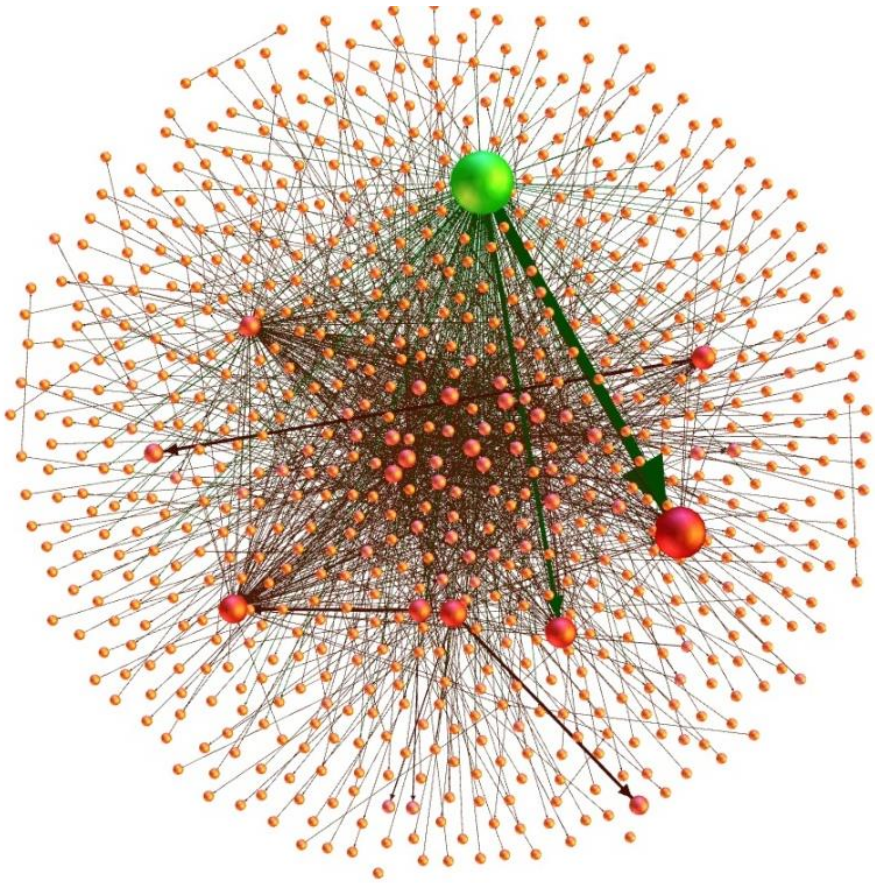
Quarter 2, 2014

Money Market Review



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

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Comments and suggestions on the Review's structure and contents are welcome at: reports@cbr.ru.

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Purpose of the Money Market Review

In this Review, the money market includes the interbank lending market, the FX swap market, and the interdealer repo market. The focus is somewhat more on the repo market due to its cross-sectoral nature. The Bank of Russia is committed to promoting money market development to achieve the following:

- a stable environment for liquidity redistribution, i.e. with acceptable volatility of short-term interest rates and smoother changes in transaction values;
- equal access to liquidity for market participants;
- counterparty default risk minimised through sound collateral management;
- a balanced development of various market segments, specifically, creation of a full-fledged segment beyond overnight maturities;
- a favourable environment for the development of the CCP-cleared market.

The importance of money market monitoring is underpinned by the following:

- the money market plays a key role in banking intermediation, which provides for on-going conversion of short-term borrowings into long-term loans to the economy; its uninterrupted functioning enables banks to refinance their liabilities continuously and efficiently use their capital to provide funding to the economy;
- the money market is the first to come under pressure in case of a financial turmoil, therefore, its parameters may serve as early warning indicators;
- the money market is crucial in intragroup operations of financial groups and conglomerates, which require close attention under consolidated supervision;
- the money market, in its interdealer repo and swap segments, may concentrate financial sector systemic risks, because its players include not only banks but also non-bank professional securities market participants;
- money market trends are a good indication of liquidity conditions in the banking sector;
- potential disruption of the money market and panic sales of collateral would significantly push up the cost of market funding and make it more difficult for non-financial entities to access it;
- money market conditions affect the central bank's capacity to manage banking sector liquidity and short-term interest rates.

In view of the money market's importance for financial stability, the Bank of Russia issues **regular quarterly reviews** of its developments and the level of systemic risks.

The ultimate purpose of this publication is to promote financial stability by minimising systemic liquidity risks via enhancing money market transparency. A better awareness of the market structure and trends will allow market participants to improve their perception and assessment of their own risks. Moreover, the Bank of Russia seeks to communicate to market participants potential collective implications of their individual investment decisions in case of domino effects that are not quite fully addressed in market risk assessments.

The Review, rather than being a Bank of Russia official publication, is a research paper focused on the analysis of market developments in the period under review. The latest reported data are given as of the last business day of the quarter, while potential material events after the reporting date are excluded from the analysis. The Review is available in Russian and English on the Bank of Russia official website.

SUMMARY

- In the second quarter of 2014, autonomous liquidity factors had a basically neutral impact on the money market largely due to changes in the direction and volumes of Bank of Russia operations in the local FX market (the Bank of Russia was selling and buying foreign exchange), resulting in net autonomous flows of +41 billion rubles in the second quarter versus –1.1 trillion rubles in the first quarter. Banks' refinancing structure saw a major change, with their outstanding amounts on loans secured by non-marketable assets and guarantees expanding significantly, and their repo debt, in contrast, contracting. Utilisation of marketable collateral declined considerably (from 63% at the beginning of the second quarter to 53% at the end), releasing collateral for interdealer trade and alleviating marketable collateral shortage risks.
- Interest rates stayed within the Bank of Russia's interest rate corridor. Overall, with no material default risks, the money market remained stable. Cross-sectoral liquidity allocation was also steady. A study of liquidity transmission shows that the changes in Bank of Russia refinancing volumes are not highly correlated with the changes in interdealer repo trading volumes, or with the patterns of liquidity flows from the repo market into the swap and interbank markets. Therefore, it suggests that increased central bank refinancing for the banking sector observable in the recent years does not constrain money market activity.
- By the end of the second quarter 2014, outstanding volumes in the exchange-traded interdealer repo market almost fully recovered after a sizeable contraction in the first quarter of 2014, largely on the back of banks' lending to non-resident clients, increasingly via a central counterparty (CCP).
- After swap trading volumes peaking at the end of the first quarter of 2014, the situation came back to normal in the second quarter, with the swap market value reverting to its historically sustainable level at about 60% of the money market. Further on, the spread between long- and short-term indicative premiums tended to narrow in the second quarter, suggesting that market participants do not expect deterioration of money market conditions.
- In the interbank market, the cross-border segment continued to stagnate. Following the escalation of geopolitical tensions in March 2014, the cross-border interbank market contracted considerably, including FX transactions (from 1.4 to 0.9 trillion rubles). The interbank non-resident trade in the second quarter never recovered its volumes observable before March 2014 (1.4 trillion rubles on average), which may be attributed to the absence of the option of using CCP for risk mitigation (as was the case in the cross-border repo market).
- Preliminary analysis of Russian trade repositories' data suggests some structural specifics of the OTC repo and swap markets (including FX transactions). Specifically, these markets feature varied maturities (the share of the more than one week maturity bucket is 98% in the repo market and 97% in the swap market), a large share of FX transactions and of non-resident trade. In total, these characteristics may suggest a wide range of potential risks (interest rate, currency, and counterparty risks), which are less typical for the exchange-traded segment.

- The second quarter of 2014 saw a resumed inflow of foreign investment into OFZs to amount to 905 billion rubles on 1 June, which is 90 billion rubles more than at the beginning of that quarter. In contrast, the liberalisation of the corporate bond market since early 2014 did not have any implications for the volumes of non-resident investment in this segment of the Russian market, with its share staying at 1%. Consequently, the corporate debt market showed higher volatility of the yield index in 2012 – first half of 2014 than the OFZ market.
- The stress tests of the money market suggest that the banking system has an adequate central bank refinancing capacity to address potential shock-induced changes in money market parameters. However, the stress test does not take into account potential losses of funds on banks' other liability items. Moreover, even under these assumptions some participants may face the problem of inadequate collateral to pledge to the Bank of Russia. Such participants should revise their liquidity management policy to maintain a higher level of liquid assets.
- In the second quarter of 2014, to implement Russia's international commitments to OTC derivatives reforms it was agreed to establish a Standardisation Committee on the basis of the National Securities Market Association, a self-regulating organisation. The key objective of the Committee will be to create an environment for the development of the standardised OTC derivatives market in Russia and their central clearing. Central clearing of OTC derivatives will promote transparent pricing, daily margining and in this way will enhance protection of the market against systemic shocks.

1. MONEY MARKET LIQUIDITY ALLOCATION

1.1. Autonomous liquidity factors have eased their impact on the money market

As the external political environment somewhat stabilised and the ruble appreciated in the second quarter of 2014, the Bank of Russia scaled down its operations in the domestic foreign exchange market compared with the first quarter of the year. As a result, Bank of Russia interventions had a less significant impact on banking sector liquidity, amounting to –14 billion rubles in the second quarter (Chart 1).

A more significant impact on banking liquidity throughout the second quarter of 2014 came from currency in circulation developments. However, the rise in currency in circulation volumes in early second quarter (by 228 billion rubles in April) was offset by its contraction in May-June (by 147 billion rubles), bringing the net impact of this factor on banking liquidity in that quarter to a modest level of –81 billion rubles.

Liquidity effects of government financial flows were positive (+126 billion rubles) in the second quarter, specifically, due to extra budget expenditures related to the public holidays in May. Another 193 billion rubles came from increased Federal Treasury deposits with banks.

Therefore, in the second quarter of 2014, autonomous factors had a weaker impact on banks' liquidity than in the previous quarter (+41 billion rubles in the second quarter versus –1.1 trillion rubles in the first quarter). The net liquidity inflow came mostly via the budget channel, which allowed reducing the net liquidity injection from the Bank of Russia.

Chart 1. Autonomous liquidity factors

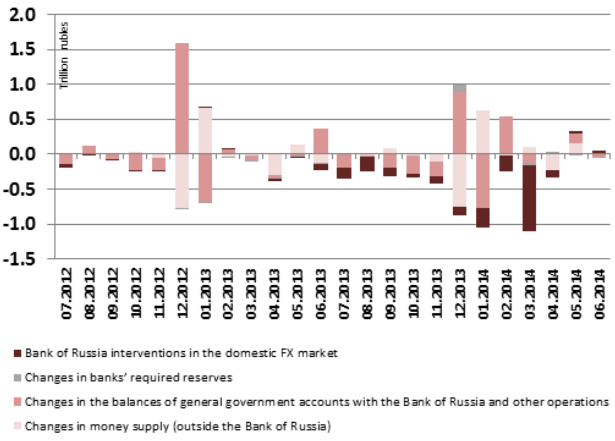


Chart 2. Liquidity-providing/absorbing operations by the Bank of Russia

Similar to the first quarter, repos with the Bank of Russia remained the main refinancing facility for credit institutions, with outstanding repo debt edging down from 2.9 trillion rubles at the beginning of the second quarter to 2.8 trillion at the end (Chart 2).

The second largest channel of liquidity provision in the period under review was Bank of Russia loans secured by non-marketable assets or guarantees. The banking sector outstanding amount under these operations increased from 1.7 trillion rubles in early April to 2.4 trillion rubles by the end of June. Another important refinancing instrument in the second quarter was FX swaps with the Bank of Russia, printing more than 0.3 trillion rubles in outstanding amount on some days.

However, as this Review shows below, Bank of Russia operations did not have any material impact on liquidity allocation across various money market segments.

1.2. Bank of Russia operations have no impact on liquidity allocation across various money market segments

As the previous Money Market Review explained, central bank liquidity comes to the money market via two channels: the repo market and the swap market. Given more attractive interest rates, participants tend to satisfy most of their funding needs via repos (Chart 3).

Chart 3. Net funding of participants

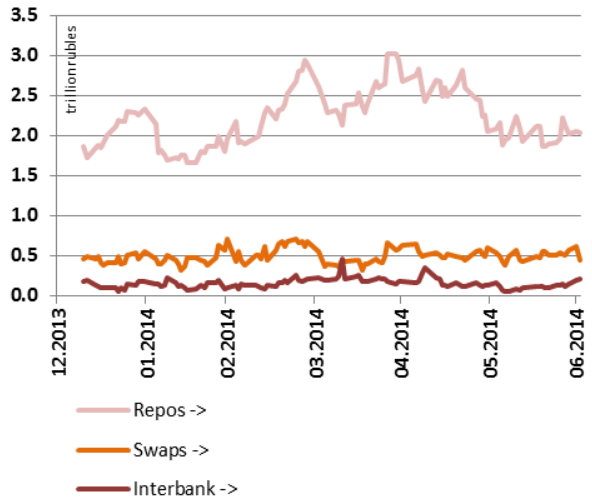


Chart 4.Net liquidity flows for the repo market

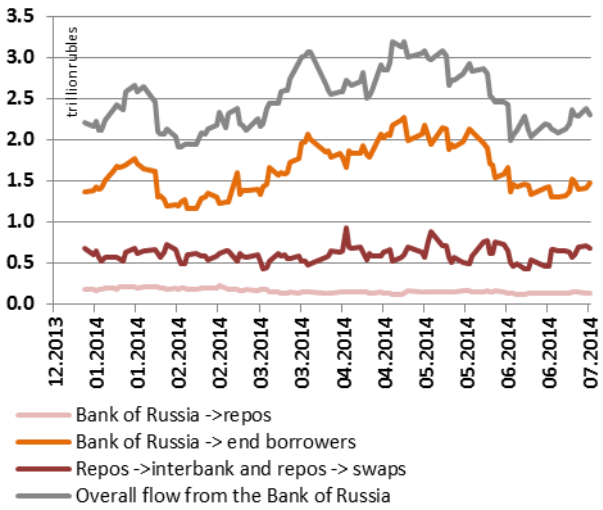


Chart 4 shows that that funding volumes for end borrowers are closely linked to funding provided by the Bank of Russia. At the same time, the net liquidity inflow into the repo market and through the repo market into the other money market segments, i.e. the swap and interbank segments, is relatively steady, and is not highly correlated with Bank of Russia trading volumes[1]. Therefore, it suggests that Bank of Russia refinancing largely goes to end borrowers and is generally neutral for intersectoral liquidity allocation.

Box 1. ECB liquidity injection programmes fail to galvanize the money market

In the second quarter of 2014 (on 5 June), the European Central Bank (hereinafter, the ECB) announced a new package of monetary policy measures to support lending to the real economy. In particular, the ECB decided to resume its longer-term refinancing operations (LTROs) to be conducted quarterly from September 2014 to June 2016, maturing in September 2018.

In these LTROs, banks will be able to borrow no more than three times each bank's net lending[2] to the non-financial sector as of 30 April, 2014 – up to 1 trillion euros[3]. The ECB specified that these operations are targeted: they are aimed at increasing bank lending to the non-financial sector. If a bank's lending to the real sector is below a specified benchmark, it will be required to make an early repayment to the ECB in September 2016. Therefore, for two years banks will be able to use ECB funds without assuming any commitments. In addition to longer-term refinancing operations, the ECB also announced preparation of programmes to purchase asset-backed securities (ABS).

[1] The coefficient of correlation between rates of growth of Bank of Russia refinancing and funding to end borrowers is around 0.5, while the coefficient of correlation between rates of growth of Bank of Russia refinancing and net liquidity flows from the repo market to the swap and interbank segments is around zero.
[2] Issued loans less repayments.
[3] Loans to the corporate non-financial sector stood at 4.329 trillion euros, loans to households excluding house purchase loans – at 1.360 trillion euros as of 30.04.2014.

In this context, a question arises: how these new programmes can impact the money market of the EU, and of the euro area in particular?

According to ECB data[4], the money market turnover was estimated at 75 trillion euros in 2013 (570% of EU GDP[5] for 2013). The bulk of trade falls on the secured lending market, i.e. repos and swaps, which account for 40% and 21% of the aggregate turnover, respectively.

It is noteworthy that the last seven years have seen important changes in the money market structure. In this period, as the money market contracted (in 2013, it stood at 98% of the 2006 volume), the share of repos increased from 29% to 40%, and swaps – from 18 to 21%, while the unsecured interbank market share shrank five times down to 4%.

One of the previous Reviews (see Money Market Review for the fourth quarter of 2013) indicated a critical decline in the unsecured interbank market activity, which may put at risk the credibility of Eonia – the key benchmark rate of the ECB – due to declining turnovers of transactions it is based on.

Given the heightened risks, unsecured money market transactions started to be replaced with secured trade, primarily, repos. Moreover, CCP-cleared repo trade tended to increase (from 42% in 2009 to 71% of the total repo business[6] in 2013), as well as repos executed on electronic trading platforms (via EUREX REPO, Brocer Tec and MTS – from 44% in 2009 to 61% of the total repo business in 2013).

This suggests that EC money market participants see the CCP-based repo market less risky than the other money market segments.

Dunne, Fleming and Zholos (2013)[7] find out in their study that ECB funding operations to provide liquidity in variable-rate limited allotment auctions at the beginning of the crisis encouraged increased post-auction repo activity. However, when the ECB switched to fixed-rate auctions, relationships between ECB funding operations and repo market rates leveled out, because banks were active in only one of the two funding venues: they either borrowed in the repo market (against higher quality collateral) or from the ECB (against lower quality assets[8]).

According to Mancini, Ranaldo and Wrampelmeyer (2014)[9], official liquidity provision at low fixed rates brought repo rates down. However, when excess liquidity[10] achieved the level of 300 billion euros, repo market rates declined to about the ECB deposit rate, as also noted by Dunne, Fleming and Zholos (2013). This low-rate environment led to a contraction in repo activity, which may be explained by substitution of the market with ECB operations. Mancini, Ranaldo and Wrampelmeyer interpret this situation as a kind of liquidity trap.

ECB data indicate that excess liquidity was higher than the 300 billion euros estimated by the authors from October 2011 to March 2014, i.e. when the ECB was using its longer-term liquidity provision operations. After these operations were discontinued in late 2013 - early 2014, excess liquidity was under 300 billion euros, thus the new ECB programme announced in early June 2014 could replenish it.

However, the lessons from the ECB's earlier liquidity injections suggest that its new fixed-rate funding operations will not allow to galvanize the EU money market and to fully restore the monetary transmission mechanism, which is needed to amplify regulatory impact on credit supply.

[4] On the basis of data from 161 credit institutions of EU countries, including the United Kingdom and Switzerland.
[5] The GDP of the 28 EU states stood at 13.1 trillion euros in 2013.
[6] On the basis of data from 161 EU credit institutions surveyed under the EURO MONEY MARKET SURVEY. November 2013.
[7] Dunne P.G., Fleming M. J., Zholos A. ECB Monetary Operations and the Interbank Repo Market. Federal Reserve Bank of New York Staff Reports. No. 654. December 2013.
[8] E.g., PIIGS sovereign bonds, which are included on the ECB eligible collateral list.
[9] Mancini, L., Ranaldo, A., Wrampelmeyer J. The euro repo market. University of St. Gallen Working Paper. April 2014.
[10] Excess liquidity is calculated as the net balances in banks' current and deposit accounts with the ECB less reserve requirements.

2. MONEY MARKET STRUCTURE AND CONDITIONS

2.1. Exchange-traded interdealer repo volumes recovered

At the end of the second quarter of 2014, outstanding volumes in the exchange-traded interdealer repo market (hereinafter, the repo market) almost fully recovered after a sizeable contraction in the first quarter of 2014 (Chart 5). By 30 June 2014, the total repo business volume was almost 500 billion rubles. This growth was largely caused by CCP-cleared repos (for more details see Section 4.1).

Chart 5. Outstanding repo volumes

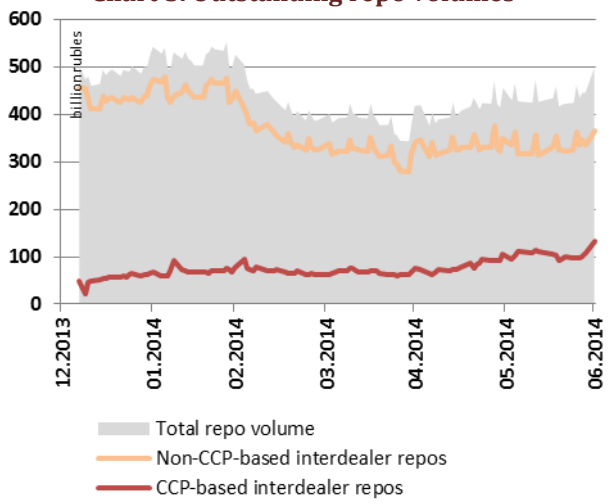
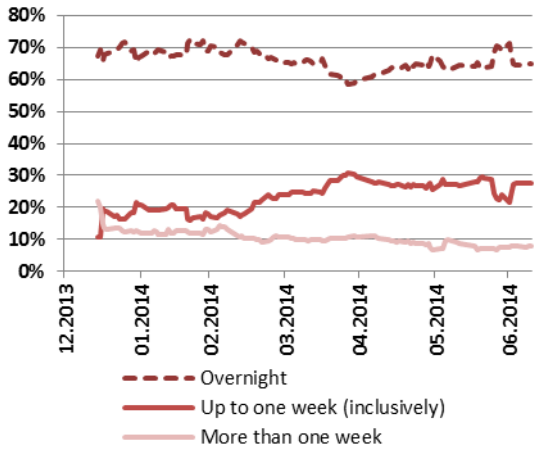


Chart 6. Repo transactions, by maturity



The second quarter of 2014 saw continued changes in the maturity breakdown in the repo market. An increase in the share of the up to one week (inclusively) tenor was accompanied by declining volumes in the more than one week maturity bucket (Chart 6). These developments, alongside shortening maturities of other liabilities, follow the overall maturity declining trend in the sector. However, the shortening of liabilities' maturities of market participants creates some space for higher sensitivity of market rates to the Bank of Russia's key rate, and, consequently, facilitates effectiveness of the central bank's interest rate policy.

The recovery of the repo market size in the second quarter of 2014 was largely driven by increased lending by banks to non-resident clients (Chart 7). Arguably, this trend may indicate easing of external political conditions in the second quarter suggesting an enhanced propensity of non-residents to buy Russian securities to use in repo trade. Further on, Russian banks tended to opt for CCP-cleared trade with non-residents (Chart 8).

Chart 7. Outstanding repo volumes by counterparty

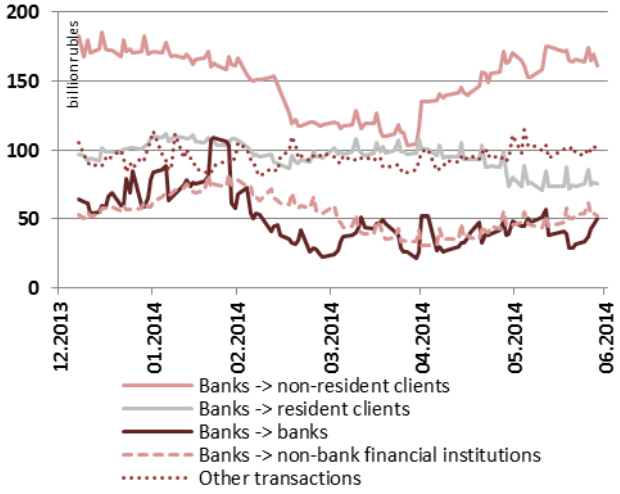
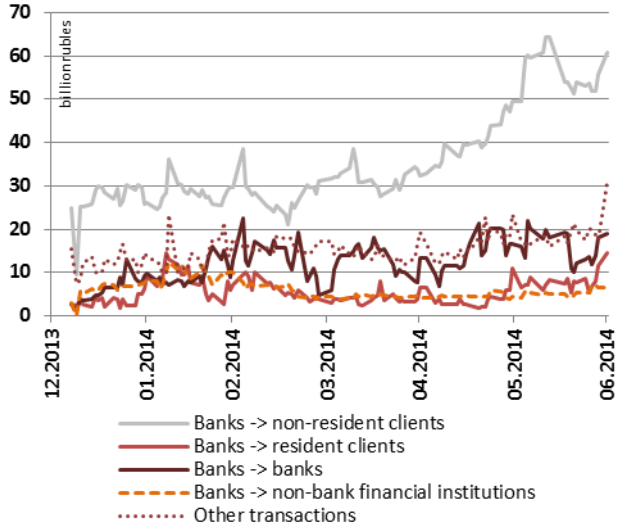


Chart 8. Outstanding volumes of CCP-based repos by counterparty



Box 2. OTC repo market analysis: preliminary findings (on the basis of data from the NSD trade repository and the Saint Petersburg Stock Exchange)

Now that the Russian NSD trade repository of the non-bank credit institution ZAO National Settlement Depository (NSD) has come into operation, it is possible to make some preliminary[11] analysis of the OTC repo market structure. The general conclusion is that this market is significantly different from the exchange-traded interdealer repo market.

Chart 9. Maturity breakdown of the market as of 30 June 2014

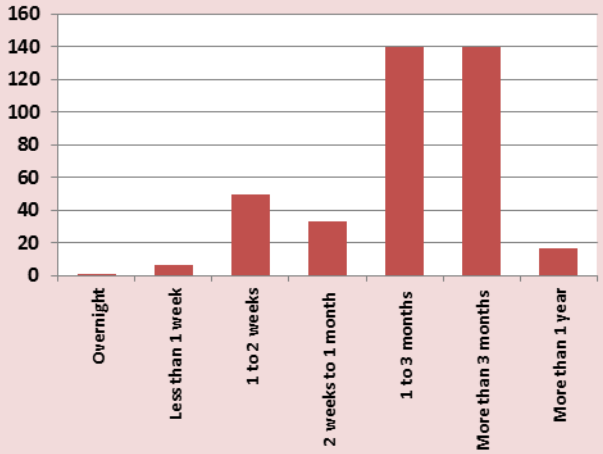
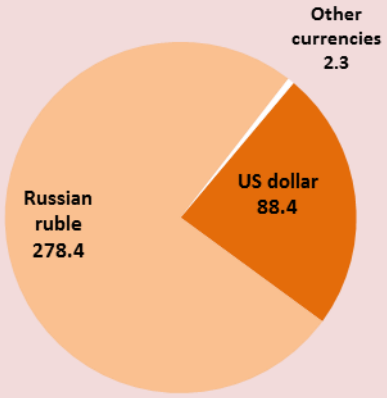


Chart 10. Currency breakdown of the market as of 30 June 2014, billion rubles



As of the end of the second quarter of 2014, the total value of open positions, reported to the repository was 0.4 trillion rubles.[12] Therefore, the size of the OTC repo market is broadly comparable with the exchange-based repo market, albeit a little smaller in volumes (according to available data).

The maturity breakdown of the OTC repo market is more varied compared with the exchange-based market, with relatively longer maturities prevailing (Chart 9).

Outstanding trade with non-residents was virtually equal to the trade with residents, with the majority of residents (about 60%) acting as borrowers (i.e. sellers of securities in the first leg of the transaction).

The bulk of trade was made in foreign exchange, with the total outstanding value of FX transactions amounting to 280 billion rubles or 76% of the total repo business at the end of the second quarter (Chart 10).

[11] At present, these data are not complete, because not all market participants report their transactions to the repository. However, the number of reported transactions seems sufficient to support some conclusions about the OTC market.
[12] Excluding OTC repos with the Bank of Russia. The FX repo value has been converted in rubles at the Bank of Russia rate.

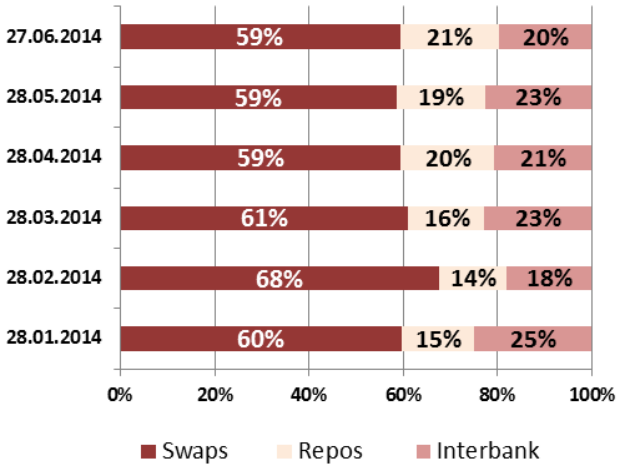
Overall, the repo market remained stable in the second quarter, with no large-scale defaults. Given the subdued volatility, required deposits of further cash or securities (margin calls) were several times smaller than those observed in the first quarter. Interest rates in the repo market stayed within the interest rate corridor of the Bank of Russia.

2.2. The swap market came back to normal

After swap trading volumes peaking at the end of the first quarter of 2014 (at about 1.6 trillion rubles), the situation came back to normal in the second quarter, with the swap market value averaging 1.2 trillion rubles (Chart 11). As a result, the share of the swap segment of the money market reverted to its regular level, typical of the recent years (about 60%) following the peaks (about 70%) observed in the first quarter of 2014 (Chart 12).

Chart 11. Trade volumes in the FX swap market

Chart 12. Breakdown of trade volumes in the money market



The decline in the volumes of swaps, both with the Bank of Russia and between market participants, has been caused by improved liquidity conditions in the banking sector (for more detail see Section 1.1). When market participants need cash, their first best solution would be to borrow from the Bank of Russia via repos because it is cheaper. Moreover, as it has been noted, liquidity transmission via the repo market into the swap and interbank markets is relatively stable (for more detail see Section 4.2). Therefore, when demand for liquidity subsides, participants cut their swap trading with the Bank of Russia.

In contrast to the interdealer repo market, where non-resident trade is substantial, the swap market is largely local. The value of swaps with non-resident banks is relatively small, taking up about 4% of the market. Moreover, this share tended to decline throughout the second quarter of 2014 (Chart 13). As the trading with non-resident banks is mostly intragroup, it does not have any significant impact on market conditions.

Chart 13. Shares of client and non-resident trade in the swap market

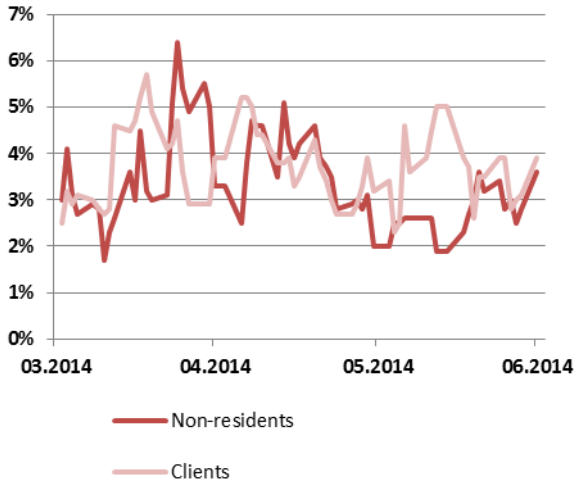
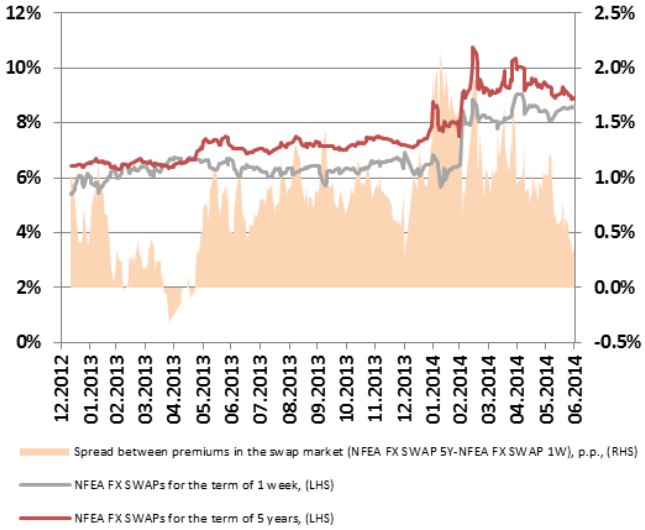


Chart 14. Indicative premiums in the swap market



In the second quarter of 2014, the swap segment volumes and term premiums came back to normal. Despite the Bank of Russia key rate increases in the first and second quarters followed by respective rises in implied ruble swap rates, the spread between long- and short-term indicative premiums tended to narrow in the second quarter, reaching the average level of 2013 by the end of the period under review (Chart 14). This suggests that market participants do not expect ruble depreciation or any significant deterioration of money market conditions.

Box 3. OTC swap market analysis: preliminary findings
(on the basis of data from the NSD trade repository and the Saint Petersburg Stock Exchange)

Repository data as of the end of the second quarter of 2014 suggest that in contrast to the repo market, the OTC swap market volume is much smaller than the exchange-based swap market. At the end of the second quarter, outstanding swaps with rubles stood at 0.4 trillion rubles, while swaps without the Russian ruble (i.e. when both currencies are foreign) amounted to 0.3 trillion rubles.

The OTC swap market features relatively longer maturities. As of 30 June 2014, the initial term length of over 60% of outstanding contracts was more than three months, while 21% of outstanding swaps had initial maturities of more than one year (Chart 15).

In transactions where one currency is the ruble, the other will in most cases be the US dollar (96% of trades), with the remaining 4% taken largely by the euro. As regards transactions without the ruble, most of them fall on US$-EUR currency pair (74% of outstanding business) and US$-GBP (10% of trade, Chart 16).

Chart 15. Maturity breakdown of the swap market as of 30 June 2014

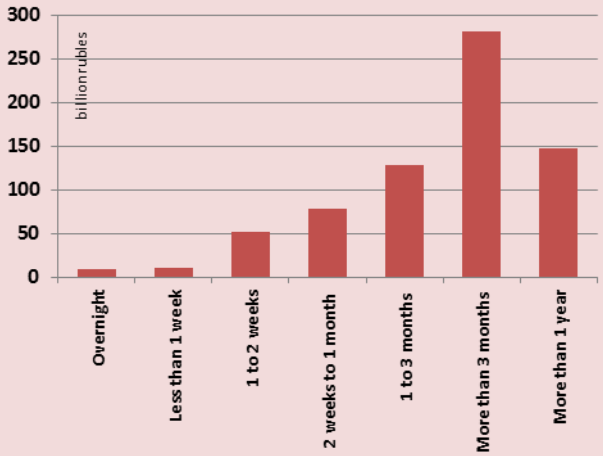
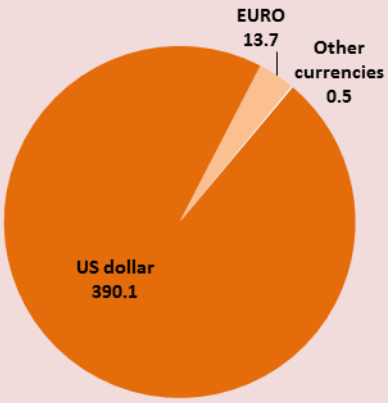


Chart 16. Currency breakdown of the swap market as of 30 June 2014, billion rubles



In contrast to the OTC repo market, most transactions in the OTC swap market are done with non-residents. As of 30 June 2014, outstanding swaps with non-residents accounted for 62% of the aggregate. This share does not vary significantly between the ruble swap segment (where one of the currencies is the ruble) and the foreign currency segment (i.e. in transactions without the ruble). In these segments, non-resident swaps take up 56% and 66% respectively.

2.3. The interbank market shows structural change

In the second quarter of 2014, interbank trade volumes remained steady averaging 400 billion rubles, like in the recent years. However, there were some changes observed in the structural characteristics of the aggregate trade volume. The second quarter of 2014 saw a rise in trade volumes in the periphery segment of the market, i.e. between banks excluded from the Ruonia list. Average daily outstanding trade volumes increased from 100 to 150 billion rubles in this segment of the interbank market, while outstanding trade volumes of borrower banks included in the Ruonia list contracted by 50 billion rubles on average (Chart 17).

Chart 17. Interbank borrowing volumes by groups of borrowers

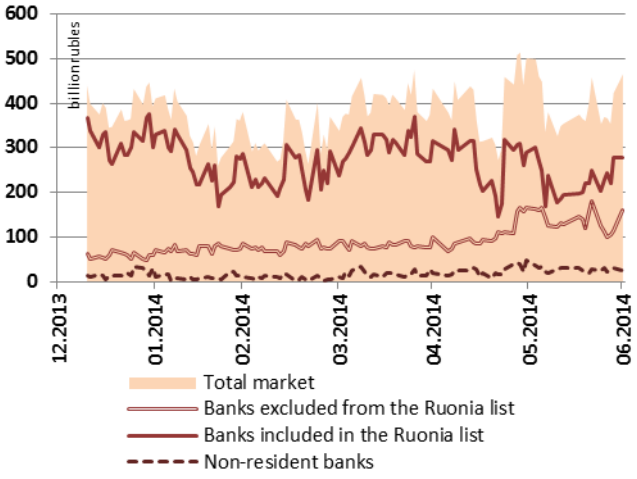
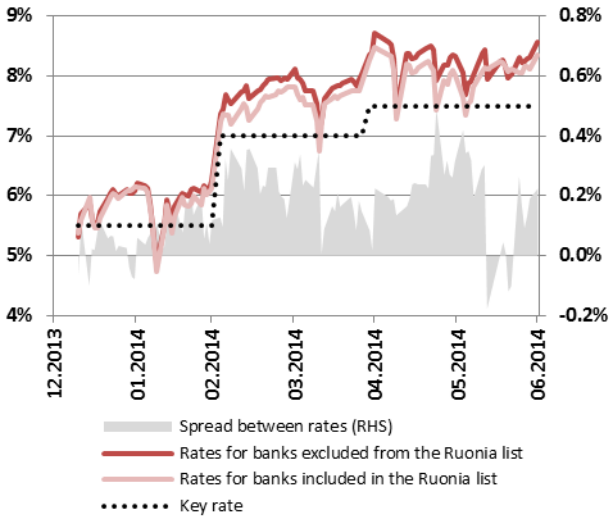


Chart 18. Interbank borrowing rates



Further on, the spread between borrowing rates for banks excluded and those included in the Ruonia list, narrowed significantly by the end of the second quarter of 2014, while remaining quite volatile (Chart 18). Therefore, the rise in demand for short-term funds from borrower banks excluded from the Ruonia list, observable in the second half of the second quarter, did not entail a higher credit risk premium. Partially, this may be attributed to improved banking sector liquidity conditions, and also the market's stronger immunity to the Bank of Russia's measures to rehabilitate the banking sector and to the continuing political uncertainty of the external environment.

This period also saw changes in the cross-border interbank market, including FX transactions with non-residents. Following the escalation of geopolitical tensions in March 2014, the cross-border interbank market contracted considerably. Moreover, in contrast to the cross-border repo market, the interbank non-resident trade in the second quarter never recovered its share observable before March 2014 (Chart 19).

Chart 19. Cross-border interbank market (including FX transactions)

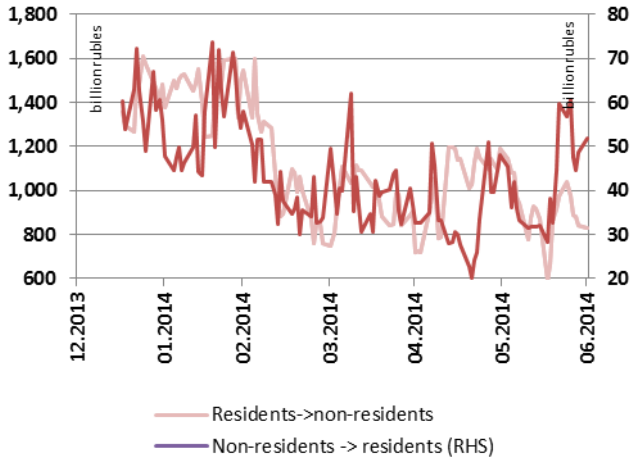
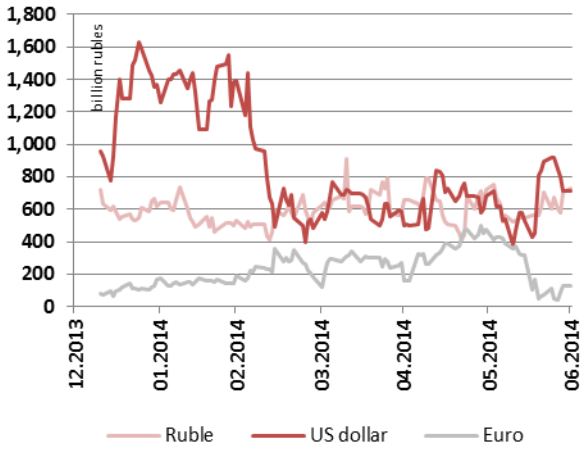


Chart 20. Interbank market volumes by currency



An analysis of the currency breakdown of interbank trade volumes reveals similar trends. Following a contraction of interbank trade in US dollars in the first quarter of 2014, these volumes stayed unchanged on average in the second quarter (Chart 20). While the recovery of the cross-border repo market may be attributed to the option of using CCP for non-resident trade (which means lower risk weights), the absence of this option in the interbank market did not allow it to restore its earlier volumes of trade with non-residents observable before the escalation of geopolitical tensions.

3. MONEY MARKET SYSTEMIC RISK

3.1. Marketable collateral shortage risks eased considerably

The second quarter of 2014 saw major changes in the refinancing structure of Russian banks. Bank's debt on loans secured by non-marketable assets and guarantees increased significantly, while their repo debt tended to decline. Consequently, by the end of the second quarter 2014, banks' debt under these two refinancing instruments came very close together, to stand at 2.4 and 2.6 trillion rubles on 1 July 2014. This trend strengthened in the first half of July 2014, amid declining banks' demand for central bank funding (Charts 21 and 22).

Chart 21. Credit institutions' debt to the Bank of Russia and utilisation ratio of marketable assets

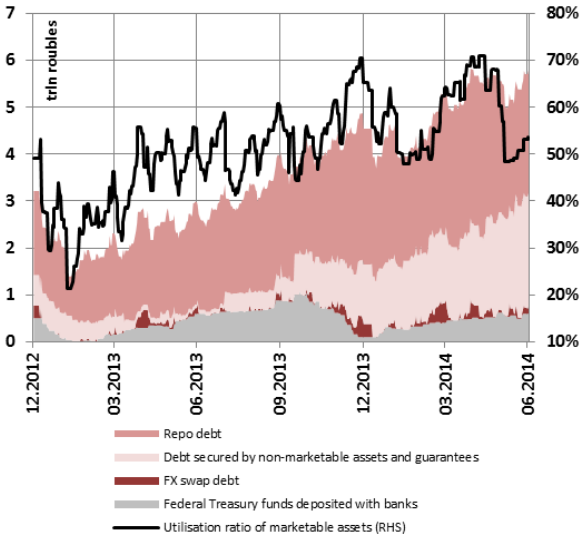
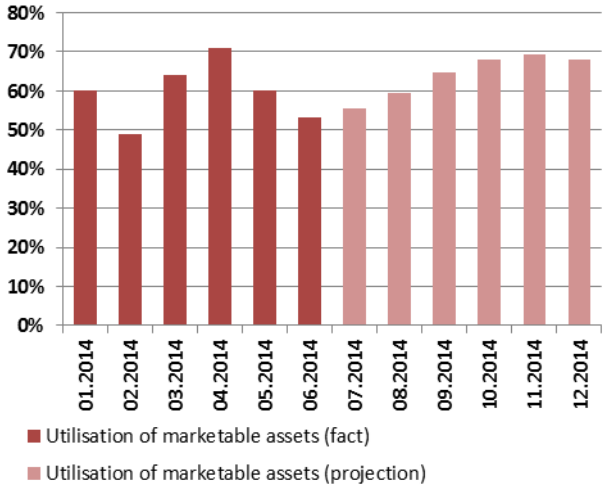


Chart 22. Utilisation ratio of marketable assets: actual and projected values



The rise in bank borrowing against non-marketable assets and guarantees had a positive effect on available marketable collateral. In the second quarter of 2014, the marketable collateral utilisation ratio declined considerably, significantly alleviating the risks of marketable collateral shortage. The release of marketable assets had a favourable impact on money market rates.

However, in the second half of 2014, repo debt is expected to expand faster than available marketable collateral, driving utilisation ratios of marketable collateral further upwards. But due to a more extensive use of non-marketable assets, the average utilisation ratio of marketable collateral is not expected to exceed 70%.

Table 1. Marketable collateral pledged in Bank of Russia repos, 1 June 2014, trillion rubles

Collateral	Outstanding value	On bank balance sheets	On bank balance sheets (conservative estimate)
Debt securities	8.3	4.8	4.7
Equities	4.0	0.1	0.1
TOTAL	12.3	4.9	4.8

Note: the figures are adjusted for Bank of Russia repo haircuts; outstanding debt securities do not include domestic Eurobonds; the conservative estimate adjusts for collateral held by banks, which do not participate in repos with the Bank of Russia.

As the previous Review noted, in the first quarter of 2014, bank balance sheets did not show virtually any expansion in collateral held by banks, due to declining bond issuance. However, in the second quarter, marketable collateral held by banks resumed growth, adding 248 billion rubles in the first two months of the quarter. As of 1 June 2014, the value of marketable collateral on bank balance sheets was estimated at 4.9 trillion rubles (Table 1).

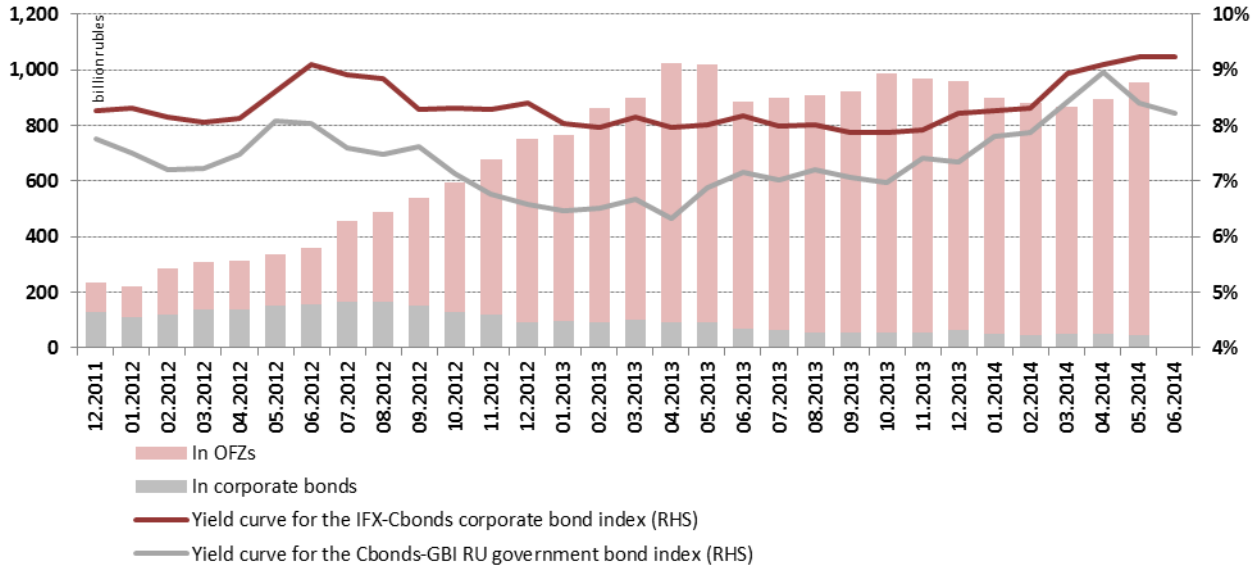
The refinancing capacity increased on the back of new securities issues included in the repo list. The largest bond issue came from Vnesheconombank in June 2014, and its new issues increased the stock of marketable assets on banks' balance-sheets. Therefore, banks' further investments in marketable assets will create ample space for containing the utilisation ratio from rising.

3.2. OFZs are still more attractive for non-residents than corporate bonds

The opening of foreign clearing and settlement organisations' nominee accounts with the Russian central securities depository facilitated an increase in non-resident investments in OFZs. The subsequent stage of Russian securities market liberalisation was focused on the corporate segment. In early 2014, international CSDs started to provide settlement for Russian corporate bonds via their direct link to the National Settlement Depository (the NSD).

In early 2012, non-resident investments in OFZs and corporate bonds of Russian issuers were roughly equal (at over 0.2 trillion rubles). Starting from mid-2012, in anticipation of the liberalisation of the government securities market, non-residents' investments in OFZs grew robustly, while their holdings of corporate bonds contracted. Apparently, foreign investors saw OFZs as a more attractive asset given the overall balance of its characteristics, i.e., yields, liquidity and risk, including infrastructure risk, which resulted in some shedding of corporate bonds from their portfolios (Chart 23).

Chart 23. Non-resident investments (par value), yield curves for OFZs and corporate bonds



A similar liberalisation of the corporate bond market launched in early 2014 has not yet driven foreign investment up in this segment of the local market. This may be largely attributed to the heightened volatility in many emerging markets in early 2014, and also to Russia's intensified geopolitical risks.

However, it should be noted that the second quarter of 2014 saw a resumed flow of foreign investment into the OFZ market, to reach 905 billion rubles on 1 June 2014 – an increase by 90 billion rubles from the beginning of the quarter. This is roughly the same as in December 2013, when foreign holdings in OFZs stood at 911 billion rubles.

Unlike the OFZ market, where foreign investors own about a quarter (24.7% as of 1 June 2014), the local corporate bond market has a much smaller foreign presence of just about 1%. Partially this low share may be explained by non-residents' ability to buy Eurobonds issued by Russian corporates. That said, there is still room for a sizeable future growth in non-resident investment in Russian corporate bonds.

3.3. Results of stress tests indicate stability of the money market

The money market stress test assumes a market shock (ruble and securities depreciation) and reduced counterparty limits (for more detail see Box 1). As a result, some participants face liquidity shortages, making them cut their lending (if they were also lenders). It should be noted that this stress test is only focused on the money market and assumes other factors being equal, i.e. any other potential adverse effects of the stress scenario are disregarded.

A decline in liquidity supply leads to liquidity shortages for borrower participants and an overall imbalance in liquidity allocation, resulting in short liquidity for some market participants versus excess liquidity for other players.

Liquidity provision by the Bank of Russia may significantly adjust the imbalance in the money market, but it cannot eliminate it completely at the level of individual players due to limited collateral on their balance sheets.

The stress testing model runs two scenarios (see Table 2).

1) A moderate shock scenario, assuming a 10% depreciation of the ruble versus the other currencies, a 15% decline in the value of equity collateral, a depreciation of bonds in line with their yields rising by 150 pp, and a 10% contraction of the interbank market.

2) A severe shock scenario, assuming a 10% depreciation of the ruble versus the other currencies, a 30% decline in the value of equity collateral, a depreciation of bonds in line with their yields rising by 300 pp, and a 30% contraction of the interbank market.

The simulated shocks result in the following changes in the money market (Charts 24, 25).

Table 2. Comparative results of money market stress test

	Moderate shock				Severe shock			
	swap	repo	interbank	total	swap	repo	interbank	total
Market volume change, billion rubles	+93	−28	−104	−39	+93	−48	−228	−182
Market volume change, %	+6%	−9%	−15%	−1,5%	+6%	−16%	−32%	−7%
Borrowers' liquidity shortage, billion rubles	41				53			
Number of banks having liquidity shortages	28				33			
Excess liquidity held by lenders, billion rubles	116				215			
Borrowings from the Bank of Russia, billion rubles	176				263			

Chart 24. Money market volumes before and after the shock, trillion rubles

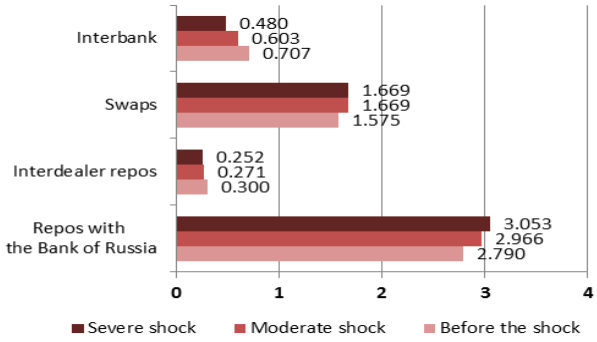
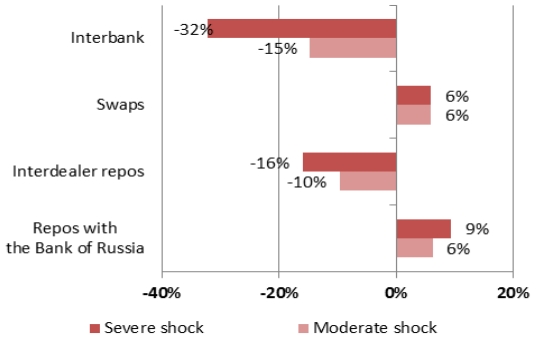


Chart 25. Relative change in money market segments' volumes



Box 4. Money market stress testing methodology

Money market stress testing is a way to assess money market participants' vulnerability to a low-probability and extraordinary, but plausible shock. Shock indicators include the ruble depreciating versus the dollar-euro basket (for the swap market), a drop in collateral value (for the repo market) and a reduction of counterparty limits (for the interbank market).

The stress test analysed banks' money market positions at the end of the second quarter of 2014. The stress test aims to assess the impact of the shock on liquidity adequacy for individual banks and on the soundness of the whole banking sector.

The algorithm is as follows.

1. As a result of the ruble depreciation (assuming that the demand for FX in the swap market stays constant), swap market participants increase their supply of rubles. If a bank does not have enough rubles, it would tap the repo market for them (provided that it has adequate collateral).
2. As collateral in the repo market is falling in value, borrowers are subject to margin calls and have to post extra securities under their outstanding repo contracts.
3. The remaining (unsatisfied) demand for liquidity is transferred to the interbank market. The moderate shock scenario simulates a 10% decline in interbank money supply, while the severe shock scenario expects a 30% contraction.
4. If the bank still needs rubles after going through the first three steps, and if it has adequate refinancing capacity, it will resort to Bank of Russia funding.
5. As money market participants have received less cash in the money market as a result of the shock, they, in their turn, will also decrease their lending.
6. Further on, the money market goes repeatedly through steps 2-5 until equilibrium is restored. The results of the stress testing exercise are the values of liquidity shortage and excess when the money market is in equilibrium.

Overall, stress test results suggest that the national banking system has an adequate central bank refinancing capacity to address potential shock-induced changes in money market parameters. Even under the severe shock scenario, the borrower banks' liquidity shortage beyond their refinancing capacity does not exceed 55 billion rubles.

The presence of money market participants who cannot fully refinance their potential liabilities in case of a shock signals that a liquidity risk may be expected to materialise in this case. In this context, the Bank of Russia recommends that such participants should revise their liquidity management policy to maintain a higher level of liquid assets.

Anyway, even given the current market parameters, the liquidity shortages experienced by borrower banks are much smaller than the excess liquidity held by lender banks. Therefore, further development of the CCP facility and the expansion of the CCP-cleared market capacity may potentially become an important tool for eliminating liquidity shortages.

3.4. Systemic Stress Indicator suggests undisrupted money market stability

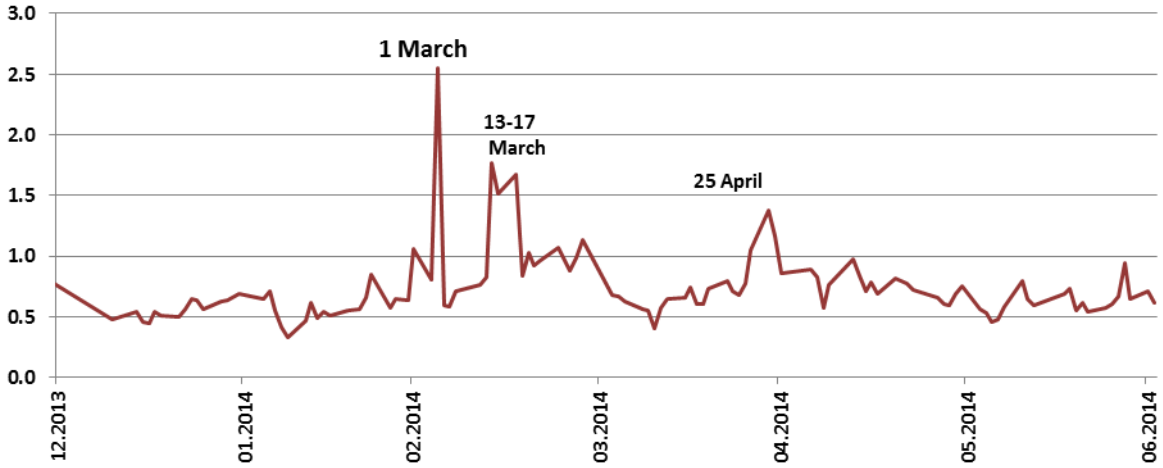
The state of the money market was measured by the Composite Indicator of Systemic Stress (hereinafter, the CISS), used by the European Central Bank. The main distinguishing feature of this index is its focus on cross-correlation between the source measures, which allows taking into account their non-linear connectivity.

The indicator aggregates eight individual systemic risk measures, which capture various aspects of the state of the Russian money market[13]:

- Volume of fixed-term repo and swap transactions with the Bank of Russia,
- RUONIA deviation from the minimum bid rate set by the Bank of Russia in its repo auctions,
- Collateral utilisation ratio for repos with the Bank of Russia,
- Variation margins in repos,
- Variation in interbank lending volumes,
- Variation in interbank borrowing volumes,
- Centrality measure in the interbank market,
- Intermediation measure in the interbank market

Peaks in the CISS coincide with the important events in the Russian money market, which proves the relevance of this index (see Chart 26).

Chart 26. Composite Indicator of Systemic Stress (CISS) dynamics, pp



The relatively low value of the index achieved in the second quarter reflects continuing money market stability, primarily associated with joint efforts of market participants and the regulator. Among other things, market participants started to give more importance to collateral shortage risks, mitigating them by improving the structure of collateral they pledge for Bank of Russia operations, i.e. by extending the use of non-marketable assets and guarantees.

[13] See Methodological Comments and Explanations for the Money Market Review / http://www.cbr.ru/analytics/?PrtId=fin_stab

Box 5. Turbulence in Bulgaria's money market

The second quarter of 2014 was marked by Bulgaria's bank crisis. While the Bulgarian National Bank announced that the crisis in the national banking system was over (in a statement dated 30 June), the risks of further aggravation of the situation persist against the backdrop of intensifying public distrust. The situation is further complicated by political uncertainty caused by the dissolution of the Parliament and the Cabinet.

In June 2014, two major Bulgarian banks were subject to an information attack. It started with media reports about dubious deals of ***Corporate Commercial Bank (CCB),*** the country's fourth largest lender by assets, and its largest shareholders. This was followed by reports that the country's third largest lender ***First Investment Bank (FIB)*** was insolvent. These reports sparked a run on these banks. CCB was reported to have lost 20% of its assets. The Bulgarian authorities had to suspend CCB's operations and transfer CCB under the temporary administration of the National Bank. If the shareholders do not inject more capital by 21 July, the government will assume control over the bank via a capital injection by the Bulgarian Development Bank and the Deposit Insurance Fund. FIB was the target of another bank run, as depositors withdrew 800 million lev (556 million US dollars) in just one day (on 27 June). The bank's operations were suspended.

The banking sector of Bulgaria is well developed *(with its total assets at 110% of GDP*). ***Foreign-owned banks*** account for a large share of assets (70%). The largest bank in the country is Italian UniCredit Bulbank with EUR6.6 billion in assets, followed by Hungarian DSK, which comes second by assets. Foreign capital flowed into the country after Bulgaria joined the European Union in 2007.

Chart 27. Asset value of Bulgarian banks and their share in the total assets of Bulgaria's banking sector as of 31 March 2014

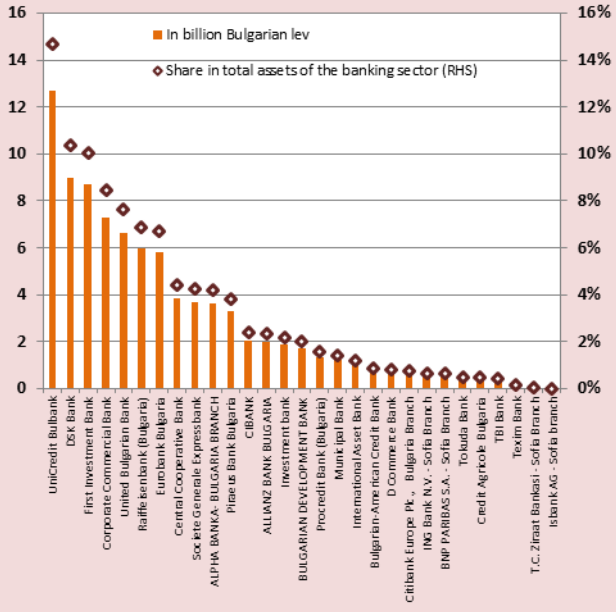
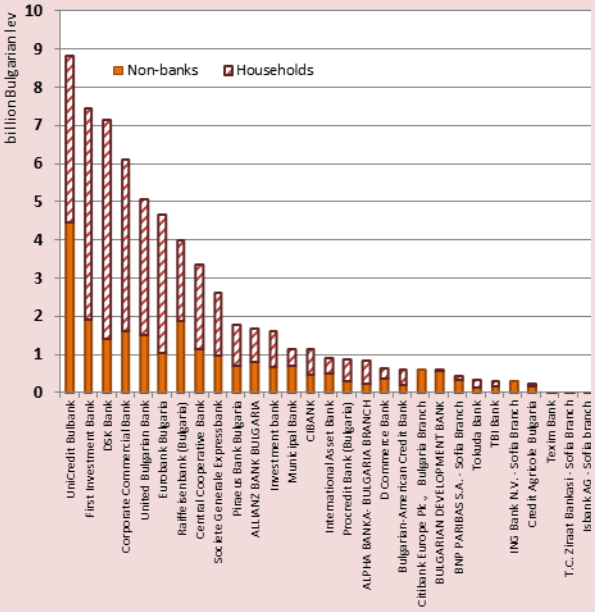
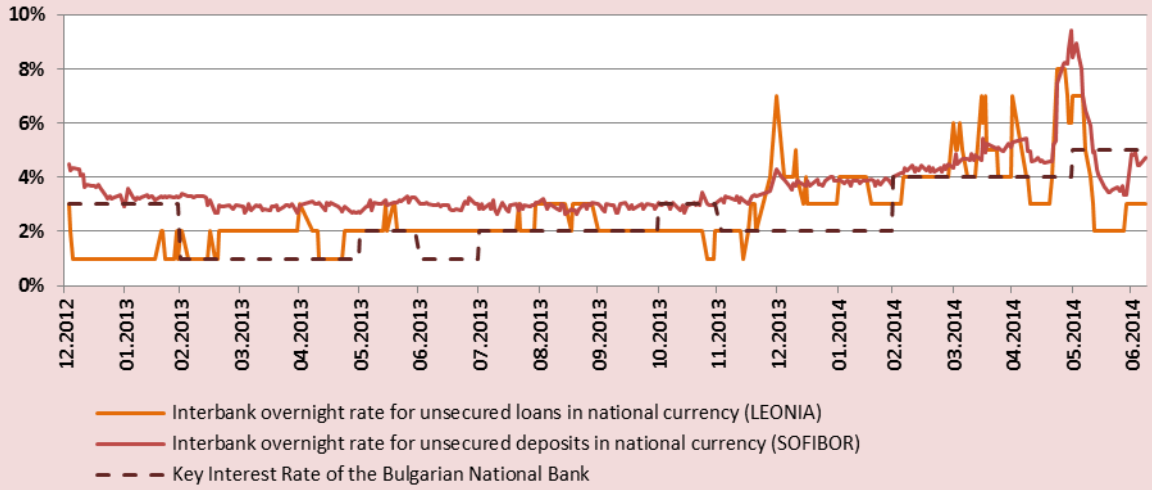


Chart 28. Non-banks and households' deposits in Bulgarian banks as of 31 March 2014



As a ***crisis response measure***, the Bulgarian National Bank issued 1.3 billion lev in special-purpose bonds to provide liquidity support to the troubled banks, and cut its collateral requirements for banks getting access to central bank funding. Bulgaria also applied to the European Union for assistance. The European Commission approved the extension of an emergency credit line of 3.3 billion lev (1.7 billion euro) to support Bulgaria's banking system liquidity.

Chart 29. Rates in Bulgaria's money market



The Bulgarian money market remained quite stable despite increased liquidity squeeze risks in the banking sector. The rise in interest rates in May-early June did not impact negatively money market trade volumes. The trading volumes under the key interbank lending operations in national currency (unsecured deposits and repos) increased to 4.455 billion lev in June from 3.878 billion lev in May. This period also saw some expansion in the share of secured lending, specifically, repos (from 21% in May to 30% in June), probably on the back of heightened credit risk concerns.

FX transactions make an important component of the Bulgarian money market. In May 2014, FX transactions took up 56% of total market activity (while transactions in lev accounted for 44%). To a certain degree, this large share of FX transactions limits liquidity deficit risks. Moreover, Bulgaria is immune from national currency depreciation risks, because the Bulgarian lev is pegged to the euro. However, given the crisis, the demand for foreign currency picked up, both in interbank trade and on the part of banks' clients (non-financial entities and households). Besides moving their savings out of the local currency into euros, depositors also transfer their funds to large foreign-owned banks.

Bulgaria's banking system, as well as the banking systems of the other East European countries, ***forms part of the single European market,*** which strengthens market confidence and supports its sustainability.

Chart 30. Money market structure as of May 2014

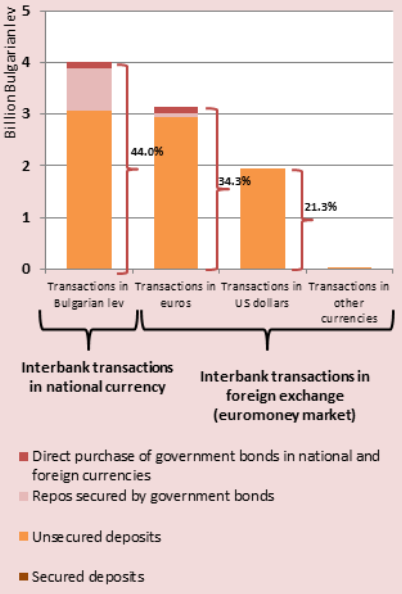


Chart 31. Changes in interbank trade structure

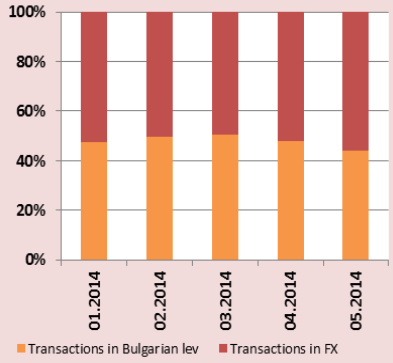
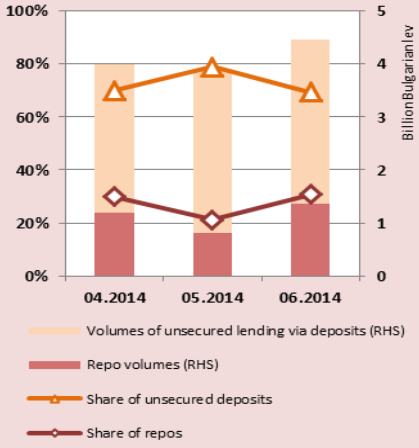


Chart 32. Key interbank segments in the Bulgarian money market



4. DEVELOPMENT OF MONEY MARKET INFRASTRUCTURE AND INSTRUMENTS

4.1. Increased volumes of CCP-based repos

Overall, trade involving a central counterparty (hereinafter, CCP) declined in the Moscow Exchange markets in the reporting period, from 25.4 trillion rubles in April 2014 to 23.8 trillion rubles in June (Chart 33). Meanwhile, CCP-based trade in the money market showed a rising trend. Specifically, CCP-cleared repo volumes increased from 1.5 trillion rubles in April 2014 to 1.9 trillion rubles in June, reaching an all-time high of 129.3 billion rubles on 30 June (Chart 34).

Chart 33. CCP trade in various markets

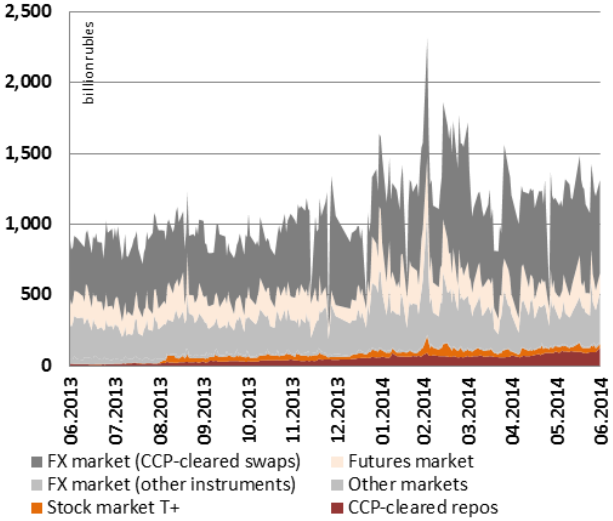
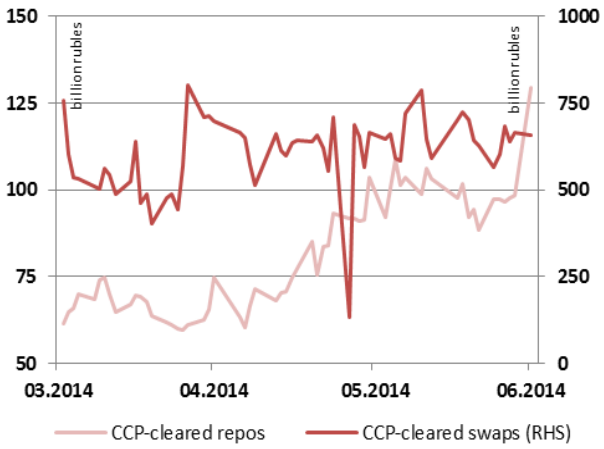


Chart 34. Structure of CCP trade in the money market



The share of CCP-cleared repos in the total interdealer repo business followed a rising trend in the second quarter of 2014 to reach 24% in June 2014 (Table 3).

Table 3. CCP-based trade share in money market segments

Instruments	April 2014	May 2014	June 2014
Share of CCP-cleared trade in total outstanding FX trade	100%	100%	100%
Share of CCP-cleared repos in total outstanding repo trade	18%	20%	24%

In April and May 2014, the National Clearing Centre (hereinafter, the NCC), which acts as a CCP in the Moscow Exchange markets, increased initial margins on some securities to levels exceeding a two-day drop in their value during the reference period, including for most liquid equities[14] (Chart 35, Table 4).

[14] The most liquid equities are defined as equities accounting for over 80% of trade on the Moscow Exchange in the second quarter of 2014.

Chart 35. Market risk measures and initial margins by instruments

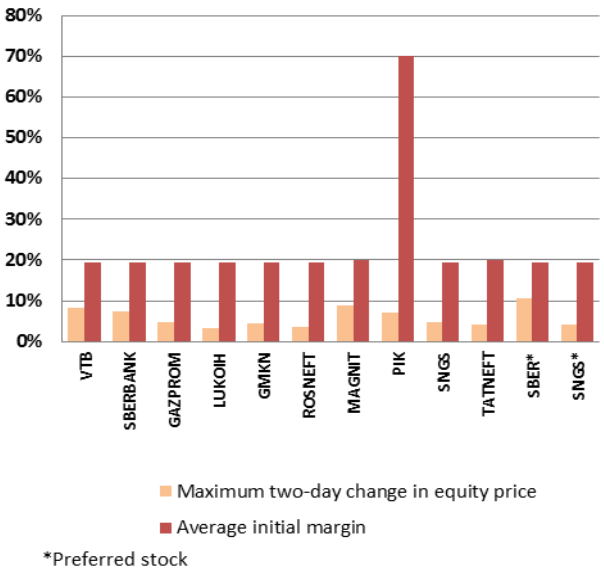


Table 4. Structure of equity trade volumes by instruments

Equities	Share of the instrument
VTB	24.1%
Sberbank	20.5%
Gazprom	18.4%
Lukoil	4.4%
Nornickel	3.1%
Rosneft	2.8%
Magnit	2.7%
PIK	2.5%
Surgutneftegaz	2.4%
Tatneft	2.0%
Sberbank, preferred	1.9%
Surgutneftegaz, preferred	1.7%
Other	13.5%

In the FX market, the NCC also changed initial margins, specifically, reduced them for the US dollar and euro from 5% to 4.5%[15] from 28 April 2014 (Charts 36 and 37).

Chart 36. Frequency distribution of a two-day change in the USD/RUB rate in II quarter 2014

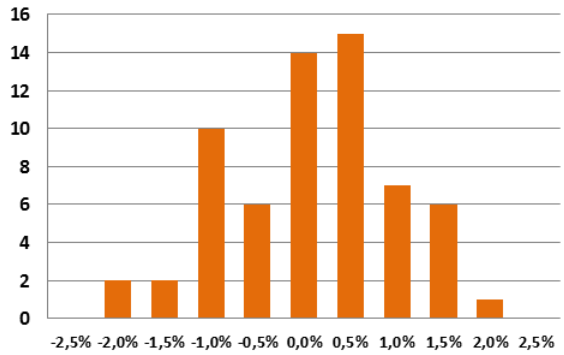
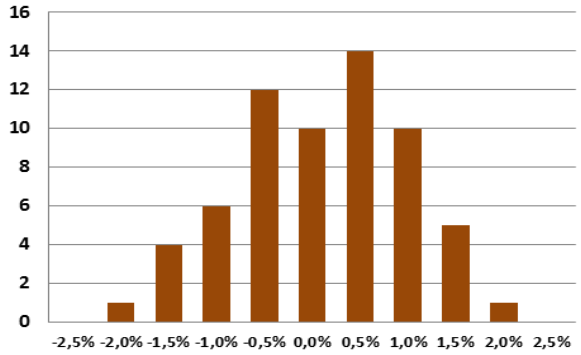


Chart 37. Frequency distribution of a two-day change in the EUR/RUB rate in II quarter 2014



The initial margins on these currencies set by the NCC fully covered any fluctuations in their value in the FX market of the Moscow Exchange in the period under review.

[15] On 30 April 2014, on the eve of public holidays initial margins were raised to 5%.

4.2. Progress in the implementation of international reforms of OTC derivatives market

In September 2009, the G20 Pittsburgh Summit committed to implement by the end of 2012 the OTC derivative market reform seeking to improve the market's transparency, mitigate systemic risk and strengthen protection against market abuse, specifically, to ensure:

- mandatory reporting of all OTC derivatives transactions to trade repositories (TR);
- clearing of all standardised OTC derivatives through CCPs;
- higher margining[16] and capital requirements for non-centrally cleared contracts;
- trading all OTC derivative contracts on exchanges or electronic trading platforms (where appropriate).

Every six months, the Financial Stability Board[17] collects information from its member jurisdictions to monitor reform implementation progress.

While not a single member jurisdiction had managed to complete the reforms by the initial deadline (end of 2012), they are making good progress in implementing the planned OTC derivatives market reforms. Most FSB member jurisdictions have made respective legislative changes to enable reforms to be implemented in the key commitment areas, with the only exception of margining requirements for non-centrally cleared derivative transactions. The delay in this reform area is largely caused by slow development of respective international standards (finalised only in September 2013).

Reporting of transactions to TR shows the most advanced progress. Across the member jurisdictions, about 25 TRs currently function or are planned to be launched. Requirements to report transactions for at least one type of instrument or one type of market participants are in force in 15 jurisdictions out of the 19[18] that responded to the FSB survey.

At the same time, foreign authorities' access to TR-held data is still an issue. Thus, some countries (Australia, Singapore, Turkey, Brazil, India, Korea, Russia, and also the US) have obstacles for foreign regulators' direct access to local TRs' data. Besides, data are stored in different formats and may be duplicated across TRs. The FSB is also focused on the issue of access to aggregated data, looking for an appropriate data aggregation mechanism. Several options for aggregating TR data are explored. The best possible option may be to maintain a central index of OTC derivatives, which would point to relevant trading data from local TR data bases.

At present, only three member jurisdictions have implemented ***mandatory central clearing*** (China, Japan and the US). By the end of 2014, a number of other jurisdictions plan to

[16] This requirement was added in 2011.
[17] The Financial Stability Board is an association established in 2009 to develop and monitor the implementation of financial regulation reforms. Its membership includes regulators from G20 countries and international financial centres, international institutions and standard-setting bodies.
[18] European Union member states are treated as one jurisdiction for the purposes of this survey.

implement the requirements or finalise consultations on them (Korea, Singapore, Hong Kong and Australia).

CCPs provide clearing services across all the five asset classes[19]. Central clearing has advanced furthest in interest rate derivatives (13 CCPs).

The availability of CCPs in various jurisdictions is constrained by rules regulating foreign financial market infrastructures, with most jurisdictions requiring that a foreign CCP receive some form of permission. Given this, only five CCPs are currently permitted to operate simultaneously in several countries. The EU and the US have the largest number of authorised CCPs, while other jurisdictions have only one or two.

Important progress has been made in the area of ***capital surcharges for banks*** to handle non-centrally cleared derivatives. Over half the member jurisdictions have implemented these requirements for capital surcharges. Russia has also introduced reduced risk ratios for bank capital adequacy purposes, when one party of the transaction is a CCP, whose management has been acknowledged satisfactory by the Bank of Russia. Almost all jurisdictions (except for Argentina, Turkey and the US) will have capital requirements in place by the end of 2014.

As regards ***marginal requirements,*** the EU and the US are the only jurisdictions that have started some work in this area, with US regulators having published regulatory proposals for consultation, while the EU is currently drafting rules, which are anticipated to be finalised by the end of 2014.

There is significant variation in approaches to the reform in the commitment area of ***organised trading platforms***. At present three jurisdictions – China, Indonesia and the US – have regulations requiring operations to be conducted on organised trading platforms. Canada, Hong Kong, India and Mexico expect to have these regulations in place by the end of 2014. The EU is now finalising the relevant legislation, which is likely to come into effect in 2016.

Inconsistent rates of progress on the reforms in various jurisdictions and absence of an internationally agreed standard of regulatory requirements creates problems for cross-border regulation of OTC derivatives. Meanwhile, the OTC derivatives market is largely cross-border in nature, with cross-border transactions accounting for about a half of trade in interest rate derivatives, according to BIS estimates.

The issues identified in the area of cross-border regulation include the need to comply with different regulation regimes, and lack of consistency and coordination in the application of regulatory requirements across jurisdictions. The same requirements (e.g. capital requirements) may be differently calibrated in various jurisdictions, also contributing to increased uncertainty for market participants. A key concern for regulators is the need for cross-border financial market infrastructures to get permission for operation in foreign jurisdictions.

[19] Commodity, credit, interest rate, FX and equities derivatives.

The FSB study notes some reorganisation of activity by jurisdictions reflecting steps taken by counterparties and financial market infrastructure to minimise their own and client risk that may arise due to various regulatory requirements. This reorganisation may result in market fragmentation and liquidity contraction in some market segments.

To resolve cross-border regulatory issues the FSB established the OTC Derivatives Regulators Group. The Group published its regular report in April 2014, which set out understandings with respect to key issues, including the need to consult each other on regime equivalence and substituted compliance assessment, use of flexible outcome-based approaches, stricter-rule approach to address differences in regulatory requirements, etc.

In 2013, the European Securities and Markets Authority delivered advice to the European Commission on the equivalence of the regulatory regimes for CCPs and TRs, as well as of risk mitigation requirements and other requirements, in Australia, Canada, Hong Kong, India, Japan, Singapore, South Korea, Switzerland and the US.

The US CFTC approved substituted compliance determinations for Australia, Canada, the EU, Hong Kong, Japan and Switzerland at the corporate level, and additionally for the EU and Japan at the transaction level.

Box 6. Standardisation of OTC derivatives in Russia

As part of the Bank of Russia's work to implement the commitments assumed by the Russian Federation at the G20 Pittsburgh Summit in 2009, to further strengthen international financial regulation and reform the OTC derivatives market, it was agreed in the second quarter of 2014 to establish a Standardisation Committee (hereinafter, the Committee) on the basis of the National Securities Market Association (hereinafter, the NSMA) – a self-regulating organisation.

The future Committee is supposed to include active participants of the Russian OTC derivatives market, NSMA, Moscow Exchange representatives, and Bank of Russia officials. The key objective of the Committee will be to create conditions for the development of standardised OTC derivatives market in Russia and to improve its legal and regulatory framework and environment.

In June 2014, the Bank of Russia hosted a working meeting of the proposed members of the Committee to discuss a wide range of issues related to future reforms of the OTC derivatives market. The Committee's key priority will be to develop a list of instruments to be standardised on a mandatory basis. Standardisation of instruments from this list will be executed on the basis of the existing standards for OTC derivatives markets (ISDA, RISDA).

In future, transactions in these instruments will be subject to central clearing, which would make it possible to mitigate counterparty risks for each participant. In fact, alongside the second counterparty limit, participants will be able to have the CCP limit, thus increasing the potential capacity of the OTC derivatives market.

Looking ahead, as the CCP-cleared OTC derivatives market expands, participants would also be able to expect capital savings (by reducing CCP-associated risk weights for capital adequacy purposes), and also may be relieved from mandatory reporting of such transactions to TR.

Overall, transition to central clearing of OTC derivatives will promote transparent pricing, daily margining and, in this way, enhance the protection of the market against systemic shocks.

4.3. Legislative changes in the operations of Russian repositories

To develop repository operations in Russia, in the second quarter of 2014, the Bank of Russia issued Ordinance No. 3253-U, dated 30.04.2014, 'On the Procedures to Maintain the Register of Contracts Made as General Terms Contracts (Master Contracts), Timelines to Submit

Data Required for This Register, and Data from This Register, and Also to Submit This Register to the Central Bank of the Russian Federation (Bank of Russia)' (hereinafter, Bank of Russia Ordinance No. 3253-U).

Bank of Russia Ordinance No. 3253-U moves to 1 January 2015 the deadline for obligatory reporting to the repository of all types of general terms contracts, excluding repo and swap contracts.

As regards cross-border transactions, the Ordinance provides for repository services for Russian participants irrespective of whether the repository has a repository service contract with a foreign participant. In this case, the Russian and the foreign participants should determine that either the Russian counterparty or a third party should be responsible for reporting.

Alongside the above, in the second quarter, the Bank of Russia worked at streamlining data reported to the repository, reporting timelines and defining individuals responsible for submitting data about contracts to the repository. This work is expected to continue in the next quarter.

Further on, to comply with the international regulatory standards for trade repositories, a draft federal law has been prepared 'On Amending Federal Law 'On the Securities Market' and Certain Laws of the Russian Federation' (hereinafter, the draft law).

The draft law aims to define repository operations as a single type of accredited financial market operations, to set requirements for these operations and for repository risk management, and also to draw up a list of transactions to be reported to repositories, and a list of responsible individuals.

The draft law prescribes that repository operations may be pursued by a legal entity provided it gets accredited, and sets forth some restrictions on combining repository operations with other types of activity.

The draft law also obliges participants to report to the repository all the repos and OTC derivatives made outside organised trading platforms, and all the contracts involving securities, precious metals and (or) foreign exchange, made in line with the general terms contract (master contract) or otherwise.

The draft law also sets forth that the Bank of Russia should prescribe a list of data to be disclosed by the repository in an aggregated format to all stakeholders.

Moreover, it should be noted that the draft law proposes changes to the Russian Administrative Offense Code as regards fines and penalties for incompliance with the procedures and (or) deadlines for reporting to the repository, incomplete or false reporting, and violation of contract register maintenance rules by the repository.