RUSSIAN INSTITUTIONAL INVESTORS AND PRIVATIZATION POLICY

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The resources of pension and investment funds for mobilizing domestic savings are particularly important in attracting investment and carrying out large-scale privatization considering restrictions associated with the sectoral sanctions. With all the limitations and disadvantages, the existing non-state pension funds and mutual funds managed by private companies have significant potential in dealing with problems of domestic savings provided stable macroeconomic environment is maintained.

In current conditions, citizens' domestic savings are one of the key sources of attracting investment. However, to transform citizens' savings into investments, it is necessary to improve the work of those financial institutions that are responsible for ensuring reliable operation of collective investment. In various countries, non-state pension and mutual funds usually act as such intermediaries. As a rule, they are called institutional investors.

Over the past decade, since 2005, there has been a steady increase in savings in private non-bank financial institutions in Russia (*Table 1*). Assets of open-end and interval mutual funds increased from 69 billion rubles in 2005 to 131 billion rubles as of June 2016. Over the same period, assets of closed-end mutual funds grew even more significantly – from 163 billion rubles to 2,262 billion rubles respectively, as well as pension savings in non-state pension funds – from 2 billion rubles to 2,023 billion rubles, pension reserves in non-state pension funds – from 278 billion rubles to 1,044 billion rubles. Overall, from 2005 to June 2016, the size of citizens' domestic savings in non-state pension funds and private asset management companies grew 11-fold: from 0.5 trillion rubles to 5.5 trillion rubles, reaching 6.8% of GDP.

Table 1

PENSION SAVINGS AND MUTUAL FUNDS MANAGED BY PRIVATE ASSET MANAGEMENT COMPANIES

	2005	2010	2015	2016 (half-year)
Billion rubles				
Open-end and interval mutual funds	69	121	133	131
Closed-end mutual funds	163	336	2249	2262
Pension savings in non-state pension funds	2	155	1720	2023
Pension savings in asset management companies	6	20	41	40
Pension reserves in non-state pension funds	278	643	992	1044
Total	518	1275	5134	5499
% GDP				
Open-end and interval mutual funds	0.3	0.3	0.2	0.2
Closed-end mutual funds	0.8	0.7	2.8	2.8
Pension savings in non-state pension funds	0.0	0.3	2.1	2.5
Pension savings in asset management companies	0.0	0.0	0.1	0.0
Pension reserves in non-state pension funds	1.3	1.4	1.2	1.3
Total	2.4	2.8	6.4	6.8

Source: authors' calculations based on the data provided by the Bank of Russia, Federal State Statistics Service, Pension Fund of the Russian Federation, and the National League of Asset Management Companies.

However, the volumes of domestic savings accumulated by institutional investors are not sufficient for investment and economic growth in the country; their size is much smaller than the potential for collective investment not only in developed but also in many developing countries. As shown in Table 2, open-end and interval mutual funds' share of GDP in Russia remained practically unchanged for 10 years from 2005 to 2015, accounting for only about 0.2% of GDP. At the same time, the comparable mean value in the group of the largest non-European Anglo-Saxon countries increased from 70.1% of GDP in 2005 to 96.8% in 2015; in all European countries – from 37.7 to 65.1%, respectively; in the group of "Asian Tigers" – from 20.0 to 45.9%; in BRICS countries – from 9.4 to 14.1%.

Table 2

OPEN-END INVESTMENT FUNDS IN RUSSIA AND OTHER GROUPS OF COUNTRIES*, % OF GDP

	2000	2005	2010	2015
USA, Canada, Australia	68.7	70.1	84.2	96.8
Europe	34.5	37.7	47.0	65.1
Japan, South Korea, Hong Kong, Singapore, Malaysia	13.4	20.0	32.0	45.9
BRICS	6.9	9.4	13.5	14.1
Rest of the world	2.6	7.0	6.7	5.9
Russia	0.1	0.3	0.3	0.2

* The average is calculated as the quotient of the total net asset value of mutual funds in different countries by the total cost of GDP.

Source: authors' calculations based on the data provided by ICI, World Bank's WDI, and the countries' national statistical data.

Russia also lags considerably behind most OECD member countries by the size of pension savings correlated with the scale of the economy (*Table 3*). Despite the "freezing" of pension savings that has been going on for the third year in a row since 2014, their overall size in Russia increased from zero in 2005 to 4.7% of GDP in 2015, including in non-state pension funds – up to 2,1%. However, this is significantly less compared to mean values of the share of pension fund assets in OECD member countries, which rose from 27.9% of GDP in 2005 to 37.0% in 2015.

Table 3

PENSION SAVINGS IN RUSSIA AND OECD MEMBER COUNTRIES, % OF GDP

	2000	2005	2010	2015
OECD countries mean value	**27.90**	**27.85**	**30.60**	**36.96**
Including:				
Canada	60.94	63.88	71.42	90.98
Chile		59.89	68.25	69.48
Czech Republic		3.9	5.76	8.16
Denmark		32.0	49.4	74.64
Germany	5.05	9.90	13.72	16.79
Hungary	2.85	8.42	15.06	4.25
Ireland		45.2	48.2	43.12
Japan	15.9	30.80	29.20	32.03
South Korea		1.8	3.48	8.75
Netherlands	104.57	114.48	125.23	183.33
New Zealand		11.1	13.4	23.00
Norway	6.54	6.72	7.03	10.12
Poland		8.7	15.56	7.97
Sweden	3.92	11.97	17.33	26.57
Switzerland	88.78	96.18	92.53	110.50
USA	83.19	86.79	97.11	101.00
Russia – total savings		**0.85**	**1.98**	**4.67**
Russia – savings in non-state pension funds		**0.01**	**0.34**	**2.13**

Source: authors' calculations based on the data provided by OECD and the Bank of Russia.

As shown in *Table 4*, in the general structure of owners of most financial instruments in Russia, domestic institutional investors still play a modest role. But in such financial assets as corporate and regional bonds, non-state pension funds even now occupy a solid position as investors. The share of pension savings in non-state pension funds in the structure of corporate bond owners rose from 0.8% in 2007 to 11.9% in June 2016; over the same period, their share in the structure of sources of regional bonds increased from 2.0 to 10.8%. In recent years, it was non-state pension funds that acted as the main driver of the growing domestic market of corporate and regional bonds. During the period from 2007 to June 2016, the capitalization of ruble corporate bonds rose from 1.3 to 8.4 trillion rubles, or 6.7-fold; the cost of regional bonds rose from 0.2 to 0.6 trillion rubles, respectively, or 2.5-fold.

On the contrary, investment of institutional investors in stock as risky assets remains moderate. The share of mutual funds in the total capitalization of Russian issuers' stocks decreased from 1.0% in 2007 to 0.2% in 2015, while the share of savings of non-state pension funds in the same period, having increased from 0.02 to 0.8%, remains generally insignificant. In the absence of domestic institutional investors' interest in increasing investment in the shares of Russian companies, total capitalization of shares in Russia declined from 38.4 trillion rubles in 2007 to 31.7 trillion rubles in June 2016, that is, by 17.5%.

Underdevelopment of institutional investors in Russia is due to different factors. An important one is institutional investors' low portfolio return. As shown in *Table 5*, during the 10-year period from 2005 to 2015, the average portfolio return of pension savings in non-state pension funds and mutual fund types most popular among domestic private investors was lower than inflation as well as returns of federal loan bonds and mixed model portfolios. This was due not only to the high cost of asset management and problems with the effectiveness of institutional investors, but also, perhaps even more, to the low yield and high volatility of financial instruments such as shares, "junk" corporate and regional bonds. Inflation remained high. However, in 2013–2015, the situation began to improve gradually. During the 3-year period, bond mutual funds began to outperform inflation, and in 2015, all

Table 4

SHARE OF PENSION AND MUTUAL FUNDS INVESTMENT IN THE VALUE OF FINANCIAL ASSETS IN RUSSIA

	2007	2008	2009	2010	2011	2012	2013	2014	2015	6 months of 2016
Mutual funds' share in assets										
Bank deposits	0.90	0.68	0.49	0.22	0.28	0.34	0.61	0.37	0.31	
Corporate bonds	0.81	0.61	0.60	0.67	0.61	0.63	1.08	0.72	0.81	
Government securities	0.01	0.14	0.12	0.10	0.36	0.88	1.08	0.48	1.27	
Regional bonds	0.00	0.09	0.01	0.00	0.00	0.00	0.01	0.01	0.01	
Shares	1.03	0.38	0.66	0.63	0.41	0.34	0.26	0.18	0.15	
Share of mutual funds' pension savings in assets										
Bank deposits	0.01	0.04	0.15	0.19	0.52	1.18	1.43	1.02	0.87	1.02
Corporate bonds	0.81	0.93	1.11	2.52	5.14	5.45	7.61	6.70	10.02	11.93
Government securities	0.36	0.35	0.50	0.56	0.68	1.16	1.41	1.17	1.29	1.04
Regional bonds	2.01	1.65	2.20	3.03	5.65	10.72	12.53	12.04	12.51	10.76
Shares	0.02	0.04	0.03	0.04	0.12	0.13	0.21	0.39	0.79	0.83

Source: authors' calculations based on the data provided by the Bank of Russia, Federal State Statistics Service, and Moscow Exchange.

the considered pension savings portfolios and open-end mutual funds did it. Thus, in a relatively stable macroeconomic situation which implies moderate (up to 5%) inflation[1], the absence of high devaluation shifts and external shocks in relation to business, non-state pension funds' and mutual funds' portfolio investments are beginning to show positive real return and become attractive to the mass private investor. Of course, all this does not exclude, but rather reinforces the need to fine-tune the regulation of institutional investors' activity directed at maintaining competition between them and enhancing their performance.

Table 5

AVERAGE YIELD ON PORTFOLIOS OF NON-STATE PENSION FUNDS, CERTAIN CATEGORIES OF MUTUAL FUNDS AND BENCHMARKS AS OF 01.01.2016

	1 year	3 years	5 years	10 years
Pension savings in non-state pension funds*	11.16	7.44	5.98	8.29
Open-end mutual funds (stocks)**	28.65	8.51	0.18	5.24
Open-end mutual funds (bonds)**	20.99	9.83	8.01	6.23
Open-end mutual funds (mixed investment)**	22.05	8.04	2.17	4.84
MICEX Index	26.12	6.10	0.85	5.71
RTS Index	-4.26	-20.85	-15.63	-3.89
Federal loan bonds yield	11.46	9.11	8.56	8.12
Inflation	12.9	10.23	8.66	9.51
MICEX – 50% / Federal loan bonds – 50%	18.79	7.79	4.93	9.81
MICEX – 70% / Federal loan bonds – 30%	21.72	7.16	3.35	9.06
MICEX – 30% / Federal loan bonds – 70%	15.86	8.36	6.43	9.71

* Non-state pension funds' yield is not free of costs to pay for the services of management companies, specialized depositaries and fund maintenance costs. The yield in 2005–2008 is indicated based on the data by the Association of Non-State Pension Funds.

** The average yield of the relevant categories of mutual funds was calculated taking into account the profitability of both the funds operating as of 01.01.2016 and the funds that had been liquidated in 2006–2015.

Source: authors' calculations based on the data provided in the financial statements of mutual funds' management companies, the Bank of Russia, and Moscow Exchange.

As an illustration of the positive processes going on in the field of portfolio management, *Fig. 1* shows the rates of return and portfolio risks of different categories of investors in the Russian stock market, according to 2015 data. Marked by black dots on the graph are the potential portfolios of pension savings in non-state pension funds with regard to the existing restrictions on composition and structure of different asset classes (e.g., equity investments may not exceed 65% of asset value of savings in non-state pension funds). Marked by light gray dots are a set of portfolios that are potentially available for unskilled private investors. Rectangular dots represent actual portfolios of various types and categories of mutual funds in 2015, and the gray area is the area of mutual funds' potential portfolios that could be composed of the assets available to them. The letters in the chart refer to the list of assets which were available in 2015 to private investors and non-state pension funds, namely:

1 In various countries, pension funds steadily bring positive real return only provided the country's annual inflation rate is less than 4.5%. See: A. Abramov, A. Radygin, M. Chernova, K. Akshentseva. Effectiveness of Pension Saving Management: Theoretical and Empirical Aspects // Voprosy Ekonomiki. 2015. № 7. P. 26–44.

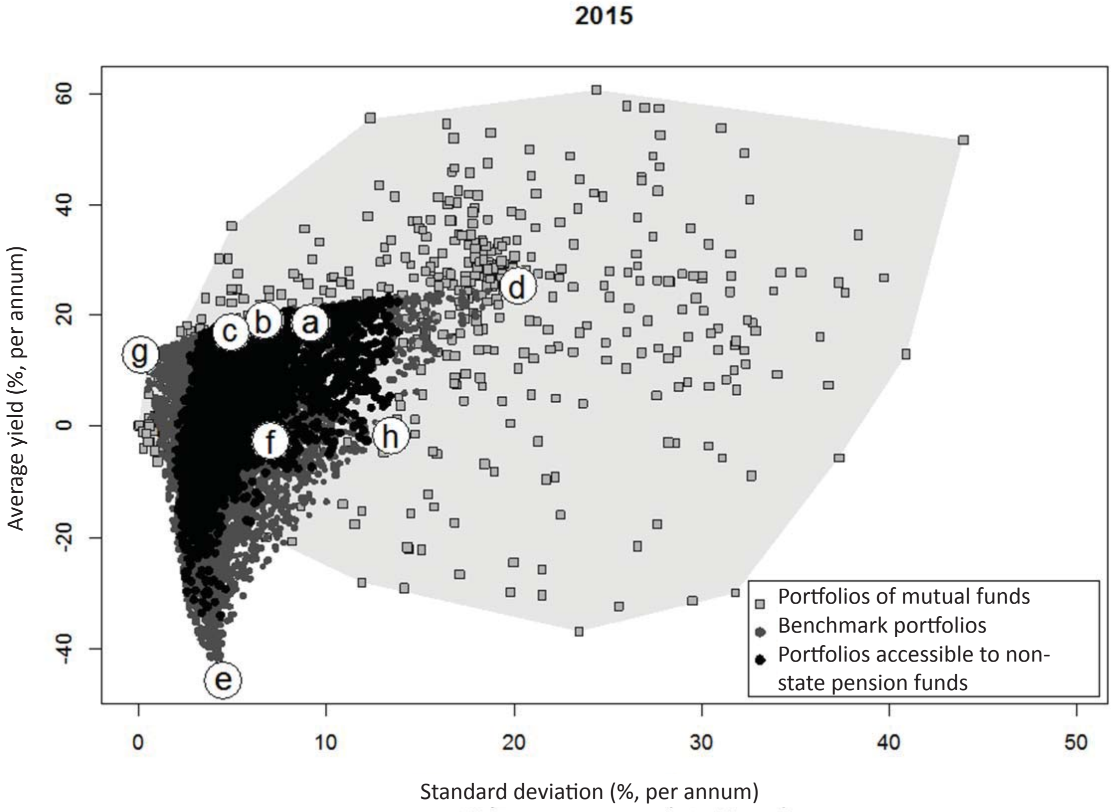

Fig. 1. Sets of potential portfolios of pension savings of non-state pension funds, mutual funds and private investors with regard to the existing restrictions on the composition and structure of assets for certain categories of investors as exemplified by 2015 data

a – Russian Government Bond Index on the Moscow Exchange;
b – Cbonds-Muni Index;
c – Corporate Bond Index on the Moscow Exchange;
d – MICEX Index;
e – Price Index for Real Estate in Moscow;
f – Interest Rate on Deposits – IMF source;
g – "Overnight" Interest Rate;
h – MSCI World Index.

Thus, the fields of portfolio solutions as exemplified by 2015 data show (*Fig. 1*) what results in profitability and risk could be reached by private investors who directly invest in different classes of financial assets, as well as institutional investors represented by non-state pension funds and mutual funds management companies – with regard to the existing restrictions on the composition and structure of assets. The graph shows that investing in mutual funds (square dots) is able to significantly enhance the potential of private investors' (gray dots) and non-state pension fund pension savings' (black dots) portfolio investment in terms of the optimal combination of risk and return. At the same time, removing artificial restrictions on the structure and composition of non-state pension fund saving portfolios, such as the ban on investment in certain mutual funds or foreign securities, could significantly increase the attractiveness of pension portfolios to members of the pension system[1].

1 The attractiveness of mutual funds for implementing investment strategies of pension funds and private investors has been investigated in more detail through the example of vari-

One of the important efficiency criteria for institutional investors' activity is a measure of the inflow of new funds from private investors. Unfortunately, the "freezing" of pension savings in 2014–2016 significantly limited the inflow of new money into non-state pension funds, which has had a negative impact on domestic demand for stocks and bonds. At the same time, the relative stabilization of the macroeconomic situation in Russia that was achieved in 2015 despite the sanctions, led to the fact that since July 2015, for the first time in a long period, there has been a steady inflow of new funds of investors into open-end mutual funds (*Fig. 2*). However, to secure this success, it is not enough just to change the external parameters of the market's risks and returns. It is important that the process of interaction between individuals and institutional investors be cost effective and ensure that the shares of different mutual funds and non-state pension funds are accessible for citizens. For this, fine regulation of the activity of finance and investment product sellers is needed, promoting competition between them and their interest in introducing advanced technology and sales methods, in particular moving from the sales model aimed at mainly «in-house» products to the use of an open sales architecture when the investor gets access to financial products of different manufacturers through one vendor.

As a resource for Russia's domestic stock market growth, one should primarily rely on the funds of domestic investors. As shown in *Fig. 3*, the behavior of private investors in investment funds that invest in stocks and bonds of Russian issuers differs significantly. Since September 2013, foreign private investors have been steadily withdrawing money from foreign investment funds that specialize in investment in Russian companies' shares[1]. The

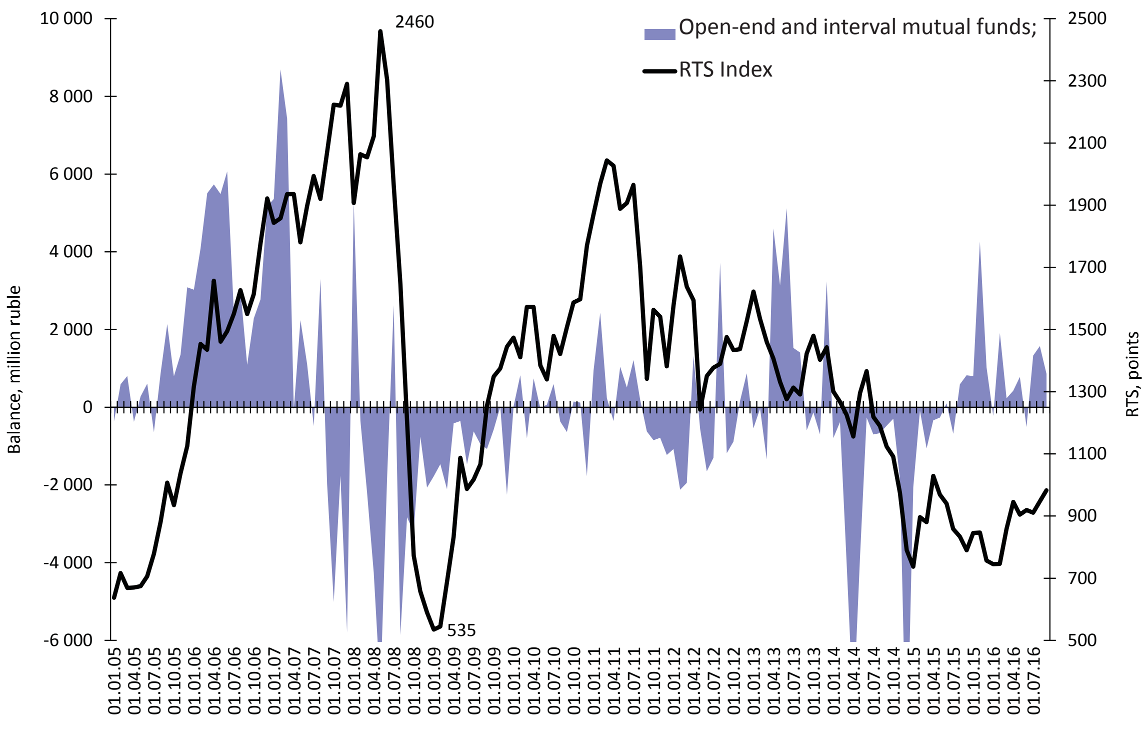

Fig. 2. Cash flows of private investors in open-end mutual funds in Russia

ous countries. See: Abramov A., Radygin A., Akshentceva K. Mutual Funds Performance in Russia // Economic Policy. 2015. № 4, August. P. 60–86.

1 EPFR publishes statistics on these funds weekly. In this case, foreign funds specializing in investment in Russian joint-stock companies' shares are meant (Russia-dedicated funds).

behavior of this category of investors is usually cyclic: they bring in new funds amidst the apparent underestimation of the internal market and withdraw them at the first signs of devaluation of the local currency or economic slowdown. However, in the past three years, it coincides with the behavior of investors of Russian mutual funds dealing with shares, who are so far mostly oriented at withdrawing funds. A completely different behavior is observed with domestic Russian investors at the market of mutual funds dealing with bonds, where since the beginning of 2015, as the macroeconomic situation has stabilized, a significant inflow of new investment in mutual funds has been observed (see *Fig. 3*). This shows that private investors closely follow the situation with different types of financial assets and are sensitive to positive signals associated with the formation of conditions for the growth of investment profitability and reducing market volatility.

Thus, the rapid development of domestic institutional investors is currently particularly important not only for the growth of the stock market, but also for the achievement of economic policy objectives. Gradually, institutional investors become the key intermediaries who accumulate long-term domestic savings of individuals, one of the most important sources of investment. Non-state pension funds and private management companies, among other things, are promising actors in the privatization of Russian companies with public ownership, as well as agents with the largest interest in spreading the best corporate governance practices in companies.

Based on the potential development of the program of denationalization of the Russian economy, there is an obvious problem of imbalance on the supply side (relatively marketable securities of companies waiting for privati-

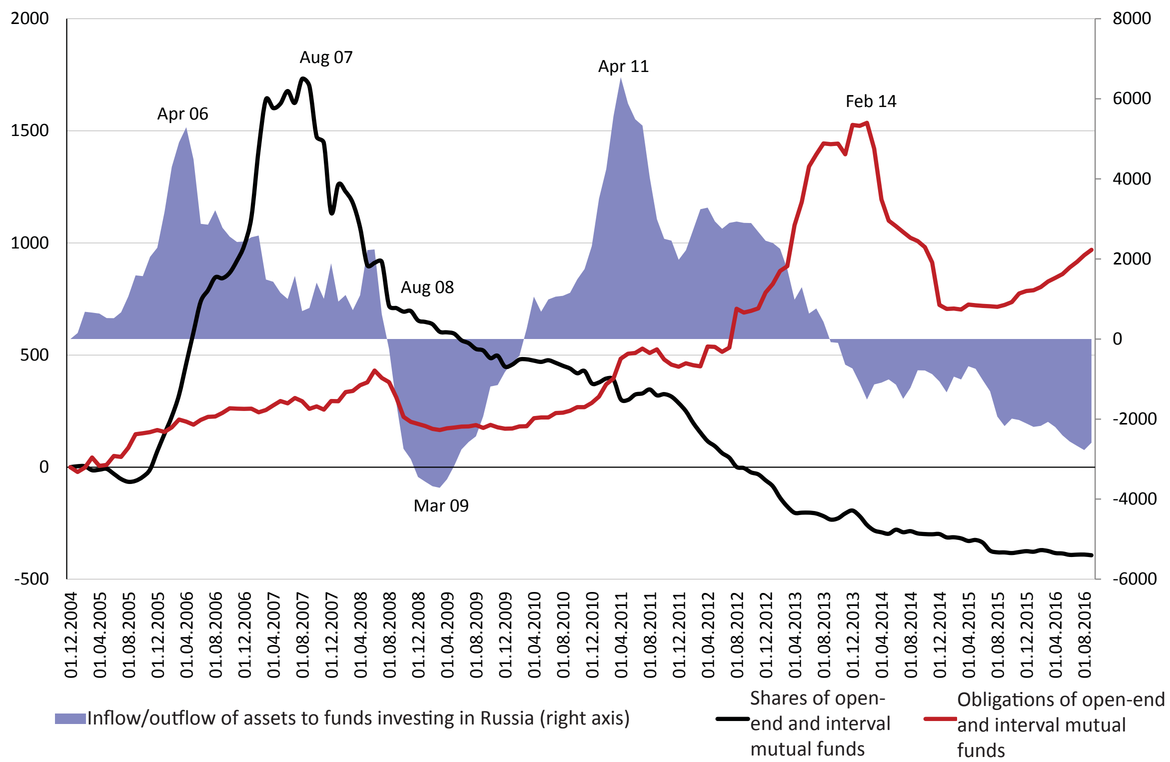

Fig. 3. Comparative analysis of the behavior of private investors in Russian mutual funds and foreign investment funds that specialize in investment in Russian companies' shares, for the period from December 2004 to September 2016 (million dollars, December 2004 = $0)

zation, IPOs of largest companies and banks, including those in the process of restructuring of corporations with public ownership and development institutions, subsidiaries and affiliates, non-core assets, institutions, treasury, primarily land and other real estate, investment in the development of privatized assets) and on the side of funding sources (equity capital that has increased in 5–6 years, but stayed "bond", internal loans that are barely accessible to "ordinary" customers due to the high cost and corruption problems, foreign borrowings limited at the moment due to sanctions, domestic savings of the population).

If one tries to abstract from all variants of participation of state-owned corporations and vertically integrated systems, largest companies and banks with state participation in the privatization (as buyers who indirectly have priority access to the financial resources of the state), then one can so far only talk mostly about international financial markets. However, competition among national governments willing to implement certain privatization projects becomes extremely high again.

During 2012–2015, most governments directly or indirectly initiated programs of denationalization of assets worth $813.25 billion. Since January 2009, the total volume of privatization proceeds (including the post-crisis re-privatization) exceeded $1.3 trillion, which is much more than in any comparable period since the times of Margaret Thatcher who opened the way to the modern era of privatization in 1979[1]. New privatization plans affect countries in almost all regions of the world, although targets may vary significantly: strategic and/or structural considerations, purely tactical steps (ideology, budget replenishment means), increasing efficiency of the economy, etc.

High competition (sanctions limitations) in international financial markets and the lack of domestic financial resources may lead to a return to pseudo privatization (through state-owned companies and banks). This leads to the conclusion that successful denationalization policy depends on a whole complex of solutions that lie in the area of system development of institutional environment, investment climate and financial system in Russia. First of all, we are talking about a "moratorium" on the expansion of the government sector, easing restrictions on foreign investment in strategic sectors, property rights guarantees and law enforcement in general, stimulating domestic long-term investment sources, including collective investment institutions and stock technologies. It is clear that encouraging the development of institutional (collective) investors depends on the overall institutional environment to the same extent as effective denationalization.

From the viewpoint of development prospects of the Russian corporate governance model, internal institutional investors could become an important "player" in boards of directors (supervisory boards) not only in private joint-stock companies, but also in companies with state participation, the so-called "strategic core" potentially remaining in state ownership. For these companies, the model of maximization of state interest (both short- and long-term) is now typical, with all the costs of the majority model of corporate control, including discrimination against minority shareholders and the corresponding weak incentives to enter the open financial markets. It appears that it is institutional investors that could act as "liaisons" in the model of "positive

1 Data by Privatization Barometer, 2014–2015 (www.privatizationbarometer.net).

conflict" (long-term strategic interests of the state – short-term commercial interests of minority shareholders) in the modified "influence – independence – awareness" coordinate grid. In this sense, institutional investors are the drivers of not only attracting domestic investment, but also of improving the efficiency of the real sector economy enterprises.