, sums up.

Foreign influx

An international investor also faces legal obstacles to trading in Russia. Kazarin at Rosbank comments: "I don't think at the moment it is a very wide phenomenon for foreigners to come to the Russian derivatives market. But I think it's going to change. There is an interest. More foreign institutions are interested to participate in RTS derivatives trades."

Forts reckons that 1,453 out of its 56,324 active participants are foreign. Credit Suisse Moscow is the biggest foreign account, while Otkritie Brokerage House is the most active in attracting international investors.

Foreign investors have to go through authorised brokers to gain access to Russian exchanges. But, as Otkritie's Kuteev explains, if one wants to have exposure to Russia, there is a further hurdle: "you have to deposit all the margins in Russian roubles, as this is the exchange's requirement".

He says several domestic and foreign brokers offer different schemes where they allow foreign firms to trade on Forts through various financing schemes. But domestic brokers can only accept roubles at the moment.

Tax can also be offputting for foreign participants. "You may be taxed automatically on your gains because each and every domestic broker simultaneously is a taxing agent," Kuteev says. "So the broker will charge you and the tax rate is not very attractive. A foreign entity can avoid being charged the tax if there is a double taxation treaty between its country of residence and Russia. In this case the entity should provide a tax residency certificate."

Otkritie is developing a platform to enable clients to trade on Forts alongside all exchange-traded products. Rosbank, too, is working on a project that should provide foreign clients and brokerages with direct market access.

However, Kuteev at Otkritie says that even then, a brokerage with an account on Forts cannot "internally" have two clients acting as counterparties to each other. "When the other client submits the order to sell, the exchange will reject this order, because this order technically speaking belongs to that order," he says.

Kuteev explains that this is caused by the absence in Russia of a legal structure for the 'omnibus' model widely used by other exchanges. Another model missing in Russia is give-ups, Kuteev says, meaning that brokers cannot offer pure execution services.

Hopes of legislation

The exchange market is "more or less developed in terms of legal environment", believes Elena Deshina, tax and legal services partner at

The exchange market is "more or less developed in terms of legal environment", believes Elena Deshina, tax and legal services partner at Deloitte in Moscow. But that does not mean changes are not needed

Deloitte in Moscow. But that does not mean changes are not needed. "The crisis pushed the regulators and exchanges to start a dialogue about changing the status of exchanges in the market," she says.

Today, a Russian exchange provides the platform and an IT solution, but there is no counterparty from the legal perspective, Deshina says. At the moment, the exchanges are changing their approach to the legal formalisation of trades. They are trying to ensure they become a central counterparty in transactions, which is liable to market players.

The taxation of transactions is another issue to be addressed. Deshina hopes that at this year's autumn session, the Duma – the Russian parliament – will adopt a law to alter it.

At the moment, different tax bases make a hedging scheme ineffective. The taxation of transactions involving financial instruments is on the same level of taxation as other activities, says Deshina.

"The new changes address this matter and they want to allow [market participants] to deduct the losses on the special tax base [from] the profits made on other activities or operations," Kazarin says.

Changes to taxation were ready in spring this year, but the approval of the tax law has been delayed because the regulator wants the definition of a derivative to be included. The Federal Financial Market Service is working on an amendment to the Securities Law which will include the definition.

Gutbrod says Russian law has "no understanding of derivatives being linked to risk management." Rather, it "treats them as normal, simple contracts, not appropriate for corporations… Some companies have been affected by high losses for the simple fact of not hedging."

But exchange-traded contracts remain much more attractive than OTC derivatives from the accounting, tax and credit risk points of view, according to Romanchuk.

The market awaits a law that will recognise close-out netting in the insolvency of Russian banks. The law was proposed several years ago; this year it passed its first reading and it is now awaiting a second reading in the autumn. Some hope it will be adopted then and come into force at the end of the year.

The law is expected to help the derivatives market, though Gutbrod remains sceptical because it "contradicts" rules that prohibit Russian banks from offsetting.

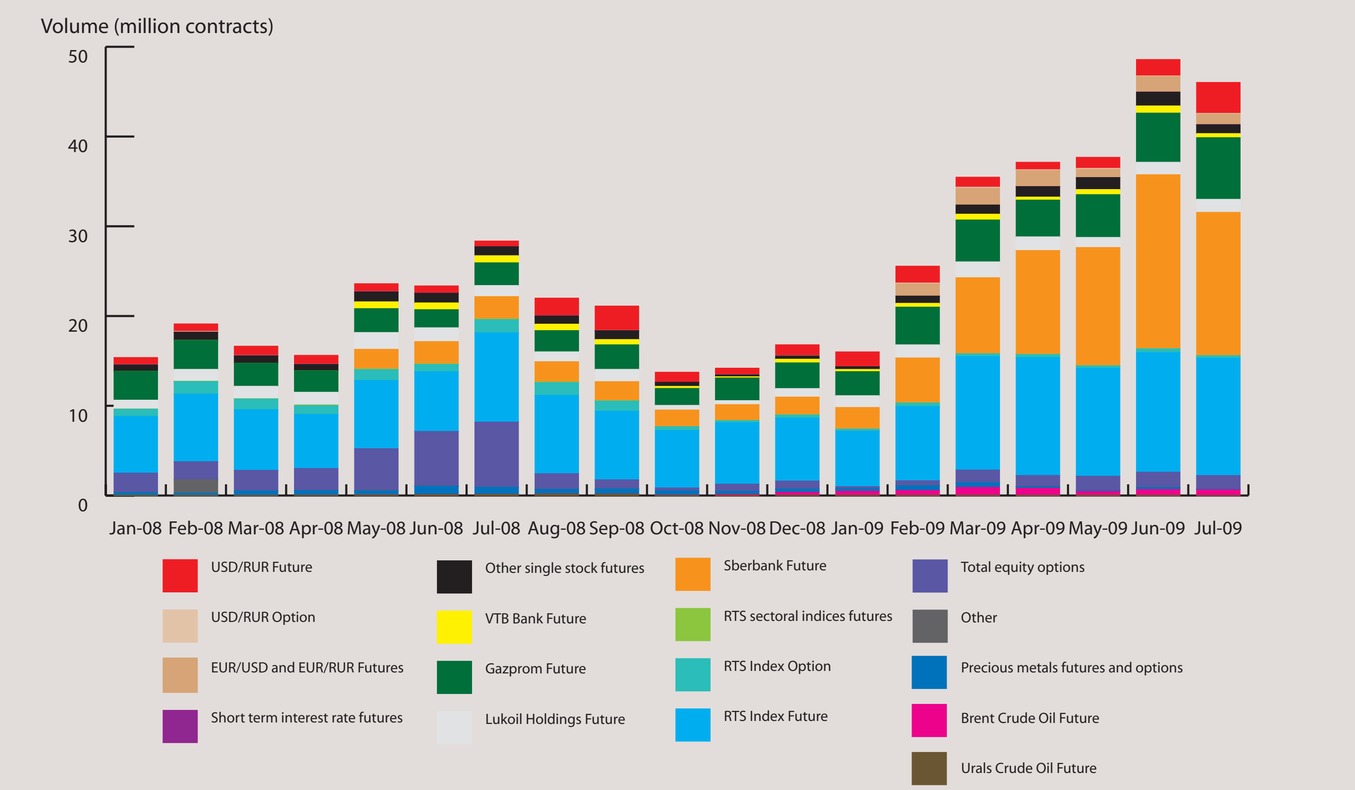
New master document

In June this year, the National Association of Securities Market Participants (Naufor), Association of Russian Banks and National Foreign Exchange Association published a Standard Documentation for derivative transactions, analogous to the Isda Master Agreement.

Alexey Artamonov, director of Naufor's office of international affairs, explains that a main reason for the master agreement's publication is the unregulated nature of the OTC derivatives market. "From the point of view of the civil registration of Russia, only derivative contracts that are registered or traded on the exchange are subject to court protection," he says. "Over the counter derivative transactions still do not have any court protection."

If the three associations' members choose to use the new documentation, it should reduce the contractual risk of transactions. Deshina says: "It is good because it provides the possibility for

Forts: strength in diversity



Source: www.fointelligence.com

medium sized banks to enter this market and to work with these instruments.

She concedes: "Of course, the market downturn doesn't help to develop the derivatives market…. Once the market improves and derivatives trading grows, it will be a good support for many banks trading these instruments."

Market fights back

Even though some changes are slow to come and the derivatives market is still in recovery mode, lawyers have their hands full of work. "Oddly enough, the derivatives practice has been probably the most vibrant among everything else that we do… We've been very busy on both the regulatory and transactional sides," says Tamer Amara, partner at Clifford Chance in Moscow.

The exchanges are busy, too, improving their service. Micex has embarked on several improvements and new projects. It introduced a new Span-based risk management system in April, bringing portfolio margining, calendar spreads, and as a result lowering margin requirements.

Micex is also developing its risk management systems, building up extra funds to cover risks. The exchange wants to create a mutual clearing fund. It is also working on providing inter-commodity spreads to help participants further decrease margin requirements.

The exchange also wants to increase the number of its accounts, especially by bringing in retail investors. This could give it a better balance of liquidity between big, high-volume traders and numerous small ones.

In April Micex launched futures on Gazprom and Sberbank shares, as part of its effort to take on Forts. It wants to list some other Russian blue chip stock futures and interest rate contracts. Options on futures are also in the pipeline.

The good news for Micex this year is that, although the USD/RUB Future still makes up 98% of volume, that is a lower percentage than before. Although its short term interest rate futures have died in 2009, three classes of Feed Wheat are now trading, the Micex Index contract is picking up pace and the EUR/RUB is still going, although volume is likely to underperform 2008.

The way ahead

The big change coming at EDX is the migration of trading to the Sola trading platform developed by Montreal Exchange, a subsidiary of TMX. This is scheduled for mid-November. EDX is also looking at new products, but Betsill refuses to reveal the details.

Forts, meanwhile, has launched co-location services, and expanded its presence in Ukraine and Kazakhstan. RTS owns 49% of the Ukraine Exchange and 60% of Kazakhstan's Eurasian Trading System. It is helping both exchanges to develop commodity derivatives.

Despite turbulent times, the exchanges are pressing ahead with improvements and new projects. Though the derivatives market has not fully recovered, there is much more confidence among participants than last autumn.

"In October," as Deloitte's Deshina comments, "everyone was just stopping the deals and not understanding what will happen. Now, more or less, it's clear what's going on with the market; how government is going to support the market. And market participants now understand the environment better. They understand what their opportunities are and which financing they can rely on." ■