June 2014

Financial Stability Review

The Central Bank of the Russian Federation
(Bank of Russia)

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FINANCIAL STABILITY REVIEW

June 2014

Moscow

All statistical data and calculations in this Review are given as of April 1, 2014 if available as of June 3, 2014.

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Table of contents

List of charts

List of Tables

Summary

High volatility was observed both in Russia and in the global markets in the fourth quarter of 2013 and the first quarter of 2014. This volatility was initially caused by the US Federal Reserve's decision to start tapering and the negative macroeconomic data from some emerging market economies, including Russia. From February, these problems encountered by Russia were aggravated by geopolitical risk related to the Ukraine crisis and the concerns about sanctions from the United States and the European Union. As a result, in March 2014 the Russian financial market experienced a stress, which was more moderate than during the crisis of 2008-2009.

In the first quarter of 2014, Russia registered a net private capital outflow of $50.6 billion (taking into account currency swap deals concluded between the Bank of Russia and resident banks and the growth in resident banks' funds on foreign currency correspondent accounts with the Bank of Russia, which increased by $63.7 billion) while the terms of access to foreign borrowings and market financing became tighter for non-financial organisations and banks. The volume of household deposits decreased in the first half of March 2014.

Pressure on the foreign exchange market increased sharply in March and the Bank of Russia changed the parameters of the mechanism of its interventions to ensure financial stability. The volume of the Bank of Russia's foreign currency interventions totalled $41.2 billion in the 1st quarter of 2014. Inflation also started to accelerate in February-March and the Bank of Russia was forced to raise the key rate by 200 bps (to 7% in March and to 7.5% in April) to prevent possible inflation and financial stability risks.

The situation improved noticeably in April and May amid lower geopolitical risks and as a result of measures implemented by the Bank of Russia: the capital outflow fell considerably, the pressure on the rouble decreased. The volume of bond issues placed by Russian issuers in the domestic market totalled 86 billion roubles in May or almost three times the volume of bond placements in April. The banking sector, however, continues to experience considerable problems, such as the shortage of eligible collateral for refinancing operations and the widening gap in the maturity of assets and liabilities. Despite an increase in interest rates on loans to non-financial organisations, their demand for loans is growing faster than the supply of household deposits.

Current global financial market trends are not quite favourable, first of all, for emerging markets amid US monetary policy tightening. In this situation, Russia is demonstrating good fundamental indicators (a current account surplus, a balanced budget, the low level of the government debt and the private sector's moderate debt burden, including liabilities to external creditors) whereas some other countries may experience problems related to the excessive debt burden of the private sector and the need of government support for it. Capital outflow from emerging market economies is likely to intensify, if investors become more concerned about risks in these economies. At the same time, the ECB's decision in early June 2014 to set a negative interest rate on bank deposits and take quantitative easing measures, if necessary, to prevent deflation will help increase an inflow of investor funds into emerging market economies under otherwise equal conditions.

The debt problems in the eurozone have lately receded into the background for global investors but the rising government debt to GDP ratios in many countries suggest that these problems may re-emerge in the future.

The temporary deterioration in the Russian financial market in the first quarter of 2014 caused an inconsiderable revaluation of credit institutions' securities portfolios (55 billion roubles or less than 1% of the portfolios). However, the market shock had a more noticeable impact as it reduced the number of new bond issues and increased the volume of bond tender offers realised by issuers. As a result, the volume of debt securities in banks' securities portfolios fell from 6.3 trillion roubles to 6.2 trillion roubles in March 2014. The persistence of these trends in the second half of this year may exacerbate the problem of the shortage of marketable collateral available to banks for refinancing operations with the Bank of Russia. This problem is becoming a topical issue, considering that credit institutions increased the share of Bank of Russia's funds in their liabilities from 5.8% as of October 1, 2013 to 8.4% as of May 1, 2014 amid the slower growth of other funding sources.

Russian companies and banks have fewer possibilities to refinance their external debt. The volumes of Eurobond issues and foreign bank loans contracted in March-April 2014. At the same time, short-term foreign currency liquidity available to Russian credit institutions for a term of up to 12 months is sufficient to cover all pending external debt payments by banks and non-financial organisations in 2014. In recent months, Russian banks have noticeably increased lending to non-financial organisations that comprise both residents and non-residents integrated into Russian groups.

The non-financial organisations' aggregate financial result is declining while their debt burden is rising amid the slower growth of the Russian economy and the unfavourable dynamics of world raw material prices (first of all, the prices of metals and coking coal). The share of overdue payments on loans to non-financial organisations decreased from 4.3% to 4.2% over the six-month period. At the same time, the quality of the corporate loan portfolio is expected to deteriorate in 2014-2015.

The declining quality of the consumer loan portfolio is becoming ever more evident: the annual rates of growth in unsecured loans with overdue payments of more than 90 days reached 82% as of April 1 whereas the rates of growth in outstanding unsecured loans decelerated to 27%. The most serious deterioration in the loan portfolio quality is typical of the group of banks specialising in this segment. The share of loans with overdue payments of more than 90 days reached 14.7% in their loan portfolios compared with 9.3% in the banking sector as a whole. Nevertheless, banks started to tighten their lending standards already in 2013 in the wake of macroprudential measures implemented by the Bank of Russia. Under the baseline scenario, the level of bad consumer loans is expected to stabilise in the medium term. Microfinance organisations continue building up the volume of loans to households more rapidly than banks; however, this is largely explained by the low base effect. The current changes in their regulation (provisioning, the need to disclose and cap the effective rates of loans and the tighter requirements for attracting individuals' funds) will help prevent the accumulation of households' excessive debts.

The rates of growth in mortgage lending increased noticeably in the past six month: this growth accelerated to 31% on an annual basis, although it is still largely of catch-up nature. Nevertheless, it is a cause for some concern that loans with the loan-to-value ratio (LTV ratio) of over 70% account for almost 50% of the debt and the volume of mortgage loans with the LTV ratio of 80-90% has been observed to grow considerably since 2013. The Bank of Russia has launched regular stress tests of loan portfolios of the largest mortgage market participants. The results of the stress test available as of April 1, 2014, indicate that banks holding the leading positions in the market remain resilient to the 2008 scenario (a fall in household income and real estate prices).

Expressly negative trends among noncredit financial organisations in 2013 were demonstrated by the insurance sector: the loss ratio was observed to grow in auto insurance while some types of business insurance registered negative premium dynamics.

The situation in the Ukrainian economy remains tense: production decline and the growth in the government debt are accompanied by the high debt burden for non-financial organisations, the deterioration in the quality of assets and the decrease in banks' liquidity. Possible direct consequences for the Russian financial system in the event of the Ukraine crisis escalation are limited: Russian banks' investments in subsidiary banks in Ukraine and loans provided to residents of Ukraine do not exceed 1% of their assets. At the same time, economic problems in Ukraine may potentially cause a new wave of geopolitical tension.

Chapter 1. Global Economic and Financial Market Risks

1.1. Risks and Economic Prospects in Advanced Economies

The International Monetary Fund (IMF) predicts world economic growth rates to increase in the short term from 3% in 2013 to 3.6% in 2014 and 3.9% in 2015. Economic growth rates are expected to increase more dynamically in developed countries compared with emerging market economies: in the period of 2013-2015 this growth will accelerate almost twofold from 1.3% to 2.3% and from 4.7% to 5.3%, respectively. Economic growth acceleration in advanced economies will be mostly facilitated by the United States while the contribution of emerging market countries to global growth will decrease due to slower economic growth in China (Chart 1).

The global economy is still far away from its return to sustainable and balanced growth, despite favourable economic forecasts. At present, the world's leading central banks continue to provide considerable support to financial markets by means of highly accommodative monetary policies, even though the US Federal Reserve has started to scale down its quantitative easing programme since 2014. In March 2014, the Fed uncoupled its decisions on the federal funds target rate (FFTR) from the 6.5% unemployment threshold amid improvements in the US labour market. The US unemployment rate fell from 7.2% as of September 2013 to 6.3% in April 2014, the lowest level since the autumn of 2008. The Fed has also decided to postpone the FFTR hike by six months after its exit from quantitative easing programme (in mid-2015, given the current rate of stimulus tapering).

Amid tightening monetary conditions in global markets, regulators and economic agents of other countries will have to take considerable efforts to eliminate accumulated balances and limit new risks. It is quite probable that the transitional period will continue to be accompanied by upsurges in volatility in financial markets. The cost of sovereign and corporate borrowings has already risen since mid-2013 (Chart 2) while the growth of investor risk aversion is accompanied by capital flow re-distribution in favour of more stable developed markets.

The US economy is demonstrating moderate growth rates: the US GDP grew by 1.9% in 2013 compared with 2.8% in 2012. At the same time, the US GDP contracted by 2.9% in the first quarter of 2014 after its growth by 2.6% in the fourth quarter of 2013. The US GDP declined in the first quarter of 2014 due to lower expenditures on health care and a weak growth in consumer spending amid unfavourable weather conditions.

Chart 1. **Economic Growth in Advanced and Emerging Market Economies, %**

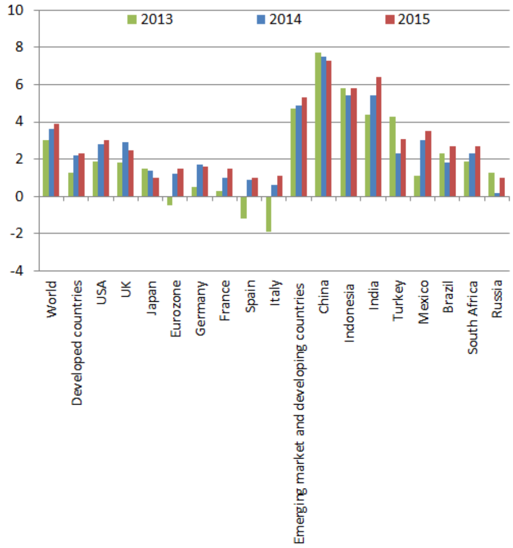
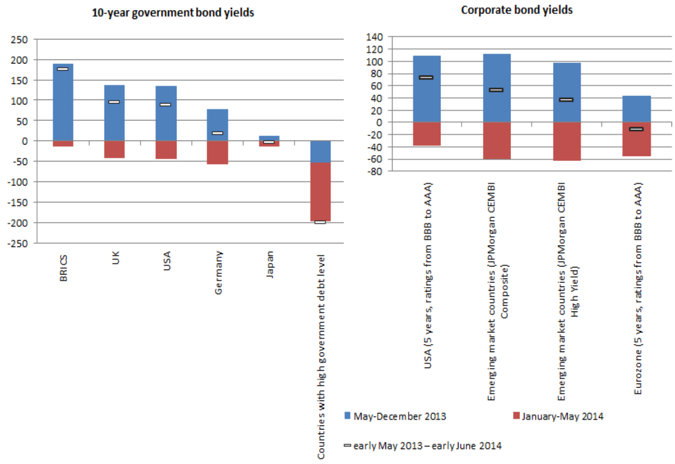


Chart 2. **Sovereign and Corporate Borrowing Cost Change in Global Markets from May 1, 2013 to June 2, 2014, bp**



2014–2015 – forecast.

Source: IMF.

Sources: Thomson Reuters Eikon, Datastream, Bloomberg.

Like in the USA, pre-requisites are emerging in the UK for monetary policy tightening. The UK economy grew by 1.7% in 2013, the fastest growth since 2010. The unemployment rate fell below the 7% threshold established by the Bank of England in August 2013 as a target level for raising the key rate (in January-March 2014, the unemployment rate stood at 6.8%). The Bank of England gave up this target in early 2014.

As some countries are tightening their monetary policies, other countries may face continued weak growth dynamics amid low inflation (Chart 3). Deflation risks are especially typical of eurozone countries (Chart 4).

Chart. 3. **Global and Regional Inflation Dynamics, % per annum**

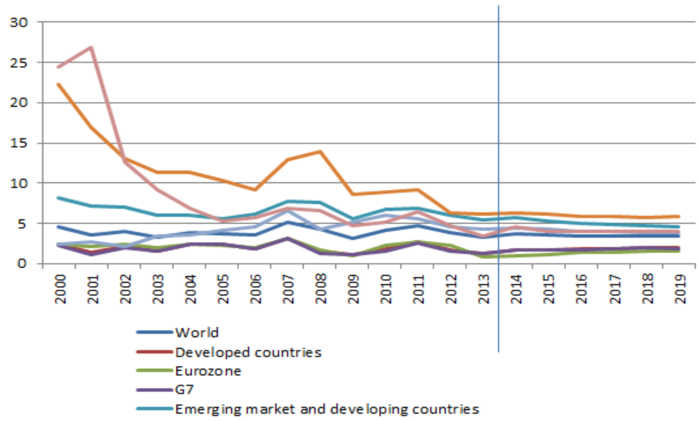
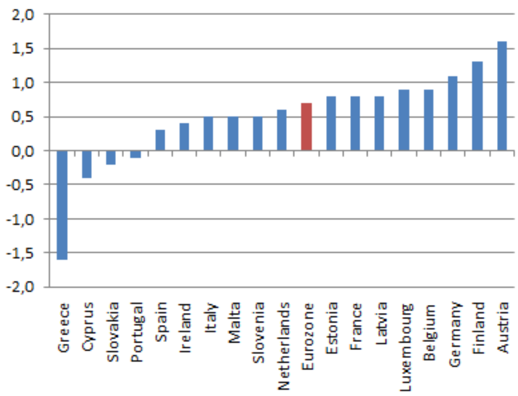


Chart. 4. **Eurozone Inflation by Country in April 2014**
(%, on an annual basis)



Eurozone inflation stood at 0.5% in May 2014, according to Eurostat estimates.

Source: IMF.

Source: Eurostat.

The eurozone economy started to recover slowly in the second half of 2013. The annual GDP growth amounted to 0.5% in the fourth quarter of 2013 and 0.9% in the first quarter of 2014. In 2013, the eurozone real GDP contracted by 0.5%. The GDP dynamics improved both in the key eurozone countries (Germany and France) and in the countries with high government debt levels (Spain, Italy and Greece), although quarterly year-on-year GDP growth rates in the latter countries remained negative throughout 2013. At the same time, the eurozone demonstrated growth in business activity: the Purchasing Managers Index (PMI) in the manufacturing sector exceeded 50 points in July 2013 and rose to 52.2 points in May 2014.

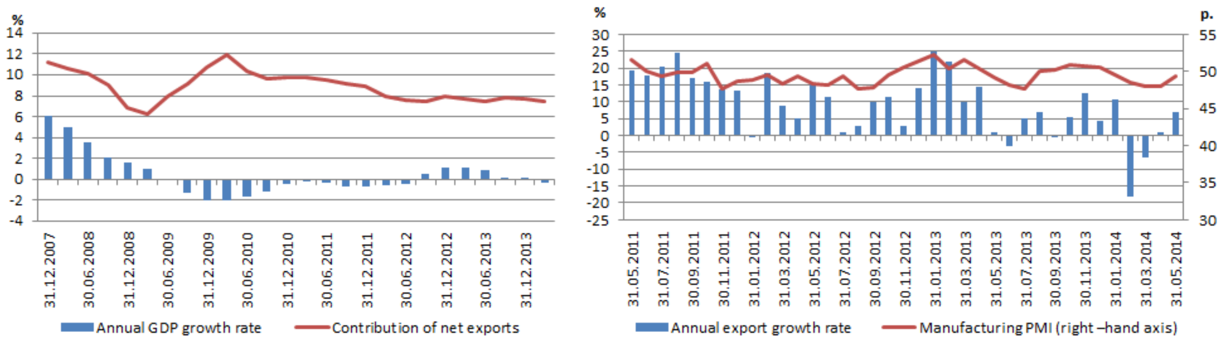
Despite a gradual economic recovery after the debt crisis, eurozone countries continue to experience a lot of problems: high unemployment (11.8% in March 2014), low inflation (0.5% in May 2014) and imbalances related to the government sector's debt burden (especially considering that many countries have virtually used up their budget consolidation possibilities), as well as negative rates of growth in lending to non-financial firms (-2.8% on an annual basis in April 2014). Aside from this, comprehensive Asset Quality Review and banking sector stress-testing, which are conducted this year by the ECB and the European Banking Authority (EBA), may reveal a shortage of capital at some banks.

Considering these risks, the ECB continues implementing accommodative monetary policy. At its June policy meeting, the ECB decided to cut the key refinancing rate to 0.15% from 0.25% and set a negative interest rate on bank deposits at minus 0.1%. The European regulator also announced plans to hold several rounds of targeted long-term refinancing operations.

In Japan a weak balance of payments is also an evidence of the need to continue stimulus policy (Abenomics) to achieve sustainable growth and a stable price level. The Bank of Japan will possibly have to boost its economic stimulus, considering the restraining effect, which may be exerted by a decision that came into force in April 2014 to increase the country's consumption tax.

Chinese economy continues to demonstrate slower growth rates amid large-scale structural reforms (Chart 5), including measures aimed at credit boom restriction. China's GDP growth slowed to 7.4% in the first quarter of this year, the lowest level in the past eighteen months (in the fourth quarter of 2013, China's GDP grew by 7.7%). The Chinese authorities will possibly fail to reach the target GDP growth of 7.5% in 2014. The country is experiencing difficulties with its transition to a new growth model, which can be evidenced by the fact that a considerable contraction in China's current account surplus (to 1.5% of GDP in the first quarter of 2014 from 3.9% of GDP in late 2010 and 9.7% of GDP in 2007) is not accompanied by any expressed rebound in domestic demand, which in turn restrains the real sector's development. The Manufacturing PMI calculated by the HSBC (The Hongkong and Shanghai Banking Corporation) was lower than 50 points in January-May 2014.

Chart. 5. **Macroeconomic Indicators in China**



Source: Bloomberg; Bank of Russia calculations.

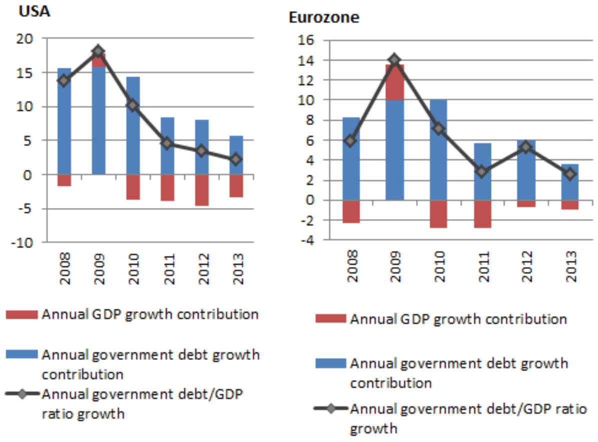
Economic prospects of emerging market countries increasingly depend on global factors. Tighter financial conditions restrain investments and adversely affect economic growth. The cause for special concern is the increased dependence of some emerging market economies on external funding and the larger debt burden of the private and government sectors.

1.2. Risks of Government and Private Debt Sustainability

The debt burden of the government sector in developed countries increased considerably as a result of the 2008 crisis while emerging market countries accumulated their debts, primarily in the private sector, taking advantage of the favourable conjuncture in global financial markets. The risk of the loss of debt sustainability will become increasingly essential amid the Fed's monetary policy tightening and the subsequent growth in the borrowing costs in global markets. It should also be noted that market participants are currently showing less concern for developed countries' risks, and investors are returning to the eurozone countries with high government debt levels as well. The investors' changing sentiment in favour of developed markets is creating additional difficulties for the corporate sector of emerging market economies.

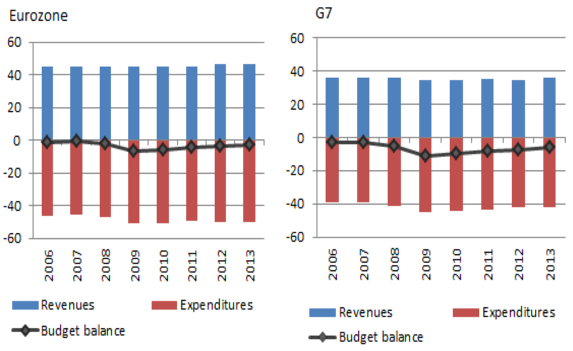
The IMF data as of April 2014 indicate that the government debt of developed countries rose from 80% of GDP in 2008 to 107.1% of GDP in 2013, which was primarily related to government debt increase after the crisis along with GDP contraction in 2009 and slow economic recovery in subsequent years (Chart 6, 7). The situation has stabilised since 2010 due to implementation of fiscal reforms; however, even at present moment the government debt growth in developed countries exceeds GDP growth.

Chart. 6. **Government Debt, GDP Contribution to Government Debt/GDP Ratio Growth, %**



Source: IMF; Bank of Russia calculations.

Chart. 7. **Budget Balance in Advanced Economies, % of GDP**



Source: IMF.

Fiscal risks increased significantly in eurozone during debt crisis, which intensified in 2010-2012. Many European countries were compelled to implement tight fiscal consolidation measures. The European Commission data show that the problem countries achieved considerable progress in fiscal adjustments in 2009-2013; however, many eurozone countries failed to reduce their budget deficits and cut their government debts to below the threshold levels of 3% and 60% of GDP, respectively, despite their improved budgets (Table 1). The government debt of many European countries continues to increase, which is an evidence of their fiscal vulnerability.

Table 1. **Eurozone Government Debt and Budget Balance, % of GDP**

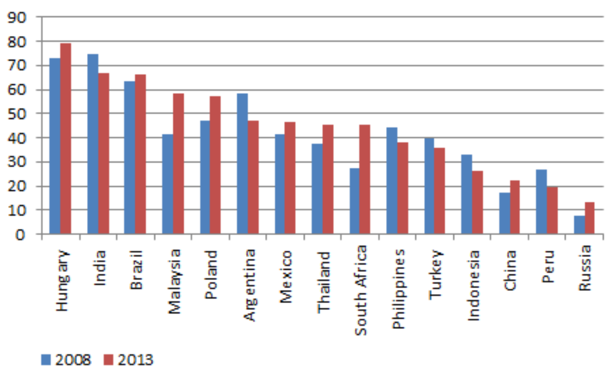
	Overall budget balance			Primary budget balance			Government debt		
	2009	2013	difference	2009	2013	difference	2009	2013	difference
Eurozone	**−6,4**	**−3,0**	**3,4**	**−3,5**	**−0,1**	**3,4**	**79,8**	**95,0**	**15,2**
Germany	−3,2	0,0	3,2	−0,5	2,2	2,7	74,4	78,4	4,0
France	−7,5	−4,3	3,2	−5,1	−2,0	3,1	79,0	93,5	14,5
Netherlands	−5,6	−2,5	3,1	−3,4	−0,7	2,7	60,8	73,5	12,7
Austria	−4,1	−1,5	2,6	−1,3	1,0	2,3	69,5	74,5	5,0
Italy	−5,4	−3,0	2,4	−0,8	2,2	3,0	115,5	132,6	17,1
Spain	−11,2	−7,1	4,1	−9,4	−3,7	5,7	53,8	93,9	40,1
Ireland	−14,2	−7,2	7,0	−12,1	−2,5	9,6	65,2	123,7	58,5
Portugal	−10,1	−4,9	5,2	−7,3	−0,6	6,7	83,0	129,0	46,0
Greece	−15,8	−12,7	3,1	−10,6	−8,7	1,9	129,3	175,1	45,8
Cyprus	−6,1	−5,4	0,7	−3,6	−2,0	1,6	58,5	111,7	53,2

Source: European Commission.

Most emerging market countries have more stable fiscal positions compared with developed economies. Their government debt to GDP ratios increased insignificantly in the post-crisis period (from 33.5% to 34.9% in 2008-2012), although some countries (South Africa, Malaysia) demonstrated quite a considerable increase in government debt (Chart 8). The highest sovereign debt level among emerging market countries is registered in Hungary (79% of GDP), India (67% of GDP) and Brazil (66% of GDP).

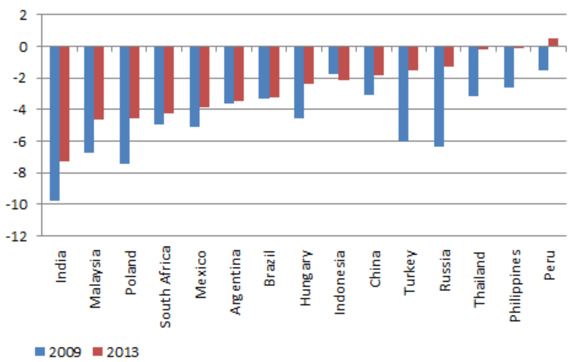
It should be noted that faster economic recovery after the 2008 crisis allowed emerging market countries to reduce their fiscal deficits (according to the IMF data, their overall budget balance improved by 1.5 percentage points in the period of 2009-2013). However, the state of the budget of some countries (Brazil, South Africa) improved to a lesser degree than it could be expected considering the positive effect of credit growth, assets' appreciation and higher commodity prices (Chart 9). The budget deficit of Indonesia even widened during this period.

Chart. 8. **Total Emerging Market Government Debt, % of GDP**



Source: IMF.

Chart 9. **Total Budget Balance in Emerging Market Economies, % of GDP**



Source: IMF.

In general, it should be noted that fiscal risks rise higher with the greater need for fiscal adjustments required to reduce the government debt to GDP ratio. Many European countries have quite a large fiscal gap (the difference between projected expenditures and revenues). Such a factor as the **ageing of the population** can be expected to exert an increasing pressure on the budgets in the medium- and long-term perspective. Both developed and developing countries may face rising budget expenditures on social needs in the future (including expenditures on pension provision). At the same time, large volume of government debt creates uncertainty for economic agents about future tax measures and budget expenditures.

The vulnerability of countries is determined by **the central bank's possibility to influence interest rates**, and also by **the debt structure** (the share of short-term and medium-term borrowings). From this standpoint, eurozone countries are in a relatively favourable position. However, their bond yields also have substantial potential for growth in case of monetary policy normalisation (Table 2).

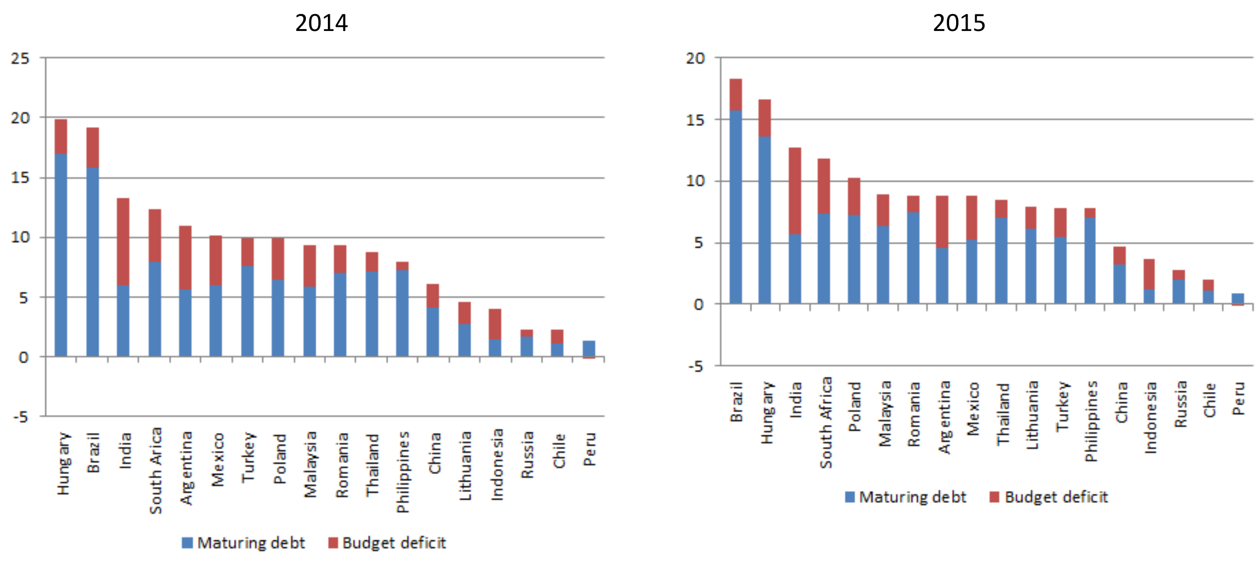
Table 2. **Average Yields on 10-Year US, UK and Eurozone Government Bonds, %**

Country	Average for Q1 2014	Average for 2000–2013	Average yearly high for 2000–2013
USA	2,75	3,89	5,99
United Kingdom	2,78	4,09	5,25
Germany	1,68	3,60	5,26
France	2,26	3,86	5,39
Italy	3,64	4,61	5,59
Spain	3,57	4,57	5,89
Greece	7,62	7,80	24,05

Source: Thomson Reuters Eikon.

The budgets of emerging market countries experience **quite a strong need for new borrowings** to cover fiscal deficits and make pending government debt payments, which may also push up the cost of sovereign borrowings in these countries. The IMF data indicate that the strongest need for government debt refinancing among emerging market economies in 2014-2015 will be experienced by Brazil (37.5% of GDP), Hungary (36.5% of GDP), India (25.9% of GDP), South Africa (24.2% of GDP), Argentina (19.7% of GDP) and Mexico (18.9% of GDP) (chart 10).

Chart. 10. **Gross Finanicng Needs in Emerging Market Countries , % of GDP**

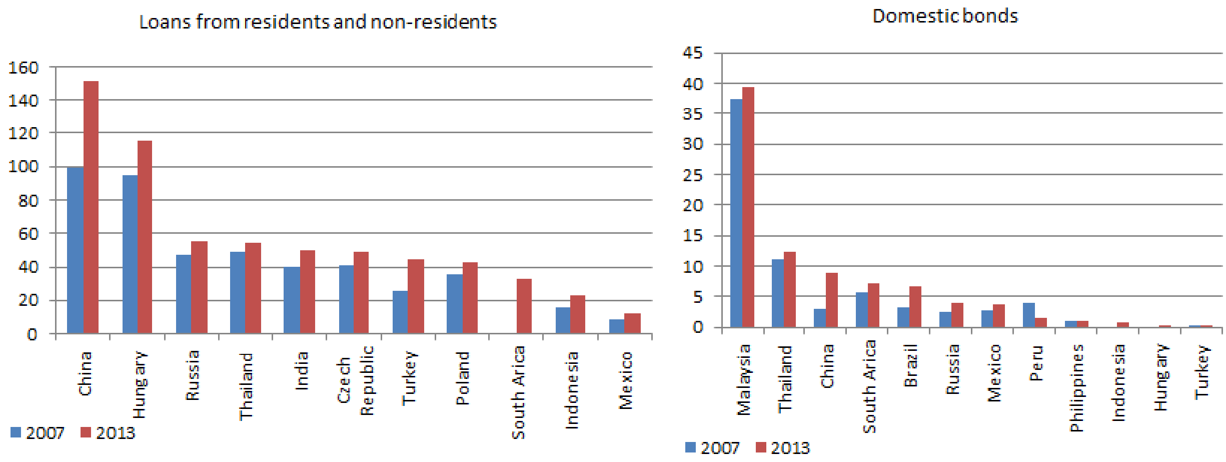


Source: IMF.

Many emerging markets have also registered a rapid growth in corporate debts in recent years, especially debts on loans. The data of the Bank for International Settlements (BIS) indicate that the volume of non-financial firms' outstanding loans reached record levels in 2013 (China, Hungary) (Chart

11). Outstanding amount of bonds issued in the national currencies is several times smaller but also tends to grow.

Chart. 11. **Emerging Market Non-Financial Sector Debt, % of GDP**



*The data for 2007 are not available on South Africa (outstanding loans), Indonesia and Hungary (outstanding domestic bonds).

Sources: BIS, IMF; Bank of Russia calculations.

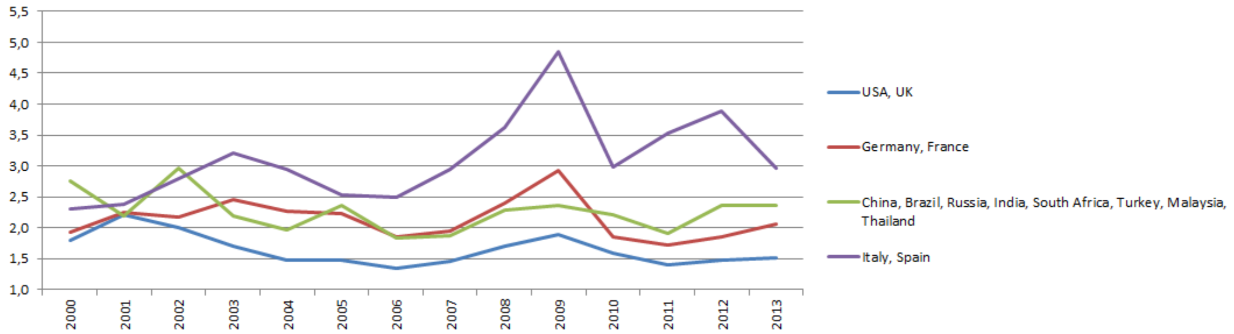
Many companies have increased borrowings from non-residents in the years after the 2008 crisis and, as a result, have become more exposed to capital outflow risks, especially to withdrawal of capital by investors pursuing short-term investment strategies (for example, global hedge funds). In this situation, it is more likely that companies may find it difficult to refinance their obligations and a massive assets' sell-off may start in financial markets of these countries. Many companies from emerging market economies may bear considerable losses amid a rise in interest rates as they will have to make larger interest payments to service their debt.

While the ratio of non-financial firms' net debt (the sum of borrowed funds adjusted for the amount of cash and cash equivalents) to earnings before interest, taxes, depreciation and amortisation (EBITDA) is comparable in developed and developing countries, the fall in profits observed in recent years adversely affects the non-financial companies' ability to service their debt. The net debt-to-EBITDA[2] ratio of the largest non-financial firms from BRICS countries[3], and also from Turkey, Malaysia and Thailand rose on average from 1.8 in 2007 to 2.4 in 2013 (Chart 12).

2 The net debt is calculated as the sum of short-term and long-term loans less cash and cash equivalents. The EBITDA is calculated as corporate profit before depreciation and amortisation, interest and tax expenses.

3 The group, which comprises five rapidly developing countries: Brazil, Russia, India, China and South Africa.

Chart. 12. **Net Debt/EBITDA Ratio Dynamics for Variosu Groups of Countries**



Note. The 50 largest non-financial firms by market capitalization were selected for each country.

Source: Thomson Reuters Eikon; Bank of Russia calculations.

Risks may intensify simultaneously in the government, financial and non-financial sectors of emerging market economies in the coming years in the light of the global trend towards the higher cost of borrowings and a slower economic growth in some countries. This scenario may particularly realize in countries with high debt levels in the government and private sectors. Corporate default risks may increase amid foreign capital outflow, depreciation of assets and national currencies, which will result in the deterioration of the state of the banking sector. In this situation, the government sector debt burden may suddenly increase, if financial aid is required to rescue companies or banks that may find themselves on the verge of bankruptcy.

Chapter 2. The Impact of the Ukrainian Crisis on the Russian Financial Sector

2.1. The Current State of the Ukrainian Economy and Ukraine's Debt Risks

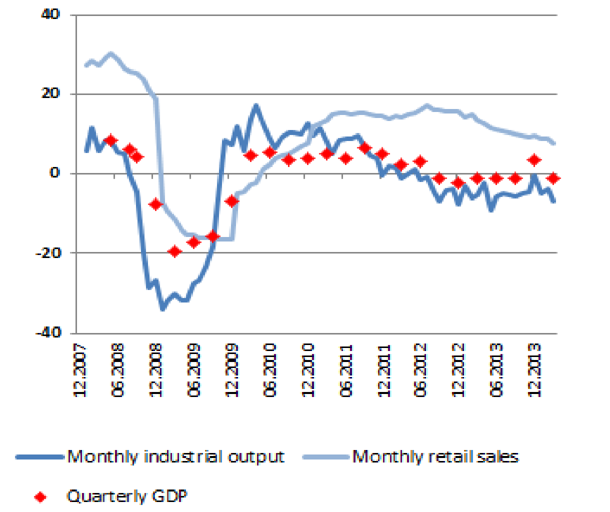
Recession and Marco-Economic Imbalances

Ukraine is living through a recession for the second time in the past six years amid political crisis and larger macro-economic imbalances, including the current account and state budget deficits. Ukraine's GDP contracted by 1.1% in the first quarter of 2014 compared with the corresponding period of 2013 (Chart 13). A survey conducted by the Bloomberg news agency shows that analysts on average expect a decline in economic activity and a fall in the country's GDP by 3% in 2014.

Ukraine has had a current account deficit since 2006. This deficit increased sharply in 2011, rising to 6.3% of GDP, and in 2013 it widened further to 9.2% of GDP (Chart 14). In the past few years, Ukraine's current account deficit has been offset by a capital account surplus. Ukraine used a manageable floating exchange rate (close to the fixed exchange rate) until recently. However, a strong growth in the non-financial sector's demand for foreign currency in 2014 amid a political crisis in the country prompted a significant contraction in Ukraine's international reserves to the level sufficient to cover commodity imports for only 1.5 months[4] or 38% of foreign debt payments in the current year (Chart 15). As a result, in late February 2014, the National Bank of Ukraine (NBU) announced the transition to a floating exchange rate. In January-May 2014, the US dollar rose by 44.4% against the Ukrainian hryvnia (to 11.9 hryvnias per US dollar as of June 2, 2014). At the same time, Ukraine has quite a tight system of foreign exchange regulation and foreign exchange control, which restrains a possible net capital outflow and helps reduce the hryvnia volatility. In February 2014, Ukraine temporarily restricted withdrawal of funds from foreign currency deposits and purchase of foreign currency in the interbank foreign exchange market under certain operations amid the aggravation of political crisis in the country.

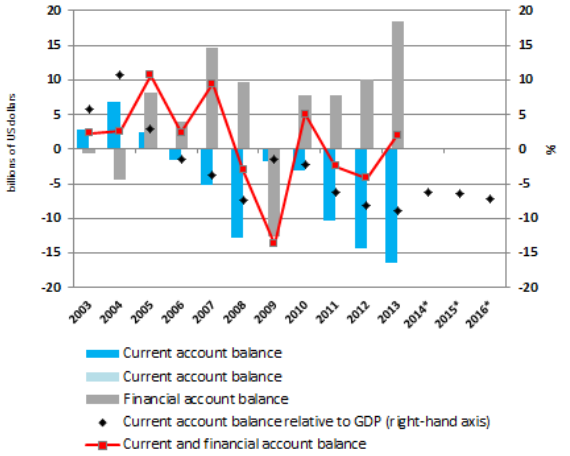
4 The average monthly commodity imports were calculated as the average volume for 2013.

Chart 13. **Annual Growth Rates of Ukraine's Macro-Economic Indicators, %**



Source: State Statistics Service of Ukraine.

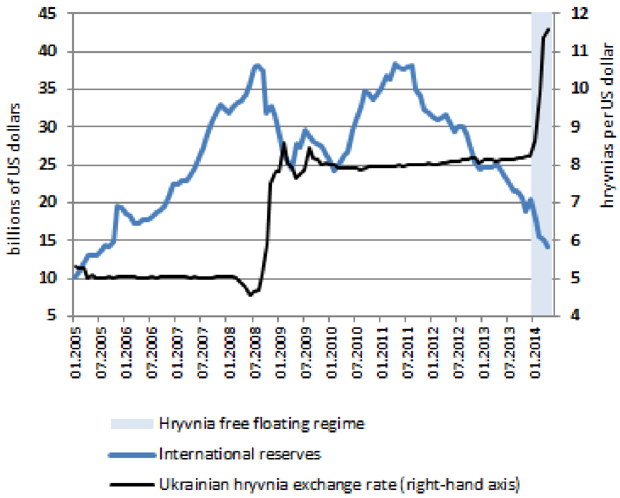
Chart 14. **Ukraine's Balance of Payments***



* IMF forecast.

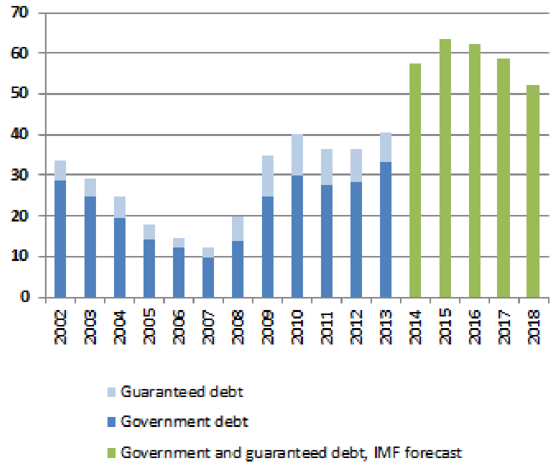
Sources: Bloomberg, IMF, Bank of Russia calculations.

Chart 15. **Ukrainian Hryvnia's Exchange Rate and National Bank of Ukraine's International Reserves**



Source: Bloomberg; Bank of Russia calculations.

Chart 16. **Ukraine's Government and Government-Guaranteed Debt to GDP, %**



Sources: Bloomberg, IMF; Bank of Russia calculations.

Government Sector's Debt Risks

Ukraine's state budget has had a deficit exceeding 2% of GDP since 1994 (except for 1999, 2002, 2003 and 2006). As a result, the government debt has demonstrated an upward trend since 2007 and reached 40% of GDP in 2013 (Chart 16). Ukraine's government and government-guaranteed debt is expected to grow by 16.6% to 57.5% of GDP in 2014 and by 6.1% in 2015 to 63.6% of GDP, above the threshold level of 60% of GDP[5].

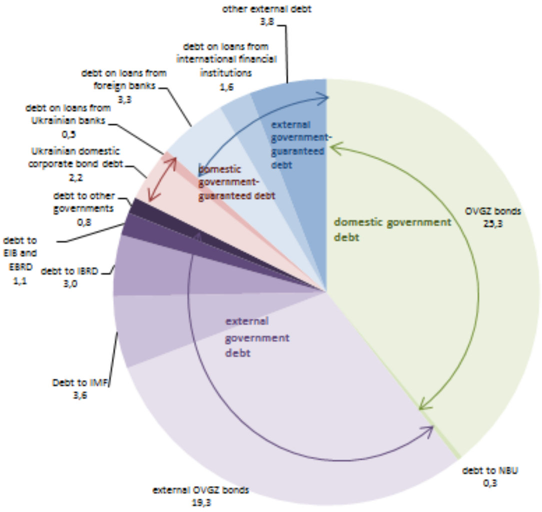
5 The government debt to GDP ratio at 60% is often viewed as a threshold level for the assessment of fiscal stability of developed countries. The ratio's threshold level for emerging market economies is 40%. For details, see: From stimulus to consolidation: revenue and expenditure policies in advanced and emerging economies / a staff team led by B. Clements, V. Perry, J.Toro. Washington, D.C.: International Monetary Fund, 2010.

Ukraine's government and government-guaranteed debt totalled $65.2 billion as of April 30, 2014, of which the government debt accounted for 82% and the government guarantees made up 18% (Chart 17). According to the Ukrainian Ministry of Finance, the maturity of outstanding government obligations averaged 4.7 years as of late 2013. A high proportion of the external government and government-guaranteed debt (56.5%), with the larger part of it ($19 billion) made up of market debt (bonds floated in external markets), can be considered as a negative factor.

Considering the Ukrainian hryvnia depreciation, expenditures on foreign government debt service in 2014 may amount to 48.6 billion hryvnias ($4.1 billion) to repay external debt and 13.6 billion hryvnias ($1.1 billion) to pay interest (Chart 18). As a result, total budget expenditures on government debt service will reach 4.3% of GDP, given that the exchange rate stays at the level of 11.9 hryvnias per US dollar. In this situation, the risks of external debt refinancing and further depreciation of the Ukrainian hryvnia will pose a systemic risk for the Ukrainian budget.

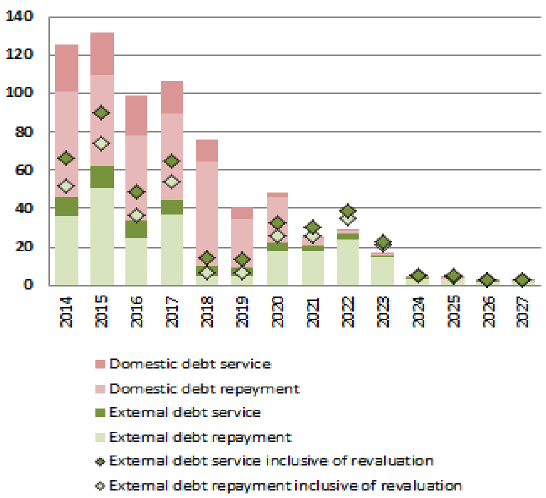
Nevertheless, as the IMF approved a loan programme for Ukraine, the Ukrainian Finance Ministry did not experience any difficulties in government bond placements either in the domestic or external markets, despite a downgrade of Ukraine's sovereign ratings by international rating agencies[6]. In April-May 2014, government bond placements in the domestic market totalled 10.1 billion hryvnias ($900 million). In May 2014, Ukraine issued five-year Eurobonds worth $1 billion with a yield of 1.844% p.a. against guarantees of the US government.

Chart 17. **Government and Government-Guaranteed Debt as of April 30, 2014, billions of US dollars**



Source: Finance Ministry of Ukraine; Bank of Russia calculations.

Chart 18. **Expenditures on Ukraine's Government Debt Service, billions hryvnias**



Source: Finance Ministry of Ukraine, Bank of Russia calculations.

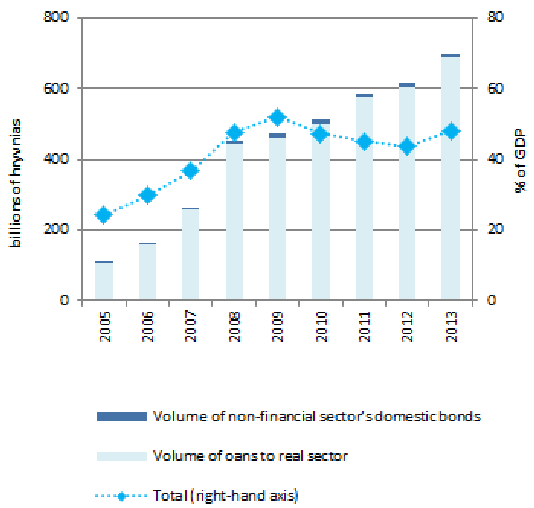
6 In February 2014, S&P rating agency cut Ukraine's short-term foreign currency sovereign credit rating to C and the country's long-term and short-term national currency ratings to B and B-. Fitch downgraded Ukraine's long-term foreign currency rating to CCC in February 2014 and in April 2014 Moody's lowered the country's government bond rating to Caa3.

Private Sector's Debt Risks

While the government sector's debt sustainability is largely supported by the IMF loan programme, the private non-financial sector's positions seem less stable due to the high level of debt (first of all, external debt) and a considerable share of short-term liabilities.

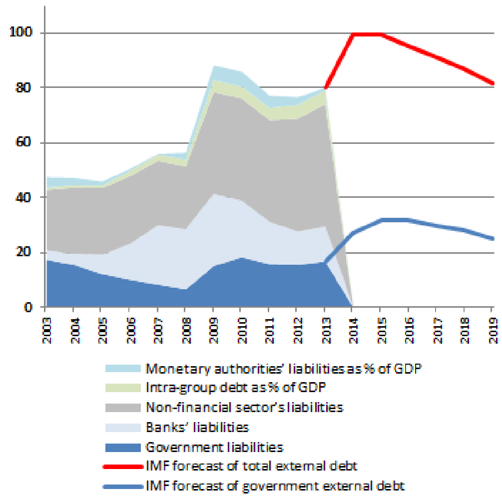
The Ukrainian non-financial sector's domestic debt reached $85 billion in late 2013 or 48% of GDP (Chart 19) while its external liabilities totalled $79.4 billion (45% of GDP). These levels are quite high compared with similar indicators in other emerging market countries. In particular, the Russian non-financial sector's total domestic and external liabilities account for about 60% of GDP.

Chart 19. **Ukrainian Real Sector's Domestic Debt**



Sources: NBU, Cbonds; Bank of Russia calculations.

Chart 20. **Ukraine's External Debt, % of GDP**



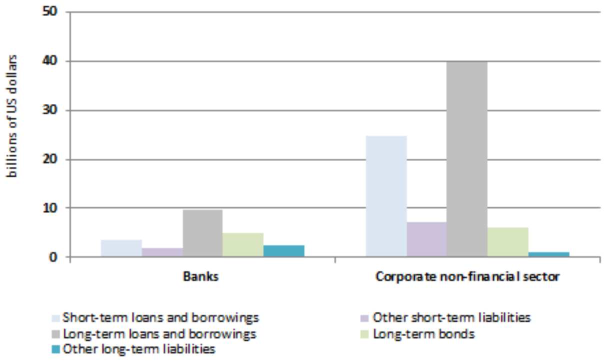
Sources: Bloomberg, IMF; Bank of Russia calculations.

The non-financial sector's short-term liabilities accounted for 40% of the entire corporate external debt (14% of GDP), which exceeds budget expenditures on short-term government debt service.

Compared with the real sector of the economy, Ukrainian banks are less exposed to external debt refinancing risks during 2014 as their external liabilities are three times as small as of those of real sector and amount to $22.6 billion (12.7% of GDP) (Chart 21) while the share of long-term instruments in the overall borrowing structure is higher (76%).

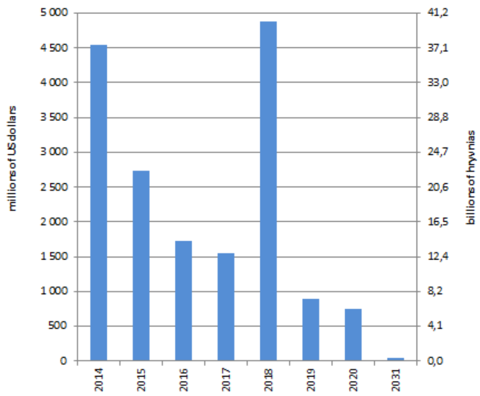
It should be noted that most of corporate Eurobonds are scheduled for repayment in the next five years (Chart 22). It is quite probable that a further deterioration in the economy could tighten access for Ukrainian companies and banks to foreign loans and the Eurobond market and reduce their ability to repay external short-term liabilities amid the hryvnia's depreciation.

Chart 21. **Ukrainian Private Sector's External Debt as of December 31, 2013**



Source: Bloomberg.

Chart 22. **Schedule of Private Sector's External Debt Repayments as of December 31, 2013**



Source: CBonds; Bank of Russia calculations.

Banking Sector Risks

The Ukrainian banking sector's assets make up about 90% of the country's GDP (vs 86% in Russia). The political crisis in Ukraine and the decline in the country's economy have adversely affected both Ukrainian banks' liquidity and the quality of their assets. The level of overdue debts on loans rose from 7.7% as of January 1, 2014 to 9.3% as of April 1, 2014. The banks' regulatory capital adequacy ratio[7] dropped from 18.3% to 14.8% amid growing loan impairment provisions. An additional risk for Ukrainian banks stems from a large share of their investments in Ukrainian government securities, which account for about 46% of their regulatory capital, according to Moody's estimates.

Ukrainian banks have confronted with a considerable outflow of household deposits denominated in the national currency (-13% for the first quarter of 2014) amid a sharp depreciation of the hryvnia. The volume of foreign currency deposits grew by 18.5% however this was attributed only to foreign currency revaluation while the volume adjusted for the hryvnia depreciation declined by 15%. Deposits outflow caused liquidity shortage in the banking sector and resulted in interest rates rise. The volume of banks' refinancing conducted by the National Bank of Ukraine grew from 8.5 billion hryvnias in January (at a rate of 3.6% p.a.) to 32.3 billion hryvnias in March 2014 (at a rate of 15.7% p.a.). As a part of "Emergency credit aid" program the NBU extended the list of eligible collateral for banks. Thuswise aside from government securities, the NBU included loans to large companies and mortgages.,. The NBU imposed limits on foreign currency withdrawals from deposits to the equivalent of 15,000 hryvnias per person per day.

The growth of dollarisation of Ukrainian banks' deposits continued amid the hryvnia's depreciation: the share of household foreign currency deposits increased from 42% to 49% in the first quarter of 2014. While the relatively high level of dollarisation is typical for such an open economy as the Ukrainian (foreign trade turnover exceeds 100% of GDP), the growth of deposit dollarisation increasingly reduces the efficiency of the central bank's interest rate policy. In addition, despite the fact that the high share

7 The minimum N2 ratio is 10% under the NBU's bank regulatory requirements.

of banks' foreign currency liabilities is offset by the corresponding share of assets denominated in foreign currency, banks all the same bear risks in the event of hryvnia depreciation because borrowers (companies and the population) do not always have incomes in foreign currency. In particular, the share of mortgage loans denominated in foreign currency stood at 78% as of April 1, 2014.

Ukrainian banks have started to curtail lending to enterprises amid liquidity problems: the volume of loans to non-financial organisations in hryvnias dropped by 3.9% in the first quarter of 2014 while the volume of this type of loans in US dollars decreased by 2.4% (adjusted for foreign currency revaluation). The decline in bank lending along with the absence of access to market financing may in turn restrain economic recovery.

In early April 2014 the NBU announced plans to conduct stress tests of the country's 35 largest banks in order to determine their additional capital requirements; banks' recapitalisation has been already stipulated in the IMF programme. In accordance with the IMF's stand-by loan arrangement, the National Bank of Ukraine may grant up to 15 billion hryvnias in loans to the Deposit Guarantee Fund in 2014 or buy out government bonds worth this amount in order to finance the Household Deposit Guarantee Fund or recapitalise banks.

Therefore, the Ukrainian government sector's debt may rise significantly in the coming years compared with the existing forecasts because aid may be required for non-financial companies to refinance their external liabilities, on the one hand, and demand for additional funds may arise to recap banks , on the other hand.

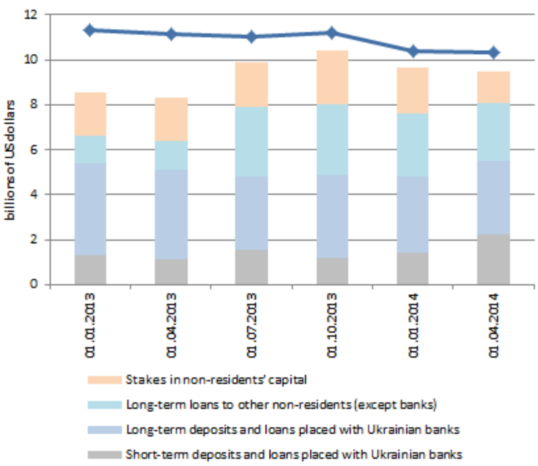
2.2. Russian Banks' Relationships with Ukrainian Residents

The direct effects of the impact of the Ukrainian crisis on the Russian banking sector relate to potential consequences of current developments for Ukrainian banks with Russian stakes in their equity and for Russian banks with claims and liabilities to Ukrainian residents.

Russian banks act as a net creditor for Ukraine: the volume of their claims to Ukrainian residents totalled \$10.4 billion as of April 1, 2014 (less than 1% of Russian banks' assets) whereas the volume of their liabilities amounted to only \$1.0 billion.

Most claims comprise long-term deposits and loans placed with Ukrainian banks (\$3.3 billion), long-term loans to the non-bank sector (\$2.6 billion), short-term deposits and loans to Ukrainian banks (\$2.2 billion), as well as stakes in non-residents' equity (\$1.4 billion).

Chart 23. **Russian Banks' Claims and Liabilities to Ukrainian Residents, billions of US dollars**



Source: Bank of Russia own calculations).

As of late April 2014, the Ukrainian banking sector comprised 180 banks, including 11 banking institutions with Russian stakes[8], of which four are on the list of Ukraine's top twenty banks by assets

8 From April 17, 2014, they include the Bank of Cyprus with assets of \$273 million purchased by Alfa-Group.

(Table 3). In aggregate, banks with Russian stakes account for 13% of the Ukrainian banking system's assets.

Table 3. **Ukrainian Banks with Russian Stakes in Equity**

Bank (Ukraine)	Beneficiary	As of 01.04.2014	
		place in Ukrainian banking system by assets	Assets, millions of US dollars[9]
PROMINVESTBANK	VEB	5	4 450
Sberbank of Russia	Sberbank of Russia	8	3 867
ALFA-BANK	Alfa-Group	10	3 252
VTB Bank	VTB Group	12	2 678
Russian Standard Bank	Russian Standard Group	53	305
BM Bank	VTB Group	65	265
VS Bank	Sberbank of Russia	75	205
Energobank	Roylance Services Ltd.	77	193
Bank Petrocommerce-Ukraine	IFD-Kapital	93	127
Trust Bank	National Bank Trust	125	59

Source: National Bank of Ukraine

(http://www.bank.gov.ua/control/uk/publish/article?art_id=6738234&cat_id=51342).

During the last two quarters, Russian banks' claims[10] to Ukrainian residents declined (–8%[11]) in all the segments under review, except for short-term deposits and loans (Chart 23). Lately the largest Russian banks have started to employ more conservative approaches to the issuance of new loans to Ukrainian borrowers.

Timely lending tightening can be generally expected to help reduce the effect of the Ukrainian crisis impact on Ukrainian banks with Russian stakes. The volume of Ukrainian assets relative to the size of the Russian banking sector is insignificant and therefore a possible depreciation of Ukrainian assets does not pose a threat to stability of the domestic banking sector.

2.3. The Impact of Geopolitical Risks on the Russian Financial Sector

The consequences of risk reassessment by major categories of Russian banks' counterparties and their response to market changes play an important role in the financial condition of credit institutions, apart from the direct impact of the geopolitical situation.

9 Based on the NBU's exchange rate as of April 1, 2014.

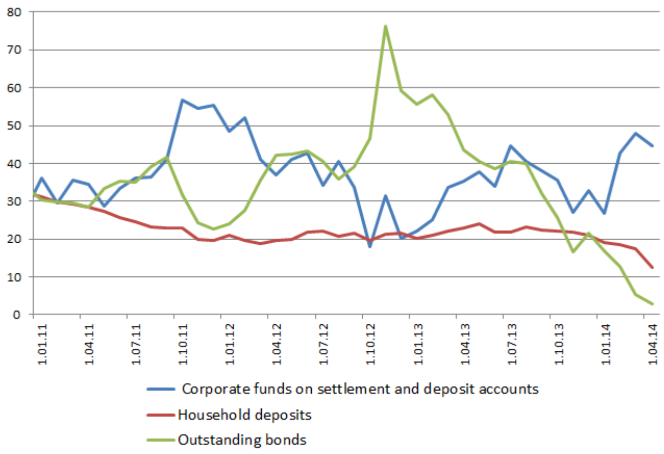
10 Excluding Vnesheconombank.

11 In US dollars, taking into account revaluation in roubles (+1.1%).

Banking Sector Funding Risks

The structure of the Russian banking sector's funding sources changed in the first quarter of 2014. The annual rates of growth in the volume of banks' outstanding bonds had dropped almost to zero by the end of the first quarter of 2014 (Chart 24). However, considering that the share of bonds in the banking sector's liabilities does not exceed 2%, risks related to this trend are limited.

Chart 24. **Annual Growth in Credit Institutions' Liabilities by Creditor Group, % per annum**



A downside trend was also typical of the dynamics of banks' liabilities to individuals. Household deposits had demonstrated stable growth rates of about 20% in the past few years. Since early 2014, household deposit growth rates have been observed to decline steadily, staying below the rates of growth in loans extended to non-financial organisations. In March 2014, the volume of deposits contracted in absolute terms amid fears that the West might impose sanctions against Russia. The amount of cash foreign currency in circulation grew by $5.8 billion (in US dollar equivalent) in March whereas this growth in the previous two months amounted to $2.7 billion and $2.2 billion, respectively. The slower growth in household deposits was largely offset by the faster growth in corporate funds on settlement and deposit accounts.

Higher market volatility and the rouble's weakening caused some change in the currency and term structure of banks' liabilities. The currency structure of banks' liabilities to households and corporate entities[12] registered an increase in the share of foreign currency liabilities; however, this increase adjusted for the dynamics of the rouble value of the dual currency basket was insignificant (Table 4).

Table 4. **Share of Bank Foreign Currency Liabilities in Total Liabilities, %**

Share of Bank Foreign Currency Liabilities to Households in Total Liabilities to Individuals, %		
01.10.2013	18.5	
	Net of adjustment for the rouble's depreciation	Adjusted for the rouble's depreciation
01.04.2014	20.3	18.7
Share of Bank Foreign Currency Liabilities to Corporate Entities (Except Credit Institutions) in Total Liabilities to Corporate Entities (Except Credit Institutions), %		
01.10.2013	38,7	
	Net of adjustment for the rouble's depreciation	Adjusted for the rouble's depreciation
01.04.2014	44.7	42.2

12 Based on accounting form 0409101 "Turnover Balance Sheet for Ledger Accounts" used by all operational banks to submit monthly reports.

The maturity of banks' liabilities to non-financial and non-credit financial institutions[13] slightly decreased in the fourth quarter of 2013 and the first quarter of 2014. The ratio of demand rouble liabilities to term rouble obligations increased over this period from 93% to 107% and this ratio for foreign currency liabilities grew from 46% to 52%.

The current liquidity ratio (N3) calculated as the ratio of a bank's liquid assets to its obligations for a term of up to 30 days declined in March-April 2014 amid a decrease in the maturity of bank obligations (Chart 25). The volume of the banking sector's liquid assets tended to contract, which was another cause for the lower current liquidity ratio (Chart 26). The number of banks with the N3 ratio of less than 60% increased among the 30 largest banks from two banks as of October 1, 2013 to seven banks as of April 1, 2014. However, the N3 ratio stays above the 50% minimum requirement, which means that the banking sector has a sufficient stock of liquid assets to cover a potential outflow of funds under banks' short-term liabilities.

Chart 25. **Current Liquidity Ratio (N3), %**

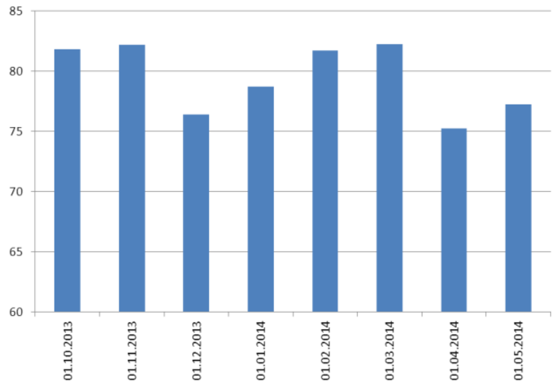
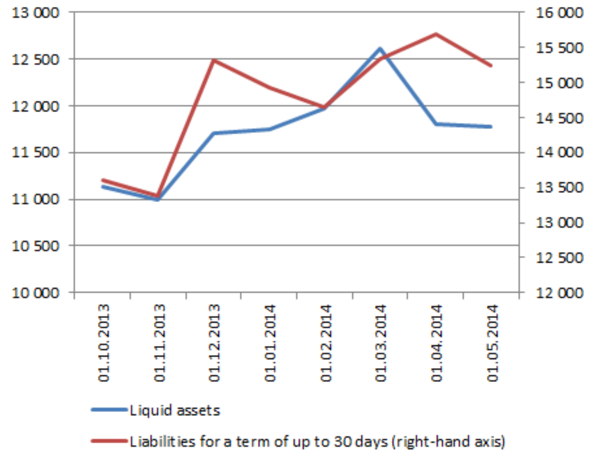


Chart 26. **Banking Sector Liquid Assets and Liabilities for a Term of up to 30 Days, billions of roubles**



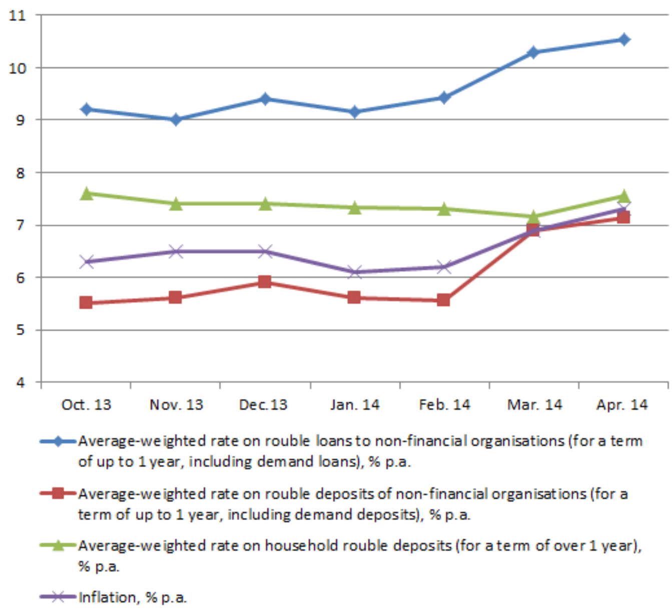
13 Based on accounting form 0409301 "Individual Indicators Characterising Credit Institutions' Activities," which is used by 250 banks to submit reports every five days. Term liabilities in accordance with the procedure for preparing financial statements under this accounting form comprise all term liabilities, including obligations with a maturity of up to 30 days.

Banking Sector Interest Risks

Interest rates and interest rate risks in the banking sector tended to increase as the US Fed was tapering its quantitative easing programme and the Bank of Russia raised the key rate by 200 bps amid a faster growth in inflation, which accelerated to 6.9% in March 2014. Banks are raising interest rates on deposits in order to maintain the stability of their deposit base (Chart 27).

In this situation, the volume of lending is growing mainly due to the provision of loans to large clients refinancing their external debt while loan rate hikes are restrained by competition among banks. Nevertheless, credit institutions will shift a part of interest rate risks onto borrowers. While loans at a floating interest rate hold an insignificant share in Russian banks' portfolios, credit institutions normally have a possibility to raise the loan rate through the provision of the principal in several tranches with different interest rates. Moreover loan agreements frequently include a clause on an option such as the bank's right to raise the interest rate in the event of a material change in market conditions.

Chart 27. **Inflation and Interest Rates on Bank Operations, % per annum**



Box 1. Higher Eurobond Risk Premium and Yields

Sovereign bond yields were affected by external political developments, which changed the conditions on the credit default swaps (CDS) market used as credit derivatives. Sovereign CDS premiums increased considerably in the fourth quarter of 2013 and in the first quarter of 2014 (by 140 bps on average), which has also affected CDS premiums on the debt securities of the largest credit institutions. The dynamics of CDS contracts on Russia determine CDS dynamics of Sberbank of Russia and VTB Bank (Chart 28). The growth of CDS premiums on Russian banks pushed up their borrowing costs. Chart 29 shows increases in CDS premiums on Russian banks and their Eurobond yields.

Chart 28. **CDS Premiums on Russian Banks and the Russian Federation, bps**

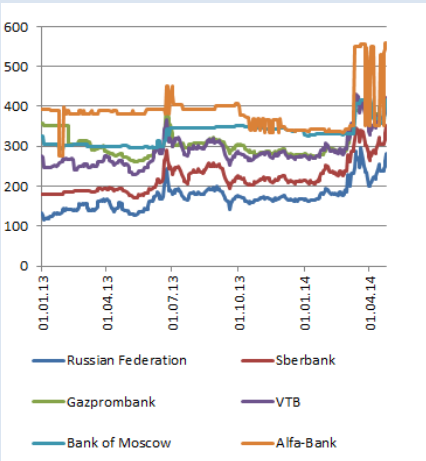
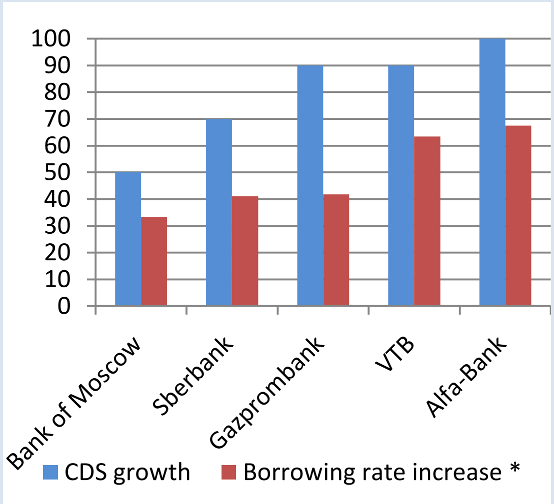


Chart 29. **CDS Premiums and Eurobond Yields Growth in Q1 2014, bps**



* The borrowing rate increase was calculated as the growth in the yield to maturity on two-year Eurobonds of the corresponding banks in the first quarter of 2014.

Banking Sector Refinancing Risks

The share of funds raised from the Bank of Russia increased in the banking sector liability structure during the reporting period. The share of debt to the Bank of Russia in banks' liabilities grew from 5.8% to 7.9% in the fourth quarter of 2013 and the first quarter of 2014, which was primarily related to the withdrawal of rouble liquidity in the banking sector amid a growth in Russian economic entities' foreign assets.

Moreover the growth of market interest rates increased the attractiveness of Bank of Russia refinancing instruments, which substituted a part of deals in the money market. As a result, the share of credit institutions' funds in banking sector liabilities continued to shrink in the period (Chart 30).

Chart 30. **Share of Bank of Russia's and Credit Institutions' Funds in Bank Liabilities, %**

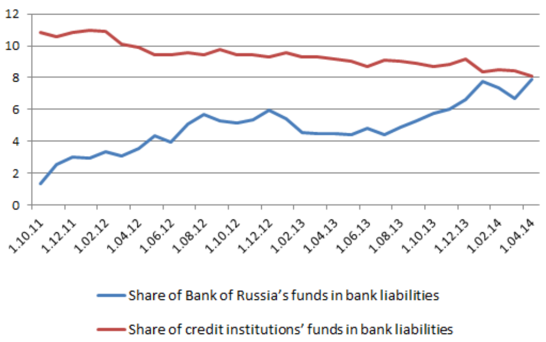
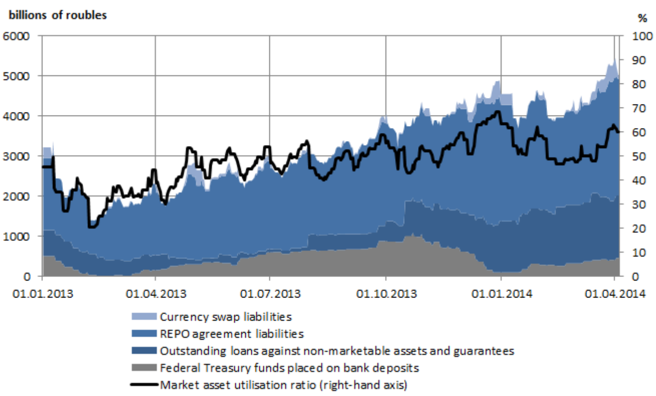


Chart 31. **Bank Debt to Bank of Russia and Federal Treasury and Market Asset Utilisation Ratio**

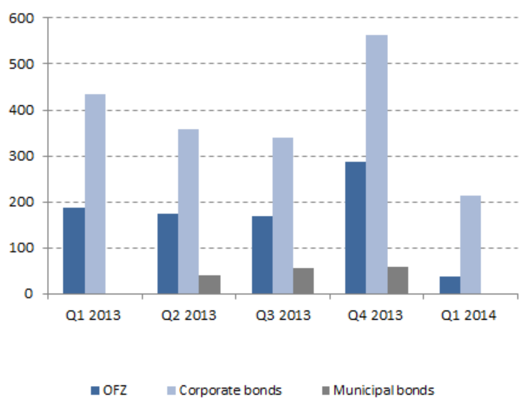


Despite the growing share of banks' refinancing against non-marketable assets and guarantees, repo operations with the Bank of Russia currently remain the basic refinancing instrument for credit institutions. Bank of Russia auctions for the provision of loans secured by non-marketable assets helped maintain the market asset utilisation level at 60% in the fourth quarter of 2013 and the first quarter of 2014 but risk exists that this ratio may increase during the remainder of 2014. Issuance activity in the bond market is of key importance for maintaining this ratio at an acceptable level as debt instruments traditionally prevail in credit institutions' securities portfolios (chart 31).

Issuance activity in the domestic bond market was comparatively low in early 2014. Corporate and federal bond placements were smaller than in the previous quarters in 2013 (Chart 32). The issuance volume on domestic market totalled less than 300 billion roubles in the first quarter of 2014 (Chart 33).

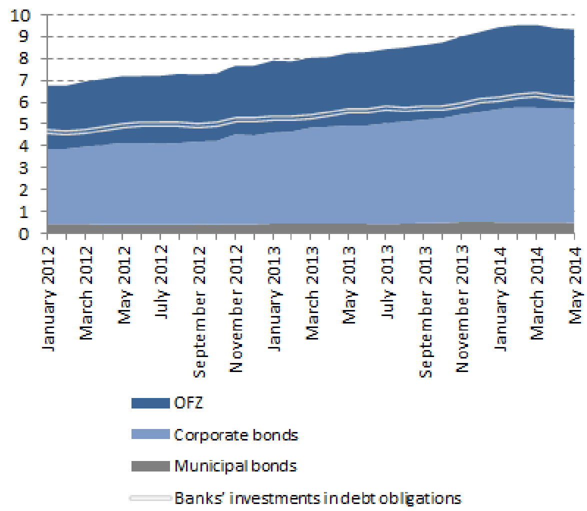
The increased volume of exercised bond tender offers amid higher market volatility had a restraining effect on the growth of bonds issued by both banks and non-bank institutions. Specifically, bond tender offers totalled at least 125 billion roubles in the first quarter of 2014, or five times as large as the amount registered in the first quarter of 2013.

Chart 32. **Domestic Market Bond Issuance, billions of roubles**



Source: Cbonds.

Chart 33. **Domestic Bond Market Volume and Credit Institutions' Investments in Debt Securities, billions of roubles**

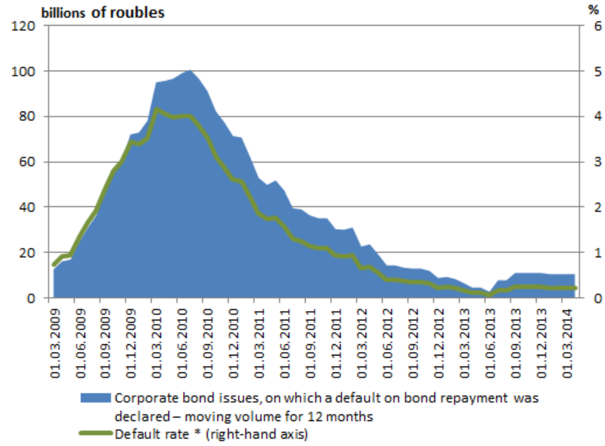


Sources: Cbonds, Bank of Russia.

As the issuance activity declined due to increased volume of tender offers exercised for Russian issuers' , the volume of the domestic debt securities market contracted (by about 40 billion roubles) in March 2014. Banks' investments in debt securities likewise corrected in March, from 6.3 trillion roubles to 6.2 trillion roubles.

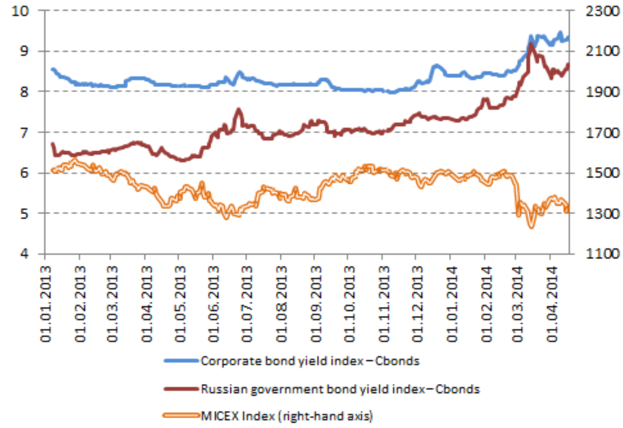
Despite growing tension on financial markets in early 2014 the volume of defaults in the Russian corporate bond market stood still (Chart 34). In particular, the default rate[14] currently stands at about 0.2% on the Russian corporate bond market.-

Chart 34. **Russian Corporate Bond Market Defaults** *



** See also footnote 14 in the text.*
Source: Cbonds; Bank of Russia calculations.

Chart 35. **Russian Bond Yields and MICEX Index, p.**



Sources: Cbonds, Bloomberg.

Liberalisation of the Russian securities market will have a positive effect on the domestic bond market in the long term. In the first quarter of 2014, international depositary and clearing systems became allowed to open nominee holder's accounts for Russian corporate and municipal bonds at the National Settlement Depositary (NSD), which acts as the Russian central depositary. This event is expected to have a positive effect on the issuance activity and price dynamics of bond market's corporate segment and help facilitate the growth of outstanding debt securities.

Market Risk

The first quarter of 2014 was characterised by increased market volatility and the Russian stock indices demonstrated a downside trend coupled with rising yields on both corporate and government bonds (Chart 35). Market indicators suggest that a moderately negative stock market and interest rate shock materialised in the first quarter of 2014. The market value of securities held by banks fell by 200-300 billion roubles as a result of the shock.

14 The default rate was calculated as the ratio between the moving volume of corporate bond issues in the past 12 months, on which a default on bond repayment was declared, and the average volume of the Russian corporate bond market in the past 12 months.

The shock which happened had no significant negative effects on the banking system's stability. This can be explained, in particular, by the relatively low volume of the largest banks' investments in securities compared with the total volume of their assets, as well as the positive revaluation of foreign currency-denominated securities held by some credit institutions.

Based on the estimate as of April 1, 2014, the banking sector will remain stable, if new market risks materialize. A repeat of the shock registered in the first quarter of 2014 could reduce the banking sector's capital adequacy ratio (N1.0) by no more than 0.4 percentage points and is unlikely to create considerable need for additional capital within the banking system.

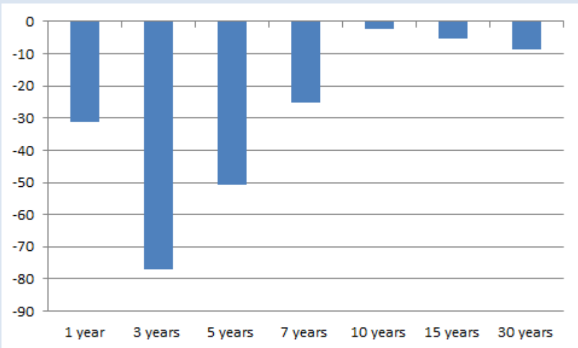
In general, the increased financial market uncertainty and volatility in the fourth quarter of 2013 and the first quarter of 2014 adversely affected the conditions of the Russian financial sector's operation, first of all in terms of funding needs. At the same time, the changes were not critical and did not affect the Russian financial sector's stability.

Box 2. The Impact of Foreign Investments on OFZ Bond Interest Rate Risk

Non-residents' increased activity in the OFZ market in 2013 had a positive effect on OFZ bond pricing and helped eliminate the structural premium from OFZ yields. At the same time, as the share of non-residents in the market grows, the expansion of the group of investors reduces the market's resilience to unfavourable external developments. The non-residents' share in the OFZ market almost recovered in the fourth quarter of 2013 after a period of heightened volatility in May-June 2013; most of non-residents' investments were focused on medium-term issues and the sensitivity of medium-term rates to a change in the flows of foreign investments in the Russian economy was the highest according to our estimates.

A regression analysis[15] was held to assess the sensitivity of OFZ yields to the dynamics of foreign investments. Aside from the volume of non-residents' investments in Russian bonds (based on the EPFR data), the analysis considered such factors as the MICEX stock index, the Mosprime three-month money market rate, the RTS-VIX volatility index and the yields of Russian government Eurobonds with different maturities. The analysis showed that OFZ bonds with terms of 3-5 years were especially sensitive to an inflow of foreign investments while a change in the volume of investments by $1 billion caused a change in OFZ yields by no more than 80 bps (Chart 36).

Chart 36. **OFZ Bond Yields Sensitivity to Foreign Investments by Maturity (Yields Change in Basis Points from Change in Investments by $1 Billion)**



15 The EPFR data on investments in Russian bonds were used as an explanatory variable to assess a foreign capital inflow into the OFZ market. At the same time, these data may fail to reflect actual foreign investment in OFZ bonds and were considered only as an indicator (a proxy indicator) of the scope of this investment.

Box 3. Risks Related to the Activity of Global Asset Management Companies

Global asset managers are potentially important participants of national financial markets as they help increase market liquidity and therefore reduce borrowing costs for both the state and companies. At the same time, the activity of global asset management companies exerts direct influence on asset price volatility and capital flows and may become a source of systemic risks in a changing financial market environment. The events in mid-2013 have showed that asset managers respond very quickly to higher financial market volatility and may increase the volume of funds' withdrawal from emerging economies' instruments, if instability grows.

Asset managers can be divided into three classes: institutional investors (insurance companies, pension and sovereign funds); investment and hedge funds; private wealthy investors. Institutional investors largely invest in assets with high credit ratings and low risk levels. They do not respond so promptly to market changes as their investment committees normally review investment strategies on a quarterly basis or more rarely. At the same time, they have considerable funds at their disposal and, therefore, even a minor change in their investment strategies may cause a significant capital inflow or outflow. Investment funds and hedge funds are generally more inclined to risk-taking and frequently make short-term investments. It is typical of this class of investors to use leverage and carry-trade strategies and quickly respond to any market changes. Private wealthy investors are largely similar to hedge funds in their investment strategies but are characterised by an even higher propensity to take risks. This class of investors is most of all prepared to assume foreign exchange risk and invest in corporate shares and bonds denominated in the national currencies of developing countries.

The Russian market is less popular among global asset management companies than other emerging markets. Unlike such countries, Russia has not registered an increase in the share of foreign investors in the market of national currency-denominated corporate bonds in recent years. The share of foreign investors in the market of corporate rouble bonds does not exceed 1%. Foreign investors make investments mostly in Eurobonds (to minimise foreign exchange risk) or open positions on Russia through derivatives (credit default swaps – CDS). Non-residents' investments in the OFZ market have grown considerably after the market was liberalised and foreign investors gained access to the market through the Clearstream and Euroclear systems in 2013: their market share rose from 3% in 2012 to 28% in May 2013.

The share of Russian securities in global indexes varies considerably: as of April 1, 2014, this share stood at 4.44% for J.P. Morgan (the Government Bond Index Emerging Markets Broad), 12.0% for Vanguard (the Vanguard Emerging Markets Government Bond Index ETF), 1.4% for BlackRock (the BGIF Emerging Markets Government Bond Index), 6.27% for PIMCO (the Global Advantage Government Bond Index), 12.26%/7.1% for Citigroup (the Ceemea Government Bond Index / Emerging markets government bond index) and 4.99%/0.17% for Barclays (the EM Local Currency Government Index / Global Aggregate Index).

The risks of global investors' operations are generally related to the following factors:

1. Investment strategies and asset managers' behaviour considerably depend on a country's credit ratings and share in investment banks' indexes (benchmarks). Such investment policy raises the risk of cliff effects as investors begin to rely on these benchmarks to a larger extent than on their own assessments and a reduction in a country's share or its exclusion from the index may trigger automatic sell-offs.

2. Management companies' behavior is normally influenced by such global factors

as monetary stimulus programmes in developed countries and tendencies for yield-seeking stratagies rather than by macroeconomic indicators of a country used for investment. This practice makes investments in the assets of emerging market economies potentially highly volatile.

3. Considering the volume of their funds, management companies can be seen as systemically important financial institutions and may bring systemic risks both to individual segments of the financial market and the market as a whole.

In order to limit the above-mentioned risks, the Financial Stability Board is developing a methodology jointly with the International Organisation of Securities Commissions to identify non-bank non-insurer systemically important institutions. The draft methodology proposes assessing the systemic importance of investment funds (including, in particular, unit investment funds, money market funds, hedge funds, exchange-traded funds and venture capital funds). Possible alternatives for the methodology also propose assessing asset managers either on a stand-alone basis or collectively with the funds under their management.

Chapter 3. Financial Sustainability of the Non-financial Sector

3.1. Non-financial Institutions' Systemic Risks

Companies' lower profitability and, as a result, their reduced ability to service their debts pose major risks to the non-financial sector's stability amid a slowdown in the Russian economy and the persistence of low prices in world raw material markets.

Rising Debt Burden

Financial statements compiled under the Russian Accounting Standards (RAS) indicate that the non-financial sector's liabilities comprising the financial debt and accounts payable grew considerably in 2013 (by more than 27%), which led to an increase in the debt to equity ratio amid a slower growth in capital. At the same time, this ratio was moderate across the sector (0.8 roubles per rouble of equity) and differed considerably depending on the type of activity and the size of companies' assets (Table 5). A fall in companies' profitability deteriorated their ability to service their liabilities: companies in virtually all key types of economic activity could generate less revenue to cover their obligations.

Table 5. **Financial Indicators of Enterprises in Key Types of Activity in 2013**

Indicator	Agriculture, hunting and forestry		Industrial output		Construction		Wholesale and retail trade		Transport		Communications	
	2013	2012	2013	2012	2013	2012	2013	2012	2013	2012	2013	2012
Debt to equity ratio	1,3	1,2	0,7	0,7	5,0	4,4	2,6	2,3	0,5	0,4	1,8	1,5
Current liquidity ratio (excluding overdue receivables)	1,6	1,6	1,6	1,7	1,1	1,1	1,2	1,3	0,1	0,9	1,1	0,7
Absolute liquidity ratio	0,06	0,05	0,15	0,14	0,1	0,05	0,15	0,07	0,19	0,18	0,11	0,11
Debt coverage ratio, revenues as % of obligations	99,1	79,5	147,7	160,1	84,9	93,2	259,7	270,7	145,8	150,1	98,3	109,5
Return on assets, %	4,0	4,7	6,9	8,0	2,9	2,3	3,8	6,7	1,6	2,9	13,5	11,5
Net cash flow, as % of revenues	–0,6	0,7	1,4	0,7	2,5	–0,5	0,7	–0,7	–1,1	–1,7	0,3	–1,7

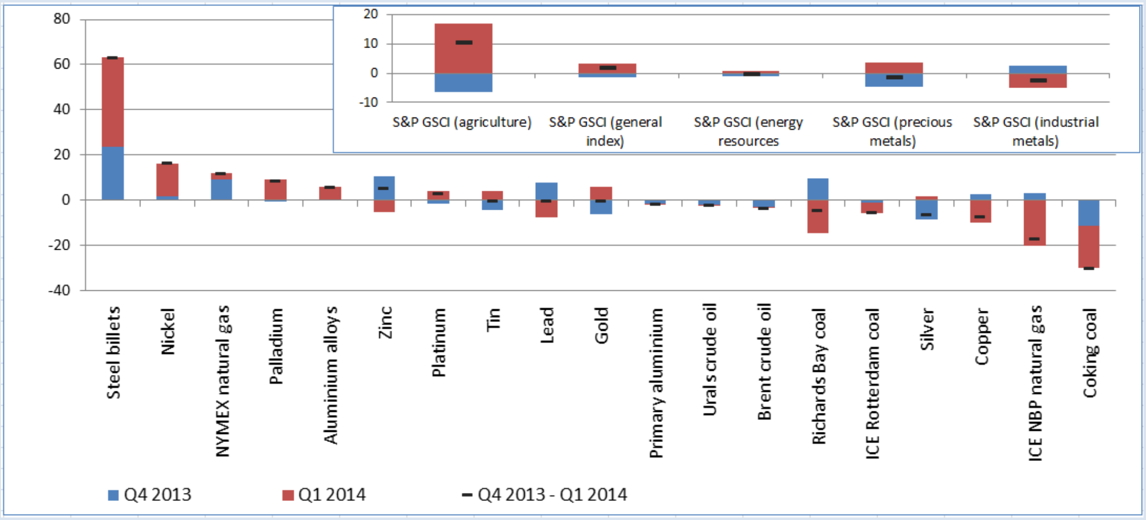
A Bank of Russia poll[16] indicates that enterprises' expectations of a deterioration in their financial standing intensified noticeably in the first quarter of 2014 amid the rouble's weakening, a worsening situation in commodity markets (for details, see Box 4) and the growth of overdue receivables.

16 The polls of non-financial commercial organisations are regularly held by the Bank of Russia in 79 Russian regions; as of April 25, 2014, the polls covered over 17,000 enterprises.

Box 4. Change in Price Trends in Commodity and Raw Material Markets

Chart 37 gives S&P GSCI composite commodities price indexes by category (the general index, energy resources, precious metals, industrial metals, agriculture), spot prices for Urals and Brent crude oil; the spot price of coking coal (China); the prices of monthly ICE coal futures contracts in Rotterdam and Richards Bay coal; the prices of ICE NBP and NYMEX natural gas futures contracts with delivery in June 2014; the spot prices for precious metals (gold, silver, platinum and palladium); the price of three-month forward contracts on base metals at the London Metal Exchange (primary aluminium, aluminium alloys, copper, zinc, nickel, lead, tin, steel billets).

Chart 37. **Change in Price Trends in Commodity and Raw Material Markets, %**



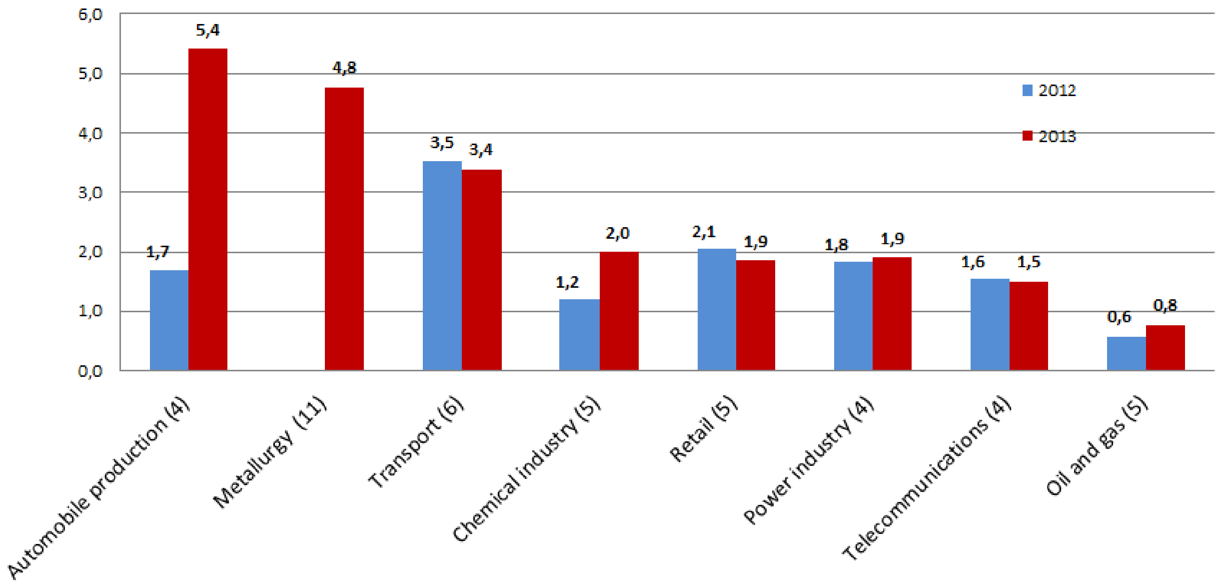
In 2013, the Bank of Russia started to monitor on a consolidated basis the financial standing of 52 companies from various sectors that are of systemic importance for the economy in order to analyse non-financial organisations' systemic risks more carefully. Importantly, an analysis conducted on a consolidated basis (using financial statements compiled under the IFRS and US GAAP standards) takes into account foreign assets of Russian groups of companies, and also helps analyse particular country and operational segments of their activities.

The net debt/EBITDA ratio was used to assess the debt burden of companies. This indicator is widely used in international rating agencies' methodologies and, as practice shows, also serves as a parameter that is most frequently stipulated in loan agreements (loan facilities) to limit the size of a borrower's debt (the covenant).

The average debt burden of these largest companies measured by the net debt/EBITDA ratio rose in virtually all the sectors (Chart 38). The most considerable growth was typical of automobile and metallurgical companies where the ratio increased to the levels exceeding comfortable debt burden values.

Chart 38. **Average Net Debt/EBITDA Ratio Based on the Sectoral Selection of the Largest Companies**[17]

17 The chart gives data calculated for 44 largest companies. The number of companies is given in the brackets.



Along with the debt build-up[18], the growth of the debt burden of **automobile companies** in 2013 was attributed to lower operating profits due to negative car output dynamics. In particular, Rosstat data show that the manufacture of cars in Russia contracted by 2% in 2013 from the previous year while the production of trucks declined by 1.5% and the output of buses decreased by 9.1%. A decline in car sales continued in the first quarter of 2014 and was registered by all the largest car manufacturers. In general, ready-made automobile output dynamics will most likely remain negative in 2014 as well due to a further decline in consumer demand. The programme of concessional auto lending launched in 2010, under which the government subsidises a part of interest rate on auto loans, expired in late 2013. There are no plans to restart this programme; instead, the Russian Ministry of Industry and Trade is considering providing support to the manufacturers of commercial vehicles (freight auto transport and buses for municipal needs running on gas fuel)[19] because this segment of the automobile market registered the largest output decline in 2013.

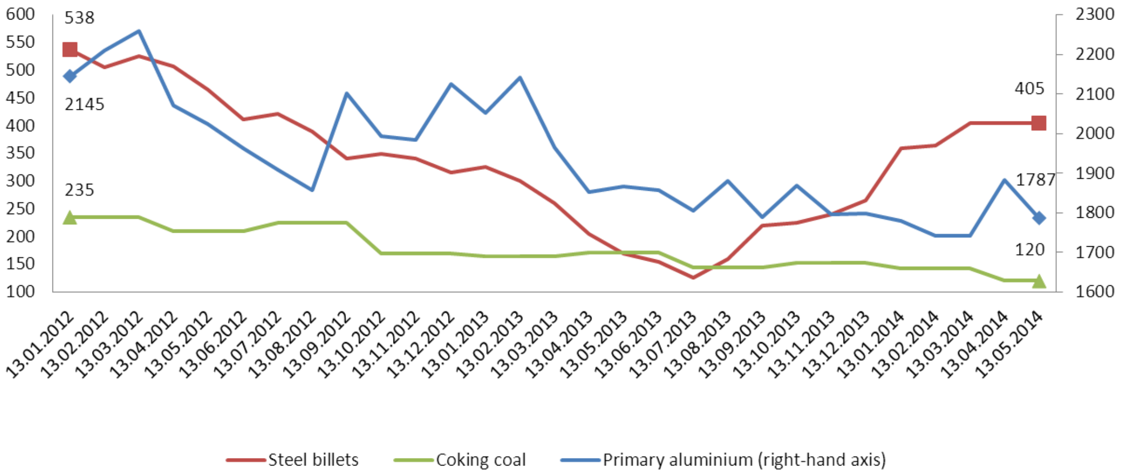
The debt burden levels of **metallurgical companies** also increased considerably: the average net debt/EBITDA ratio grew from 4.0 to 4.8 in 2013. At the same time, the debt burden differs considerably, depending on companies' specialisation.

The operational performance of some large companies in 2013 was affected by the negative dynamics of steel, aluminium and coking coal prices, which fell by an average of 48%, 8% and 23%, respectively (Chart 39). These companies' operating profits decreased considerably both due to lower revenues and loss recognition from business restructuring. As a result, their debt burden level rose to critical levels.

18 This was mainly done by AvtoVAZ car maker to finance its large-scale investment programme.

19 There are plans to oblige executive authorities to purchase buses and municipal utility vehicles produced in the territory of the Single economic space that run on gas fuel, and also to take off the road commercial vehicles past the age of 7 years.

Chart 39. **Metal Prices, US Dollars per Tonne**



Along with a overall reduction in the demand for metal products, the price fall could be attributed to steel and aluminium overproduction and China's expansion of its own coal mining. Steel and non-ferrous metal output growth in China is expected to slow down in 2014 as the country plans to tighten environmental standards.

The debt burden in **the construction sector** is expected to increase as a whole against the reduction in the volume of works in construction (by 1.5% from 2012, according to Rosstat data). It is difficult to measure the debt burden by the net debt/EBITDA ratio due to the low level of the market's transparency: consolidated financial statements are only available from a limited number of companies and solely in the residential construction industry. Financial statements prepared under the Russian Accounting Standards suggest that the construction sector is characterized by the highest leverage and one of the lowest debt coverage ratios. The leverage level tended to grow in 2013 whereas revenues, which construction companies could generate to cover their debts, was observed to decrease.

Construction companies' debt service problems can be seen in bank reporting data, which indicate that the share of overdue debts has risen from 4.7% to 6.8%, coming close to the level of agriculture industry as the most heavily indebted sector of the economy. A trend towards an increase in the share of short-term funding in the debt maturity structure of construction companies can also be considered as a negative factor for the debt refinancing needs.

The debt burden growth is also registered by **oil and gas and chemical companies** but this increase does not cause any serious fears so far because their debt level is not critical.

Interest Rate Risk

Floating interest rates are frequently set for companies' external loans. LIBOR and EURIBOR rates with maturities from three to six months are normally used as benchmark (reference) rates. Therefore, a rise in market rates will push up companies' debt service costs on floating rate instruments.

As for Russian banks' loans, interest rates on these facilities are expected to rise in the near term. The cost of funding will primarily increase for low credit quality borrowers. At the same time, large companies with good creditworthiness have a possibility to raise funds on terms close to the previous ones due to competition among banks for customers with a stable financial position.

It should be noted that interest rates may increase both on banks' new loans and outstanding loan agreements as some loan arrangements have embedded escalation clause to raise lending rates. Banks currently prefer shorter-term lending, which raises the risk of refinancing at higher interest rates. Construction and autombile industries are the sectors with the largest share of short-term financing.

Foreign Exchange Risk

The external corporate debt is mainly denominated in foreign currency: liabilities in US dollars, euros and other foreign currencies account for about 93% of the total debt to non-residents (see Box 5 for risks related to foreign debt refinancing). Overall, the external debt makes up less than a third of Russian non-financial institutions' aggregate debt liabilities. Foreign currency-denominated debt to Russian banks accounts for about 20% of overall debt to banks.

Some of the largest companies may have their foreign currency-denominated debt as large as 90% of their debt portfolio. These companies are normally export-oriented and have a considerable share of foreign currency-denominated revenues. Therefore, they naturally hedge their foreign exchange risks by counter flows of revenues and debt in the relevant currency. Most exporters gain from the rouble's depreciation. Risks exist for companies, which fail to offset the negative consequences of an increase in their foreign currency debt service obligations with a sufficient inflow of foreign currency-denominated funds. These are primarily companies with a high debt burden and companies oriented mostly to the domestic market with a relatively small share of export sales and a large foreign currency-denominated debt. In terms of industry sector, these are primarily metallurgical companies. At the same time, oil and gas, chemical, power and retail companies (retail trade networks) have low exposure to foreign exchange risk. Most companies without foreign currency proceeds brought their debt portfolios into compliance with their revenue structure after the crisis of 2008-2009, i.e. they converted their liabilities from foreign currency into roubles.

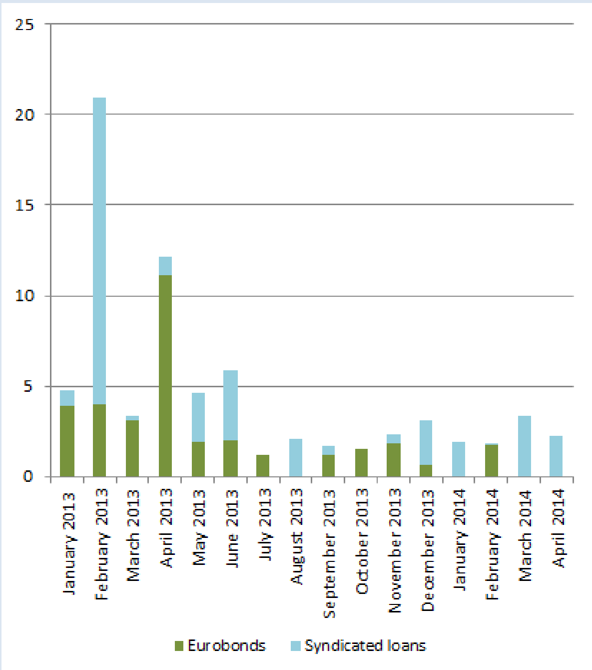
In general, companies that are able to maintain an acceptable debt level will be relatively stable in 2014. Companies with high debt levels need to continue their efforts to reduce the operational costs and dispose of non-core and loss-generating assets as the potential for cost savings and business efficiency improvements remains. Sectorally, risks exist for metallurgical companies (until aluminium, coal and steel prices stabilise), automobile companies, construction firms, agricultural producers and leasing companies. Creditors' and investors' expectations regarding these companies' reporting data deteriorated considerably in the first quarter and the first half of 2014.

Box 5. Non-financial Sector's External Debt

External debt accounts for about a third of the non-financial sector's overall debt. The growth in non-financial companies' external liabilities slowed down in the fourth quarter of 2013 and the first quarter of 2014. The annual growth in external debt in terms of US dollars slowed from 22.8% as of October 1, 2013 to 7.3% as of April 1, 2014.

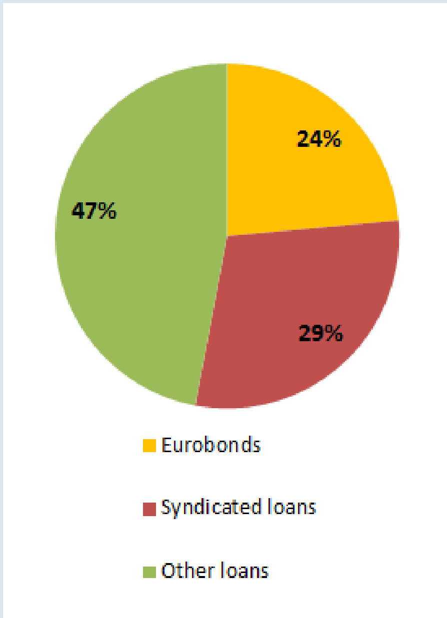
A slower growth in external debt can be explained by tighter conditions for Russian non-financial firms to raise funds abroad, namely: the actual closure of the Eurobonds market (Chart 40), which account for a considerable share in the external debt structure (Chart 41), the increased cost and the shorter maturities of loans extended by foreign banks. In this situation, companies have tended to switch to the domestic bank lending market[20]. Some non-financial organisations also consider a possibility to raise funds in Asian capital markets. Nevertheless, the capacity of this market is insufficient to cover the requirements of the largest companies for financing large-scale investment programmes.

Chart 40. **Foreign Borrowings by Russian Non-financial Organisations[21], billions of US dollars**



Source: Cbonds.info.

Chart 41. **Non-financial Sector External Debt Structure, %**



Sources: Cbonds.info, Bank of Russia.

External debt mostly includes long-term liabilities (obligations with more than 1 year maturity account for over 75% of the aggregate external debt), which is a factor that restrains refinancing risks in short-term period. Under the external debt repayment schedule, non-financial companies have to

[20] In the first quarter of 2014, the non-financial sector's liabilities on bank loans grew by 6% and by 4.2% considering foreign exchange revaluation (in the first quarter of 2013, the non-financial sector's liabilities on bank loans increased by 0.7% taking into consideration foreign exchange revaluation and by 11.9% for the whole of 2013 taking into account foreign exchange revaluation).

21 The schedule reflects Russian companies' borrowings made through public borrowing instruments: Eurobonds and syndicated loans.

repay $57 billion to non-residents in May-December 2014. Therefore, presuming that companies will turn to Russian banks for refinancing their entire debt, the additional demand for loans during eight months may amount to around 1,982 billion roubles. Considering that banks have been seen to increase the monthly lending volumes to non-financial organisations by 300 billion roubles on average during the previous year, the maximum estimate of the potential demand volume can be considered as moderate. In addition, the banking sector's liquid foreign currency-denominated assets (assets with more than 1 year maturity amount to 5.4 trillion roubles), exceed the planned volume of external debt redemptions by both banks and non-financial firms over the year (5.2 trillion roubles). Therefore, banks will be able as a whole to meet non-financial firms' additional demand for loans without negative impact on their own external debt redemptions. At the same time, there is a risk that larger and more stable borrowers may edge out small borrowers with a high level of leverage and debt burden from the bank lending market.

There is a risk that lenders may demand early debt redemption from companies breaching debt covenants, but this risk mainly exists for highly-leveraged firms. Most probably, foreign creditors will agree to ease terms by providing borrowers with delay in payments, as was the case in 2008-2009.

Chapter 4. The Assessment of the Banking Sector's Credit Risk

4.1. The Dynamics of the Quality of Loans to Non-financial Organizations

There was no considerable increase in credit risks on loans to non-financial organisations in the period between October 2013 and April 2014. The continued trend of the non-financial firms' profits decline (-11.4% year-on-year as of April 1, 2014) caused some increase in overdue loans. At the same time, the share of overdue loans remained virtually stable, contracting over the six-month period by 0.1% to 4.2% as of April 1, 2014. Since September 2013, the growth rates of overdue loans have increased for the first time in the past two years. The volume of corporate loans classified as IV-V quality category loans (the lowest credit quality loans) also grew faster: this growth accelerated by 1.9 percentage points over the last six months to 17.1% as of April 1, 2014 (Chart 42)[22].

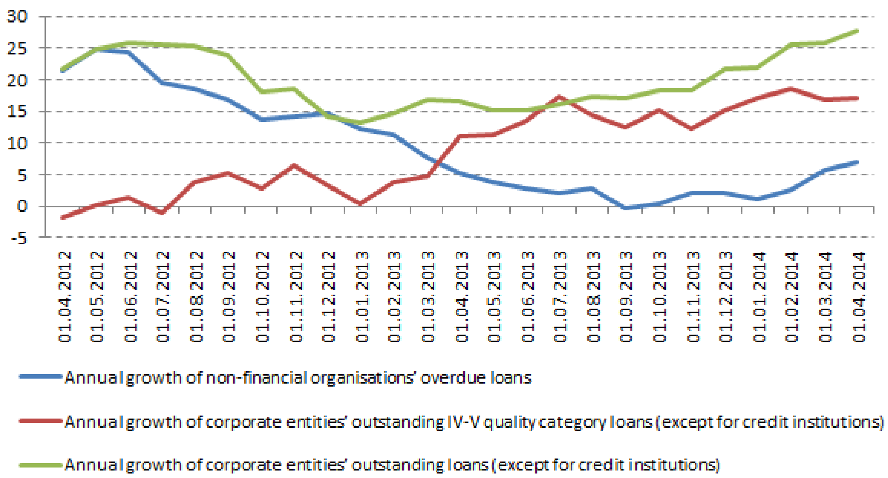
At the same time, the share of IV-V quality category loans contracted by 0.4 percentage points over the last six months due to the faster growth of the loan portfolio and stood at 5.4% as of April 1, 2014. Given the persistence of the current trends of non-financial organisations' profitability decline, the growth rates of IV-V quality category loans are expected to remain at 17-18% in the next 12 months. The share of restructured corporate loans remains unchanged so far (24.3% as of April 1, 2014)[23].

The weighted average interest rate on new loans with up to 3 months maturity extended to non-financial organisations increased by 1.3 percentage points to 9.6% in the period under review, which was mostly due to the growth in the cost of bank funding. No significant changes have been registered in interest rates on longer-term loans so far. At the same time, the weighted average lending tenor to non-financial institutions slightly decreased over this period. Banks' expectations regarding the borrowers' financial standing have deteriorated as a whole, which leads to an increase in interest rates and a reduction in the volume of loans provided to borrowers of medium and below-medium credit quality. Loans to large and the most reliable clients are provided on terms close to those of the previous year.

22 The calculations were made using sections 1 and 2 of credit institutions' reporting form 0409115. The calculations include credit claims on loans extended to corporate entities, except for credit institutions, small and medium enterprises.

23 The data on restructured loans are based on an analysis of the banking system's 30 largest loans as of April 1, 2014. These loans make up 7,988.6 billion roubles.

Chart 42. **Credit Risk Factors, %**

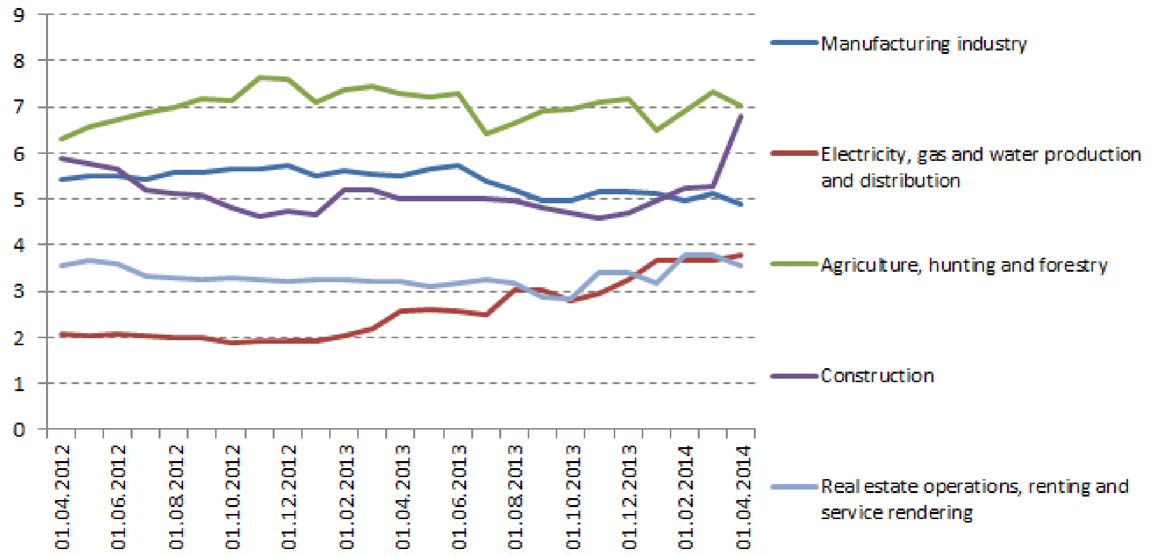


Sources: reporting forms 0409115, 0409101.

Lending has been observed to slow down considerably in some types of economic activity. During the period from October 1, 2013 to April 1, 2014 the most significant decrease of outstanding loans growth rate was registered in such segments as agriculture, hunting and forestry (a decrease by 7.5 percentage points to 4.9%), real estate operations, renting and service rendering (down by 7.9 pp to 13.5%) wholesale and retail trade, repairs of auto transport vehicles, motorcycles, household appliances and personal items (a fall by 5.9 pp to 7.1%). The slower growth of lending to specific segments of economic activity may adversely affect adjacent sectors in the future. At the same time, some types of economic activity registered a faster growth in outstanding loans in the period under review: mining (+14.3 pp to 21.6%), manufacturing industry (+8.2 pp to 20.2%), transport and telecommunications (+8.8 pp to 7.1%).

The largest increase in the share of overdue loans is registered in construction (+2.1 pp to 6.8%), electricity, gas and water production and distribution (+1 pp to 3.8%) and real estate operations, renting and service rendering (+0.75 pp to 3.6%). Agriculture, hunting and forestry continue to account for the largest share of overdue loans (7%), but substantial growth in overdue liabilities in construction may change this trend in the future. The significant growth of overdue loans in construction may be related to the bankruptcy of some companies implementing state projects.

Chart 43. **Share of Overdue Loans by Sector, %**



Source: reporting form 0409302.

As overdue loans in construction are rising rapidly, it is appropriate to enhance control over debt financed projects. In order to minimise losses on newly issued loans, it is necessary to ensure more careful approaches to the practice of assessing collaterals and setting appropriate discounts.

4.2. The Influence of Bank of Russia's Macro-Prudential Measures on the Consumer Lending Market

In 2013 the Bank of Russia started to implement macro-prudential measures in respond to the excessive growth of unsecured consumer lending. With the aim to cool the market, the regulator increased the minimum requirements for loss provisions of unsecured consumer loans and raised risk ratios for calculation of capital adequacy for loans with increased effective interest rate. These measures were introduced at three stages: they first applied to loans provided after January 1, 2013 and then were extended to loans granted after July 1, 2013 and after January 1, 2014.

Chart 44. **Annual Growth in Lending to Households by Segment,%**

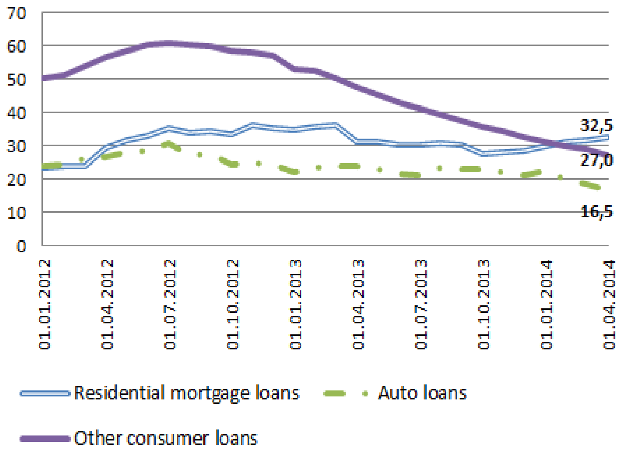
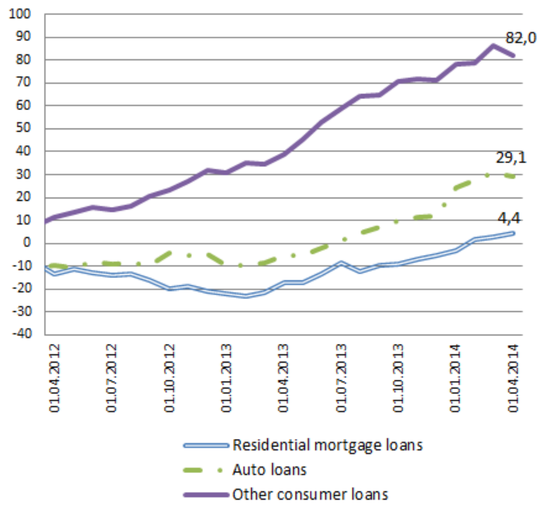


Chart 45. **Annual Growth in Loans with Overdue Payments of 91 Days or More, %**



Source: reporting form 0409302.

Unsecured Loans

The growth rates of unsecured loans with increased credit risk levels slowed down in the banking sector as a whole to 27%[24] per annum as of April 1, 2014. The growth rates calculated for banks with the increased concentration of their operations in the consumer lending market (hereinafter, the sampled banks)[25] dropped to 28.8%. Currently, there is no tendency for re-distribution of the unsecured loan market in favour of the largest government-related banks.

The quality of unsecured loans continues to deteriorate (Chart 45). Loans with overdue payments (over 90 days) are growing at an annual rate of 82% per annum, considerably exceeding the rates of growth in lending.

The deteriorating quality of the loan portfolio is most of all demonstrated by the sampled banks. This situation is largely the result of banks' quite risky policies conducted in 2011-2013 for the issuance of unsecured loans. The share of bad loans (with overdue payments of more than 90 days) is considerably larger in the sampled banks' portfolio than in the banking sector as a whole: 14.7% as against 9.3%, respectively.

The deteriorating loan quality forced the sampled banks to increase their loan impairment provisions. The Bank of Russia's measures also contributed to this process. Apart from this, as the regulator raised risk ratios, these banks limited the issuance of risky loans at increased rates. Specifically, loans with the effective interest rate of 35-45% accounted for 60.7% and those with the effective interest rate of over

24 Based on credit institutions' reporting data as per reporting form 0409115 (section 3, debts on other consumer loans grouped together in the portfolio of homogeneous loans).

25 The sampled banks meet the following criteria: unsecured loans amount to over 10 billion roubles, the share of unsecured loans in banks' assets exceeds 20% and the share of interest income on loans to households is over 35% in the total volume of interest income. The sample included 27 banks as of April 1, 2014; the aggregate portfolio of unsecured loans totalled 2.5 trillion roubles.

45% made up 30.9% of outstanding loans as of October 1, 2013[26], whereas the proportions of these loans as of April 1, 2014 fell to 51.8% and 20.3%, respectively.

These changes affected the sampled banks' profitability: the return on assets fell to 1.7%, which is slightly below the average level calculated for the banking sector as a whole (1.8%).

In order to maintain their capital adequacy ratios, the sampled banks were building up their equity through an enlargement of their authorised capital and additional share issues. These measures helped the sampled banks increase the average capital adequacy ratio over the six-month period by 0.25 percentage points to 12.2% as of April 1, 2014 (compared with the banking sector's average ratio of 13.2%).

The quality of the unsecured loan portfolio will continue to deteriorate amid a worsening macro-economic situation (in the conditions of a fall in real wages and faster inflation[27]) and the households' rising credit burden (see Box 6). This trend will prompt banks to create additional loan impairment provisions and further reduce their profitability: the return on the sampled banks' assets is expected to fall to 1.4% by October 2014.

Our estimates show that in the medium term (1-2 years) banks are expected to renew the portfolio of loans issued before January 1, 2013 and still exempt from new regulatory requirements. Therefore, once the loan portfolio is renewed, the regulatory measures implemented by the Bank of Russia will not exert additional pressure on banks' profitability, which will be primarily determined by lending growth rates and the quality of the loan portfolio. The return on assets will stabilise, given moderate loan portfolio growth rates and a stable macro-economic situation.

Federal Law No. 353-FZ of December 21, 2013 "On Consumer Loans," which sets caps on the effective interest rate of loans and will come into effect on July 1, 2014, will help reduce the issuance of potentially risky loans at higher rates. Considering all payments, the loan cost should not exceed the average market level by more than a third. The Bank of Russia will determine the average market loan cost quarterly, using data on the 100 largest creditors or at least a third of creditors providing the corresponding category of consumer loans. Data on the average market levels of the total cost of loan categories will begin to be published no later than November 14, 2014.

As credit risks increase, an assessment of a borrower's ability to repay loans is a key criterion for concluding a consumer loan agreement. Banks need to have true data on borrowers' incomes and debt burden to analyse their financial position properly. A task group is currently working in the Bank of Russia on the issue of ensuring access for creditors to information on borrowers' incomes and financial obligations, including data available to the Pension Fund of the Russian Federation, tax bodies and the Federal Bailiff Service.

26 The data are given on loans issued after July 1, 2013.

27 The index of real wages per worker fell to 103.1% as of April 1, 2014 while the annual consumer price index growth accelerated to 7.3% as of May 1, 2014.

Box 6. Results of the Survey of the Largest Retail Banks in the First Quarter of 2014

Since 2013, the Bank of Russia has been holding quarterly surveys of individuals' outstanding loans by polling the largest banks operating in the consumer loan market. The poll held in the first quarter of 2014 covered 21 banks (58% of the market of outstanding loans).

The borrowers' debt burden was virtually unchanged in the first quarter of 2014 (1.24 loans per borrower). The average-weighted DTI[28] amounted to 32% as of April 1, 2014, while the average-weighted DTI inclusive of the borrowers' debts to other banks stood at 42%.

Banks continued to increase the volume of lending to borrowers with relatively high income: the fastest growth in the first quarter of 2014 was registered in the number of borrowers with incomes from 75,000 to 125,000 roubles (it grew by 5% over the quarter) and over 125,000 roubles (by 7%).

The average effective interest rate of auto loans issued over the quarter was observed to grow across banks *from 24% to 27%.* The effective interest rate of credit cards, on the contrary, fell from 41% to 39%. As a result, POS-credits[29] became the most expensive type of loans (with their effective interest rate at 41%).

The growth rates in the segment of credit cards were slowing down but remained higher than in other segments. The segment's intensive growth can be explained by its relatively small capacity (13% of the remainder of outstanding loans), large banks' marketing policy to develop the credit card segment (for example, the mass issuance of credit cards to salary card clients) and also the convenience of card use for borrowers compared with cash loans and POS-credits.

Chart 46. **Consumer Loan Market Segment Comparison by Value[30], Quarterly Outstanding Debt Growth and Increased Loan Total Cost, %**

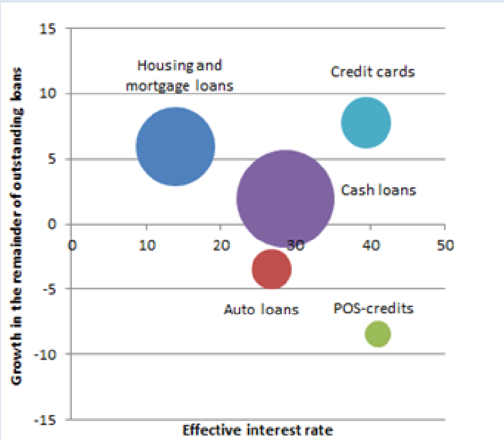
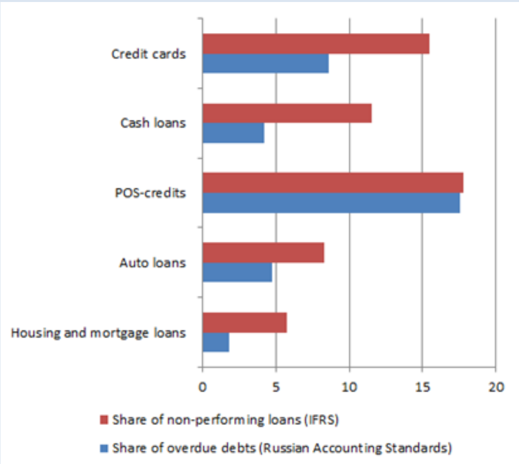


Chart 47. **Share of Overdue Debt by Segment, %[31]**



28 DTI (debt to income) is the ratio between the amount of a borrower's loan repayment for the past quarter under the terms of a loan agreement and the amount of a borrower's income. The DTI is calculated using the amount of an individual's debt to one bank as the numerator, excluding debts to other banks and non-credit financial organisations.

29 POS (point of sale) credits are loans issued to borrowers for the purchase of goods at the place of their sale.

30 The circle size is proportional to the remainder of the segment's outstanding loans.

31 Excluding data of Sberbank of Russia.

The largest share of overdue debts (under the RAS and IFRS standards) is still typical of the segment of POS-credits (17.6% and 17.8%, respectively). The fastest quarterly growth in overdue debts under the RAS standards is observed in the credit card segment (23%). This can be explained by the deterioration in the borrowers' financial position and high rates of growth in outstanding credit card balances while it is more likely for borrowers to miss a payment date on a credit card than on other types of loans (frequently due to insufficient knowledge of the terms of agreements).

Banks provide a considerable share of loans to borrowers with outstanding debts to banks as of the date of loan provision: *in the first quarter of 2014, these borrowers accounted for 41% of the number and 44% of the value of loans issued by banks.*

Housing Mortgage Loans

While the growth in the volume of outstanding unsecured consumer loans is slowing down, housing mortgage loans are growing rapidly. Over the six-month period, their growth rates increased to 31% and the volume of outstanding mortgage loans exceeded 3 trillion roubles. Overdue debts in this segment at are the minimum level of about 1%.

In order to monitor this lending segment, the Bank of Russia has set up a working group with the participation of five banks accounting for over 72% of the mortgage loan market. Stress tests of the portfolio of mortgage loans were held for various stress scenarios, including the scenario similar to the crisis of 2008-2010. The stress tests were conducted using the matrices of loan migration across overdue debt periods.

The results of the stress tests generally indicate banks' resilience to a crisis scenario. Systemic risks are decreasing as the largest banks by assets are diversifying their business strategies (the mortgage loan portfolio accounts for 5-20% of the largest banks' assets) and banks maintain their equity (capital) at a sufficient level.

It should be noted, however, that a considerable share of mortgage loans is characterised by increased LTV levels (over 70%). In particular, loans with the LTV of over 70% account for almost 50% of outstanding loans and loans with the LTV of over 80% make up 34%. Apart from this, a trend has been observed since early 2013 towards a considerable increase in the issuance of loans with the LTV of 80-90% and, on the contrary, a decrease in the provision of loans with the LTV of no more than 40%, which may testify both to the banks' relaxed mortgage lending standards and the stronger demand for mortgage loans from borrowers with increased credit risk.

A considerable share of outstanding loans with high LTV levels may eventually pose systemic risks, if real estate prices and household incomes fall considerably. In order to monitor mortgage lending risks, the Bank of Russia will hold specialised stress tests on a regular basis (once every six months), as well as surveys of the largest banks.

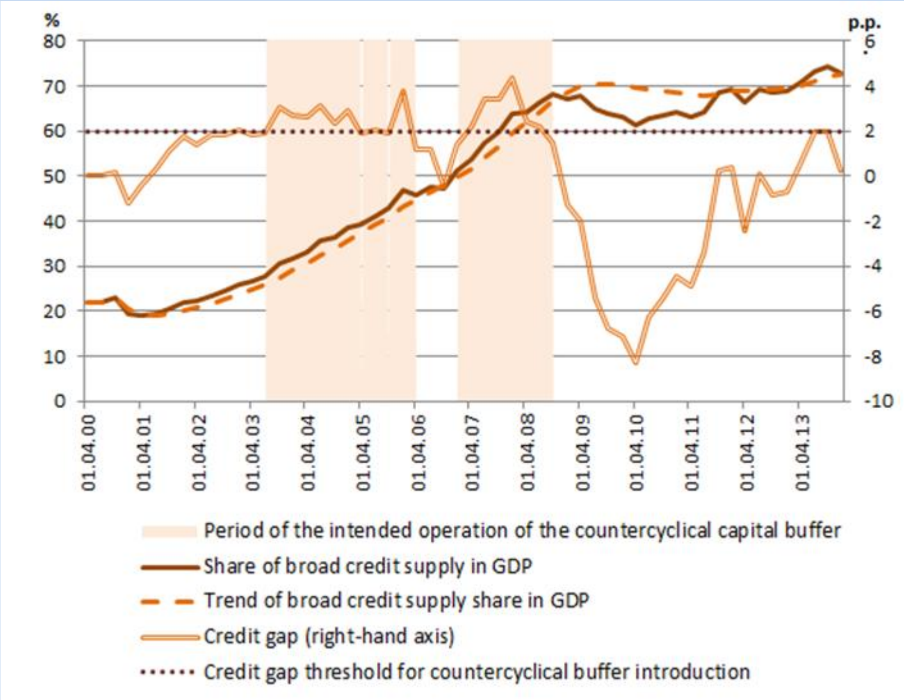
Box 7. Credit Cycle

The countercyclical capital buffer is a capital addition to the capital adequacy ratio, which is set to restrict the banking sector's systemic risk build-up in the period of a credit boom. The countercyclical capital buffer is an instrument of macro-prudential regulation developed by the Basel Committee on Banking Supervision (BCBS) as part of Basel III Framework recommendations.

In its credit cycle analysis, the Bank of Russia uses the BCBS methodology for building the countercyclical capital buffer[32]. Under this methodology, the current phase of the credit cycle is determined on the basis of credit gap dynamics – a deviation of the share of credit supply in GDP from its long-term trend. The countercyclical capital buffer is introduced at the stage of a credit boom, when the credit gap exceeds 2 percentage points.

A credit cycle analysis indicates that the credit gap is currently narrowing, which points to the absence of the need to introduce the countercyclical capital buffer (Chat 48).

Chart 48. **Credit Cycle Parameters (BCBS methodology)**



Source: Bank of Russia calculations.

32 Basel III: A global regulatory framework for more resilient banks and banking systems. Basel Committee on Banking Supervision. December 2010.

Chapter 5. The Financial Standing of Non-credit Financial Organisations

A number of bills were adopted in the period under review to raise the financial sustainability and information transparency of non-credit financial organisations, first of all, micro-finance organisations and non-governmental pension funds. At the same time, the cause for the greatest concern is the financial standing of insurance companies, which has deteriorated due to systemic problems in the segment of auto insurance.

5.1. Insurance Organisations [33]

The situation in the Russian insurance market in the fourth quarter of 2013 and the first quarter of 2014 was primarily characterised by systemic problems in the segment of auto insurance (this segment accounted for 39.1% of overall insurance premiums and 56.4% of total insurance payments in 2013). Growing losses in auto insurance related to changes in judicial practice reduced the entire sector's profit margins and investment attractiveness. As well, the growth in insurance premiums decelerated considerably in the insurance market (from 22.4% in 2012 to 11.4% in 2013; overall premiums totalled 812.5 billion roubles and 904.9 billion roubles, respectively). This situation can be partially attributed to a general decline in business activity affecting the insurance market with a lag of 3-4 quarters. Some corporate types of insurance demonstrated negative premium dynamics. It should be noted that the most considerable growth slowdown in the insurance market was registered in the fourth quarter of 2013 (Chart 49). This trend is expected to persist in 2014.

Chart 49. **Quarterly Insurance Premium and Payment Dynamics, %**

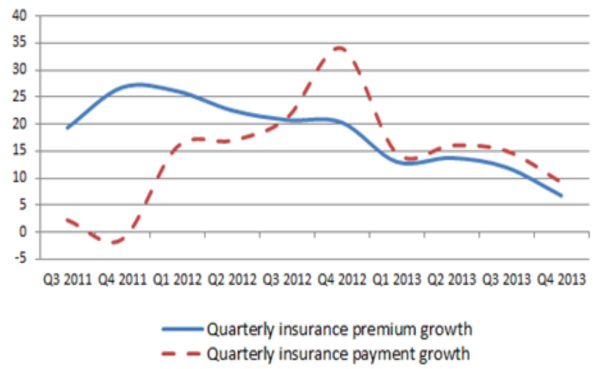
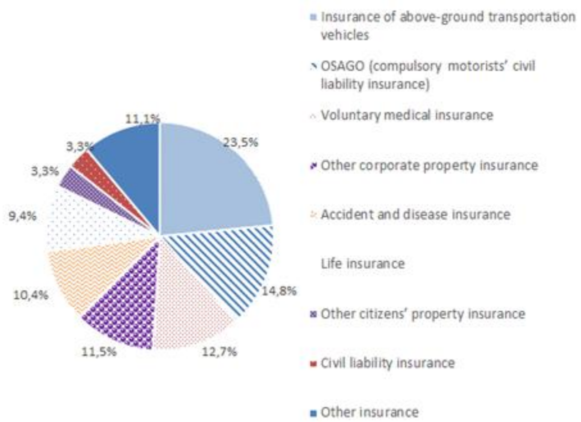


Chart 50. **Insurance Premiums by Insurance Segment in 2013, %**



At the same time, instability in the foreign exchange market and the rouble's weakening in the first quarter of 2014 had a little effect on insurance companies' balance sheets as they mostly had inconsiderable foreign currency exposure: as of September 30, foreign currency assets accounted for 11.0% of the consolidated balance sheet (10.3% a year earlier) while foreign currency liabilities made up

33The register of insurance providers comprised 419 insurance companies as of April 1, 2014 (450 insurance organisations a year earlier).

2.7% (2.9%)[34]. Nevertheless, considering the rising prices of auto parts and the increased cost of international reinsurance protection, insurance companies will be forced to raise their rates for some types of insurance during 2014.

Growing Auto Insurance Loss Margin

Changes in judicial practice and a sharp increase in lawsuits filed against insurance companies were a major factor that caused a growth in auto insurance loss margins. The growth in payments under court rulings on events and circumstances unspecified in insurance agreements[35] is especially noticeable.

These payments were not taken into account in standard tariff models and, consequently, insurance reserves were not created for them. The situation in the first quarter of 2014 was aggravated by the rouble's weakening, which caused a growth in the cost of auto parts for foreign-made cars and, therefore, an increase in the average size of payments. As a result, insurance companies' real liabilities exceeded their reserves they had set up earlier.

The net combined ratio for voluntary motor vehicle insurance (auto casco) stood at 93.6% in the first nine months of 2013[36] (91.4% in 2012).

It should be noted that this indicator does not take into account insurance companies' administrative and judicial costs, which have also risen noticeably[37].

Considering these costs, the final result from auto casco insurance operations is close to zero and turns negative for some insurers.

The net combined ratio for OSAGO operations stood at 86.9% across the market as a whole in 2013 (compared with 86.6% in 2012). The OSAGO loss ratio varied considerably across Russian regions. Specifically, OSAGO insurance payments exceeded 70% in 13 Russian regions and 90% in four constituent entities in 2013 (six regions and one region in 2012).

Falling Demand in Corporate Sector

Corporate insurance key risks are posed by falling demand (in 2013, negative rates of growth in premiums were registered in the segment of other corporate property insurance (-1.5%) and freight insurance (-6.0%)) and the associated trend towards the reduction of tariff rates. On the one hand, the negative economic environment forces corporate insurance policy buyers to adjust their insurance budgets, limit insurance coverage or look for insurance companies ready to revise their rates. On the other hand, many insurers interested in expanding their corporate portfolio are reducing their rates or offering various discounts amid high auto insurance loss margins. All these factors adversely affect the sector's financial stability.

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34 Based on federal statistical observation reporting form No. 1-FS (IC) "Insurance Company Borrowings and Investments" approved by Rosstat order No. 308 of December 10, 2008.

35 For example, payments concerning drivers unmentioned in insurance agreements or compensation for the loss of commodity value.

36 The loss ratio for the first nine months of 2013 is based on information on 161 insurance companies providing agricultural insurance, OSAGO, compulsory civil liability insurance of hazardous facility owners and compulsory insurance of carriers' civil liability (information on 430 insurers for 2012).

37 Russian Federation Law No. 2300-1 of February 7, 1992 (in the wording of July 2, 2013) "On the Protection of Consumer Rights," which was extended to insurance (Resolution by Russian Federation Supreme Court Presidium No. 17 of June 28, 2012 "On the Examination of Civil Litigation Cases by Courts under Disputes on Consumer Rights' Protection") made it possible to charge penalties from insurers in the amount of up to 50% of the sum awarded by a court ruling.

In general, the corporate segment remains a source of profit for the Russian insurance market, although some types of operations generate losses for insurance companies. In particular, in the first nine months of 2013, the net combined ratio of over 100% was registered in civil liability insurance of railway and air transport owners, compulsory state insurance of the life and health of servicemen and compared persons in compulsory state insurance, and also in water transport insurance. The profitability of some companies in the corporate insurance segment in 2013 was also affected by large disastrous losses caused by an accident at the Zagorskaya GAES-2 pumped-storage hydropower plant and floods in the Russian Far East.

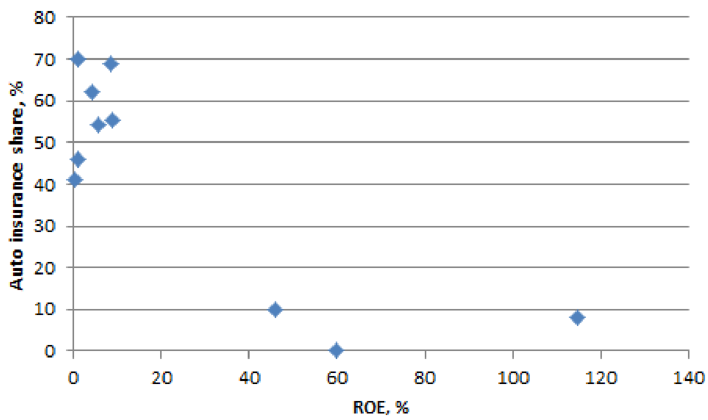
The insurers' financial result in corporate insurance in 2014 will be specifically affected by the higher cost of foreign reinsurance protection as a result of the rouble's depreciation. At the same time, uncertainty persists about a possible negative effect on relationships between western reinsurers and Russian reinsurance buyers due to sanctions against Russia.

Insurance Market Investment Attractiveness and Future

Lower insurance profitability in 2013 affected the insurance sector's investment attractiveness. The return on Russian insurers' equity fell to 12.1%[38] in 2013 from 15.5% a year earlier.

At the same time, the insurance market is highly heterogeneous by profit distribution. A considerable part of profit is concentrated in a small number of companies specialising in corporate insurance and the insurance of banks' borrowers. Meanwhile, auto insurers' profitability is considerably below the average market level (Chart 51).

Chart 51. **Return on Equity of 10 Largest Insurance Companies Depending on the Share of Auto Insurance in Premiums in 2013, %**



Problems in auto insurance prompted a whole number of insurance organisations to reduce their presence in this market. In particular, in the fourth quarter of 2013, falling premium growth rates were registered by four out of the 10 largest companies operating in the OSAGO market and seven out of the 10 biggest operators in the auto casco market. In the spring of 2014, some insurance companies made a decision to close all their sales offices and restructure their insurance portfolio. It will still be highly likely throughout 2014 that new decisions will be made on insurance portfolio restructuring and voluntary exit from the market.

38 The ratio of balance sheet profit to average equity based on data provided by consolidated RAS statements.

Changes in the market will largely depend on final amendments to the OSAGO law[39] and the approval of a common damage evaluation methodology.

As well, active discussions are underway to introduce an electronic OSAGO contract to help resolve the problems of stolen insurance blank forms and the refusal to sell insurance in some regions. In the long term, this measure will help reduce transaction costs and increase profitability.

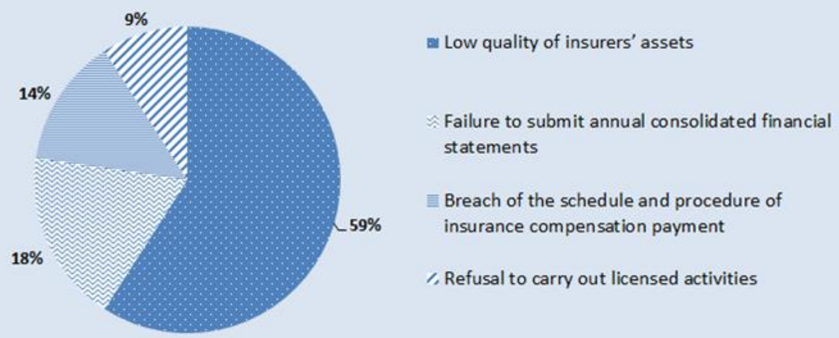
The adoption of a bill on housing insurance will have an indirect effect on the sector's attractiveness. But this bill is primarily intended to help cover a larger part of the population with insurance and also contribute to an increase in the insurers' share in the compensation of damage caused by natural disasters.

Box 8. The Causes of License Sanctions against Insurance Companies

The suspension of insurance licences (a total of 22 cases were considered)[40] was mainly caused by the low quality of insurers' assets, making it impossible for them to fulfil orders by the Finance Ministry of Russia on insurance reserve and equity coverage.[41]

The insurance licences were also suspended due to the insurers' failure to submit annual consolidated financial statements within legislatively-established time limits, the breach of the schedule and the procedure of insurance compensation payments and the refusal to carry out activities stipulated in the licence.

Chart 52. **Causes of Licence Sanctions, %**



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39 Federal Law No. 40-FZ of April 25, 2002 "On Compulsory Motorists' Civil Liability Insurance" (OSAGO).

40 Grounds were analysed for licence suspension in the cases considered by the Bank of Russia Financial Supervision Committee from the first day of its meeting (September 18, 2013) to April 1, 2014.

41 Russian Finance Ministry Order No. 100n of July 2, 2012 "On Approving a Procedure for Insurance Organisations to Invest Insurance Reserves;" Russian Finance Ministry Order No. 101n of July 2, 2012 "On Approving Requirements for the Composition and Structure of Assets Accepted to Cover Insurers' Equity."

The signs of untrue reporting data relating to the asset composition and structure were revealed in six out of 13 cases of the insurers' failure to fulfil Russian Finance Ministry Orders No. 100n and No. 101n. In five instances, the insurers failed to provide documents in full confirming the possession of securities and bank deposits. In two cases, the authenticity of documents submitted by the insurers was not confirmed by additional inquiries sent to their counterparties. In two instances, the insurers actively cooperated with the depositaries which had their licences suspended or invalidated.
The Bank of Russia plans to enhance control over the quality of insurers' assets, including by way of introducing the institution of curators.

5.2. Microfinance Organisations

The microfinance market is currently characterised by the considerable growth potential determined by the low base effect, the growth in the number of market participants and high accessibility of microfinance services.

The number of agreements signed in the first nine months of 2013 and the volume of microloans issued over this period considerably exceeded the levels registered for the whole of 2012 (by 89% and 75%, respectively)[42].
Loans extended to households account for most of outstanding microloans (see Chart 51). As a result, the microloan portfolio reached 96.9 billion roubles as of October 1, 2013 or 1.03% of the banking sector's household loan portfolio. The market growth was partly attributed to the increase in the number of market participants: a total of 4,039 entities were included in the register of microfinance organisations (MFOs) as of April 1, 2014 or 42% more than a year earlier (Chart 54). It should be noted that this market is characterised by the presence of a considerable number of corporate entities staying outside the MFO register and carrying out microfinance activities.

42 From 68% to 71% of the number of MFO entered into the state register.

Chart 53. **Microfinance Loans Issued in Nine Months of 2013 by Borrower, %**[43][43]

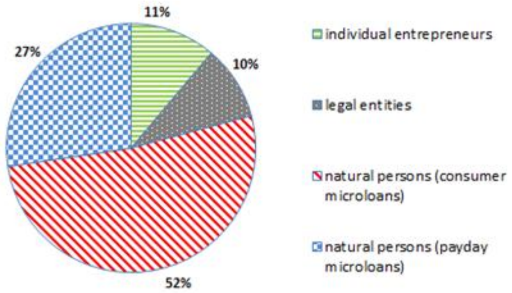
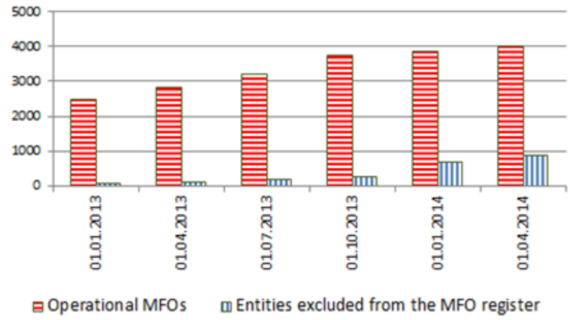


Chart 54. **Number of Operational Microfinance Organisations and MFOs Excluded from MFO State Register**



In the fourth quarter of 2013 and the first quarter of 2014, the Bank of Russia initiated the following changes in the activities of MFOs to slow down the accumulation of households' excessive debt:

- A requirement for MFOs to create loan impairment provisions depending on overdue debt periods, the borrower category and the availability of collateral.

Provisioning will help smooth ROE volatility on the one hand, and facilitate accurate taxable base accounting, on the other hand, which will increase the MFO's financial stability. This measure is also designed to create favourable competitive conditions for bona-fide market participants who have already voluntarily started to make provisions as part of their risk management policies.

- A requirement for MFOs to disclose the loan total value in agreements and comply with LTV limits[44].

LTV limits will help reduce the issuance of household loans with the increased debt service cost (at usurious rates), lower the household debt burden and raise the microfinance sector's sustainability in the long term.

- New rules for funding sources will be established.

On the one hand, the new rules expand funding sources[45], which allows MFOs to diversify their resource base and, on the other hand, they specify and tighten the terms of raising funds from unqualified investors (now the amount raised from a private individual should be no less than 1.5 million roubles during the entire term of an agreement).

- A requirement for MFOs to provide data to credit bureaus.

As the households' debt burden is rising, the amendments will help raise the transparency of information on the borrowers' obligations, which is expected to lower credit risks in the microloan market.

* The new requirements limit the size of penalties levied on overdue loans, and also set limits on

43 Payday loans or PDL microloans are microloans normally worth no more than 45,000 roubles issued to individuals for a term of up to two months.

44 The LTV disclosure requirement will be in effect from July 1, 2014. Starting no later than November 14, 2014, the Bank of Russia will quarterly determine the average LTV for each category of consumer loans. Microfinance loan rates should not exceed the value calculated by the regulator by more than a third.

45 MFOs are allowed to sell bonds worth 1.5 million roubles and more to private individuals and also raise any amounts of loans from qualified investors.

the provision of additional services (fees, insurance, etc.)[46], which will contribute to civilised pricing in the microfinance market.

Apart from enhancing regulatory requirements, the Bank of Russia faces the task of raising the sector's information transparency, developing high-level financial management and increasing operational efficiency. For this purpose, changes have been prepared for the transition to electronic reporting, which will help verify data submitted by MFOs and raise the quality of MFO reports. It has been proposed to make MFOs mandatory members of self-regulated organisations in order to unify and standardise the accounting practices of MFO market participants. Also, from January 1, 2014 MFOs are not allowed to use a simplified taxation system, which will also help raise information transparency and facilitate the elaboration and endorsement of sectoral accounting standards for non-credit financial institutions.

The planned changes in the functioning of the microfinance market will probably reduce the number of market participants registered in the MFO state register in the medium term.[47]

Nevertheless, the exit of MFOs unprepared to comply with the new requirements will facilitate the creation of a favourable investment environment in the market and help improve the image of microfinance as a whole.

In the short term (until the end of 2014), the MFO market can be expected to demonstrate a build-up in the household loan portfolio, mainly as a result of a growth in the portfolios of the largest market participants. Starting from 2015, the market is most likely to grow through the expansion of microloans to small business and register a gradual decrease in the share of consumer loans, which can be attributed to the adoption of the law on consumer lending and the predicted fall in household real incomes in 2014-2015, as well as the government's efforts to focus state support on small and medium business development.

5.3. Non-governmental Pension Funds

The number of pension market participants fell considerably in the period under review (from 126 funds as of July 1, 2013 to 118 funds as of April 1, 2014) with the approval of a new procedure for the pension market regulation, in particular, the requirement for all non-governmental pension funds (NPFs) to transform into joint-stock companies.[48]

At the same time, the volume of pension accumulations exceeded 1 trillion roubles in 2013, increasing by 62.4% over the year, while the volume of pension reserves grew by 9.7% to reach 831.6 billion roubles. As many as 35 funds have already launched corporatisation procedures to keep a considerable

46 The new requirements limit the maximum size of a forfeit (penalty, fine) charged for a borrower's failure to fulfil or improper fulfilment of obligations: 20% per annum or 0.1% of the amount of overdue liabilities for each day of delay. The rate is determined depending on the accrual (non-accrual) of interest on the debt during the period of the breach of obligations.

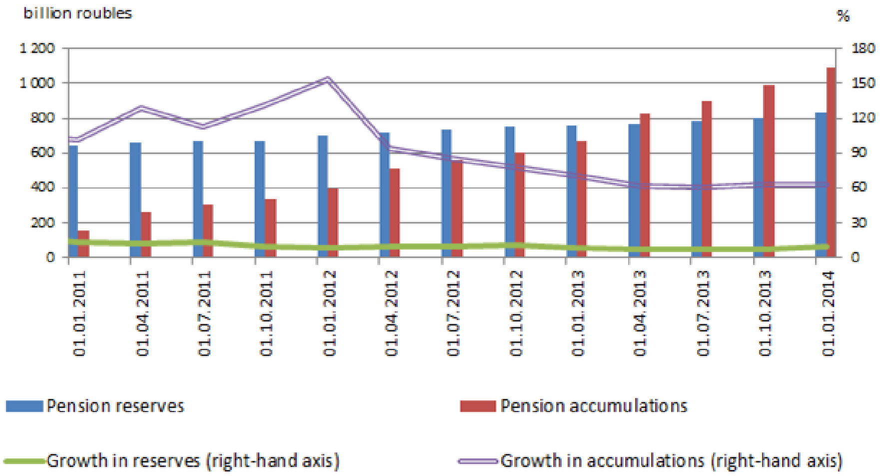
47 Pursuant to Federal Law No. 375-FZ of December 21, 2013 "On Making Amendments to Some Legislative Acts of the Russian Federation," an MFO may be struck off the state register if it breaches the approved rules of loan provision numerously and materially during the year and (or) submits untrue reporting data.

48 NPFs engaged in compulsory pension insurance must be corporatized before January 1, 2016 while the other NPFs must be transformed into joint-stock companies by January 1, 2019.

volume of pension accumulations and the client base (the number of insured persons reached 22.2 million people).[49]

The non-commercial status of all the pension market participants was a factor preventing the improvement of the investment environment in the sector. The NPF corporatization process will also help raise the market's financial stability and transparency and improve its operability.

Chart 55. **NPFs' Pension Accumulation and Reserve Value and Annual Growth**



After the corporatisation process is over, funds involved in compulsory pension insurance (CPI) are expected to join the guaranteed pension accumulation system[50], which will be similar to the deposit insurance system and will ensure the preservation of socially important pension accumulations.

The system's participants will be required to comply with quantitative criteria (capital adequacy) and qualitative parameters (the disclosure of the structure and composition of shareholders, risk management, investment procedures, etc.). These measures are intended to ensure the preservation of socially important pension accumulations.

The system's participants will have to bring their property required for statutory activity into compliance with the minimum quantitative requirement of 150 million roubles[51].

As of late 2013, 64 funds[52] complied with this requirement while the remaining 27% of the funds will have either to look for new investors or consider the options of mergers with other funds or terminate their activities.

The exit of such market participants will not have any considerable impact on the market amid high market concentration (the 20 largest NPFs account for about 86% of the market of pension accumulations).

49 As of May 13, 2014, 18 NPFs submitted corresponding applications to the Bank of Russia while 17 NPFs are preparing documents for submission (according to data posted on the NPFs' official website).

50 The two-tier system will comprise the guarantee fund set up by each NPF and also the national fund of guaranteed pension accumulations under the Deposit Insurance Agency.

51 For comparison, the minimum size of property required for statutory activity amounts to 100 million roubles for a non-commercial NPF.

52 As of April 1, 2014, 88 NPFs operated in the system of compulsory pension insurance.

The NPF market is characterised by a steady decrease in the ratio of property required for statutory activity to the value of liabilities[53], which can be attributed to a slow growth in assets necessary for statutory operations (they grew by 16% in 2013) and a substantial increase in pension obligations (by 34.7%).

At the same time, some funds increased their property required for statutory activity ahead of a new pension reform, raising the financial sufficiency of funds across the market to 6.59% as a whole (from 6.05% in the third quarter of 2013). As a result, the aggregate volume of property required for statutory activity reached 127.5 billion roubles as of January 1, 2014.

Apart from capital injections to comply with capital requirements, NPFs will have to invest in improving the quality of internal control, risk management and organising investment activity.

NPFs are currently pursuing conservative investment policies (Chart 56). The market's aggregate assets totalled 1.9 trillion roubles in 2013 (a growth by 34.5% over the year), of which cash and deposits account for 30.5%.

Chart 56. **Property Required for Statutory Activity Relative to Pension Liabilities, %**

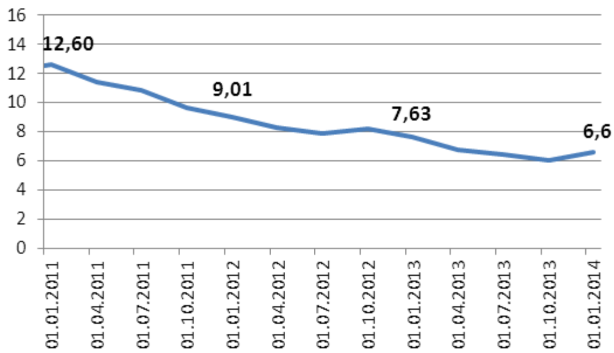
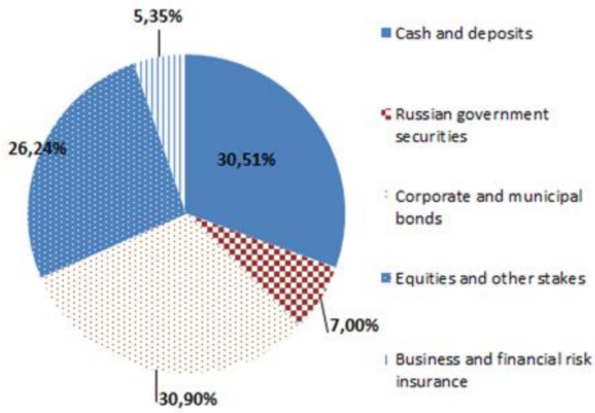


Chart 57. **NPF Aggregate Assets, %**



The Bank of Russia will check the affiliation of NPFs and their management companies to assess how conflicts of interest are managed in the process of investment. The need for this control has been prompted by the growing dependence of NPFs on captive management companies: the share of the largest management companies in the NPF pension accumulation portfolio rose on average from 68% to 72% in 2013.[54]

NPFs will also be required to disclose information on their activities and the ownership structure. Large corporate NPFs unwilling to disclose their owners will probably detach funds to operate in the CPI system under the ownership of funds for non-governmental pension provision (NPP).[55]

Apart from legislative changes, the market's investment attractiveness will also be strongly influenced by the cancellation of transfer agent agreements. Under the new rules that have been in effect since the start of this year, individuals writing requests to transfer their pension accumulations to NPFs must personally bring these applications to the Pension Fund of Russia. This new requirement has made work with banks ineffective and complicated the funds' efforts to attract new clients both from other funds

53 The sum of pension reserves and accumulations, short-term and long-term liabilities.

54 According to data provided by Expert RA.

55 Russian legislation allows the use of this scheme of the fund's ownership until 2019.

and the Pension Fund of Russia. This situation can be reversed by using the mechanism of certifying applications for the transfer of pension accumulations with electronic signatures or ensuring full-fledged work of the government services portal.

Therefore, the non-governmental pension fund market will exist until late 2015 amid conditions of a transitional period related to a large number of legislative and infrastructural changes, and material investment risks are unlikely to appear.