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The Central Bank of the Russian Federation

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BANK OF RUSSIA FOREIGN EXCHANGE ASSET MANAGEMENT REPORT

Moscow

Bank of Russia
Foreign Exchange Asset Management Report
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FOREWORD

This issue of the Bank of Russia Foreign Exchange Asset Management Report presents the results of foreign exchange asset management in April 2015 – March 2016.

Due to global financial markets' high price sensitivity to the actions of major market participants, including the Bank of Russia, data on Bank of Russia operations on foreign exchange asset management are published at least six months after the end of the reporting period.

Information on Bank of Russia foreign exchange assets is also published in the Bank of Russia Annual Report (data on foreign exchange reserve assets and gold assets) and on the website of the Bank of Russia (data on Russia's international reserves). Please note that any difference in the data provided between the reports is due to data composition and calculation methodologies only.

Terms shown in the text in italics are defined in the glossary.

Please send any feedback, including comments and suggestions regarding the contents of the report and data presentation to reservesmanagement@mail.cbr.ru.

PRINCIPLES OF FOREIGN EXCHANGE ASSET MANAGEMENT AND FINANCIAL RISK MANAGEMENT

The Bank of Russia's foreign exchange assets include government and non–government bonds of foreign issuers, deposits and nostro accounts balances, *reverse repo* operations, Russia's net position with the IMF, Russian Eurobonds and other claims on counterparties. These assets are denominated in US dollars, euros, pounds sterling, Canadian and Australian dollars, yen, *Special Drawing Rights (SDR)*, Swiss francs, and yuan (hereinafter, foreign currencies). Foreign securities purchased by the Bank of Russia through reverse repo transactions are excluded from the total volume of foreign exchange assets.

The objective of foreign exchange asset management is to ensure the best balance between the safety, liquidity and profitability of assets.

For the purpose of management, foreign exchange assets are grouped into single–currency portfolios. To assess the efficiency of the management of single–currency portfolios their returns are compared to *benchmark portfolio* returns.

Foreign exchange asset management takes into account the Bank of Russia's liabilities in foreign currencies (balances on foreign currency accounts of clients, mainly *government funds*). Foreign currency holdings expose the Bank of Russia to financial risks, such as credit risk, foreign exchange risk, interest rate risk and liquidity risk.

Credit risk means the risk of counterparties or issuers defaulting on their obligations to the Bank of Russia. Credit risk is constrained by various limits and requirements for the credit quality of counterparties and issuers, which must have a minimum *credit rating* of A under the Fitch Ratings and Standard and Poor's classifications and a minimum rating of A2 under the Moody's Investors Service classification.

Foreign exchange risk means the probability of a decrease in the value of net foreign currency assets (assets net of liabilities) due to foreign currency exchange rate movements. The Bank of Russia limits the level of foreign exchange risk by specifying a benchmark currency structure of net foreign exchange assets with target weights of eligible currencies and the limits of their deviations.

Interest rate risk is the probability of a decrease in the value of foreign exchange assets due to any unfavourable changes in interest rates.

The level of interest rate risk for the Bank of Russia's assets portfolios is measured by *duration*. The interest rate risk exposure is limited by setting the minimum and maximum durations allowed in each of the eligible currency portfolios. Additionally, the maturities of eligible securities, deposits and repo operations are limited.

Liquidity risk means the risk of losses due to insufficient funds to cover Bank of Russia current liabilities in foreign currencies. In order to lower this risk, the volume of liquid assets in each currency is maintained at a level exceeding the volume of liabilities in the same currency. The most liquid assets are government securities, which are the major component of foreign exchange assets. Sources of liquidity also include nostro account balances, credit lines, short–term deposits and repo operations, as well as cash inflows from coupon payments and redemptions of securities denominated in foreign currencies.

The Bank of Russia pays interest on the foreign currency accounts balances equal to the rate of return on indices composed of foreign countries' bonds. The Bank of Russia makes interest payments in rubles. Since the Bank of Russia has the right to issue currency, these obligations don't expose it to interest rate and liquidity risks.

The Bank of Russia has a multilevel collective system for investment decision–making.

The Bank of Russia Board of Directors sets the objectives of foreign exchange asset management, the list of eligible investment instruments, and the target level of foreign exchange risk.

The Bank of Russia Committee in charge of investment strategy sets the levels of interest rate and credit risks and approves the lists of eligible counterparties and issuers.

The adopted investment decisions are implemented by the authorized divisions of the Bank of Russia. External managers are not involved in foreign exchange asset management.

MACROECONOMIC TRENDS IN APRIL 2015 – MARCH 2016

The foreign currency exchange rates and government securities yields in major developed economies throughout the period under review were primarily driven by the ongoing sovereign debt problems in certain euro area member states, the China slowdown and *quantitative easing* (QE) programmes in euro area and Japan as well as by continued slump in oil prices.

USA and Canada

In June–September 2015, the Fed revised its forecasts on the US economy downward (given negative spillovers from global financial market turbulence and weakening EM economies).

In December 2015, the Fed concluded that the conditions for a hike stipulated in March were finally met and opted for an increase in the target range for the Federal funds rate by 0.25 pp to 0.25–0.50%.

In 1Q16, the FOMC abstained from raising the Fed funds rate further and substantially lowered the appropriate level of the rate for the end of 2016. The result was a correction in the US dollar, which weakened relative to other major currencies, and lower rates for US Treasuries with longer maturities.

In July 2015, the BoC lowered the key rate by 0.25 pp to 0.50% for the second time that year. It happened amid still falling investments in the energy sector and inflation howering near 2%.

Canadian economy moved out of a technical recession in 3Q15: its GDP grew by 2.3% after declining for two consecutive quarters. In order to sustain the economic recovery the budget with large fiscal stimulus was approved by the new Canadian government, thus reducing the necessity for the BoC to lower rates further. This supported the strengthening of the Canadian dollar relative to the US dollar, which was already underway given the recovery in oil prices in 1Q16.

Europe

In June 2015, Greece missed the IMF payment amounting to 1.6 bn euros. The government announced a national referendum on 5 July on the issue of accepting international creditors' demands. Despite the fact that the population of Greece rejected the international creditors' conditions, the government introduced its own reform agenda containing only minor differences from these conditions.

Credit risk growth in the euro area contributed much to the weakening of the euro against the US dollar in the first half of the year.

In February 2016, the UK government announced a referendum on the issue of the country's membership in the European Union for 23 June. The reason for the referendum had been the growing discontent of the population over the EU migration policy and toughening banking sector regulation. The concern over the exit of the UK from the EU and breaking economic relations with other European countries caused the depreciation of the pound sterling against the US dollar in late 2015 – early 2016.

Chart 1. Changes in exchange rates to the US dollar, as % of start of period

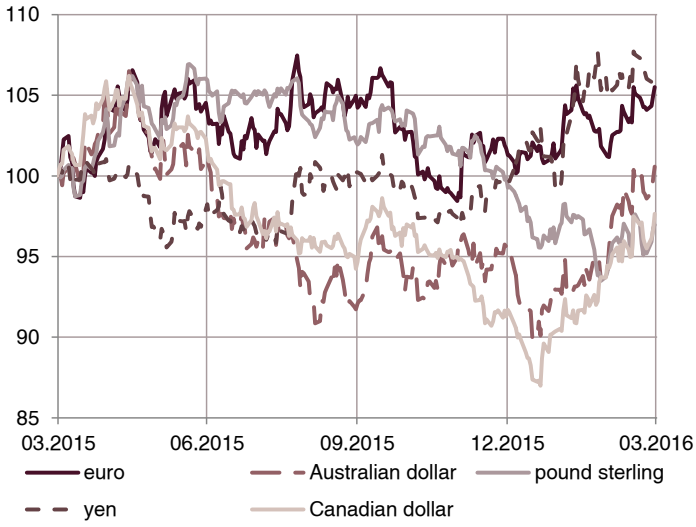
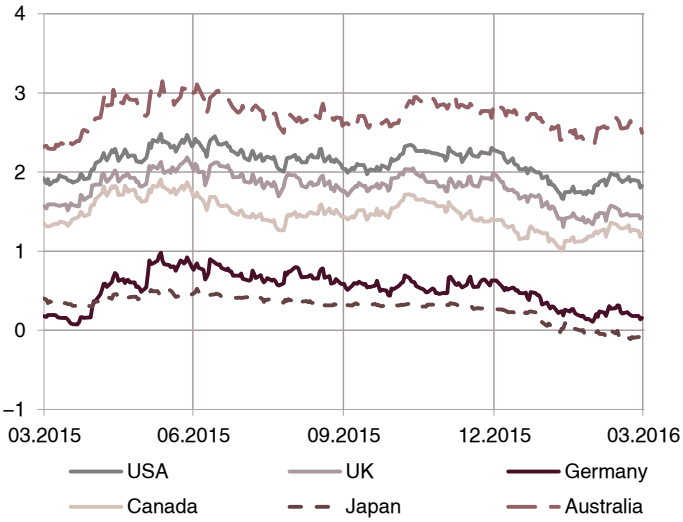


Chart 2. Yields to maturity on 10–year government bonds, % p.a.



In March 2016, the European Central Bank (ECB) cut the main refinancing rate to 0% and the deposit facility rate to –0.4%. The monthly purchases under the asset purchase programme were expanded from 60 bn to 80 bn euros, investment grade euro–denominated bonds issued by non–bank corporations in the euro area were included in the list of eligible assets. Moreover, a new series of targeted long–term refinancing operations (TLTRO II) has been launched since June 2016. These measures matched the market expectations and didn't cause significant euro depreciation.

In June 2015 and February 2016, the Riksbank lowered the repo rate from –0.25% to –0.35% and –0.50% respectively.

Australia and Asia

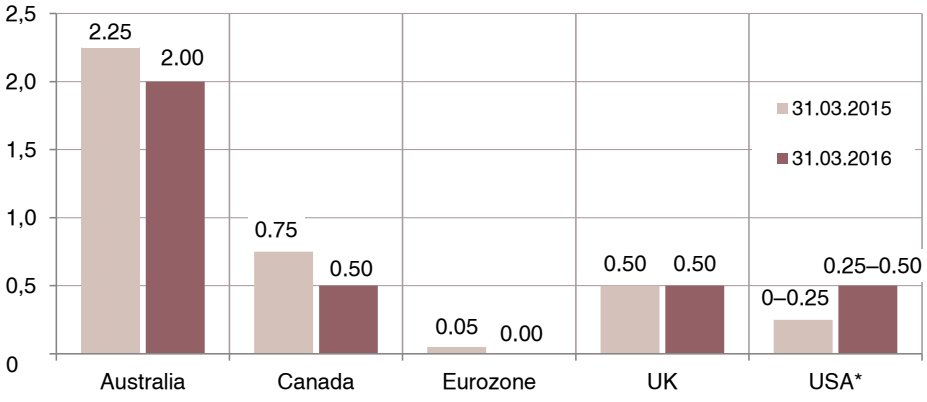
After the first rate cut (since 2013) in February 2015, the Reserve Bank of Australia (RBA) cut its key rate again in May 2015 by another 0.25 pp to 2%. The motivation for the decision was mainly the same as with the February cut, i.e. the weak growth of internal demand, overvalued Australian dollar and decline in inflation.

The lack of clear plans for fiscal consolidation and poor macroeconomic performance forced Fitch rating agency to cut the sovereign rating of Japan from A+ to A in April 2015, while the rating cut of Standard & Poor's rating agency was from AA– to A+ in September 2015.

In mid–February 2016, the Bank of Japan adopted negative interest rate on reserves that exceeded required ones in order to stimulate credit to real sector and to combat the decline in inflation.

During the period from April 2015 to March 2016, the People's Bank of China (PBoC) cut its key rates four times. As a result of these cuts, both one–year benchmark lending rate and one–year deposit rate were lowered by 1 pp to 4.35% and to 1.5% respectively. Also, deposit reserve ratio for major banks was cut four times over the same period, from 19.5% to 17.0%. These actions can be explained by the attempts of economic authorities to revive moderating growth by monetary measures. In August 2015, the PBoC announced a new and more market–oriented rule for CNY mid–rate setting. Since then, the mid–rate was determined by the previous trading day closing rate. The new rule was accompanied by one–off devaluation of the Chinese currency by 3%. At the end of 4Q, the PBoC completed process of interest rates liberalization by abandoning deposit rate ceiling.

Chart 3. Central banks key rates, % p.a.



* The Fed funds target rate was 0–0.25% as of 31 March 2016 and 0.25–0.50% as of 31 March 2016.

FOREIGN EXCHANGE ASSET MANAGEMENT IN APRIL 2015 – MARCH 2016

In the period under review, Bank of Russia foreign exchange assets increased by $10.1 billion to reach $343.6 billion (Table 1). The major driver of the growth was currency interventions on the domestic foreign exchange market (Chart 4). The increase of foreign exchange assets was also due to foreign currency exchange rate movements against the US dollar (Chart 1).

In April 2015 – March 2016, the government and non–government securities portfolios increased as well as the amount of deposits and nostro account balances with the Bank of Russia (Table 1).

In the period under review, the amount of foreign currency refinancing operations decreased twofold.

Chart 4. Changes in foreign exchange assets in April 2015 – March 2016, billions of US dollars

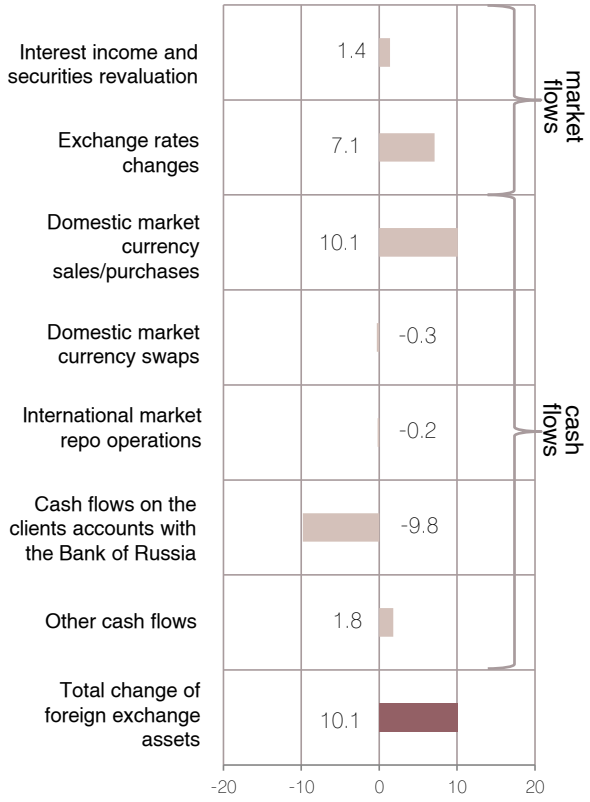


Table 1. Foreign exchange assets by asset class

Foreign exchange assets	As of 31 March 2015		As of 31 March 2016		Change in April 2015 – March 2016, billions of US dollars
	billions of US dollars	Share of foreign exchange assets	billions of US dollars	Share of foreign exchange assets	
Government securities	253.9	76.1%	267.0	77.7%	13.1
Deposits and account balances	42.3	12.7%	43.6	12.7%	1.3
Non–government securities	3.8	1.1%	13.1	3.8%	9.3
Net position with the IMF	2.6	0.8%	2.0	0.6%	–0.6
Reverse repo operations	0.4	0.1%	1.1	0.3%	0.7
Claims on counterparties on foreign currency supply	0.0	0.0%	0.2	0.1%	0.2
Claims on Russian credit institutions under foreign currency repo operations and loans	30.4	9.2%	16.6	4.8%	–13.8
Total*	333.5	100%	343.6	100%	10.1

* The total value may differ from the sum of asset classes values due to rounding.

Chart 5 shows the actual currency structure of foreign exchange assets as of 31 March 2016. Assets denominated in US dollars and euros retained the dominant position in the structure.

Chart 6. Geographical structure of foreign exchange assets as of 31 March 2016

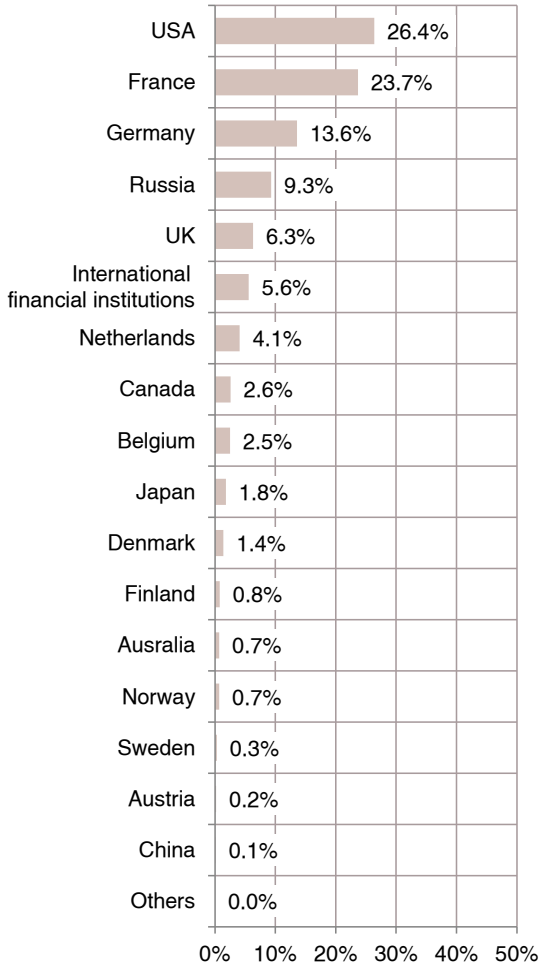


Chart 6 shows the geographical structure of foreign exchange assets by location (place of residence) of legal entities that are counterparties and issuers of the securities included in foreign exchange assets. Russia's location in the geographical structure at the fourth position was a result of Bank of Russia transactions on liquidity provision to Russian credit institutions in foreign currency (repo transactions and loans in foreign currency).

Chart 5. Foreign exchange assets by currency as of 31 March 2016

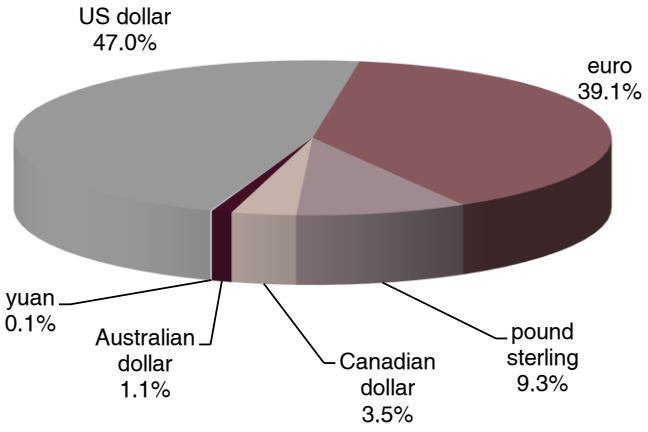
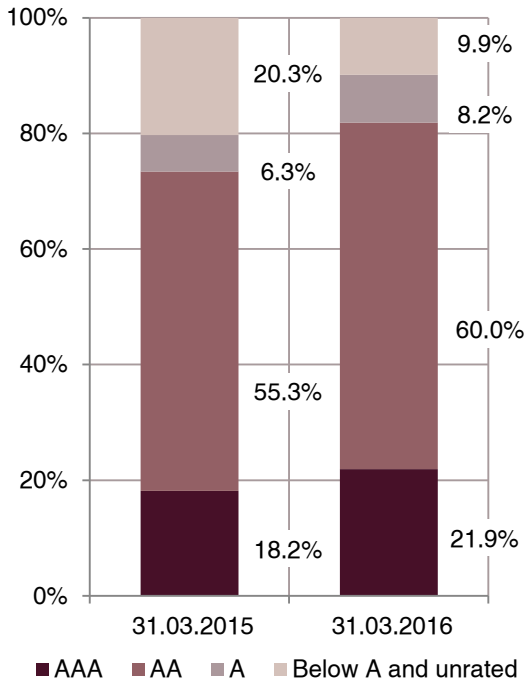


Chart 7 shows the distribution of foreign exchange assets by credit rating as of 31 March 2015 and 31 March 2016. The Chart is based on Fitch Ratings, Standard and Poor's and Moody's Investors Service data, with the lowest credit rating grades used.

Chart 7. Foreign exchange assets by credit rating



Decrease in the share of assets with 'Below A and unrated' rating as of 31 March 2016 was partly due to the reduction of credit institutions refinancing in foreign currency.

Data on the return of the actual and benchmark single–currency portfolios of Bank of Russia foreign exchange assets are shown in Table 2.

Table 2. *Return on Bank of Russia foreign exchange assets* in April 2015 – March 2016, % p.a.

Indicator	US dollar	euro	pound sterling	Canadian dollar	Australian dollar
Return on actual single–currency portfolios of foreign exchange assets	0.63	0.01	0.73	0.56	1.88
Return on benchmark single–currency portfolios of foreign exchange assets	0.51	–0.02	0.70	0.51	1.80

GLOSSARY

Benchmark portfolio

A set of financial instruments in each reserve currency taken in appropriate percentage. Benchmark portfolios reflect the target distribution of Bank of Russia assets in each foreign currency.

Central bank key rate

A rate set by a central bank to impact interest rates in the economy. Usually a change to the key rate is a major monetary policy tool.
Examples of key rates used by the leading central banks include:

- US Federal Reserve System (Fed) – A target for an interest rate at which depository institutions lend reserve balances to other depository institutions overnight;
- European Central Bank (ECB) – A minimum rate at ECB repo auctions;
- Bank of England – An interest rate on commercial bank reserves deposited with the Bank of England;
- Bank of Canada – A target for an interbank loan rate;
- Reserve Bank of Australia – A target for an interbank loan rate;
- Bank of Japan – Until April 2013, this was an overnight interbank loan rate. Starting from April 2013, the Bank of Japan has been targeting the monetary base instead of the interest rate.

Credit rating

A rating agency's assessment of the credit worthiness of a borrower and its ability to fulfill its financial obligations.

Currency swap

An agreement pursuant to which counterparties exchange payments in different currencies. The Bank of Russia enters into currency swap operations in order to supply Russian credit institutions with ruble funds using foreign currency funds as collateral.

Duration

A measure of the relative sensitivity of the value of a fixed–income instrument or a class of instruments to changes in the corresponding interest rates by one percentage point.

Government funds

The Reserve Fund and the National Wealth Fund of the Russian Federation including their foreign currency deposits with the Bank of Russia (in US dollars, euros, and pounds sterling).

Quantitative easing (QE)

A monetary policy used by central banks to stimulate the economy. To carry out QE, a central bank purchases government securities or other securities from the market or provides funds collateralised by financial assets in order to increase money supply.

Repo (reverse repo) transactions

Securities sale (purchase) transactions with an obligation of their repurchase (resale) at future date at a stated price.

Return on Bank of Russia foreign exchange assets

The holding period return is calculated using chain index based on a daily return. Daily return on a single–currency portfolio is calculated as the ratio of aggregate (realised and unrealised) returns of the portfolio to its market value as of the end of the previous day.

SDR (Special Drawing Rights)

An international reserve asset created by the IMF to supplement the existing official reserves of member countries. It is a potential claim on the freely usable currencies of IMF members. The SDR rate is determined based on the dollar value of a four–currency basket made up of the US dollar, euro, yen, and pound sterling.