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Bonds gaining ground as a finance tool in Russia

Although Russian companies and households were rapidly taking on debt before the onset of economic crisis, their debt ratios remain relatively low. Bank lending was still growing at an annual rate of 50% at the start of 2008, which had a positive influence on economic growth. But more recently the impact has been negative, as the stock of outstanding bank credit measured in real terms declined last year. The Russian government also acknowledges the importance of the financial sector for economic recovery, and the state-owned banks have been under pressure to increase their lending. Since the start of summer 2009, the top companies have been obtaining financing via the bond markets.

Finance in short supply during the crisis

Russian companies rely mainly on retained earnings to meet their financing needs. Bank loans cover only about 12% of their fixed investment financing, and their share and bond issuance has been modest. As has been the case in other countries, Russian companies have found it difficult to obtain finance during the crisis. Even with no apparent liquidity problems in the banking sector, lending activity is badly impaired. Despite interest rate cuts by central bank, the banks are shunning risks and keeping their lending rates high, largely because the risk of continuing increase in nonperforming loans. Syndicated loans arranged in the international markets still accounted for about a fourth of the domestic loan stock in 2007. But Russian companies are unable to tap this source of finance at a time when banks are reluctant to lend, and the total of these loans shrank by some 90% last year. Russian companies, like those in other countries, have thus turned to bond issuance to meet their financing needs¹.

Bond markets as a source of finance

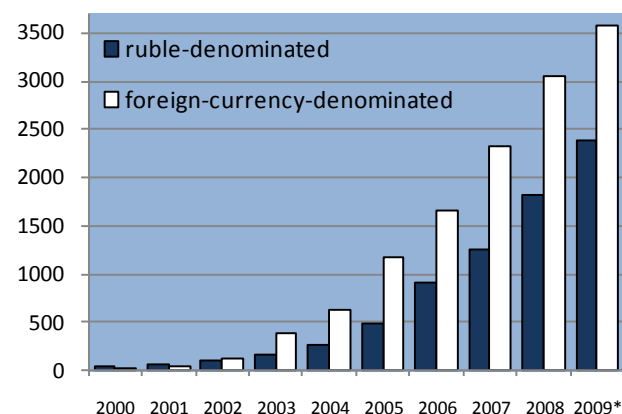
Bond financing in Russia is generally an option only for the top (often state-owned) companies, banks, and the federal and regional governments. The large energy companies also issue dollar-denominated debt in international markets, as much of their revenue is in dollars. The wide swings in exchange rates during

¹ Bond issuance by nonfinancial companies in international markets amounted to USD 1310 billion in Jan-Sep 2009, which is more than the stock of bank lending to companies (USD 1080 bn, Dealogic).

the last year and the high cost of defending the ruble may have largely kept other companies away from the international capital markets.

Although most individual bond issues of Russian companies are ruble-denominated, 60% of the amount of bonds outstanding in November 2009 was foreign-currency-denominated, as was the case in the years prior to the crisis. However, in 2009 most of the bonds issued were in rubles.

Amount of outstanding bonds issued by Russian companies (bn rubles)



*Jan-Nov 2009 (www.cbonds.ru)

Source: Russian Central Bank

Due to robust economic growth, the Russian bond market grew rapidly in the years preceding the crisis. The trend came to a halt with the onset of the international crisis. With the devaluation of the ruble, these investments quickly lost value last winter; and this, along with the liquidity shortage, led to a collapse in the demand for bonds. Between September 2008 and February 2009, only a few new ruble-denominated bonds were issued. Russian companies returned to the market in March 2009, and last summer the monthly issuance of new bonds exceeded the pre-crisis levels. Russian companies issued ruble-denominated bonds in the amount of nearly 820 billion rubles (EUR 18 bn) in January-November of 2009, compared with 470 billion rubles in the whole previous year. The state railway company, RZD, and the state oil pipeline monopoly, Transneft, were the largest issuers in 2009.

Issuance by Russian companies in the international bond markets amounted to USD 9.4 billion in January-September, 2009. This was 15% of total is-

suance in the international bond markets during that period.

Secondary trading in Moscow's MICEX exchange hit record highs in the latter part of the year, but even so the structure of trade reveals the thinness of the Russian bond market. Eight companies accounted for half of the secondary trade volume. Unsurprisingly, the most liquid debt instruments are bonds issued by the energy companies, financial institutions, and the state railway company.

Who is buying ruble bonds?

The largest investors in the ruble-denominated bond market, which last September accounted for nearly 2300 billion rubles (EUR 52 bn), are the Russian banks. Surplus liquidity has flowed into the bond markets. Moreover, bonds of the top companies can be used as collateral for lucrative central bank loans. In September of 2009, companies' bonds accounted for over 60% of repo operations and for a third of the collateral used in other central bank lending.

Russian banks' portfolios included nearly 40% (ca 850 bn rubles) of outstanding private-issue ruble bonds at the end of September 2009. At that time, the aggregate banking sector assets had grown by 15% pa while the banks' aggregate bond portfolio expanded by 60%. Especially rapid growth occurred in investments in foreign companies' debt instruments, but investment in Russian company debt has also increased, by 50% year-on-year. On the other hand, bank loans to Russian companies increased by only 6% on the previous year, which amounts to a decline in real terms.

Investments of the large state-owned banks (Sberbank, VTB, Bank Moskvyy) into bonds have increased sharply, as have other federally supported banks' bond investments (Alfa Bank). These investments doubled in January-October 2009, and their average share of the large banks' aggregate balance sheet total grew from 3% to nearly 7%.

Potential for further growth of the bond markets

In recent times, central banks have promoted growth of the world's bond markets by supplying low-cost liquidity, which has flowed mainly into the government bonds and the bonds of companies with high credit ratings. So far, the central banks have kept the financial markets awash with liquidity, but the first signs of tighter monetary policy are already on the horizon. If bank and bank-syndicated loans remain difficult to obtain, there will continue to be large numbers of issuers in the bond markets. Competition for money will probably also heat up in the capital markets, especially as compared with the pre-crisis years of abundant liquidity.

Given that most Russian companies do not have access to the international financial markets, one might question whether there will be enough investors in the Russian corporate bond markets to satisfy even the better companies' funding needs, especially when the Russian federal government is also set to issue bonds this year. However, with oil prices currently at fairly high levels, it seems that the financing needs of the Russian federal government are smaller than anticipated, and the government is looking to tap the international markets as much as possible in an effort to ensure an adequate supply of liquidity in the domestic markets.

Despite the potential for further growth, the Russian bond market is unlikely to alter the role of bank lending in corporate finance. But in any case, the further diversification of corporate finance and deepening of the financial markets strengthen Russian companies' ability to finance and expand their activities also on the basis of debt.

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