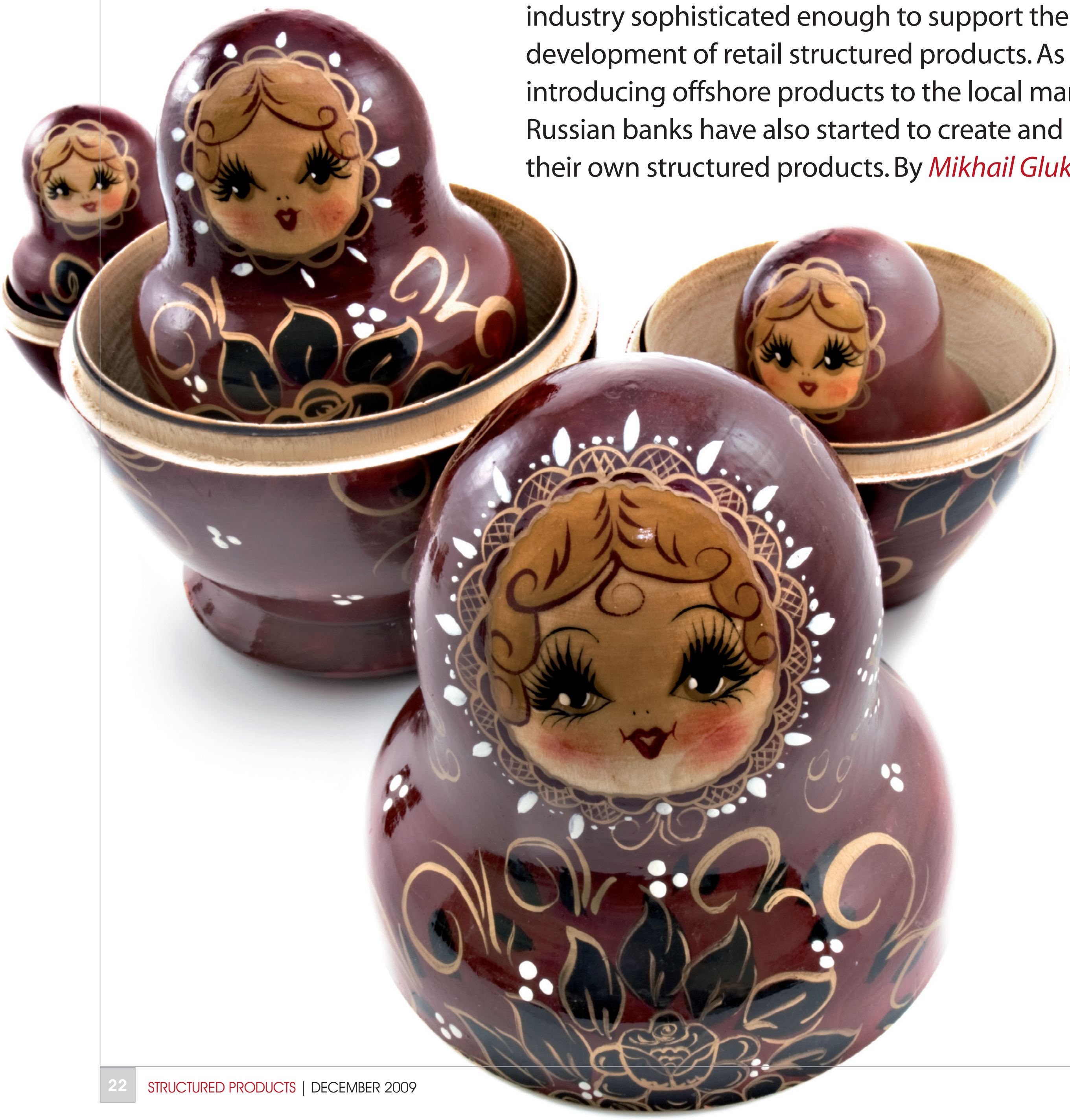
Unwrapping Russian structures

Since the 1998 stock market crash, Russia's financial sector has evolved to play host to a derivatives industry sophisticated enough to support the development of retail structured products. As well introducing offshore products to the local market, Russian banks have also started to create and offer their own structured products. By *Mikhail Glukhov**



> The issuance of Russia's first onshore structured bond in June 2009 by investment bank Troika Dialog has added a new wrapper to the traditional deposit, nudging the Russian market one step further in its development. The 18-month product was sized at a modest Rbs176.6 million (US$6.2 million), linked to the benchmark RTS equity index and offered a participation rate of 45%. While the payoff incorporated a simple call structure, the Troika Index Bonds were the first capital-guaranteed structured bonds issued in Russia to conform to domestic regulations. The bank followed up with a second issue of the same product at the end of September, a one-year-and-nine-month product maturing in June 2011, also linked to the RTS Index and with a participation rate of 47%.

The search for a wrapper that complies with local laws and is also tax efficient has a long history. Over-the-counter options were legalised in Russia only in 2007, before which option contracts were almost considered to be gambling. Unfavourably taxed, these contracts permitted no legal defence if challenged.

The first wrappers arrived in 2005, when Citi introduced deposits with an index-linked interest rate. Probably the most retail-oriented wrapper for structured products, deposits in Russia are insured by the government (for up to Rbs700,000), are relatively tax-efficient and familiar to most investors.

Both the deposit and the bond wrapper are tax-efficient and transparent, although the law requires that they both provide positive returns. As a result, it is not possible to issue a non-capital-guaranteed product (such as a reverse convertible) when using either of these wrappers.

The third style in which structured products appear in Russia is through asset management or brokerage agreements, which require banks to buy a portfolio of bonds and options for the client. No payoff formula is fixed in the agreement and the banks do not have any obligation to generate a certain payoff. However, the structure of the portfolio is such that it protects capital and provides participation in rising markets. In most cases, the bank would buy exchange-traded Forts (Futures and Options on RTS, the derivatives market of the Russian Trading Exchange) options, but some companies and banks also use OTC options. This is probably the easiest way to create a structured product. In many cases, the providers are not selling their own options to the client, but are buying them in the market from options market-makers (such as Renaissance Capital or Troika Dialog). In this way, they avoid taking any hedging risk.

In some cases, products are even structured within the brokerage agreement: the broker's client buys a portfolio of bonds and options, taking advice from the company on how to structure the portfolio to obtain a product with certain characteristics.

Other wrappers used in Russia include miscellaneous schemes with promissory notes (which include, for example, a repurchase agreement whereby investors buy promissory notes from a bank which it sells them back at an index-linked price at maturity), index-linked loans and other types of OTC index-linked agreements. All of these wrappers are less transparent from the legal and taxation points of view.

Hedging defines underlyings

The selection of underlyings on offer is determined by the hedging appetite of the banks, with the RTS Index generally the most popular for derivatives and structured products. Although denominated in US dollars and therefore less convenient than the rouble-denominated Micex Index, there is a liquid market for futures and options (exchange-traded and OTC) on the RTS Index.

Many products are denominated in roubles, although they are directly linked to the dollar-based RTS Index without any currency adjustment in the product formula, making them quanto products.

Individual blue-chip Russian stocks are also common base assets for structured products – but only the most liquid of them, particularly those with a corresponding futures contract traded on Forts.

Some Russian banks offer structured products linked to commodities, notably Kit Finance, which produces deposits linked either to a single commodity (such as futures on oil), or a basket of commodities (including, for instance, futures on corn, and wheat). Those futures are traded on futures exchanges outside Russia, as is the hedging.

Products linked to foreign exchange rates are uncommon. Kit Finance, for example, has only one forex-linked deposit, based on the US dollar/rouble exchange rate. In the past, Citi also had deposits linked to forex rates. Interest rate-linked structured products are equally uncommon in the Russian market: a rare example is the deposit offered by VTB24 (a subsidiary of one of the largest Russian banks VTB) linked to either Libor (for euro and dollar deposits) or the Russian Central bank refinancing interest rate (for deposits in roubles), with a very basic payoff (the interest rate on the deposit equals the benchmark rate).

The RTS Index is generally the most popular underlying for derivatives and structured products

American or Global Depository Receipts on Russian stocks are often used in structured notes issued by foreign banks (such as Société Générale or UBS), since the hedging process for such notes is held on foreign exchanges (such as the London Stock Exchange). The first Citi structured deposits that appeared in 2005 were linked to the Dow Jones Industrial Average (DJIA) index, probably motivated more by the availability of hedging (which was done outside Russia) than by customer demand.

Keeping it simple

The first structured products that appeared on the Russian market were capital-guaranteed products with embedded vanilla call and put options and these are still the most popular: they are the easiest to issue and hedge, while most investors are uncomfortable with more complex payoffs.

There are products that include a combination of vanilla calls and puts. There are also those with embedded binary options: local broker BCS has offered a product with a higher fixed return if the RTS Index closes inside a predetermined range at maturity, and 0% if it closes outside.

Products with more complex payoffs are rare and more difficult to price and hedge, as well as harder to sell to investors. Probably the most complex offered regularly to retail is a rainbow product with best-of/worst-of features, which comes in the form of a deposit linked to a basket of four commodity futures: different participation rates apply to

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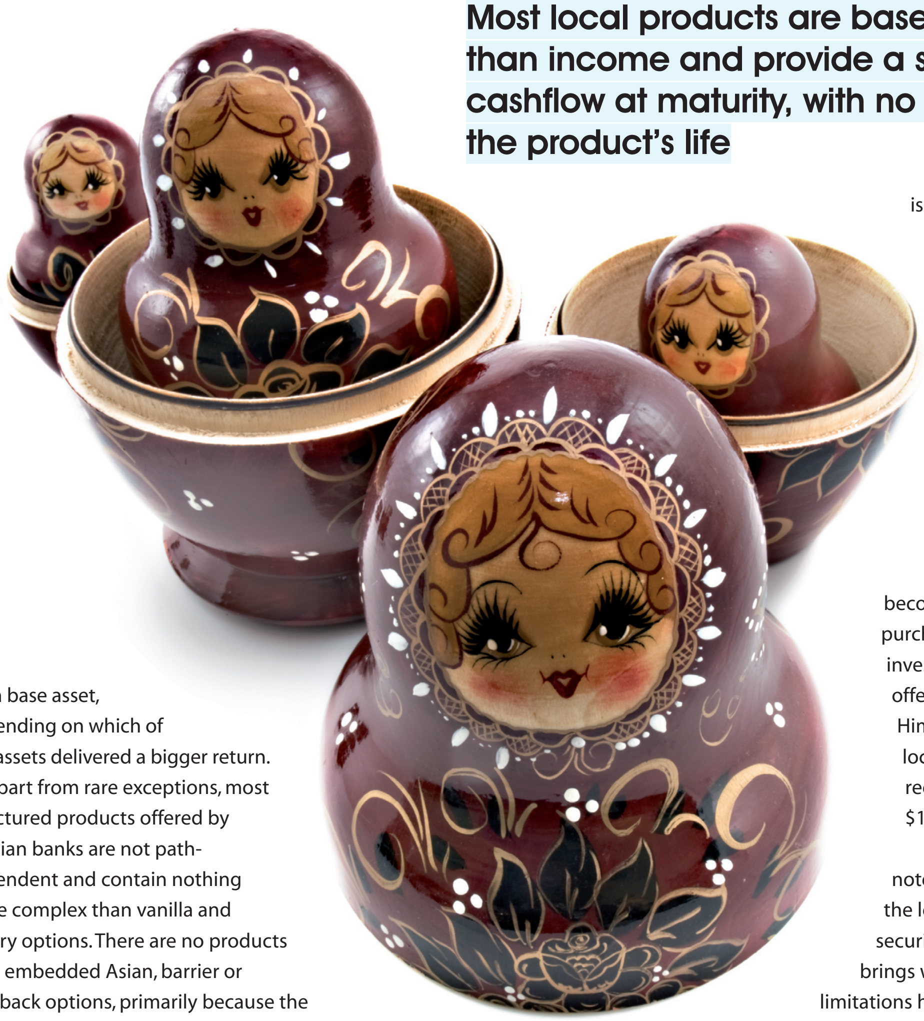

each base asset, depending on which of the assets delivered a bigger return.

Apart from rare exceptions, most structured products offered by Russian banks are not path-dependent and contain nothing more complex than vanilla and binary options. There are no products with embedded Asian, barrier or lookback options, primarily because the experience of Russian banks in pricing and hedging of such products is very limited.

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Although the majority of products offered in Russia generate return in case of a market rise, there are also products designed for other market scenarios. There are products benefiting from market falls and products generating a higher return in case the base asset is not volatile (and stays within a predetermined range, for example).

Maturities are short, certainly compared to those in Europe. They typically last for one year, although six-month tenors are common, and tenors of two years are rare. The shortness of the term makes the products less attractive for investors, with typical participation rates for one-year capital-guaranteed products around 40–50%.

There is virtually no secondary market for Russian structured products, and those investors wishing to sell before maturity can only deal with the bank that sold the product, which often renders the terms unfavourable. Exchange-traded structured products remain part of the future as far as Russia is concerned.

Foreign issuance

Global banks do not offer structured products issued under local rules as volume and demand is low and the legal risks associated with issuance are uncertain. Citi was an exception to this rule when it was offering index-linked deposits in full accordance with local rules.

Other banks, such as BNP Paribas, Société Générale and UBS, as well as Citi, have offered structured notes issued outside Russia to local investors for several years through their local offices and local banks. UniCredit has also become prominent following its 2007 purchase of Aton-Broker, a large Russian investment company: the bank now offers structured notes such as Himalayas (issued abroad) on the local market, with a minimum required investment sum of around $1 million.

The drawback is that structured notes issued abroad and based on the local market are considered foreign securities and, as such, investing in them brings with it legal limitations. Such limitations have become even more significant since May 2009, when amendments to Russian law required these sales to be made only to qualified investors. As a result, these sales are more often done with the use of an offshore company and under foreign law. This tends to limit the sales to high-net-worth investors, often with a minimum investment equivalent to hundreds of thousands of dollars.

Although structured products are already being offered by at least a dozen companies and banks in Russia, the market is at the very first stage of its development and issuance volumes are low.

The main obstacles to the market's further development include the legal framework for derivatives and structured products, which is not very clear and transparent, although this has not hindered the creation of deposit and bond wrappers.

As well as the lack of information and marketing (few investors are aware of what 'structured products' are and the benefits they offer), there are also very few local banks with the knowledge and expertise necessary to price, issue and hedge derivatives and structured products. Even those banks that are active offer quite basic products (compared to those offered by the international banks). Another limiting factor is that the Russian options market is not yet fully developed and liquid.

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