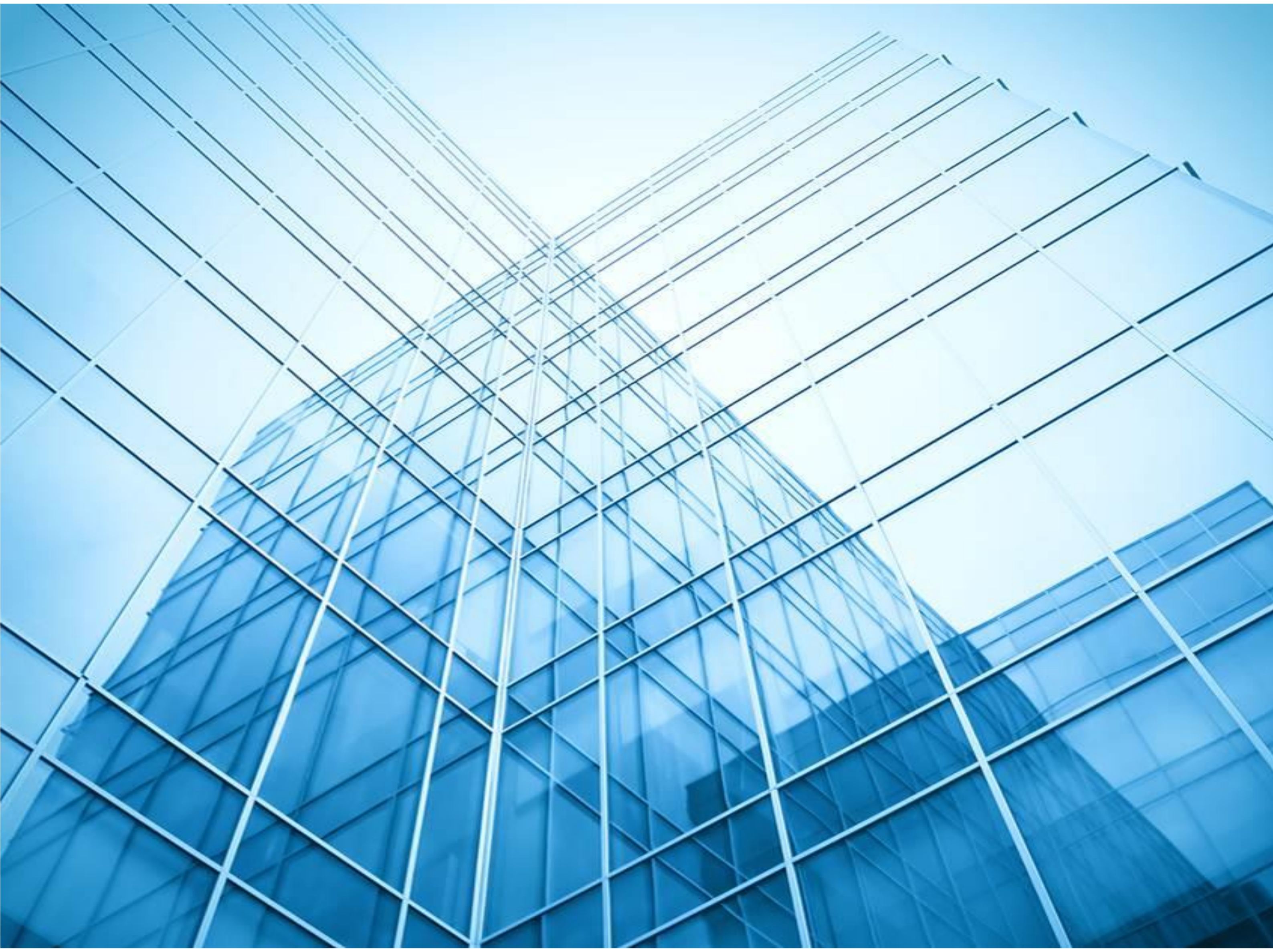
UK-Russia Liaison Group



Challenges for long-term finance in Russia

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MIFC Taskforce
TheCityUK

Challenges for long-term finance in Russia

The Russian securities market is evolving into a rather stable and attractive component of the global market and starts to occupy an increasingly prominent place. However, in order to successfully operate in the Russian market, its peculiar features and weaknesses should to be taken into consideration.

In addition, investment operations in general and operation in Russian capital markets in particular face a number of artificial obstacles – largely the consequence of government action or inaction. They are well known:

- an unpredictable and costly business environment; corruption, absence of the rule of law; frequent and arbitrary government interventions
- an inefficient bureaucracy; an inefficient and unpredictable legal framework
- barriers to foreign entry: restrictions on the entry of foreign financial firms, on foreign ownership of Russian firms, on entry of foreign professionals
- chaotic and complicated regulation: an excess of red tape; inconsistent enforcement
- counter-productive tax laws: VAT on financial transactions and services, high tax rates on financial firms, excessive taxation of foreign residents etc.
- weak tax incentives for individuals to save for retirement
- unavailability of individual retirement accounts, pension mutual funds, and annuities from insurance companies
- excessive policy volatility and instability of the legal regime, particularly in the pension area.

Capital Market Features

Market Participants

• ***Banks dominate among institutional investors***
In Russia banks account for more than 90 per cent of assets held by financial institutions (in the U.S.A. non-bank financial intermediaries account for some 60 per cent of the total assets. In Poland in 2007 their share already reached one third of the total assets.)

Domination of state-controlled banks
- State-controlled banks control more than 70 per cent of total bank assets while remaining instrument of government policy instead of purely for-profit institutions.
- non-state banks' play rather modest role in purely commercial intermediation. Majority of the numerous non-state banks are very small, many of them are in fact "pocket banks" owned by and serving a single company or a group. Many others exist only to provide their owners with tax advantages or to facilitate money laundering.
- Foreign banks account only for 18 per cent of the total bank assets (as of the end of 2011) which is much lower compared to other transition economies. The role they play on the securities market is insignificant. Their lending consists mainly of working capital loans to large oil and metal enterprises or to subsidiaries of foreign multinationals.

• Non-Bank Financial Intermediaries
- *Mutual funds*
The industry has been growing at a relatively fast pace between 2001 and 2008, but by international standards its client base was very narrow (slightly more than 3000,000 investors), and asset share expressed as a percentage of GDP was extremely low (Fig. 1). In 2012 mutual funds assets amounted to 0.84 per cent of the GDP. According to the National league of Asset Managers (NLU) estimates, total net assets of the open-end and interval Russian mutual funds amount to 0,2% of the GDP.

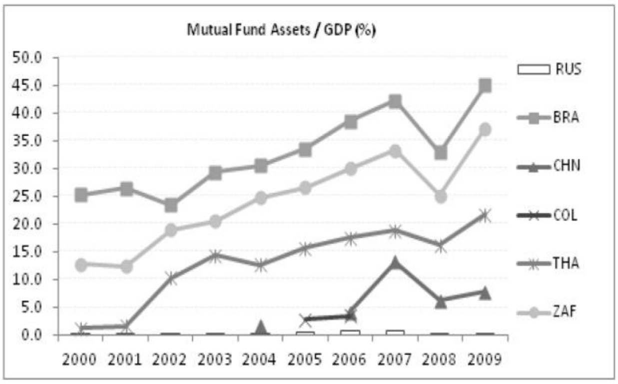


Fig. 1: Mutual Funds Assets, % GDP

(http://pif.investfunds.ru/analitics/statistic/market_profile/?compare_type=date&date=28.06.2013&date_from=&date_to= w/o data on hedge funds, venture, credit, direct investment and long-term direct investment funds)

- pension funds

Non-state pension funds (NSPF) collect voluntary and mandatory pension contributions. Employee-sponsored pension plans dominate the voluntary pension market. Mandatory pension contributions are collected by both NSPFs and the Pension Fund of Russia (PFR). The latter has both more participants and more mandatory pension contributions. Pension funds may not invest mandatory contributions on their own. These are invested by asset management companies, and the PFR assets are managed by the State Asset Management Company with its functions performed by Vneshekonombank (VEB). Its investment portfolio mainly comprises government securities (market-based and non-market); investing in stocks is not allowed. Voluntary contributions are partly invested by NSPF independently. As of the end of 2012, mandatory and voluntary contributions combined can be estimated at 5 per cent of the GDP, of which NSPF account for 2.3 per cent. The development of mutual funds is mitigated by the weak tax incentives as compared to other financial products (especially bank deposits). Undeveloped distribution infrastructure represents another constraint. Russian market lacks financial consultants, financial supermarkets, open structure of banking distribution system, ETFs, hedge funds, money FX market funds, REITs funds. Another challenge is the lack of exchange distribution system for funds (like Fund Settle and Fundserve). Insufficient development of the pension schemes also represents an impediment. One more barrier is related to difficult application procedure for the status of qualified investor both for the legal and physical persons represents another barrier.

- insurance companies

The insurance industry in Russia is relatively small and life insurance is virtually non-existent. In 2010 life insurance was less than 2 per cent (compared to a world average of about 50 per cent).

As a percentage of GDP Russia’s insurance companies’ assets lag behind Columbia and Brazil and are a long way behind countries such as South Africa.

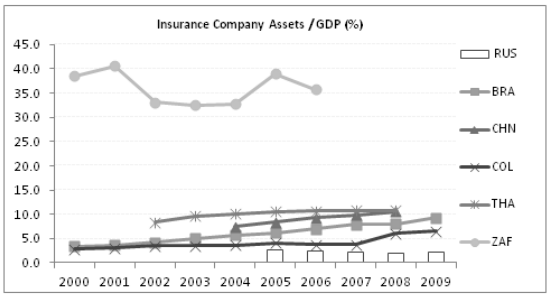


Fig. 2. Insurance companies assets, % of GDP

Note: in 2012 insurance companies assets in Russia reached 1.8 per cent of the GDP.

Up to recently, there have been some 700 insurance companies operating in this small market. Increased minimal capital requirements that were introduced in 2012 caused a major reduction in their number (454 companies as of mid-2013). Insurance industry has a poor history in Russia. The 1990s saw a great deal of bankruptcies and fraud. Moreover, until a tightening of the tax laws in 2007, much of the subsequent activity in the industry – particularly in life insurance – was not insurance at all but rather transactions undertaken to avoid taxes and to disguise flows of money. With the tightening of the tax laws, life insurance premiums collapsed. They have since slowly begun to recover helped by the growing practice of requiring life insurance to mortgage borrowers. The negative image of insurance industry has stuck, however. There remain significant barriers to entry and operation of foreign insurers. The industry also suffers from a shortage of specialized professionals – especially in the actuarial profession, the accounting and auditing professions, and insurance law. A lack of marketing channels, especially for the public at large, is an obstacle. Independent insurance agents are used for life insurance. The sale of insurance by banks, "bankassurance", is widespread in Western Europe. However, In Russia bankassurance still has a very limited penetration. Russian legislation impedes introduction of annuities and unit-linked products.

Market Infrastructure

• Stock exchanges

Recently there has been a merger of two main trading sites - MICEX (traditionally targeting Russian clients) and RTS (traditionally targeting foreign clients). Non-residents are not allowed to directly trade on the equities market (this can only be done through members of the stock exchange or a custodian).

•***Registration of securities ownership***.
A two-tier securities ownership scheme is implemented in Russia: ownership of securities is confirmed by an entry in the registry and/or depository (nominal owners in the registry). One distinctive feature of the Russian system of securities transfer and registration is a big number of trading settlement, depositary and clearing systems. In its current state, the system is burdensome and slow and affects efficiency of settlements. Companies are somewhat reluctant to support its streamlining since their current owners may manipulate the system to oppose takeovers by means of buying up stock in the market.

A joint operation of two parallel securities ownership registration systems with multiple participants (customer-oriented depositories and issuer-oriented registrars) creates uncertainty over ownership, since entries made in securities registries are regarded by court as prevailing over entries in depositories thus forcing some investors to register their ownership interests with registrars instead of relying on a more efficient depositary-based trading system. Although the Law on Securities allows storing information needed to identify securities and ownership rights of their owners in registries and depositories in e-format, paper-based documents still predominate in Russia.

• ***Nominal accounts for foreign depositories.*** The Russian legislation mandates that a nominal account holder should be a "professional securities market participant" licensed in Russia. Currently a foreign depository cannot obtain a license and become a professional market participant; therefore, it cannot establish inter-depositary relations with a Russian depositary.

When foreign investors purchase Russian securities directly, clearing and settlements may take up to two weeks.

In practice many investors prefer to purchase ADRs (securities issued abroad that confirm the rights to a certain volume of Russian securities) instead of issuing RDRs locally.

• ***Intermediaries***
More than 1,000 companies (broker-dealers and/or investment banks) operate with securities but majority of them are quite small.

All top-20 companies are Russian; many of them are affiliates of large state-owned banks. Most of serious international players working with securities have some presence in Moscow and none of them is in the top-20.

<u>The Equities Market</u>

•**The Russian equities market differs from equities markets in the English-speaking common law countries**. It is dominated by a relatively small number of large companies. It also differs in the pattern of ownership. In the English-speaking common law countries, ownership is highly dispersed, with individuals rarely owing more than a few percent of total shares. In Russia ownership and control are highly concentrated – often in the hands of the state or of those closely connected with it: concentrated owners typically hold about 60-65 per cent of total shares. The equities markets of continental Europe also exhibit a greater concentration of ownership, but Russia is an extreme case.

These differences have a number of implications. Because free float is small – estimates range from 5-35 per cent of a company's total shares – the Russian equities market is much less a market for ownership. It thus plays a much smaller role in the mergers, acquisitions and restructurings. Since it is impossible to assemble a controlling stake through purchases in the open market, market-mediated hostile takeovers are impossible. Similarly, the potential role of the equities market in privatization is limited, since the sale of shares by the state will generally not imply its relinquishing control.

• As a rule, **non-residents are allowed to buy equities of Russian companies**, However, the stake in state-owned oil and gas monopolies for foreign investors is limited (e.g., non-residents' share in the charter capital of insurance companies may not exceed 25 per cent). Since state-owned monopolies issue a lot of listed shares, participation of non-residents in the Russian capital market is constrained.

• ***Private equity in Russia is underdeveloped*****.** Consequently, startups and expansions have little access to the equities market as a source of financing for investment. In fact, almost all private equity activity is performed by the state or in partnership with it.

• ***The equities market serves mainly as a source of liquidity for the concentrated owners*** – a way of cashing out some of their investment without giving up control. Since market-traded shares do not provide control, their value should be lower than that of shares exchanged outside the market in large blocks that represent an element of control.

• ***Disclosure of information by Russian companies is rather limited.*** This lack of transparency means that share prices, particularly of companies in energy and minerals – which account for the bulk of trading volume – are likely to be moved by news about commodity process rather than by news about the companies themselves***.*** Consequently, foreign institutional investors may see these shares primarily as commodity plays.

• ***Listing and market capitalization.*** Total capitalization of the domestic equities market in 2012 was 817 billion US$, i.e. slightly more than 40 per cent of the GDP, and remains below its pre-crisis level (in 2007 it was 116 per cent). However, the share of top-ten companies is very high by international standards – in excess of 60 per cent in 2010.

Russia lags behind its country peers on the number of companies traded at its capital markets; the same is true with respect to the number of listed companies.

• ***International investors constitute the bulk of the demand***
Altogether, foreigners held about a quarter of total market capitalization at the end of 2010. This would have presented two thirds or more of the free float. The share of foreign investors might have been even higher were it not for certain restrictions and obstacles: e.g., a 2008 law limits foreign investment in "strategic sectors" including telecoms and mining. Also, the arrangements for foreign investors to trade and hold securities leave much to be desired. Foreign investors often have the generally preferable alternative of trading and holding Russian securities in global financial centers. The share of top-ten traded companies is very high by international standards – in excess of 90 per cent in 2010.

Debt Markets

• ***Government securities***

- federal government

Due to high energy prices, appetite for borrowings is insignificant. The total amount outstanding as of August 2013 was 3888 billion rubles *or only 6.2 per cent of the GDP.* *(http://www.rusbonds.ru/cmngos.asp)*

The secondary market is relatively illiquid. Much of the outstanding debt settles in long-term investment portfolios of state-owned financial institutions, the largest being the CBR, Sberbank and Vneshekonombank. Besides, the little trading in the secondary market is fragmented due to the large number of different types of instruments and the large number of different issues of each instrument. The total volume traded in August 2013 was 8.6 trillion rubles *(http://www.rusbonds.ru/cmngos.asp)*

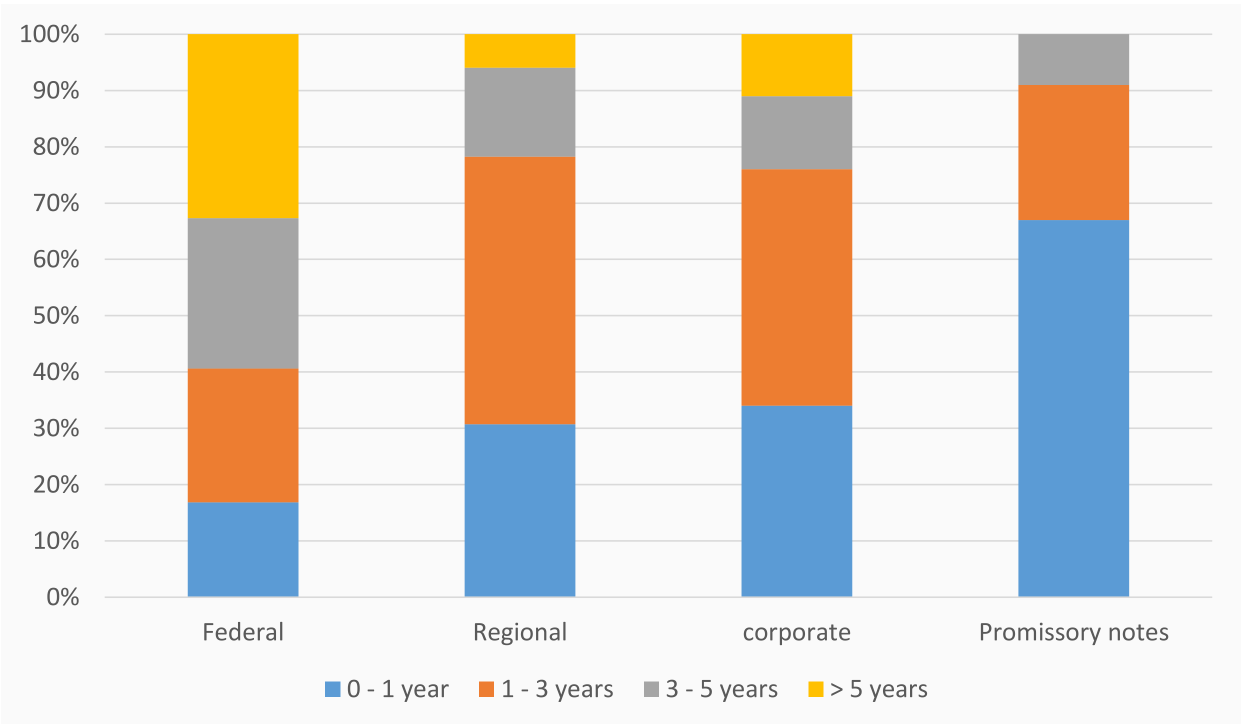


Fig. 3. Term structure of the Russian debt market, end 2012
Source : http://www.auver.ru/files/Ermak.pdf

Almost one third of the federal securities have duration exceeding 5 years (see fig.3). Banks are the main buyers at primary placements of federal securities (see fig. 4) and main operators at the secondary market of federal securities (OFZ) (see fig.5).

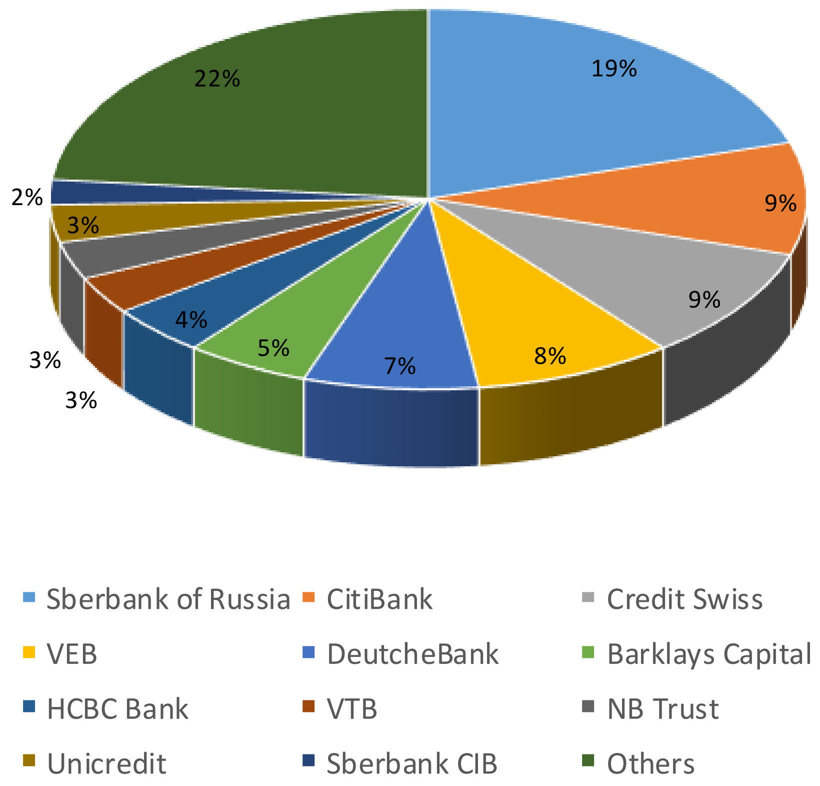


Fig.4. Main buyers at primary placements of federal securities (OFZ) in 2012
Source : http://www.auver.ru/files/Ermak.pdf

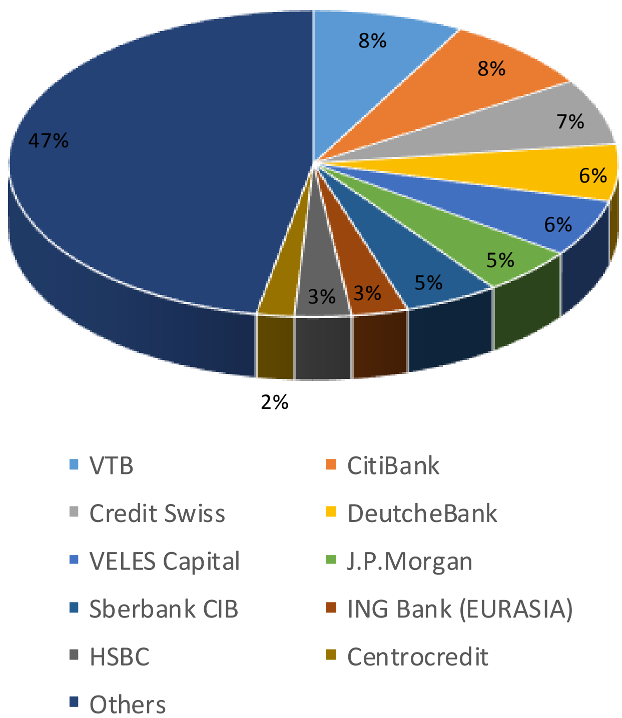


Fig.5. Main operators at the secondary market of federal securities (OFZ) in 2012
Source : http://www.auver.ru/files/Ermak.pdf

- subfederal

As of August 2013, the total outstanding debt was 436 billion rubles, 97 bond issues were in circulation. The volume of trade during the month was 1.2 trillion rubles. (*http://www.rusbonds.ru/mstmun.asp#summarketval*).

• corporate

The corporate bond market has been grown rapidly, but it too remains quite small. As of mid-2010 the amount of bonds outstanding was 2.7 trillion rubles (84.5 billion U.S. dollars). The amount of Russian corporate debt from the global debt market exceeds the size of domestic corporate debt market: as of mid-2010, Russian corporations had about 105 billion US$ outstanding in Eurobonds and 88 billion US$ in syndicated loans.

The total amount outstanding as of August 2013 was 4.5 trillion rubles with 1,020 bond issues in circulation. The volume of trading during the month was 12 trillion rubles. (http://www.rusbonds.ru/cmncorp.asp).

The largest issuers are banks and commodity firms. Many of them are directly or indirectly owned by the state ("quasi-sovereigns"). Despite the fact that they do not borrow much domestically, they occupy a sizeable share in the domestic market. Banks alone in 2010 accounted for 36 per cent of the total volume of debt.

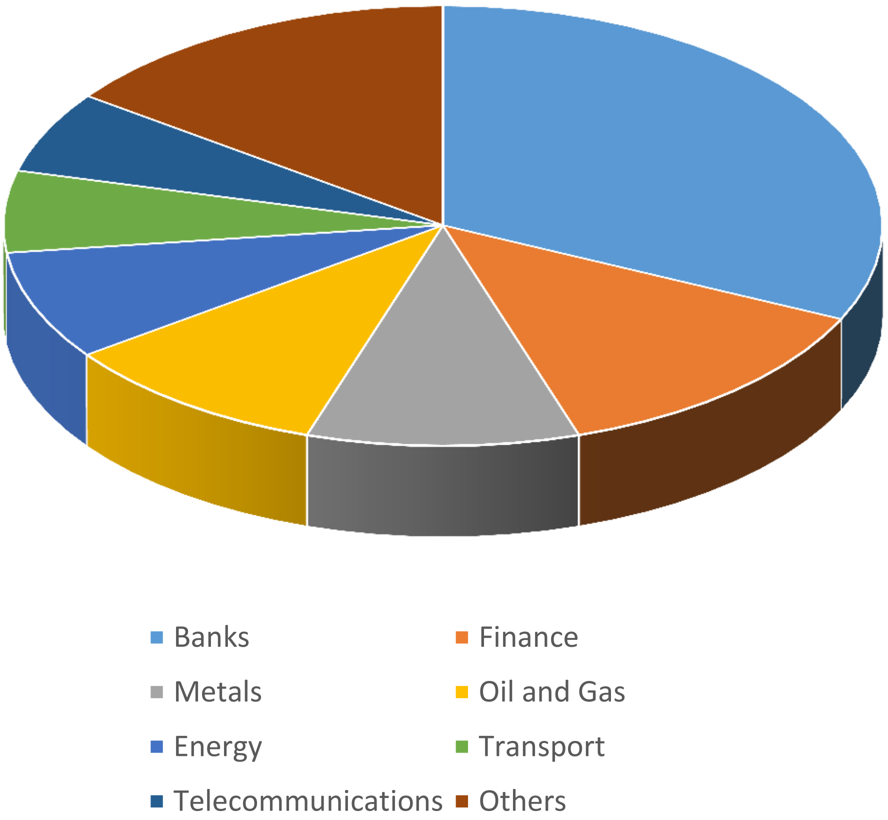
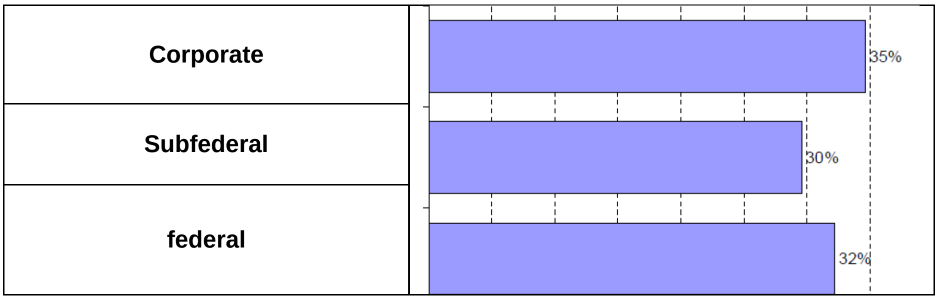


Fig. 6. Debentures issuers by sector, end 2012
Source : http://www.auver.ru/files/Ermak.pdf

Trades in corporate bonds. Mainly banks invest in debt (see fig.7). Debt instruments issued by several largest companies are mainly traded. Bonds from smaller issuers are fairly illiquid, which is typical for all debt markets.



As of end-2012

Fig.7. Share of banks at the debt market by instruments
Source : http://www.auver.ru/files/Ermak.pdf

Further expansion of the domestic bond market is limited both by demand and supply. Of note is difficulty and cost of registration. The process is unnecessarily complex and burdensome. There is a tax in registration with its level at 0.2 per cent and capped at 3,000 US$. There are also restrictions in the Civil Code on the amount of bonds a company can issue.

Regulation

In 2011 the IMF and the World Bank completed an assessment of Russia's implementation of the principles for securities regulation, as recommended by the International Organization of Securities Commissions (IOSCO). Overall, the report stated that Russia "partially" or "on the whole" implemented 24 out of 30 IOSCO principles (IMF, *Assessment of Implementation of the IOSCO Objectives and Principles of Securities Regulation*, 2011).

Regulation of financial markets may be divided into three categories:

- regulation of the markets themselves (exchanges, broker-dealers);

- regulation of the securities traded (process of issuing, what kind of securities may be issued etc.);

- regulation of the issuers (corporate governance, insider trading, takeovers etc.).

• ***Constraints in the financial infrastructure of the securities market***

- A need for better investor protection.

Insufficient legal protection of ownership transfer and settlement.
The registration procedure for registrars and depositories is slow and not synchronized, the uniform registration practices and accepted guarantee forms across the system are lacking (often all underlying documentation is required to finalize the ownership transfer), e-signatures are not widely spread.

Operational infrastructure inefficiency. Fragmented infrastructure where participants use systems that are not compatible, do not have corresponding accounts with each other, and have a high share of paper-based document turnover, combined with legal issue of registration entry priority (depositories vs. registrars) result in difficulties achieving settlement finality and may result in very high load on the system with regard to corporate actions, safekeeping etc., as the market turnover grows. With regard to cross-border transactions, restrictions on nominal accounts for foreign custodians complicate creating the inter-depositary relations with Russian depositories, combined with the 25 per cent limit on ownership shares of state monopolies and some financial companies, and rules disallowing direct trading (through nominal accounts) in domestic securities for foreign investors, which limits access of foreign investors to the Russian market and increases clearing duration.

Collateral rules are significantly lagging behind foreign practices due to a requirement for individualization of rights/assets, a limited range of assets as collateral, unfavorable taxation (VAT applied when collateral is claimed) as well as cumbersome collateral registration, no pledge of rights, difficulties with out-of-court enforcement, restrictions on depositories to engage in securities transactions without orders of the depot account holders thus preventing meeting obligations in timely manner, - and difficulties with repossession of collateral for some types of assets.

• ***The current legal environment makes it difficult to create new types of securities because only those types specifically enumerated are permitted****.* Every innovation, therefore, requires enabling legislation. Nor is a single enabling law sufficient: in each case, amendments must be made to the Civil Code, the Tax Code, the Law on Joint Stock Companies, the Law on Securities Market, the Law on Insolvency (Bankruptcy), the Law on Foreign Currency Regulation, and the Law on Banks and Banking Activity. The creation of a separate legal environment for the financial markets would make innovation much easier.

<u>Issuers</u>

• *The corporate governance problem* in Russia is different from that in the English-speaking common law countries. In the latter, the principal concern is of the managers furthering their own interests at the expense of those of the dispersed owners. In Russia, as in continental Europe generally, because ownership is concentrated rather than dispersed, owners can control managers quite effectively. This, however, creates a different problem – that of the concentrated insider owners furthering their own interests at the expense of the minority outsider owners. Observers generally consider this problem to be a serious one in Russia. One expression of the corporate governance problem is insider trading.

• ***Financial reporting and disclosure.*** It has been estimated that the stock of Russian companies sell at a discount of close to 30 per cent relative to the price they would fetch with corporate governance at the level common in more developed countries. In debt markets, a lack of transparency raises interest rates.

Opportunities lost

- long-term financing

The banking community argue that the banks have been unable to provide sufficient credit to the economy because the law does not allow to withdraw money from all individuals' deposits on demand. One alternative is long-term bonds but this segment has been slow to develop and issuance of covered bonds is not widely spread.

Securutization does not serve as a bank refinancing tool.

- private banking is underdeveloped although Russia possesses a significant wealthy class. Russian private banks invest their customers' funds abroad. Then, however, come of the funds return to Russia as a part of foreign institutional investment.

Gaps

Underdeveloped instruments include:

- hedge funds
Hedge funds have been authorized in Russian since 2008 for qualified investors. However, according to the Russian legislation, hedge funds are in essence a version of mutual funds. For hedge funds to become “true hedge funds”, i.e. with a broad range of instruments available for investment, Russian managers register such funds in an off-shore jurisdiction (about one half of the funds are registered in the Cayman Islands). There are also Western managers offering their services in Russia. Today out of hedge funds operating in Russia 100 are registered, and 60 can be regarded active. Financial performance of majority of hedge funds tends to correlate with the market developments (http://slon.ru/money/khedzh_fondy_v_rossii_est_li_budushchee-952775.xhtml).

-With the exception of venture funds, there are virtually no other private equity forms in Russia (e.g. funds buying a controlling stake through a loan and funds providing resources to support production expansion).

E-technologies are underutilized in securities trading. As a result, the market is too expensive for an ordinary investor.

Venture capital and innovations

Demand for innovations

Among Russia’s WEF Global Competitiveness rating components, innovation and business sophistication receive the lowest score (108th of 144 nations). Since 2010, it did not improve. Competition in majority of sectors remains weak, so does the appetite for innovation, especially in the large corporate sector. The general trend so far is towards deterioration, not improvement. Real sector remains shortsighted. During the 2000s investment horizon in the real sector had gradually extended to 4-5 years. But since the global financial crisis it shortened again to 2-3 years. The political uncertainty during the last 2 years have negatively affected the attitudes of entrepreneurs and investors / potential investors in high tech to Russia’s prospects of having a more innovative economy in the near future.

Venture capital

On the surface, in 2012 Russia has become Europe’s fourth largest venture market. In reality, however the data used for the ranking masks a strong statistical bias towards transactions that are not related to venture market. For example, it may include some deals of state corporation for innovations Rosnano, which can be categorized as private equity deals (late stage / investments or acquisitions of mature companies with sizable revenue streams). Exceptionally sizeable projects or projects heavily leaned towards equipment import may also be counted as venture although in reality they are not.

In reality, most of the existing venture funds have failed to develop pipelines of investible projects. With the only exception of the IT industry and Internet, venture market for earlier stages is non-existent. But even in these sectors attempts to create project pipelines have not been entirely successful so far.

Having acknowledged this gap, Rosnano was trying to shift some of its activities in Russia from early development phases to facilitating mass production of existing industrial prototypes (such as solar panels, high capacity lithium-ion batteries etc.). In these projects high early phase risks are somewhat prematurely scaled up to a mass production phase in big capex projects.

Institutional impediments for capitalization of startups

High tech exits from investments and their respective valuations for investors in startups are mostly capitalization driven (future value creation potential) rather than cash-flow driven. However, many of Russian investors still have a cash flow driven mentality. Cash flow generating businesses allow to redeem the investments faster and more predictably, especially in view of current very short term investment planning horizon. Besides, weak corporate governance perpetuates asset and cash flow stripping practices both by company managers and by dominant stakeholders with sizeable fraudulent personal gains. Inadequate protection of property rights and high risks of fraudulent hostile takeovers undermine incentives of owners and investors for capitalization.

Venture capital deals imply lots of minority shareholdings that result from the need to spread out risks to many investors – over several investment rounds or at large financing rounds. Minority stakeholders are disadvantaged and discouraged to invest. Shareholder agreement, one of the fundamental building blocks of a well functioning startup market, is far less effective under Russia's continental legal system than in the common law jurisdictions. Russian legislation effectively blocks options schemes for company management weakening incentives for the long-term capitalization upside.

High costs

Another serious deterrent is high investment and deployment costs. Earlier R&D phases – even those by Russian research teams - are usually much cheaper and easier to localize in the US and even in the EU. In the real sector similar greenfield oil refinery project in the Middle East could cost 20% less than in the US, whereas in Russia – 60% more. Most of this gap in Russia is explained by:

- high transactional costs, (including corruption)
- outdated technical regulation (costlier capex solutions and longer approval time)
- lack of skilled and experienced engineers (for the new construction projects) that results in higher labor costs in case of "imported" professionals or additional costs for rework because of engineering and other mistakes
- barriers for high skilled personnel migration
- import-export barriers
- inefficient logistics (relatively expensive, unreliable, lengthy deliveries).

All these barriers and inefficiencies negatively affect Russia's competitiveness for project deployment at commercialization phases and in many cases – for mass production phase as well.

PRUDENTIAL

SUMMARY OF UK RESPONSE

1. Background

"Challenges for the long-term finance in Russia" ("the paper", Appendix 1) was presented to The CityUK on 16 September 2013 by the Russian lead/Co-Chair of the Moscow International Finance Centre (MIFC) Group on Long Term Financing (LTF). Prudential plc has been asked to provide a UK response to the paper for verbal discussion on 30/31 October 2013.
The paper starts by summarising the key issues faced in developing LTF in Russia:

- "an unpredictable and costly business environment; corruption, absence of the rule of law; frequent and arbitrary government interventions;
- an inefficient bureaucracy; an inefficient and unpredictable legal framework;
- barriers to foreign entry: restrictions on the entry of foreign financial firms, on foreign ownership of Russian firms, on entry of foreign professionals;
- Chaotic and complicated regulation: an excess of red tape; inconsistent enforcement; and
- Counter-productive tax laws: VAT on financial transactions and services, high tax rates on financial firms, excessive taxation of foreign residents etc."

2. Why is developing LTF in Russia important?

The Russian economy is the 11th largest in the world by GDP. Since the collapse of the Soviet Union, Russia's centrally planned economy has made some progress towards becoming market-based and globally integrated (e.g. the liberalisation of the currency market). Russia runs a trade surplus, and the government's finances are relatively strong. However, as summarised in the paper, more needs to be done to develop LTF, as is evident from Prudential's assets under management: from £427 billion only about £50 million is invested in Russia. This number is low when compared to other markets Prudential currently does not operate in, such as Brazil (where the exposure is about ten times that of Russia).
Although developing deep capital markets may not appear to be a high priority for a country with such strong hydrocarbon revenues, it is important to consider other alternatives for financing now. Volatility in commodity prices and a general cooling in the global economy may make it vulnerable to economic shocks. Saudi Arabia is a great example of this, where the oil price crisis of 1973 and 1981 highlighted the need to diversify the Kingdom's oil-dependent economy and develop the capital markets; and more recently Sukuks have been used to finance the growing proportion of longer duration capital projects. LTF is necessary for the development of infrastructure within a country; not just as an alternative financing tool.

3. An approach to developing a general LTF framework

The development of LTF in a country is driven by the legal framework and tax laws. Since the objective is also to make Moscow an International Finance Centre, the key question here is:
"How can the tax and legal landscape be shaped so that it is favourable for <u>both</u> domestic and foreign investors?"
As well as creating the appropriate frameworks and stimulating *demand* from key investor classes.

4. Stimulating demand in Russia

The issues faced by domestic and foreign investors in Russia differ:

<u>4.1 Demand from domestic investors</u>: currently little demand exists since

(i) Some key sectors (e.g. insurance and mutual funds) remain underdeveloped.

(ii) Existing market participants have little incentive to invest due to prohibiting laws and tax implications.

4.2 Demand from foreign investors: to increase foreign demand, focus should be given to

(i) Specific barriers to foreign entry (legal and tax related).

(ii) State control and intervention - foreign investors often negatively perceive the state as controlling and unpredictable.

(iii) Corporate governance - laws, regulations and practices need to align more closely to international standards to improve transparency in markets.

5. Approach to developing LTF in Russia

We suggest seven key "themes" that should be reviewed in more detail to determine the approach to stimulating LTF in Russia, namely:

- Stimulating demand for long-term capital;
- Legal Framework;
- Regulation;
- Taxation;
- Barriers to foreign investment;
- State control & intervention; and
- Corporate governance.

Although the paper starts by summarising the main issues, the majority of the content is focused on describing the current landscape. Appendix 2 pinpoints which of the "themes" listed above (law, tax etc) have influenced specific prohibitive features of the Russian landscape. Since London is the world's biggest financial centre, it has the ability to share its own wealth of experience and insights across the world. However, it would be inappropriate to rigidly apply the UK model directly to Russia. Each of the "themes" could be developed into sub-work streams to be explored further with the appropriate UK & Russian specialists (lawyers, tax accountants etc). This will then provide a clearer path on how to develop LTF in Russia, adopting an approach best suited to its *particular* challenges and circumstances.

PRUDENTIAL

LEGAL FRAMEWORK			
Priority[1]	**Topic (Reference)**	**Summary of position in paper**	**Prudential response**
1	General Framework (Regulation, p6)	The current legal environment makes it difficult to create new types of securities – every innovation requires enabling legislation. Nor is a single enabling law sufficient: in each case, amendments must be made to a number of Codes and Law. A creation of a separate legal environment for the financial markets would make innovation much easier.	How can we create a separate legal environment for the financial markets? How can the legal system be made more predictable and less prone to state intervention? How does it compare to the UK?
2	Market Infrastructure (Market Infrastructure, p3)	A joint operation of two parallel securities ownership registration systems (depositories and registrars) with multiple participants creates uncertainty over ownership. Entries made in security registries prevail over depositories, forcing investors to register registries over efficient depository-based trading systems. This has led to fragmented infrastructure where systems are incompatible, and paper based systems still predominate.	The judicial system is viewed as arbitrary and slow: this has led to an inefficient operating environment that would hinder LTF. How can new laws be introduced so that there is an efficient (single electronic?) registration system?
3	Financial Reporting and disclosure (The Equities Markets, p4 & The Issuers, p6)	Disclosure is limited which means that share prices, particularly of commodity companies (which account for the bulk of trading volume) are likely to be moved by news on commodity prices rather than the companies themselves.	This could be a great hindrance to foreign investment in particular. It would be interesting to compare domestic standards to IFRS.
4	Corporate Debt (Debt Markets, p6)	Restrictions in the Civil Code on the amount of bonds a company can issue.	It is essential that companies do not take on too much financial leverage but very strict requirements could hinder the development of a primary corporate bond market. What are the rules for the UK?
5	Collateral (Collateral rules, p6)	Cumbersome collateral process, no pledge of rights, restrictions on depositories to engage in securities transactions.	Collateralised derivatives are an essential part of LTF (cross currency swaps, interest rate swaps) as well as any type of secured lending. Secured lending may be an important global financing tool for institutions with low credit ratings. Part of the issues could be resolved through an efficient ownership registration process (see LEGAL FRAMEWORK, point 2). It would be interesting to compare current Russian standards to international

[1] Key issues are prioritised in terms of importance to manage resource and timelines

			standards such as ISDA, CSA etc to identify areas of development.
REGULATION			
Priority	**Topic**	**Summary of position in paper**	**Prudential response**
1	Banks (The Issuers, p6)	Banks are not allowed to withdraw money from individual deposits on demand.	Banks are one of the most important players in any financial system and so focusing on facilitating their funding and lending activities is key. <u>BANK FUNDING (LIABILITIES)</u> Retail deposits remain unstable and volatile, making it impossible for banks to lend out too far down the curve. However, the introduction of deposit insurance in 2004 has increased overall confidence in the system. How could retail deposits be made more stable? Could the insured amount be increased from the current (RUB700,000 ($22,600))? At the moment, the central bank provides a lot of short term liquidity – should this be reduced to encourage the development of the capital markets? The opening of Russia's corporate bond market to foreign investors (similar to RUB dominated government bonds) would increase banks funding options and improve liquidity in the LTF market. <u>BANK LENDING (ASSETS)</u> How can long term lending be increased? Look into: (1) Central Bank Set up, policy, targets – how can long term interest rates be reduced? (2) Mortgage lending – how can it be increased? (Currently most residential real estate is purchased through equity) (3) Longer maturity lending is greater risk too so it is important to consider how banks can improve underwriting standards, capital, risk management (compare it to Basel III) (4) Why does securitisation not exist? Such technologies, if used correctly, can help to free up balance sheet.
2	Insurance Companies , Mutual Funds (Market Participants, p2)	In the insurance industry, increased capital requirements introduced in 2012 caused a major reduction in the number of companies (700 to 454 in mid-2013). Both the insurance and mutual fund	Institutional investors such as pension funds, mutual funds and insurance companies are essential to creating the demand for long term financing and so the work stream

		industry remain completely underdeveloped.	should focus on how to grow these sectors. At the moment, since institutional investors are small relative to the economy, borrowing for more than three years is difficult. Domestic bonds with floating coupons contain put options which effectively shorten the maturity of the debt (this is mostly bought by domestic banks?), and so long term borrowing in foreign currencies remains the preferable alternative. How do we increase domestic institutional investor presence? The paper briefly goes into reasons into the collapse of the insurance sector but what about Mutual funds? Why is that sector underdeveloped? <u>A note on supply/demand of government bonds:</u> The development of LTF in any country usually starts with government bonds. In Russia, supply is low since the government generates enough income through commodities. This should be reviewed as the commodity markets and global economy slow down. However, the demand is also not there, as stated on p5 of the paper, "much of the outstanding debt settles in long term investment portfolios of state owned financial institutions". The RUB government bond market was recently opened up to foreign investors but we must also increase demand from domestic intuitional investors. How can the government bond market be made more liquid and standardised? This would also help to increase demand.
3	Pension Funds (Market Participants, p2)	Pension funds may not invest mandatory contributions on their own. These are invested by asset management companies, and the PFR assets are managed by the State Asset Management Company with its functions performed by VEB. Its investment portfolio mainly comprises government securities. Investing in stocks is not allowed.	Currently the majority of the investors in the secondary equity market are foreigners. Allowing domestic pension funds to invest in stock should help to increase liquidity (and reduce concentration) in the equity markets. How can we do this?

4	Hedge Funds (Gaps, p6)	Hedge funds are authorised as qualified investors but are in essence a version of mutual funds. For them to be able to invest in a broad range of instruments they must be registered off shore (about 50% registered in the Cayman Islands).	What are the barriers to developing an onshore market?
TAXATION			
Priority	**Topic (Reference)**	**Summary of position in paper**	**Prudential response**
1	General (p1)	VAT on financial transactions and services, high tax rates on financial firms, excessive taxation of foreign residents etc.	This needs to be expanded to provide specific examples.
2	Domestic Corporate Debt (Debt Markets, p5)	At the moment, the largest issuers of corporate debt are banks and commodity firms directly or indirectly owned by the state. Most of the debt is then held by (state owned) banks. Domestic debt is limited by both demand and supply - the amount of foreign debt greatly exceeds the domestic bond market (approx $200 billion versus $85 billion in 2010). Of note is difficulty and cost of registration. The process is unnecessarily complex and burdensome. There is also a tax registration with its level at 0.2% and capped at $3000. Mainly banks invest in debt.	Demand for corporate debt can be increased by making the market more accessible to foreign investors (see BARRIERS TO FOREIGN ENTRY), increasing the presence of domestic institutional investors (see REGULATIONS, point 2) and increasing LTF demand from banks (see REGULATIONS, point 1). On the supply side, how can we give more favourable tax treatment and how can the registration process be made more efficient?
3	Insurance Companies (Market Participants, p2)	The tightening of tax laws in 2007 lead to a collapse in the life insurance market since many of the transactions prior to this were designed to avoid tax. The industry has since gradually recovered as mortgage borrowers require life insurance.	Given that insurance was being used for the wrong reasons, it is good that the laws were changed to address this. Since this has led to a collapse in the market, further research needs to be conducted into how to revive the market. How do we generate demand? How can we open up distribution channels? Bancassurance is virtually non-existent, why is this? How do we train people so that we have a skilled work force?
4	Collateral (Collateral Rules, p6)	VAT is applied when collateral is claimed.	Is this also the case in the UK? Can the regulations be reviewed?
STATE INTERVENTION & CONTROL			
Priority	**Topic (Reference)**	**Summary of position in paper**	**Prudential response**
1	General Political Landscape	N/A	The Russian government is relatively autocratic and the line between public and private enterprise is blurred. To provide any meaningful change to this perception, "buy in" from the very top officials is required. We must also ensure that this would

			continue following any change in government.
2	Equities in general (The Equities Market, p3)	Ownership and control of Russian companies is highly concentrated (60-65% ownership) and in most cases linked to the government. Since free float is small, it is difficult to assemble a controlling stake via the open market, limiting M&A activity, restructuring and privatization. Most of the free float (about 2/3rds) is owned by foreign companies.	There are laws that prohibit foreigners from owning controlling stakes in "strategic" companies/sectors (see BARRIERS TO FOREIGN ENTRY, point 1). This needs to be reviewed. Increasing domestic demand will help to disperse ownership (see REGULATION, points 2 & 3) The UK With Profits Fund has investment in Baring Vostok (largest private equity firm in Russia) – speak to the managers for further insights on equity market activities.
3	Banks (Market Participants, p1)	State controlled banks control more than 70% of the total bank assets. Foreign banks make up a small number (18% of total bank assets) which is low compared to other economies, and the role they play is insignificant. There is also a similar monopoly over financial intermediaries. Only a limited number of (mainly state) banks have the ability to borrow from abroad.	Dominance of state related banks distorts competition. Can competition laws be modified to encourage growth in the banking sector? How can we increase the presence of foreign banks and create a level playing field?
4	Private Equity (The Equities Market, p4)	All private equity activity is performed by the state or in partnership with it. With the exception of venture funds, there are virtually no other private equity forms in Russia.	The UK With Profits Fund has investment in Baring Vostok (largest private equity firm in Russia) so there seems to be some market existing already. Investigate further.
BARRIERS TO FOREIGN ENTRY			
Priority	**Topic (Reference)**	**Summary of position in paper**	**Prudential response**
1	Primary Equity Market (The Equities Markets, p4)	Maximum 25% foreign ownership of companies in "strategic" sectors (state monopolies, financials)	This is also linked closely to STATE CONTROL & INTERVENTION. If the state is ready to create a competitive market (see STATE CONTROL & INTERVENTION, point 1) part of the process will be to review such laws. A similar review needs to be conducted on the debt capital markets side. For example, the government recently has allowed foreign investment in RUB denominated government bonds – can this be extended to corporate debt too?
2	Corporate Governance (The Issuers, p6)	There is major risk of concentrated owners furthering their own interests at the expense of minority (foreign) owners.	On a high level, Russian authorities have recently taken steps to reduce corruption and signed an anti-bribery convention with the OECD is May 2011. However, Russia still ranks 133/174 countries in the Transparency International's 2012 Corruption Perception Index.

			Increasing transparency of reporting (see LEGAL FRAMEWORK, point 3) will also help to give more confidence around the issues surrounding corruption.
3	Market participants (The Market Infrastructure, p3)	Currently a foreign depository cannot obtain a license to become a professional market participant and therefore cannot establish inter-depository relations with a Russian depository.	Increasing the presence of foreign market participants will encourage the formation of fair and competitive markets and hence create demand from both domestic and foreign investors.
4	Secondary Equity market (The Equities Markets, p4)	Nonresidents are not allowed to directly trade on the equities market (it can only be done through members of the stock exchange or a custodian).	See point 3.
5	Market Infrastructure (The Market Infrastructure, p3)	When foreigners purchase securities directly, clearing and settlements may take up to 2 weeks.	Addressing the fundamental issues (see LEGAL FRAMEWORK, point 2) should help to resolve this.