The Integrated Foreign Exchange Market in CIS: From Theory into Practice

Alexei Kuprin – Executive Director, International Association of Exchanges of the CIS Countries (IAE CIS). Head of CIS Interexchange Integration, Moscow Exchange. He graduated from the Moscow Finance Institute. He worked at the State Bank of the USSR. Since 2000 he is an Executive Director of the International Association of CIS Countries (IAE CIS). Sphere of scientific interests: the processes of regional integration of the exchange infrastructure and CIS financial markets.
E-mail: Kuprin@micex.com

Victoria Mishina – Candidate of economic science, Chief Specialist, Currency Market Development, Moscow Exchange. Graduated from the Lomonosov Moscow State University, Faculty of economy; postgraduate course at the Central Institute of Economics and Mathematics, Russian Academy of Sciences. She is the author of over 35 scientific papers, including articles published in Money and Credit, Problems of Forecasting, Stock Market and other financial and economic periodicals. Sphere of scientific interests: macroeconomic conditions and prospects for development of financial markets, monetary and exchange rate policy, monetary and financial integration and rouble’s international role.
E-mail: MishinaV@micex.com

1. CREATING THE INTEGRATED FOREIGN EXCHANGE MARKET: BACKGROUND

For a long time the CIS exchanges and the International Association of Exchanges of the CIS Countries (IAE CIS) have been taking steps to set up an...

---

1 The International Association of Exchanges of the CIS countries (IAE CIS) was set up in Moscow in 2000 in order to coordinate the development of organised financial markets in accordance with international standards. At present, IAE CIS has twenty member institutions, including 19 leading exchanges and one depository, from nine CIS countries. The Moscow Exchange Group is an integrated exchange structure, which includes foreign exchange, money, stock, futures and commodity markets. It was set up in December 2011 as a result of the merger of Russia’s two leading exchange groups – MICEX and RTS. The Group includes the Moscow Exchange MICEX-RTS (“Moscow Exchange”), the MICEX Stock Exchange, the National Clearing Centre, the National Settlement Depository and other institutions.
integrated foreign exchange market (IFEM). On April 25, 2003 the Council of the CIS Heads of Governments approved the blueprint for the establishment of an integrated foreign exchange space, which was proposed by the Moscow Interbank Currency Exchange (MICEX) and IAE CIS. This document provided for the creation of an IFEM in the CIS with minimal costs. The idea was to launch a mechanism of cooperation between central/national banks and currency/stock exchanges in the CIS, which would make it possible for these countries’ commercial banks to become direct participants in a single foreign exchange space.

For various objective reasons (primarily because of the accession by some CIS countries to the WTO) this project had been suspended for some time before being restarted in 2010. In May 2012 the heads of the CIS governments approved the Blueprint for the Liberalisation of the Financial Services Market with the aim to simplify foreign exchange transactions and enhance cooperation between the CIS stock markets. On December 5, 2012 the Council of the CIS Heads of States signed the Agreement on Cooperation in the Establishment of an Integrated Foreign Exchange Market, which set forth the basic terms for providing CIS banks with equal access to the national foreign exchange markets of other CIS countries for the conduct of interbank foreign exchange transactions. The agreement envisages that each country should provide those banks from other countries that are entitled to conduct foreign exchange transactions with access to its national foreign exchange market on terms which are no less favourable than those provided to its resident banks.

The EurAsEC has a positive experience of adopting a similar IFEM Agreement. It was signed on January 25, 2006 and is already being used in exchange practices.

Organisational difficulties were caused by the lengthy approval and signature process and the need to adopt additional bylaws that were not included in the base agreement. In November 2009 resident banks of the EurAsEC countries that had joined the IFEM Agreement were provided with access to the Moscow Exchange currency market. However, the key condition for making this access available to a resident bank is the existence of an additional interinstitutional agreement on cooperation in the area of organising interaction between and providing informational support to IFEM participants between the Bank of Russia and the central/national bank of the respective EurAsEC member state. In 2010 these interinstitutional agreements were made between the Bank of Russia and the national banks of Kyrgyzstan, Belarus and Tajikistan. A similar agreement was signed with the National Bank of the Republic of Kazakhstan in April 2012. These instruments provide broad opportunities to ensure that EurAsEC/CIS banks mutual access to the integrated market.
2. THE MEANING AND ADVANTAGES OF IFEM

The debt crisis in a number of Eurozone countries made the benefits of integration somewhat doubtful. IMF Managing Director Christine Lagarde believes that this should be overcome. A more integrated and intertwined global economy can be very useful. However, new risks can emerge where finance has a global nature while the architecture for ensuring system stability remains predominantly national (Lagarde, 2012).

The financial and economic crisis has clearly shown the similarities in the behaviour of the CIS economies in stressful situations and fostered integration processes. In 2011 Russia’s foreign trade with the CIS countries grew by 34%, to $122.6 billion, and its share in Russia’s overall trade turnover increased to 14.9%.

Regional integration mechanisms form a new international financial architecture and promote global financial stability. A regional mechanism helps to overcome the disorganisation of intraregional trade and investment flows caused by problems in small countries and thereby maintain general stability in the region (Kawai, Lombardi, 2012).

A single foreign exchange and financial space provides the CIS countries with an opportunity to more easily resolve certain challenges that are significantly harder to tackle when they act on a stand-alone basis. These include:

- the creation of high-capacity national financial markets with a diverse set of instruments and a gradual movement towards an integrated market;
- the strengthening of national currencies and the improvement of their role in domestic money circulation and mutual settlements, including a gradual reduction of the role of the US dollar;
- the creation of a single exchange space that promotes the free movement of investments in the CIS and an increase in cross-border payments in national currencies (including the rouble).

The advantages of the IFEM include the following:

- a reduction in foreign exchange risks as a result of the use of up-to-date exchange risk management systems;
- an increase in transparency and market liquidity and in the stability of the rates of exchange following the participation in trade organised by national banks (including central ones);
- a reduction in foreign trading participants’ transaction costs as a result of the exclusion of intermediate currencies (the dollar and the euro) and the formation of narrow spreads in national currencies once all interested parties are involved in the trading.
3. THE DEVELOPMENT OF FOREIGN EXCHANGE MARKETS IN CIS AND PRECONDITIONS FOR IFEM CREATION

In 2009–2011 a number of important statutes were adopted to simplify foreign investors’ operations in the Russian market and official agreements on the Single Customs Tariff and the Customs Code of the SES of Russia, Belarus and Kazakhstan were signed. The SES member states devised the Agreements on the creation of conditions in financial markets to ensure the free movement of capital and on the Agreed principles of the foreign exchange policy. These instruments provide the necessary preconditions to the development of integration processes in foreign exchange sphere and mutually beneficial cooperation between financial institutions.

The Bank of Russia, within the framework of the Agreement on the informational support to the Agreed principles of the foreign exchange policy, has already begun to publish on its website summarised data on the status of and outlook for the domestic foreign exchange market, specifying transactions in the national currencies of Belarus and Kazakhstan. In the first quarter of 2013 the average annual volume of foreign exchange transactions closed by Russian banks exceeded $62 billion, however transactions with the national currencies of the CIS countries accounted for less than 1% of this.

<table>
<thead>
<tr>
<th>Exchanges</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Baku Interbank Currency Exchange (BBVB)</td>
<td>1.9</td>
<td>1.9</td>
<td>2.8</td>
<td>2.5</td>
<td>0.9</td>
<td>1.3</td>
<td>0.9</td>
</tr>
<tr>
<td>Belarusian Currency and Stock Exchange (BCSE)</td>
<td>10</td>
<td>10.6</td>
<td>18.7</td>
<td>14.1</td>
<td>21.2</td>
<td>17</td>
<td>30</td>
</tr>
<tr>
<td>Kazakhstan Stock Exchange (KASE)</td>
<td>41.7</td>
<td>91.4</td>
<td>138.9</td>
<td>67.7</td>
<td>106.9</td>
<td>106.2</td>
<td>96.1</td>
</tr>
<tr>
<td>Moscow Exchange</td>
<td>955.9</td>
<td>1,494.3</td>
<td>2,680</td>
<td>3,001.9</td>
<td>2,616.3</td>
<td>2,901.2</td>
<td>3,760.5</td>
</tr>
<tr>
<td>NASDAQ OMX Armenia</td>
<td>0.4</td>
<td>0.9</td>
<td>1.1</td>
<td>1.1</td>
<td>0.8</td>
<td>0.8</td>
<td>0.8</td>
</tr>
<tr>
<td>IAE CIS</td>
<td>1,010.7</td>
<td>1,600.5</td>
<td>2,843.4</td>
<td>3,087.3</td>
<td>2,746</td>
<td>3,026.4</td>
<td>3,888.3</td>
</tr>
</tbody>
</table>

Table 5.1. Foreign exchange transactions at IAE CIS exchanges ($ billion)

Source: IAE CIS, 2013

According to IAE CIS, in 2012 the foreign exchange trading volume of the association’s members grew by 28%, to $3.9 trillion (see Table 5.1). The Moscow Exchange accounted for almost 97% of the total foreign exchange turnover at IAE CIS. In 2012 the Moscow Exchange’s FX market grew by 35% and this year by another 13%. In April the average daily trading volume exceeded $20 billion (see Figure 5.1). The access to this highly liquid and technologically advanced segment opens broad opportunities for their CIS counterparts.
Electronic foreign exchange markets are developing in a very dynamic fashion. They are also being modernised in a number of areas such as the advancement of technologies, the expansion of the customer base and the strengthening of regulations. New electronic systems appear in the global market that challenge conventional interdealer platforms and provide access to the foreign exchange market for a growing number of institutional and private investors. This requires that respective changes be made to the regulatory framework in order to reduce risks and protect new categories of investors.

The American and European regulations governing OTC transactions (the Dodd-Frank Act and the MIFID) tend to favour organised markets. The new regulatory terms envisage the use of centralised clearing mechanisms and recommend that, among other things, transactions with standardised OTC instruments be effected in electronic/organised floors and compulsory reporting on OTC transactions be prepared.

The Russian laws are being subject to no less serious modifications. On January 1, 2012 the Federal law on organised trading took effect, setting the requirements for organisers and participants and the basic conditions of governmental control, as well as the Law on clearing and clearing activities, governing the creation of a central counterparty and a close-out netting mechanism in the Russian financial market. In 2013 governmental supervision is expected to include the brokerage foreign exchange market and other sectors of the non-banking financial market that remain unregulated at present. Experts are convinced that the adoption of a relevant law should make the relationships between brokers and clients more transparent and restrict the access to the market for unfair participants (Marich, 2012).
4. EXCHANGE INITIATIVES TO CREATE IFEM

An IFEM in the CIS will provide banks and financial companies with additional opportunities to enhance foreign trade and the flows of capital and labour. An organised foreign exchange market can be effectively regulated by national supervisory authorities. The Moscow Exchange considers this a promising project and is cooperating with interested partners from IAE CIS in order to ensure comprehensive use of the advantages of exchanges compared to the OTC, or unorganised foreign exchange market.

Figure 5.2.
Geographical breakdown of Russian interbank (a) USD/RUB spot transactions and (b) EUR/USD swap transactions, by non-resident counterparty’s location (January 2013, %)

The National Clearing Centre has been operating as the central counterparty in the Russian foreign exchange market since late 2007. The advantages of the Moscow Exchange’s FX market are high performance trading, clearing and settlement platforms, the continuous double auction, the market depth order book and settlement completion guarantees.

The CIS exchanges have similar priorities in their development: the improvement of corporate governance and risk management systems, the launching of the T+n settlement scheme, the use of the partial pre-deposition of funds and the launching of clearing through a central counterparty and more. All these factors make the integration of the CIS exchange market an important objective, one which envisages the creation of a single technological, trade, clearing and settlement space in the CIS and can produce synergetic effects in various areas of the financial sector.

The CIS countries have already occupied a certain niche in the Russian foreign exchange market. According to the Bank of Russia, in the geographical breakdown of interbank transactions closed by non-residents, those from the CIS accounted for 5-10% of cash transactions and 2-4% of USD/RUB FX swaps in 2012. In the EUR/USD pair the share of Russian banks’ transactions with counterparties from the CIS countries was even higher. For swap FX transactions, for example, it stood at more than 25% in January 2013 (see Figure 5.2).

These data confirm that interexchange integration projects to provide mutual accesses to non-residents are in demand and that the formation of a regional financial centre is realistic.

4.1. Direct Access for EurAsEC/CIS Banks to Exchange Market

In accordance with the EurAsEC Agreement on Cooperation in Organising an Integrated Foreign Exchange Market, the Moscow Exchange is implementing a project to provide banks from the EurAsEC countries with access to trading at the exchange. In 2012 Interstate Bank (which has international status) was provided with access to trading and made its first transactions at the exchange.

In order to provide EurAsEC banks with access to the exchange and ensure their operations at it, a number of regulatory, organisational and technological issues needed to be resolved, including taxation for non-resident participants, the dispute resolution procedure, access technology and the selection of electronic data protection tools. After all the necessary agreements had been signed by the central banks of the EurAsEC countries, the Moscow Exchange launched pilot projects to open the exchange to Belarusian, Kazakh and Kyrgyz banks.

At present Russia has restrictions on the export of cryptographic data protection (CDP) tools that are used in trading terminals and electronic document...
management (EDB) systems by the Moscow Exchange’s FX market. In practice this restricts non-resident banks’ access to foreign exchange. To tackle this problem, the Moscow Exchange decided to use alternative CDP tools, the export of which from Russia is not restricted (Microsoft CSP).

In January 2013 an access roadmap and process schemes to include EurAsEC banks in trade were completed. A second contour of exchange systems was developed for foreign banks to ensure the closure of transactions and data protection at the foreign exchange market.

On February 7, 2013 the Moscow Exchange provided access to its FX market for EurAsEC banks from Belarus, Kazakhstan, Kyrgyzstan and Tajikistan. Belarusian BPS-Sberbank was the first foreign bank to test the new exchange instruments, get access to trading and begin to conclude transactions in the IFEM. Another three Belarusian banks and one Tajik bank are in the process of getting access to trading. The exchange is also conducting a proactive search for the first pilot banks from Kazakhstan and Kyrgyzstan.

At the ceremony of opening the IFEM at the Moscow Exchange, Timur Suleimenov, Minister for Economy and Financial Policy of the Eurasian Economic Commission, said, “The integrated foreign exchange market project, which is being successfully fulfilled, is a vivid demonstration of the effectiveness of cooperation between interstate authorities, central and national banks and exchanges of our countries in forming a single foreign exchange space. I would like to note specifically that as a result of the project fulfilled by the Moscow Exchange participants get an opportunity, for the first time in the framework of the SES, to enter the integrated financial market with a licence from its national regulator and without the need to obtain a Russian foreign exchange licence” (MICEX, 2013).

4.2. Sponsored Direct Market Access

At present, non-resident CIS banks can also operate at the Moscow Exchange by making use of Sponsored direct market access, i.e. through Russian participants. They also have the opportunity to involve clients from their countries (via sub-broker accounts). The Direct Market Access (DMA) system provides non-resident clients with direct online information from the exchange, including quotations, and with the ability to become the clients of FX market participants as well as enter orders and conclude transactions through them.

The exchange launched a fully-featured DMA system with the ability to register clients in the trading system on February 13, 2012. The new access technology brought a significant increase in client activity. In 2012 the value of client transactions in Moscow Exchange’s currency market totalled RUB 12.3 trillion and the number of clients grew from 12 to 3,500. By the end of 2012 client transactions exceeded 12% of the foreign exchange market as a whole and 22% of spot transactions. DMA enhances the liquidity of the exchange due
to the involvement of new categories of participants, including non-residents, brokers and individuals. By April 2013 the number of clients exceeded 5,000 (see Figure 5.3).

![Figure 5.3. Client transactions (RUB billion) and the number of clients registered in the Moscow Exchange's currency market](image)

Until recently only Russian subsidiaries of foreign banks were allowed to trade at the exchange, accounting for 25% of the foreign exchange market. Now non-residents can engage in trading at the Moscow Exchange using DMA.

![Figure 5.4. Foreign exchange market turnover by categories of participants/clients 2012 (%)](image)
In 2012 non-resident transactions exceeded 10% of the total turnover of the foreign exchange market (see Figure 5.4). In the first quarter of 2013 a total of 150 non-resident clients from twelve countries, including Kazakhstan, Belarus, Ukraine, Latvia and Estonia, operated at the exchange via DMA. The first non-resident client from EurAsEC (Kazakhstan) joined the exchange in the summer of 2012.

**4.3. MORE SETTLEMENTS IN NATIONAL CURRENCIES: THE POSITIVE EXPERIENCE OF LAUNCHING CNY/RUB TRADING AT EXCHANGE**

The exchange began to trade the CIS national currencies in the 1990s. Over this period the trade in national currencies at MICEX ranged from very active, with a peak in 1998, to very weak, reducing to almost no trade in 2008-2009.

The relaunching of trading in CIS national currencies requires that primary liquidity exists. This means that CIS banks should be present at the exchange and play the role of market makers for their national currencies. Cooperation is needed with central/national banks from the CIS countries in order to determine reliable settlement banks and potential market makers for the respective currencies.

The Moscow Exchange has a positive experience in trading national currencies without using the dollar. In late 2010 it began to trade CNY/RUB. Russia and
China are taking joint measures to develop the infrastructure to make mutual settlements in national currencies. In June 2011 the Bank of Russia and the People’s Bank of China signed an agreement on making settlements in national currencies. In September 2011 the People’s Bank of China permitted Russian participants in the CNY/RUB segment at the Moscow Exchange to open special accounts in China.

This market is growing dynamically: in 2012 CNY trading volumes at the Moscow Exchange grew by more than 70% compared to 2011. About eighty banks took part in transactions, including five banks that operated as market makers (with two Chinese banks among them). In the first quarter of 2013 the volume of trading in CNY increased by 40% year-on-year (see Figure 5.5).

The exchange considers trading in CNY as a promising direction in the development of the financial market. Since April 15, 2013 the Moscow Exchange has been implementing a new project to align the conditions of trading in CNY with those applicable to its leading currency pairs (USD/RUB and EUR/RUB). In particular, it introduced a scheme of the partial deposition of funds and the use of CNY as collateral, as well as new instruments and swap transactions, increased the duration of trading and reduced tariffs. On the day the new terms were made effective seventeen banks took part in trading in CNY and concluded a total of 43 transactions worth CNY 16.5 million (RUB 83.8 million). The first transactions with new instruments and CNY/RUB swap transactions were concluded by the Bank of China (Elos), ICBC (Moscow), My Bank, Levoberezhny Bank and Vostochny Bank (Yarovoi, Mishina, 2013: 43-45).

The development of the CNY/RUB market at the exchange is of significant macroeconomic importance, as it makes it possible to effect settlements under Russian-Chinese contracts in national currencies and helps to strengthen the international role of the rouble.

**CONCLUSION**

Russia continues to build an up-to-date financial infrastructure in accordance with the world standards, with the aim of creating an international financial centre. In November 2012 the Federal Financial Markets Service assigned the National Settlement Depository (NSD, 99% of which is owned by the Moscow Exchange) the status of a central securities depository. This has become an important milestone in the advancement of the Russian financial market. The provision of the central registrar functions to the central securities depository will allow it to operate in line with the global standards and will significantly reduce the risks to participants. This should considerably enhance non-residents’ trust in the Russian market. In the future liquidity increase and reduction of settlement costs are expected, as all market participants will conduct transactions in a single post-trading platform.
The Bank of Russia plans to expand the time of operation of its online express payment system and expects that in a year it will be operationally ready to include the rouble in the list of the CLS (Continuous Linked Settlement) currencies (Interfax, 2012).

The launching of the IFEM, the use of the infrastructure of neighbouring countries by its participants and the availability of direct quotations for national currencies should improve the effectiveness of EurAsEC/CIS financial markets and foster their full integration with the global system. The positive experience of cooperation between CIS exchanges indicates that it is possible to set up a regional financial centre. The components of its infrastructure could be placed in different EurAsEC/CIS countries yet remain united in a single system of exchange trade, clearing and settlements.

REFERENCES


