SUMMARY

1. External and internal risks of the economy and financial system

In Q4 2018-Q1 2019, the situation in emerging market economies (EMEs), including Russia, has improved since the release of the previous review for Q2-Q3 2018. Currently, there are three major factors influencing the dynamics of the global financial markets.

– Firstly, the risks of global economic growth slowdown are increasing. According to the IMF, the growth of world GDP in 2018 slowed down to 3.6% (in 2017 - 3.8%). At the same time, the financial authorities of the advanced economies (first of all, the US and the eurozone) revised their 2019 economic growth forecasts downwards. Growth rates of the Chinese economy have declined to the lowest point over the long period.

– Secondly, there is still uncertainty regarding the central banks policies in the advanced economies. In December 2018, the US Federal Reserve still intended to increase the interest rate and to reduce its balance sheet, what significantly differed from the market expectations. Under these conditions, there was a significant decline in stock indices. In the first quarter of 2019, the US Federal Reserve and the ECB decided not to raise interest rates during the 2019 due to the risk of economic growth slowdown. That led to an increase in investor risk appetite and capital inflows into the emerging markets. Currently, the financial markets and the US Federal Reserve still differ in their estimates of the interest rate dynamics (market indicators are based on the assumption that the US Fed will decrease the interest rate at the end of 2019). The further rhetoric of central banks of the advanced economies will largely determine the volatility of capital flows.

– Thirdly, the importance of international economic and geopolitical factors is increasing. Intensifying trade disputes between the United States, China and other countries may lead to a reduction in global trade volumes and have a serious impact on inflation, consumer sentiment and ultimately on global economic growth. Brexit can have a tangible impact on market stability as well (this question remains open, taking into account the postponement of British exit from the EU until 31 October 2019), and the oil prices dynamics – on the developments in Iran and Venezuela.

Materialisation of certain risks can cause volatility in global markets. Volatility can also be amplified by the vulnerabilities accumulated in the jurisdictions. These vulnerabilities are primarily associated with the debt burden, which has increased over a long period of loose monetary policy of the advanced economies' central banks. In advanced economies, there is a concern regarding the increase in lending to companies with high debt burden. In such cases, debt accumulation is often associated not with the investment activates of the borrower, but the mergers and acquisitions (M&A), including LBO/MBO. At the same time, countries with developed markets may now face limited space in macroeconomic policies to support economic growth. Since the beginning of 2008, EMEs have experienced a significant increase in external debt levels, and in some countries (Turkey, Chile, Argentina, South Africa, Indonesia) it is several times larger than the accumulated international reserves.

The stability of the Russian economy to external challenges in recent years has increased due to improvements in fundamental macroeconomic indicators (a decrease in inflation, a transition to a budget surplus, an increase in the current account surplus, a decrease in external debt, an increase in international reserves). However, geopolitical risks associated with a possible tightening of sanctions still exist.

The domestic problems of the Russian economy can also pose a risk to the Russian financial system. In Q1 2019, the real disposable income of the population continued to decline (by 2.3% YoY), while the debt burden is growing rapidly. Income stagnation may have a negative impact on the quality of consumer loans.

2. Vulnerabilities of the financial system

• **The rapid growth of the population debt burden against the backdrop of accelerated growth of consumer lending**

The growth in consumer lending has stabilised at a high level: as of 1 April 2019, the annual growth rate of total amount of mortgages reached 24.7%, of unsecured consumer loans - 24.3%. In 2019, the debt service ratio (the ratio of loan payments to the cumulative disposable income of all households) for unsecured loans may reach its peak level of 2014 (9.0%). Further stagnation of real income of the population can lead to an increase in non-payments of consumer loans. In the first quarter of 2019, in the mortgage market, the share of loans with a small down payment (less than 20%) remained high (42.0%). The down payment on a mortgage loan reflects the financial condition of the borrower and his ability to save money. Loans with a small down payment are characterised by a higher level of credit risk of the borrower and are potentially vulnerable to a decrease in real income of the population.

Sustainability factors and actions taken

Unsecured consumer lending. Starting from 1 April 2019, in order to limit risks in the unsecured consumer lending and to stimulate banks to create capital buffers, the

Bank of Russia increased capital add-ons (risk-weights) for consumer loans with effective interest rate from 10% to 30%. If excessive growth rates of consumer lending persist, add-ons for unsecured consumer loans, depending on the effective interest rate, can be further increased taking into account the value of payment to income ratio, which banks will be obliged to calculate starting from 1 October 2019.

Mortgage. In Q4 2018, the Bank of Russia increased risk weights for mortgage loans issued after 1 January 2019, with LTV from 80 to 90%. As a result, the share of such loans in Q4 of 2019 decreased from 42.9% to 40.7%. The quality of mortgage loans, including those for new houses, still remains high. The share of overdue debt on such loans does not exceed 0.4% as of 1 April 2019.

Risks of dollarization and dependence on external financing

Crisis developments in the Russian market in 2008–2009 and 2014–2015, as well as cases of other countries (Turkey as one of the most recent examples) show that substantial dollarization of the banks' balance sheets and high dependence of the national economy on external financing are factors of vulnerability of the financial system.

Dollarization of the deposits of individuals

As inflation declined and after the transition to a floating exchange rate regime, the attractiveness of FX borrowing and FX savings in Russia decreased. However, in Q4 2018-Q1 2019, the process of reducing dollarization of the balance of the Russian banking sector was partially halted. In terms of assets, the reduction of FX loans continued (to legal entities-residents - by 16%, to non-financial organisations as a whole - by 10%), but the volume of swaps and interbank loans in foreign currency increased. The reduction of liabilities to non-residents continued, but the growth of FX deposits of corporates and individuals resumed. The share of deposits of individuals in foreign currency in the total volume of deposits of individuals in Q1 2019 increased from 20.3% to 21.5% (eliminating the exchange rate revaluation[1]).

Sustainability factors and actions taken

In order to gradually stimulate the reducing dollarization tendency, the Bank of Russia considers raising the mandatory reserve requirement for FX liabilities to individuals. Additionally, the proposal for amending the current legislation on deposit insurance to reduce the marginal deviation of interest rates on FX deposits from the base rate of return, over which banks pay additional and increased additional insurance premiums, is being discussed.

[1] Based on the rate of the Bank of Russia on 03.30.2019.

Dependence on foreign investors

Russia's total external debt has continued to decline (since the beginning of 2016 to 1 April 2019, total external debt decreased by 10% to $467.8 billion, corporate debt – by 8% to $317.9 billion, banks' debt – by 38%, to $82.3 billion) and now is fully covered by gold and foreign currency reserves ($490 billion). Nevertheless, in 2018, the Russian market faced the risks associated with its sensitivity to the behavior of foreign investors: the OFZ returns (and, as a consequence, other interest rates) were affected by the non-residents selling OFZ caused by the discussions of potential US sanctions. In 2018, the share of foreign investments in total public debt decreased from 33.1% to 24.4%. However, in Q1 2019, against the backdrop of high oil prices and a significant risk appetite of international investors, the volume of non-residents' investments in OFZ increased by 256 billion rubles; the share of non-residents' investments in OFZ in the total market volume as of 1 April was 26.7%.

Sustainability factors and actions taken

The Russian OFZ market stability is determined by the low level of total public debt (14.6% of GDP as of 1 January 2019), a relatively small proportion of non-residents (27% in Russia, in comparison: South Africa — 40%, Indonesia – 38 %, Mexico – 32%) and the high demand for OFZ from domestic financial institutions (non-government pension funds, life insurance companies and banks). In the event of high volatility, the Bank of Russia may impose a moratorium on the revaluation of securities in their portfolios.

- **Increase in banks' short-term funding**

The vulnerability of the banking sector is associated with a high sensitivity to liquidity and interest rate risks against the backdrop of a significant share of short-term borrowings. In general, in all currencies, the share of legal entities' deposits with a term of up to 1 year exceeded 60% in the second half of 2018 and continued to grow; for individuals it stabilized at 60%. At the same time, while ruble operations showed a slight upward trend in the share of long-term deposits, the share of short-term deposits in foreign currency significantly increased over the past year: for individuals - from 37% to 48%, for legal entities - from 22% to 26%. The increase in the share of short-term liabilities is also connected with the current environment (expectation of lower interest rates) and does not pose a threat in the short term. As of 1 January 2019, the actual values of the structural liquidity ratio (net stable funding ratio)[2], that ensures that stable sources of liabilities for funding of the assets and off-balance sheet liabilities are sufficient, ranged from 102% to 177%, the average value was 115%. In the long term, it is advisable to increase the share of long-term funding sources.

[2] The minimum allowed value of the structural liquidity ratio is 100%.

A high share of short-term liabilities increases the vulnerability of the banking sector to liquidity risk. Nevertheless, liquidity risks in the Russian banking sector are limited given the fact that highly liquid assets are sufficient to meet the LCR requirement. At the same time, some banks resort to the use of irrevocable credit lines as an additional option to comply with the ratio. In order to strengthen the incentives for banks to comply with the LCR requirement by forming a portfolio of highly liquid assets, the Bank of Russia decided to phase out the possibility to use this tool[3].

Sustainability factors and actions taken

In order to stimulate long-term savings of the population and reduce the risks of the banking sector, a new instrument has been introduced to the market since June 2018 - a bank deposit agreement certified by a savings certificate, the terms of which do not include the depositor's right to receive deposit on demand. Currently, the Bank of Russia is working on improving this tool. In particular, adjusting the terms of registration of conditions for issuing of certificates is being considered.

• **The growing concentration of the banks' loan portfolio in some of the largest borrowers characterised by high debt burden**

In general, the debt burden of Russian non-financial organisations (46.9% of GDP) is at an average level (Brazil - 40.6%, India - 45.7%, South Africa - 39.3%, Turkey - 69.2% , China - 157.1%), however, it is traditionally concentrated in the largest companies (92 public companies account for 35% of the total debt). These borrowers are characterised by high debt burden indicators (the median value of net debt to equity ratio is close to 80%, interest coverage ratio is close to 3). In recent years, there has been an increase in the concentration of loans issued by the Russian banks to the largest borrowers (since 1 January 2016 to 1 January 2019, the volume of loans issued to the largest borrowers[4] increased by 68%). In case of a stress scenario (for example, a decline in commodity prices), companies with a high debt burden may face substantial difficulties in servicing and refinancing their debt. This may have a negative impact on the stability of the national financial market.

Sustainability factors and actions taken

The Bank of Russia has issued a consultation report on the identification of the companies with high debt burden. Moreover, the Bank of Russia intends to monitor the exposures of the largest banks to the liabilities of such companies. At the next

[3] Since 1 May 2019, the fee for the right to utilise a newly opened irrevocable credit line has been increased from 0.15% to 0.5% per year. A single schedule has also been established to reduce the maximum number of individual limits for each bank. This will reduce the total number of utilised lines to zero by 1 May 2022.

[4] The credit requirements for 25 companies for which at least one bank had the extent of exposure to credit risk, corresponding to the total amount of credit claims of the bank to the borrower used in calculating the N6 requirement, exceeded 100 billion rubles as of 1 January 2019.

stage, the Bank of Russia may implement higher add-ons for loans to companies which debt burden is significant at the systemic level and characterised by a low ability to service accumulated debts.

3. Assessment of the sustainability of the banking sector

The profit of the banking sector in 2018 reached a record high level of 1.3 trillion rubles. The profit of credit institutions, excluding banks undergoing the financial recovery process, increased by 30%[5] to 1.8 trillion rubles mainly as a result of an increase in net interest income (by 344.4 billion rubles, or 14%) as well as net fee and commission income (by 189 billion rubles, or 21.3%). The profitability of the banking business continues to rise: as of 1 April 2019, during the previous 12 months, the return on assets increased from 1.0% to 1.8%, and the return on equity – from 8.5% to 15.9%. As of 1 April 2019, the ROA of banks that were not undergoing the financial recovery over the same period increased from 2.0% to 2.4%, while their ROE increased from 15.5% to 19.3%. The capital adequacy ratio of credit institutions remains at a stable level (14.6% with the exception of banks undergoing the financial recovery), while the capital buffers increased due to higher risk weights (up to 0.6 p.p. of capital adequacy of the banking sector[6]). In such conditions, the counter-cyclical capital buffer is kept at 0%.

4. Assessment of the sustainability of non-credit financial organisations

The risks of life insurers, which in recent years strengthened their positions on the investment market for individuals (the volume of life insurance provisions as of 31 December 2018 amounted to 3.1% of deposits of individuals on the same date), remain at an acceptable level due to high quality of assets. At the same time, the accumulated capital surplus of companies continues to decline, and the dynamics of premiums show signs of a slowdown (the quarterly increase in premiums in Q4 2018 was 26.7%, decreasing by 20.8 p.p. compared to the same period in 2017). The key risk is still the widespread practice of misseling - the number of complaints against life insurers has increased by 75% compared to the year of 2017. For non-life insurers, there has been an improvement in the results of both insurance and investment activities. The reform of the compulsory motor third party liability insurance (OSAGO) remains important for the situation in this segment.

The risks of non-government pension funds (NPFs) have substantially decreased over the past few years with the growth in the quality of their assets. At the same time, because of the materialisation of the previously accumulated credit risks, NPFs have shown low returns on the portfolio of pension savings. The requirement to guarantee the break-even results of investments of pension savings may force the

[5] Compared to the profit of credit institutions excluding banks that undergone the financial recovery in 2017.
[6] If the buffers to risk weights were reduced to zero, the capital adequacy of the banking sector would be higher by 0.6 p.p.

pension funds to utilize their own capital. At the same time, the situation is mitigated by the presence of a five-year horizon for calculating the break-even level. Moreover, increase in minimum capital requirements for NPFs up to 200 million rubles from 1 January 2020 will contribute to the financial stability of the industry.

At the end of 2018, about 40% of brokers reported losses, including those arising from the transition to a new accounting system in accordance with the requirements of the Industry Accounting Standards. Market risks were at acceptable levels: the securities portfolio for the industry as a whole consisted mainly of high-class assets. One of the main risks in the broker-dealer sector is liquidity risk. To protect clients in the financial market, the Bank of Russia plans to introduce a threshold value for the indicator of short-term liquidity.