The Russian Bullion Market: Bursting Through the Asphalt

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In Russia, the circulation of precious metals has been historically regulated on the basis of selective authorisation, in which a transaction is deemed to be prohibited unless expressly allowed. With the introduction of liberalisation, bullion trading has evolved and Russia has become an integral part of the global bullion market. However, numerous restrictions still hamper the development of market infrastructure.

History and Regulation

The foundations of the modern Russian bullion market were laid down in 1993-1994, just after the formation of a two-level banking system consisting of the Central Bank of Russia and numerous commercial banks, both state-owned and private. In 1993, the Central Bank granted several commercial banks special permission for bullion transactions.

By decree No. 756 dated 30 June 1994, the Federal Government outlined basic principles of circulation of gold and silver in the form of bars, raw materials, scrap, half-finished and finished products (with a minor exception of jewellery items). Along with foreign currency, precious metals formed at that time the special group of assets (legislatively defined as "the currency values") and their circulation was regulated very strictly according to the basic principle of "transaction prohibited, unless expressly allowed". Later on, a number of liberalisations were introduced: Federal Law No. 41-FZ, "On precious metals and precious stones", was adopted on 26 March 1998. The currency exchange control was substantially eased and precious metals were removed from the "currency values" category. The state monopoly of the export of fine gold and silver was abandoned in 1997 and the same has been done recently with regard to the platinum group metals.

Nonetheless, regulation of the Russian bullion market remains rather strict and convoluted:

- All market participants (who must be Russian residents) are categorised into several groups such as producers (mining, scrap collecting and processing companies), refiners, banks, industrial consumers (end users) and investors. The permitted types of transactions between members of various groups are specified – e.g. investors and industrial consumers can buy and sell fine gold and silver bars only from and to banks (or through them, on a commission basis). Along with the Federal Government, commercial banks enjoy the exclusive right of direct dealing with the Central Bank.
- Raw materials (both mined and extracted from scrap) must be delivered by producers only to specially authorised refiners, which process their metal into bars. Refiners provide their services as contractors; therefore, the owner of the raw material retains his title to the fine metal.
- The specially authorised federal body (Gokhran of Russia under the Ministry of Finance), as well as regional authorities with similar functions, enjoy the right of first refusal on all refined precious metals sold by producers. On the other hand, this right is subject to the buyer's obligation to conclude the contract in good time and to provide the producer with partial advance payment. Until recently, Gokhran refrained from making advance payments in view of complex and unclear security requirements and restrictions on the use of funds set forth by the Government and the Ministry of Finance; so it was not so easy to implement the right of first refusal in practice.
- Some tax exemptions have been introduced in order to facilitate circulation of precious metals as financial assets – sale thereof from producers to banks and to Gokhran of Russia is taxed at 0% VAT rate. Interbank transactions are not subject to VAT. Neither are sales of precious metals from banks to investors (provided that the bank retains physical control over the metal sold). Sale of certain types of bullion coins is also tax-exempt. However, the first attempt to reproduce "the black box" model of the London bullion market has not been completely successful; several revisions to the Tax Code have had to be adopted during the last 10 years in order to clarify various uncertainties.
- Refined gold and silver may be exported by the Central Bank, commercial banks, producers and other entities. Banks may act both on a proprietary and commission basis and are entitled to "general" (i.e. not linked to particular contract) export licences, while other exporters may sell their own metal only and a separate licence is required for every contract. No export duties are in place now, while imports are taxed at 20%.
- The official Gold Reserve of the Russian Federation is formed of fine (monetary) gold in bars and consists of two parts: one is held by the Central Bank and the other by the Ministry of Finance (as part of the State Reserve of precious metals and precious stones). The Central Bank makes decisions on the use of its part of the gold according to procedures agreed with the Federal Government. The Government also adopts the annual plans on use of gold for the Ministry of Finance.
- Various forms of control and licensing are conducted by numerous authorities. The Central Bank regulates banking transactions, capital adequacy, liquidity and accounting. The Ministry of Finance and its subordinated bodies manage the State Reserve of precious

Figure 1
Top: the Sower (10 roubles, fineness 900, fine gold content 7.742g).
Bottom: the St George (50 roubles, fineness 999, fine gold content 7.780g).

metals and precious stones, provide federal assay supervision and develop and enforce regulations for safe-keeping, transfer, acceptance and inventory of precious metals. The Ministry of Industry and Trade is in charge of export licensing and the Federal Agency for Financial Monitoring requires exhaustive reporting as part of its anti-money-laundering functions, etc.

It should be noted that the slightest failure to comply with the rules can result in very serious punishment – administrative penalties, confiscation of precious metals and funds received, and even imprisonment. If the amount of an illegal transaction exceeds 250 thousand roubles (which is the equivalent of less than 10 troy ounces of gold at the current price), the violation is qualified as "material", resulting in the imprisonment of the guilty parties for up to seven years.

Trading and Settlement

As in London, bullion transactions in Russia are usually made on an over-the-counter basis. Six or seven prime-rated commercial banks deal regularly as professional traders and form the core of the market. Their client base is made up of smaller banks, producers, industrial consumers and investors. Service functions are performed by refiners and carriers of valuable cargo. The market participants are not associated into any kind of self-regulated organisation, neither has a standard form of documentation been adopted, and no obligatory market-making is practised. The most common and outstanding problems (related to regulation, tax issues, etc.) are usually discussed on a case-by-case basis between members of a special committee of the Association of Russian Banks.

The Russian State standard specifications for gold and silver bars are similar to the London Good Delivery specifications and require an even higher fineness of metal – at least 999.5 for gold (with 999.9 forming the major part of gold actually produced) and 999.8 for silver. Smaller bars of weight from one to 1,000 grams are also available; however, the cost of their production charged by domestic refiners is much higher than the tariffs of major foreign refiners, so they are traded usually at a considerable premium. Eight Russian refiners are listed by the LBMA as acceptable Good Delivery refiners for gold, and seven for silver.

Physical metal is traded mostly between producers, banks and industrial consumers. Investors use unallocated bullion accounts with banks and also purchase bars and coins for hoarding purposes. Banks usually pick up bars sold by producers directly from the refiner's warehouse. Interbank physical transactions are commonly settled through banks' own vaults or, alternatively, through the vault of a carrier.

There is no established clearing system for paper gold transactions: core banks may clear deals between the unallocated bullion accounts of their own clients but usually do not use loco Moscow accounts for clearing with other banks. This undeveloped settlement structure can be explained by the tax risks (some VAT issues are outstanding) and, probably, by a lack of serious demand for its further development. A bank's bullion liquidity is rather easily managed by means of physical transactions; its open positions arising from trades with domestic counterparties are usually balanced by loco London deals with major international bullion banks, and clients usually prefer to deal with the bank keeping their bullion accounts and do not require transfers to other banks.

Non-deliverable (cash-settled) gold and silver futures and options are traded on the RTS Exchange, but the volumes of trade are rather small. For example, in the first quarter of 2009, the most actively traded June gold contract averaged 311 trades per day, with a mean daily volume of 206 million roubles and 6,404 contracts (the size of a contract is one troy ounce). For the same period, average daily open interest was 18,730 contracts or 709 million roubles.[1]

Figure 3: Gold Demand
(Union of Gold Producers, expert evaluation)

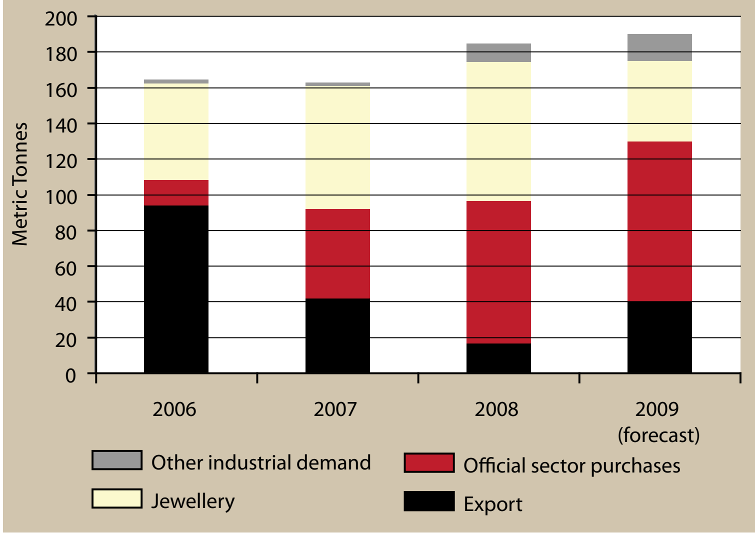
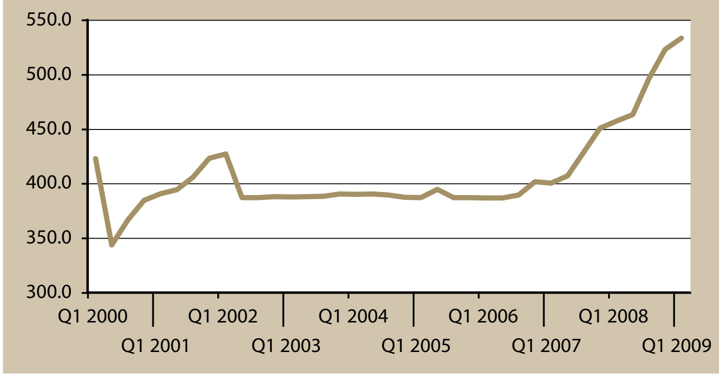


Figure 2: Gold in International Reserves of the Russian Federation



Pricing

In his trading practice, the author has many times been approached by foreigners hoping to purchase gold or silver in Russia at a considerable discount. There seems to be an erroneous belief among the market community that, as the country is one of the world's top producers, metals here should be cheaper than elsewhere. It is perhaps timely to disabuse the Russian market's trading partners of this notion: the Russian Federation became part of the global bullion market more than 10 years ago; therefore, differences in price (or, in other words, location swaps) between Moscow and London, Zurich or other centres are limited by transportation expenses, cost of funding and other similar factors, which usually do not result in substantial differentials.

As a rule, in Russia, the price of a metal is determined on the basis of the London spot market or fixing price. In wholesale trading, quotations are made in terms of a premium or discount to London (expressed as a percentage or, alternatively, in cents per troy ounce). For example, a lot of 10-20 thousand ounces of gold in standard Good Delivery bars sold ex-works refinery located somewhere in Siberia would probably be quoted at a discount of about 20 US cents per ounce; in Moscow, the same lot may be quoted flat or even at some premium. Payments between residents can be made in roubles only, so the final price is calculated through the prevailing market exchange rate. The weighted average rate of the Moscow Interbank Currency Exchange for trades valued "today" or "tomorrow" is usually taken as a benchmark.

It may be interesting to look at the

evolution of location swap differentials for gold and to consider the major driving forces that determine them:

- In 1993-1996, weak industrial and investment demand, combined with still relatively stable mining supply, over-regulation, export restrictions and the reluctance of the official sector to increase gold reserves, created a substantial surplus of metal on the domestic market, which resulted in discounts of several percent compared to the London market price.
- In 1997, the Central Bank started regular purchases of gold and silver from commercial banks, setting its bid at 2% discount, which formed a new benchmark.
- In 1997-1998, with the abolition of state export monopoly, the local prices were governed mostly by export costs and the discount fell rather quickly to 1.0-0.8%.
- In 1999, an export duty of 5% was introduced by the Government, which resulted at first in an increase in the discount (approximately up to 6-7%). In time, however, increased demand from domestic industry (mainly for jewellery), as well as opportunities arising from the regime of duty-free trade with CIS countries, lowered the discount again to less than 3%.
- In 2002, the export duty for gold was removed, and with the continuous rise of the global gold price, easier export regulation and stronger domestic industrial and investment demand, the location swap gradually settled at its present level.

Structure of Demand

Thin (and sometimes negative) margins between the prices of the international and Russian bullion markets resulted from a significant increase in domestic demand during the last few years (Figures 2 & 3). This was based on rising industrial consumption, purchases by the Central Bank and also individual investment activity (buying bars and coins for hoarding).

According to the expert evaluation of the Union of Gold Producers, compared to 2006, domestic industrial consumption of gold rose more than 50% and reached 56 tonnes of fine metal in 2008. For the same period, official gold reserves rose 35% (up to 522 tonnes as of the end of 2008).

Some idea of individual investment activity may be taken from reports of Sberbank of Russia (the Savings Bank of the Russian Federation, wholly owned by the state, which has the largest retail network covering all the country's territory). At the beginning of 2008, the bank announced it had more than 130,000 unallocated bullion accounts – their total balance being equivalent to more than 20 tonnes of gold. As of 1 December 2008, the bank held 280,000 accounts with a total balance of 51.8 tonnes in gold equivalent; by the end of first quarter of 2009, these figures had risen to 334,000 accounts and 54 tonnes in gold equivalent. The bank's total sales of gold bars to individuals for 10 months of 2008 reached six tonnes, which was three times greater than for the whole year 2007. The major share of investment demand is held by gold (70% of total sales), while other metals are less popular: silver takes 17%, platinum 9% and palladium 4% (figure 4).

It should be noted that, under the current regulation, assets kept in an unallocated bullion account are even less protected than common ("monetary") bank deposits, because bullion accounts are not covered by the state deposit insurance programme. In view of this, the scale of individual investments made through unallocated bullion accounts becomes even more impressive.

Bullion coins are very popular too – a replica of the old-time Soviet Chervonets (the "Sower", figure 1 on page 3) was returned to circulation by the Central Bank in 2001 at a 10-rouble face value. The entire issue of 6,565,000 coins (produced between 1975 and 1982) completely sold out a couple of years ago. With 7.742g of fine gold in every coin, that makes 50.8 tonnes of gold bought mainly by individuals. The current investment coin, the 50-rouble golden St. George, is also in real demand at the moment. With such an increase in domestic demand, gold export naturally declined sharply: from 94 tonnes in 2006 to approximately 17-20 tonnes in 2008.

Market Perspectives

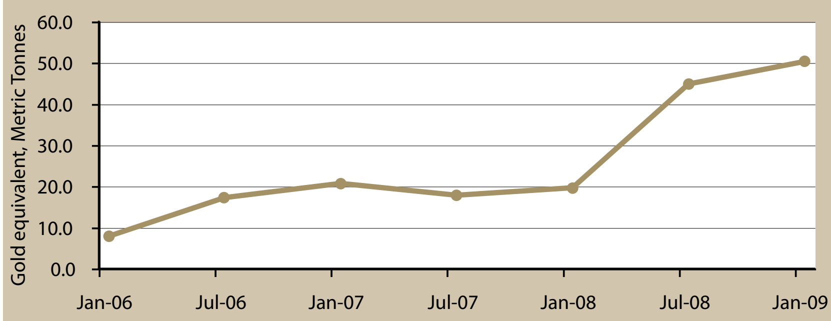
For 2009, however, the outlook is still in question. The recent spike in demand has been based mostly on the effects of general economic growth (in the first half of 2008) and the massive run on savings with the devaluation of the rouble (in the second half of 2008 and beginning of 2009). The sharp fall in disposable income and the substantial[2] increase in the rouble-denominated gold price undermined both industrial and investment demand. In view of this, a decrease in domestic consumption of gold and some increase in exports of gold should be expected for 2009. The Russian Assay House just published their Q1 report on jewellery consumption: gold fell to 10.3 tonnes (down 44.6% on Q1 2008) and silver rose to 56 tonnes (+54.7%). The situation will also depend very much on the official sector, which it is hoped will remain an active buyer. Following the Central Bank, the Government declared its intention to increase purchases of gold through Gokhran of Russia and even to provide producers with partial advance payments in order to replace collapsed financing from commercial banks.

Nevertheless, there is no doubt that due to its integrity with the international bullion market, the market of Russia will provide the required liquidity and service to all its participants and, particularly, to gold producers, hopefully allowing them to benefit from increased global demand for their product. ■

[1] Source: RTS Exchange, www.rts.ru/ru/forts/commodity/

[2] About 30% from average for Q1 2009 to average for Q4 2008.

Figure 4: Balances of unallocated accounts with leading Russian bullion banks (resident clients, excluding banks).



Source: the Central Bank of the Russian Federation

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